TAXATION OF NON-RESIDENTS AND FOREIGN DOMICILIARIES 2014-15

VOLUME ONE

by

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THIRTEENTH EDITION

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To My Jane

I love you wildly,

passionately, devotedly,

hopelessly

INTRODUCTION AND WHAT'S NEW

Scope of this book

There are three themes to this book:
(1) Taxation of foreign domiciliaries
(2) Taxation of non-residents on UK assets
(3) Taxation of UK residents on foreign assets
?To attempt to cover all these topics is ambitious, and this book is in danger of bursting, particularly because foreign aspects can only sensibly be discussed in a wider context. But one cannot address the first topic without the second and third: in taxation, as in life, everything is connected to everything else. Thus what started as a book on foreign domiciliaries has become a book which addresses all aspects of offshore taxation.

The year 2013/14 in review

The chancellor stated in 2011:

> Our tax code has become so complex that it recently overtook India to become the longest in the world".[1]

Parliament has subsequently added:
FA 2011: 403 pages
FA 2012: 703 pages (a record),
FA 2013: 648 pages.
FA 2014: 663 pages

Set against that, the Office of Tax Simplification has achieved little, and it seems unrealistic to hope for much.[2]

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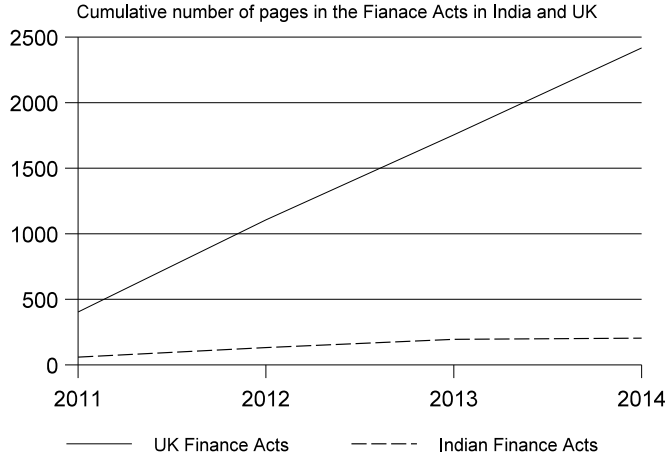
1 Budget speech 2011. It is hard to empirically assess a claim that the UK has the longest tax code in the world, but there seem to be no other serious contenders for that title.

2 "[The OTS] cannot be an effective solution to the problem of over-complication without the Treasury allowing it a far more fundamental role." Ussher and Walford, *National Treasure* (Demos, 2011)

The choice of India as comparator seems strange.[3] Four years of Indian Finance Acts together are shorter than any single UK finance act since 1999.[4] The graph speaks for itself:



It is easier to *talk* of simplification. Budget 2014 used the word simplification 23 times; even including a reference to simplifying

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http://www.demos.co.uk/files/National_treasure_-_web.pdf?1299511925.
In (I think) 2013 the government came up with the slogan "Creating a simpler, fairer tax system" under which the OTS now operates; which imagines away a troubling reality in which simplicity and fairness are competing values which require hard choices.
https://www.gov.uk/government/policies/creating-a-simpler-fairer-tax-system

3 The comparison seems to originate from CIOT, "The Making of Tax Law" (2010) para 3.3, *http://old.tax.org.uk/ciot_media/themakingoftaxlaw.pdf*.

4 Finance Act page counts are a rough proxy for the ever growing complexity of the UK tax system, but not an altogether bad one. A better proxy would also consider secondary legislation and HMRC guidance; and, perhaps, case law; then the page count involved would far exceed the Finance Act numbers set out here.
The Office of Tax Simplification have published two (somewhat simplistic) discussions of complexity in tax legislation:
Length of Tax Legislation as a Measure of Complexity (Apr 2012)
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193496/ots_length_legislation_paper.pdf
The Office of Tax Simplification Complexity Index (2012)
http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193493/ots_complexity_index_methodology_paper.pdf

partnership taxation;[5] those who have wrestled with the FA 2014 partnership provisions may smile, grimly.

The process of understanding the FA 2013 has only just begun its course. I stated in the introduction to this book last year:

> The FA 2013 contains the most significant set of changes in taxation since the introduction of CGT in 1965. It will take several years to work out the implications of these changes, except for the GAAR, which will take several decades.

The FA 2014 continues this trend, with many important changes, including some controversial steps back from the rule of law in relation to taxation. But apart from the provisions on remittances from dual employments, there is not much which directly concern the themes of this book.

The Courts have decided many interesting cases. *Mehjoo v Harben Barker* rolled back the boundary of tax negligence. *Ardmore v HMRC,* when final, will resolve the test for the source of interest.

Thanks ...

I am very grateful to my colleagues Robert Venables QC and Stephen Brandon QC for discussions on many aspects of tax. I owe a great debt to Jane Hunt and Ruth Shaw who work patiently on this intractable book throughout the year, and to Edward Chin who undertook the daunting role of copy-editor.

... and request for help

Comments from readers would be of the greatest value and interest to the author.

The pleasure in writing this book consists in the interest of the questions which it raises and the success which it may have achieved in answering them. It seeks to state the law as at 20 July 2014.

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5 Budget 2014 para 1.123: "The government's aim is that the tax system is simple to understand and easy to comply with. ... the government will ... simplify the taxation of employee benefits and expenses, employee share schemes and partnerships."

OBTAINING FURTHER ADVICE - AND DISCLAIMER

Further advice

If you want advice on which you are legally entitled to rely you can obtain it - but not from this work.

In particular, you may instruct the author to advise. I enjoy writing, but spend most of my time giving independent specialist professional advice in private client matters especially areas covered in this work. For further details see *http://www.kessler.co.uk.*

TFD Online

TFD Online is an online version of this book and more. It can be used:
(1) to search the text of this book or to access it online.
(2) to see if the book has been updated
(3) to correct or contribute to the book

TFD Online is a free service to individuals and firms who have purchased the current edition of this work. It is moderated by Amanda Hardy, a member of Tax Chambers, 15 Old Square, Lincoln's Inn.

TFD Online is accessible on *http://www.foreigndomiciliaries.co.uk.* The authorisation code is in the inside cover of this volume, and is valid until publication of the next edition.

Disclaimer

It is a sign of the times that the CIOT issue *professional guidance* with a disclaimer:

> While every care has been taken in the preparation of this guidance the CIOT ... do not accept any responsibility for any loss occasioned by reliance on this guidance.[1]

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1 CIOT, *Professional Conduct in Relation to Taxation* (2014), para 1.10 *http://www.tax.org.uk/Resources/CIOT/Documents/2014/02/Professional%20Conduct%20in%20Relation%20to%20Taxation%20190214%20final.pdf*

Similarly, the views contained in this book are put forward for consideration only and are not to be relied upon. Neither the author nor the publisher accept any responsibility for any loss to any person arising as a result of any action taken or refrained from in reliance of this work.

A note to the lay reader

This book is not intended as a self-help guide, and is addressed to tax practitioners, but it is readable for a lay person. Initiation in these matters must often be by the taxpayer. If you wish to research this subject in depth, and so take more control of your own tax affairs, read on. But for implementation you will need to find professionals to advise you. Self-help guides extol "the benefit of bypassing expensive lawyers"; but the bypass may prove the more expensive route in the long run.

Edition history

1st Edition 2001	5th Edition 2006	9th edition 2010
2nd Edition 2003	6th edition 2007	10th edition 2011
3rd Edition 2004	7th edition 2008	11th edition 2012
4th Edition 2005	8th edition 2009	12th edition 2013

This book was called *Taxation of Foreign Domiciliaries* for the first nine editions; it changed to *Taxation of Non-residents & Foreign Domiciliaries* in the 10th edition.

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Income Tax/IUT Conventions

IHT Conventions

TABLE OF ABBREVIATIONS

Statutes, Statutory Instruments, Treaties

CA	:	Companies Act
CTA	:	Corporation Tax Act
ECHR	:	European Convention on Human Rights
EUSD	:	European Savings Directive 2003/48/EC
FA	:	Finance Act
FB	:	Finance Bill
FSMA[1]	:	Financial Services & Markets Act 2000
ICTA	:	Income and Corporation Taxes Act 1988
IHTA	:	Inheritance Tax Act 1984
ITA	:	Income Tax Act 2007
ITEPA	:	Income Tax (Earnings and Pensions) Act 2003
ITTOIA	:	Income Tax (Trading and Other Income) Act 2005
LP(MP)A	:	Law of Property (Miscellaneous Provisions) Act 1989
M(SSC)A	:	Marriage (Same Sex Couples) Act 2013
OFTR	:	The Offshore Funds (Tax) Regulations 2009
SSCBA	:	Social Security Contributions and Benefits Act 1992
SSCER	:	Social Security (Categorisation of Earners) Regs 1978
SSCR	:	Social Security (Contributions) Regs 2001
STA	:	Swiss Tax Agreement 2011
TCGA	:	Taxation of Chargeable Gains Act 1992
TFEU	:	Treaty on the Functioning of the European Union
TIOPA	:	Taxation (International and Other Provisions) Act 2010
TOLATA	:	Trusts of Land and Appointment of Trustees Act 1996[2]
TMA	:	Taxes Management Act 1970
VTA	:	Variation of Trusts Act 1958

Periodicals

BTR	:	British Tax Review
OITR	:	Offshore & International Taxation Review

1 Statute sometimes uses the abbreviation FISMA.

2 I would prefer TLATA, but TOLATA has become the standard form.

OTPR : Offshore Tax Planning Review[3]
PCB : Private Client Business
PTPR : Personal Tax Planning Review
STI : Simon's Tax Intelligence

HMRC Manuals and Publications

References to HMRC manuals are accompanied by their dates of entry according to information provided at *www.taxhub.co.uk*.

BI Manual : Business Income Manual
CG Manual : Capital Gains Manual
CT Manual : Company Taxation Manual
EI Manual : Employment Income Manual
INT Manual : International Manual
IPT Manual : Insurance Policyholder Taxation Manual
NI Manual : National Insurance Manual
OF Manual : Offshore Funds Manual
PI Manual : Property Income Manual
RDR Manual : Residence Domicile and Remittances Manual[4]
SAI Manual : Savings & Investment Manual (*HMRC sometimes call this the Savings & Investment Income Manual*)
SALF : Self Assessment: The Legal Framrwork
TAH : Transfer of Assets Handbook
TSE Manual : Trusts Settlements and Estates Manual

Other

AIP : Accrued income profits
ATED: : Annual tax on enveloped dwellings
AUT : Authorised unit trust
BiK : Benefit in kind
BPR : Business property relief (for IHT)
CG : Capital gains
CFC : Controlled foreign company
CGT : Capital Gains Tax
CIOT : Chartered Institute of Taxation

3 OTPR (1992-1996) was renamed "Offshore Taxation Review" (1997-1998) and renamed OITR from 1999.

4 The RDR Manual must not be confused with HMRC Guidance Notes known as RDR1 (a very general guide to residence issues), RDR3 (the Statutory Residence Test) and RDR4 (Overseas Workday Relief).

COE	:	Chargeable overseas earnings
CRP	:	Corporate Residential Property
DDS	:	Deeply discounted security
DOTAS	:	Disclosure of tax avoidance schemes
DRs	:	Depository receipts
DT	:	Discretionary trust
DTA	:	Double taxation arrangement
EC	:	Commission of the European Communities
EN	:	Explanatory notes
ESC	:	Extra-statutory concession
E&S	:	Entertainers and sportspeople
FMC	:	Free movement of capital
FoE	:	Freedom of establishment
GAAR	:	General anti-abuse rule
GB	:	Great Britain
GWR	:	Gift with reservation of benefit
HMRC	:	Her Majesty's Revenue and Customs
ICAEW	:	Institute of Chartered Accountants in England & Wales
IFS	:	Institute of Fiscal Studies
IHT	:	Inheritance tax
IME	:	Investment manager exemptions
IOM	:	Isle of Man
IOV	:	Instrument of variation
IIP	:	Interest in possession[5]
IPDI	:	Immediate post-death interest
IT	:	Income tax
LLC	:	Limited liability company
LLP	:	Limited liability partnership
MS	:	Member state
NAV	:	Net asset value
NICs:	:	National insurance contributions
NOR	:	Not ordinarily resident
NPO	:	Non-profit organisation
oao	:	on the application of
OECD	:	Organisation for Economic Cooperation and Development
OEIC	:	Open-ended investment company
OIG	:	Offshore income gain
OTS	:	Office of Tax Simplification

5 I prefer IP, but adopt IIP to be consistent with HMRC practice.

OWR:	:	Overseas workday relief
PE	:	Permanent establishment
PET	:	Potentially exempt transfer
POEM	:	Place of effective management
POA	:	Pre-owned assets
PRs	:	Personal representatives
RFI	:	Relevant foreign income
RI	:	Revenue Interpretation
SDLT	:	Stamp Duty Land Tax
SDRT	:	Stamp Duty Reserve Tax
SP	:	Statement of practice
SRT	:	Statutory residence test
STEP	:	Society of Trust & Estate Practitioners
ToA	:	Transfer of assets abroad
TDSI	:	Tax deduction scheme for interest
TG	:	Technical Guidance
TIIN	:	Tax Information and Impact Note
TNR	:	Temporary non-residence
TSI	:	Transitional serial interest

CHAPTER ONE

FOREIGN DOMICILE: TAX POLICY AND REFORMS

1.1 Introduction

The topics of this chapter are:

(1) The policy arguments for and against a lighter tax regime for foreign domiciliaries (or some similar class of footloose individuals)[1]
(2) A history of foreign domicile tax reforms
(3) An assessment of the domicile reforms of the FA 2008
(4) The state of UK tax reform, and prospects for the future

1.2 Tax competition arguments

All UK residents have a choice where to reside, but foreign domiciled individuals are in general less securely attached to the UK. Tax competition arguments claim that if their tax burden was as great as that of a UK domiciliary, fewer would choose to live in the UK, and overall the UK economy would lose:

(1) directly, from tax paid by the foreign domiciliaries (including VAT); and
(2) indirectly, from investment and expenditure in the UK which is more likely to be made by UK residents.[2]

Similarly, UK firms competing in the global market for talent and expertise

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1 For discussion on policy issues, see STEP, "Residence and Domicile: Response to Background Paper"(2003); CIOT, "Reviewing the Residence and Domicile Rules" (2003); CIOT, "PBRN18 (Residence & Domicile Review)" (2007); all accessible *http://www.kessler.co.uk/tfd-archive*.

2 Except to the extent that tax makes investment by UK resident foreign domiciliaries difficult, which has been the case since 2008: see 12.24 (Remittance investment relief: commentary).

will find recruitment easier if the tax regime for foreign employees is lighter. Some potential employees would not choose, or could not afford, to come if the UK tried to tax them as it does its own domiciliaries.

In a nutshell: the argument is that UK benefits from foreign domiciliary reliefs.

1.2.1 *Assessing the strength of foreign tax competition*

Tax competition raises three distinct issues:
(1) To assess the existence and strength of international tax competition
(2) What the UK tax system should do in the light of tax competition
(3) What international agreements might do to regulate tax competition
The first question is essentially one of fact; the second is a question of domestic politics. The third is a matter of international politics.

In principle there are many low-tax or preferential tax regimes where wealthy individuals may choose to reside.[3] Switzerland, for instance, has a lump sum taxation regime for non-Swiss citizens specifically targeted for this purpose.[4]

In assessing the existence and strength of international tax competition several points must be borne in mind.

Effective low tax may be achieved in other countries by relaxing legal provisions at administrative level, in a non-transparent way.

One paragraph summaries of other countries tax systems are bound to be misleading.

The terms of statutory tax law are only one aspect of tax competition. Compliance costs are important. The quality of tax administration is important. An OECD study lists six desiderata: a developed legal system, confidentiality, impartiality, proportionality, responsiveness [I am not sure what is meant by that] and competence. They add:

> Frequent changes in legislation, particularly where there has been an

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3 An OECD study "Engaging with High Net Worth Individuals on Tax Compliance" para 34 (May 2009) singles out Ireland, France, the Netherlands and the UK for what it terms "preferential regimes for specifically defined groups of taxpayers"; see *http://www.oecd.org/document/5/0,3746,en_2649_33749_42902277_1_1_1_1,00.html*

4 Though this is politically controversial; it was abolished in Zurich in 2010 and some other cantons have followed suit. The debate is similar to that in the UK: see Pulfer and Sigg, "The Swiss lump-sum taxation regime: a natural evolution" [2013] JITTCP 215.

> absence of consultation, can have an adverse impact on the taxpayers and their advisers trust in the tax system.[5]

But there are others: can a tax authority subject an individual to an expensive and intrusive tax investigation without any evidence to justify doing so? Certainty is very important.[6] Perception matters as much as reality. Rates of tax on UK earned income may matter more than the rules for foreign domiciliaries. By many of these measures, the UK scores poorly.[7]

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5 "Engaging with High Net Worth Individuals on Tax Compliance" (May 2009) para 208 and 243; see *http://www.oecd.org/document/5/0,3746,en_2649_33749_42902277_1_1_1_1,00.html*.

6 See 2.6 (The rule of law).

7 Not just in foreign domicile taxation. See, for instance, KPMG, *Taxation & the Competitiveness of UK Funds* (2006):

> "For all fund types, the UK tax regime is viewed less favourably than those of Ireland and Luxembourg ...The negative perception of the UK tax regime is driven more by uncertainty than by any specific factor. ...A key feature of [structured] products is that promoters must be as certain as possible of the tax analysis for investors over a period of five years and more, and hence the uncertainty of the UK regime in this area makes the UK an unsuitable domicile location. Accordingly, most firms look immediately overseas when establishing these products. ... The most common concern with the UK tax regime is not a specific tax measure that can be fixed by a change in legislation. Rather, it is the overall management of the UK tax regime, characterised by the pace of change and the style of consultation... The majority of participants made strong calls for certainty and stability, regarding the lack of these as a key adverse factor of the UK tax regime. ...The lack of constructive consultation has led to an increasing number of surprising changes to the regulations and a number of proposed changes that were reversed after further prolonged consultation. ... Comments on derivatives caused uncertainty by questioning the appropriateness of an accounts based regime that was introduced just two years before, and the suggestion that QIS would not benefit from the established regime for authorised funds, significantly slowed development of UK based QIS. As one participant commented: 'By this stage Ireland and Guernsey were laughing.' ...There is also a view among participants that HMRC is focused on targeting avoidance rather than creating an environment to support industry development and growth. ...
>
> "The UK tax system undergoes constant change, or threat thereof, which results in ongoing uncertainty as to the tax treatment of funds and investors on assets totalling many billions. The UK Revenue can overturn arrangements without consultation albeit of very many years standing and is not seen to be working with the industry for the benefit of UK Plc, quite the reverse. This approach is very much at odds with that in other territories."

1.2.2 *Attitudes to tax competition arguments*

The debate about international tax competition is long standing and is not restricted to foreign domicile taxation.[8]

Most though not all commentators would accept that tax competition is an important factor in framing UK taxation.

Tax competition offers advantages to countries which compete successfully and disadvantages to those who do not. In many cases Government have accepted the challenge of competition, and sometimes with enthusiasm:

> The [investment manager] exemption enables non-residents to appoint UK-based investment managers without the risk of UK taxation and is one of the key components of the UK's continuing attraction for investment managers.[9]

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8 See the evidence of Lord Vestey to the 1920 Royal Commission, accessible *http://www.kessler.co.uk/tfd-archive*.

9 SP 1/01; see 44.1 (Investment manager exemptions: Introduction) .
Another example is the IHT exemption for OEICs and AUTs; see 62.3 (Non-settled property: authorised unit trusts and OEICs). Press Release 16 October 2002 (OEICs and AUTs) para 6 provides:

> "Overseas investors are in theory liable to inheritance tax on their OEIC and AUT holdings, because they are regarded as being situated in the UK for tax purposes on the investors' death. Competing centres do not charge tax in parallel circumstances. Removing the potential inheritance tax charge will help UK managers compete on an equal footing with overseas fund providers."

The text continues (inaccurately):

> "This very rarely generates any significant yield, because UK assets still have to exceed the inheritance tax threshold ... before any tax is due. But it is a deterrent in marketing terms".

I suspect that the true reason that the old IHT rule raised little IHT was rather different, namely that no-one (if properly advised and wishing to comply with UK tax rules) would invest more than the IHT threshold in AUTs or OEICs. Undetectable non-compliance must also be reckoned with. But that does not affect the point made here.

Another example:

> "The location of ownership, flagging (registration) and management activities is very 'footloose', since it can easily be transferred from one country to another. This makes it vital to have regard to the fiscal regimes in other countries if we want to maintain a successful shipping industry in the UK. The modern armoury in the battle for success invariably includes a virtually tax-exempt fiscal regime." (Independent Enquiry into a Tonnage Tax, Lord Alexander, HM Treasury 1999.)

Another example is the exemptions for major sports events. The first (as far as I

The present coalition government seems well aware of the point, at least in relation to companies:

> In recent years too many businesses have left the UK amid concerns over tax competitiveness. It's time to reverse this trend.[10]

Similarly the budgets 2011 and 2012 stated the Government's aim to create:

> the most competitive tax system in the G20.[11]

Those opposed to the consequences of this line of argument describe it as a "race to the bottom"[12] and it is correct that tax competition should logically drive tax rates on mobile sources of income to zero - at least if it were the only consideration in forming tax policy, which of course it is not. But most sober commentators recognise that the UK could not act alone, as if there were no such thing as international tax competition.[13] The expression "harmful tax competition" conceals awkward questions about harmful to whom? The focus is often on harm to the G7 countries.[14]

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know) was s.68 FA 2006 (Olympic Games 2012) but now this has become standard: sch 20 FA 2010 (Champions League 2011); s.13 FA 2012 (Champions League 2013); ss.8, 9 FA 2013 (London anniversary games and Commonwealth games). These events would not be held in the UK in the absence of tax exemption.

10 HM Treasury, "Corporate Tax Reform: delivering a more competitive system", November 2010.

11 The phrase occurs seven times in Budget 2011: it was described as an "ambition"; presumably the word "intention" was thought too strong. The claim is made nine times in Budget 2012 and five times in Budget 2013. *http://webarchive.nationalarchives.gov.uk/20130129110402/http:/cdn.hm-treasury.gov.uk/2011budget_complete.pdf*

12 This metaphor goes back at least to the OECD *Harmful Competition* (1998) *http://www.oecd.org/tax/transparency/44430243.pdf*

13 However at the extreme even this is denied; eg "Tackle Tax Avoidance" a campaign of Progress (which describes itself as a New Labour pressure group):

> "There is real fear at the heart of government that if it gets tough on business, businesses will flee the UK. But as the chief executive of Google, Eric Schmidt, himself admitted in an interview: 'Google will continue to invest in the UK no matter what you guys do because the UK is just too important for us.'

http://www.progressonline.org.uk/campaigns/tackle-tax-avoidance/articles/ (accessed October 2013).

14 See Littlewood, "Tax Competition: Harmful to Whom?" in Asif Qureshi and Xuan Gao, eds, Critical Concepts in Law: International Economic Law, Routledge, London (2010) volume VI, 162-234; reprinted from (2004) 26 Michigan Journal of

Devolution raises the possibility of tax competition within the UK. So far, debate has focused on the possibility that Scotland and Northern Ireland may have a lower corporation tax rate than England:

> a lower headline rate of corporation tax could encourage greater investment by Scottish and UK firms in both physical and human capital and in research and development within Scotland.
> At the same time, it could make the country more attractive as a location for multi-national investment. It could also act as an important signal to global companies and investors as to Scotland's ambition to be a location for competitive business.[15]

Perhaps at some point it may occur to politicians and commentators that similar arguments apply to taxation of individuals.

Unfortunately, it is always hard to predict what will be the overall economic effect of any reform, and predictions tend to reflect the views and wishes of those who make them.[16] Ascertaining the effect of reforms

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International Law 411-487 accessible *http://www.law.auckland.ac.nz/webdav/site/law/shared/about/our%20staff/academic%20staff/files/Michael%20Littlewood/Tax%20competition.pdf*
Avi-Yonah "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" [2000] Harvard Law Review p.1573.

15 See "Corporation Tax: Discussion Paper Options for Reform" (August 2011), accessible *http://www.scotland.gov.uk/Resource/Doc/919/0120786.pdf*
"Devolution of tax powers to the Scottish Parliament - Commons Library Standard Note" (Published February 2012, Amended 17 July 2013) *http://www.parliament.uk/briefing-papers/SN05984*
The consultation paper does not consider the possibility that England might match the Scottish lower rate and does not address the question of what constitutes a Scottish company for the purpose of the lower rate.
Likewise in Northern Ireland: HM Treasury, "Rebalancing the Northern Ireland economy" (March 2011) accessible *http://www.hm-treasury.gov.uk/d/rebalancing_the_northern_ireland_economy_consultation.pdf.*
Wales would also like to join in:
"If Northern Ireland is allowed to cut corporation tax, it would be outrageous if Welsh politicians did not have the option of doing the same"
Gerald Holtham, chair of the Holtham Commission for Wales (Cited in the Scottish consultation paper).
So we may have no shortage of tax competition within the UK.

16 HMRC estimate that a reduction in the rate of Corporation Tax in Scotland to 12.5% would cost £2.6bn, but the Scottish Parliament say the impact will be positive: "Corporation Tax: Discussion Paper Options for Reform" (August 2011) p.43,

after they are made is scarcely less difficult.

1.2.3 *EU law aspects*

The freedom of the UK to enter into tax competition against other countries is subject to certain constraints of EU and international law and politics. International fiscal co-operation in this area at present operates only to a limited extent, but it has made some progress in a (non-binding) EU code of conduct on business taxation.[17]

State Aid rules also impose restrictions on UK's freedom to tax and untax.[18]

The EC has expressed disapproval of the remittance basis:

> The Commission does not advocate remittance base taxation, as it may(?) lead to double non-taxation.[19]

That does not seem to have had any impact on UK domestic politics.

1.2.4 *International tax law reform*

Since tax competition extends beyond the EU, and increasing EU powers in relation to tax is (to say the least) politically controversial, those hoping for a body to curb international tax competition tend to look to the OECD.[20] At present this is focussing on corporate rather than personal taxation.[21]

1.2.5 *"Customers" of HMRC*

In the 2010/11 edition of this work I summarised the tax competition argument thus:

> Where there is tax competition, the term "customer", which HMRC

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accessible *http://www.scotland.gov.uk/Resource/Doc/919/0120786.pdf*.
The reduction in the UK corporation tax rates in Budget 2012 may partly be motivated by anticipation of Scottish tax competition, though this was tactfully not mentioned.

17 *http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm*

18 See 60.9 (State aid).

19 Kovács (EU Taxation and Customs Commissioner 2004 - 2010) IP/07/445 (2007).

20 Eg Jeffrey Sachs "Stop this race to the bottom on corporate tax" Financial Times, March 28 2011.

21 See 2.6.2 (OECD BEPS project).

> have (controversially) applied to taxpayers since 2001[22] is slightly less inapt. UK resident foreign domiciliaries are in principle more free than other taxpayers to take their "custom" elsewhere.

As far as I am aware, no other Revenue department in the world calls its taxpayers "customers" and it is interesting to digress for a moment to consider what the word implies for the taxpayer/Revenue relationship.

It must be taken to suggest that the relationship should be based on the market but what does that entail? A person who regards himself as a customer (as opposed, say, to a "citizen") has no disposition to put public good ahead of private interest, and no moral relationship with their supplier. Customers control producers of commodities only by buying or not buying what they like.

Rowan Williams (Archbishop of Canterbury, 2003-2012) sees the issue in the wider context of the ways in which the language of the market has expanded beyond a market context, and his objections to the terminology are profound:

> The language of customer and provider has wormed its way into practically all areas of our social life, even education and healthcare, and we forget that it is a metaphor when we call a student, a patient or a traveller a "customer". The implication is that the most basic relation between one human being and another or one group and another is that of the carefully calibrated exchange of material resources; the most basic kind of assessment we can make about the actions of another, from the trader to the nurse to the politician, is the evaluation of how much they can increase my liberty to negotiate favourable deals and maximize my resources.[23]

But this is not of course the inference which HMRC intended. Sir Nicholas Montagu (Chairman of the Board of Inland Revenue, 1997-2004) said that the reason for the change was to remind Revenue staff that the needs of the consumer of public services should be considered first.[24] One cannot quarrel with the aspiration, though one might question the extent to

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22 A press release at the time provided: (14/06/01) "M and C Saatchi, a leading advertising agency, has been appointed by the IR to rebrand the department. Branding and design consultants, Corporate Edge, will also be working with the IR and M and C Saatchi to 'create a customer driven department'."

23 Williams, "Knowing our Limits" in Williams and Elliott (eds), *Crisis and Recovery: Ethics, Economics and Justice* (2010), p.20.

24 See "The Customer is always right" Tax Advisor, February 2003.

which it is achieved, or whether the change of terminology was an effective aid to achieving it.

The change of terminology from taxpayer to "customer" came at a time which has seen a substantial increase in HMRC's powers and in its desire to use them to impose civil and criminal penalties.[25] The reader may speculate whether that is wholly coincidental, but the current enthusiasm for civil penalties and criminal convictions does make the usage seem a strange one.

A certain sense of the ridiculous prevents the parliamentary drafter from using the expression: for instance the SRT consistently uses the term "taxpayer". The terminology will not cease to give rise to derision as long as the current generation of tax practitioners remain in practice[26] and the Tribunal has also been moved to comment:

> I note in passing that all the reports mentioned below refer to HMRC's 'customers'. While this is a regrettable misuse of language by HMRC as it implies people have a choice whether to interact with HMRC and that therefore the payment of taxes is voluntary, nevertheless it is clear that references to 'customers' are meant to be references to taxpayers. Needless to say the payment of taxes is not voluntary despite the

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25 "The Department expects the new [civil] penalty regime to result in higher penalties as the minimum penalty for deliberate evasion and concealment is 50%. The Department should track the level of penalties imposed to ensure that it is applying the new regime rigorously." House of Commons Committee of Public Accounts, "HM Revenue & Customs: Managing civil tax investigations" (March 2011) *http://www.publications.parliament.uk/pa/cm201011/cmselect/cmpubacc/765/765.pdf.*

"We have recruited an additional 200 criminal investigators to increase the number of people prosecuted for tax evasion from 165 in 2010 to 2011, to 565 in 2012 to 2013, and to 1,165 in 2014 to 2015."

https://www.gov.uk/government/policies/reducing-tax-evasion-and-avoidance The wisdom (and cost/benefit) of the vast increase in prosecutions has never been the subject of public debate.

26 See eg Cameron, "Customer Service?" *Taxation* 10 Apr 2008, p.361: "It never ceases to amaze me that HMRC have adopted the word 'customer' to describe the taxpaying public. A customer is someone who chooses to patronise a business." Andy Wells agrees: "I will never be a 'customer' of HMRC. This disregard for the English language irks just about every tax professional I come across..." *Taxation* 4 June 2009, p.549. Similarly Anthony Thomas (then president of CIOT): "HMRC now refer to taxpayers as customers, but they do not treat them as customers"; "We need Trust", Taxation (2 June 2011) p.7; Truman, "Still Not a Customer" *Taxation* 14 Jun 2012 p.8.

misnomer ....[27]

It is conceivable that the terminology will last until a future generation sees nothing to laugh at in expressions such as *"penalties designed to change customer behaviour"*[28] but I think that unlikely. Perhaps at some point it will be dropped.

1.3 Fairness

The other consideration in the assessment of foreign domicile taxation is fairness.

1.3.1 *What is fairness?*

The starting point for any serious discussion of fairness in tax is economists terminology:

(1) **"horizontal equity"**, the view that people who are relevantly equal should pay the same amount of tax.

(2) **"vertical equity"**, the view that people who are relevantly different should pay different amounts of tax, which leads to the (more or less) accepted view that fair taxation should be progressive rather than regressive.

Economists have developed these concepts with considerable sophistication[29] but their limitations are exposed when one tries to apply them in a real life context, such as an assessment of the fairness of the taxation of foreign domiciliaries. The concept of horizontal equity is not so much a definition of fairness as an approach to identifying the issues. In deciding whether one group (foreign domiciliaries, say) is fairly taxed,

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27 *LH Bishop Electric Co v HMRC* [2013] UKFTT 522 (TC) at [234].

28 *http://www.hmrc.gov.uk/e-learning/New_Penalties_Awareness/Inaccuracy_Pen_ext/HTML/Inaccuracy_Pen_ext_106.html.* Similarly House of Commons Treasury Committee , "Administration and effectiveness of HMRC" Sixteenth Report of Session 2010–12 at 143: "we question whether a strategy focused around shifting customers' behaviour can truly be described as customer-centric."(!)

29 For a starting point, see Kaplow, "Horizontal Equity: Measures in Search of a Principle" National Tax Journal 42, no. 2 (1989) p.139-55 accessible *http://ntj.tax.org/wwtax/ntjrec.nsf/A4CE18763C5BB9608525686C00686DAC/$FILE/v42n2139.pdf*
Musgrave "Horizontal Equity Once More" National Tax Journal 43, no. 2 (1990) p.113-23 accessible *http://ntj.tax.org/wwtax/ntjrec.nsf/0/a42168feab9541ff8525686c00686dca/$FILE/v43n2113.pdf*

one needs to identify another group by way of comparison (UK domiciliaries, say) and ask if they are relevantly equal.

1.3.2 *Is a distinction between UK and foreign domiciliaries fair?*

In the author's view, domicile is in general a useful and practical measure of UK linkage, and to regard UK and foreign domiciled residents as completely equivalent is facile. Or put the other way, foreign domicile does constitute a significantly weaker UK link than UK domicile. Accordingly conferring a lighter UK tax regime on foreign domiciliaries, such as a remittance basis, is indeed fair. This is especially so bearing in mind that:

(1) Mere residence does not require a very close connection to the UK, though the SRT has mitigated the worst excesses of the common law residence test.
(2) A foreign domiciliary may not have had a fair opportunity to arrange their affairs with UK tax in mind; for instance creating settlements from which they were excluded.
(3) Another consideration is the impracticality (both for taxpayers and HMRC) of untangling ownership of assets, especially in family ownership arrangements which are common in third world countries.

This view is not universally held. Some maintain that any distinction (for IT or CGT) between UK residents based on domicile is unfair. The two are relevantly equal. It is difficult to see how the dispute between the rival views can be judged, or what either side could do or say to convince the other. The concept of fairness is insufficiently precise to resolve the dispute. One might say that it comes down to a matter of impression, or politics; which is to say the same thing.

Those who advocate this view most strongly are not tax practitioners, and I think would be surprised to find how little is required to be UK resident: their views are based on a paradigm of a foreign domiciliary who is a very long-term UK resident. Thus in Ireland, which has similar rules, a Commission on Taxation report argued:

> Equity requires that taxpayers who are in a comparable situation should be afforded the same treatment for tax purposes. Making a distinction between individuals based on their domicile results in a situation where taxpayers who are otherwise in a comparable situation are treated for tax purposes in different ways. This is inequitable. Thus, for example, an individual who, although domiciled outside of Ireland, is a *permanent resident* should be treated the same as any other resident taxpayer. The

> special treatment afforded to individuals who are resident, but not domiciled, in Ireland whereby they are only taxable in Ireland on foreign source income and capital gains to the extent that the income and gains are remitted to Ireland is inequitable and should be discontinued.[30]

To repeal the remittance basis in order to tax "permanent residents" (however that expression is defined) is to throw out the baby with the bathwater.

It has to be said that in political debate, depth of analysis is not to be expected; assessment of fairness is visceral, and sensitive ears might sometimes detect elements of class or wealth hostility and xenophobia.

1.3.3 *Is a remittance basis fair?*

Even if it is accepted that it is fair to tax foreign domiciliaries less than UK domiciliaries, the question of what constitutes a fair reduction is a separate issue. The 2008 reforms accepted the principle of a distinction (which is why they did not go far enough for some commentators) but significantly reduced the extent of the tax reduction by making the remittance basis less attractive.

The remittance basis of taxation is a form of qualified non-taxation. In assessing its fairness it is relevant to compare different groups of foreign domiciliaries:

(1) *Short-term residents* who are:
   (a) wealthy individuals, who can elect for the remittance basis and are able to retain (or spend) significant foreign income/gains abroad, and
   (b) less wealthy individuals for whom the remittance basis offers little or no benefit since they have no foreign income/gains, or cannot afford to retain (or spend) much foreign income/gains abroad.

(2) *Long-term residents*
   (a) ultra-wealthy individuals, who can elect for the remittance basis and are able to retain significant foreign income/gains abroad, and
   (b) less wealthy individuals for whom the remittance basis does not justify the remittance basis charge.

The effective rate of tax under the remittance basis approximately declines

30 [Ireland] Commission on Taxation Report (2009) para 6.2.2 accessible *http://www.commissionontaxation.ie/downloads/Commission%20on%20Taxation%20Report%202009.pdf*

with income and it can be described as regressive taxation. If one accepts that taxation ought in principle to be progressive, which has been a broad feature of UK taxation, then there is the basis for an argument that the remittance basis is unfair.

What effect have the 2008 reforms had in this area? So far as they have decreased the attractiveness of the remittance basis by withdrawal of personal reliefs as a cost of the remittance basis they have decreased the unfairness.

So far as they have introduced the remittance basis claim charge, the reforms have targeted the benefit of the remittance basis at a small number of ultra-wealthy individuals. That may make sense under the tax competition argument, but from a fairness point of view it is difficult to justify.

1.4 Suitability of domicile as a fiscal test

The domicile concept is not ideally framed to identify the "footloose" individuals, whose UK links are sufficiently less that a lighter tax regime is appropriate on fairness or tax competition arguments. The adhesive quality of a domicile of origin, and the restrictive rules for the acquisition of a domicile of choice, allow some fortunate individuals to enjoy foreign domicile tax treatment, despite very close UK links and only tenuous, historical and fortuitous links to their domicile of origin. To the extent that they do so the current tax system fails both on economic and fairness criteria.

In considering this objection to domicile, however, one should bear in mind that no perfect criteria exists: the question is not whether domicile always produces the right answer, but whether one can do significantly better with other concepts or refinements.

Other concepts are sometimes used:

(1) Long term residence, of which UK tax uses a variety of tests:
   (a) IHT deemed domicile rule: 17 years residence
   (b) Remittance basis claim charge: 7 and 12 years residence
   (c) Temporary non-residence: 4 years residence and 5 years absence
   (d) Arriver/leaver rules for residence & OWR: 3 years residence
(2) Citizenship (not much used in UK domestic tax law but used in the OECD model treaty and some IHT DTAs).

These are all alternative ways to make the distinction between UK residents with strong and weaker UK links; whether they would serve better than a domicile test is very doubtful.

It is suggested that domicile is the best that can be done, subject to one refinement: those born in the UK *and* deemed domiciled here on IHT principles (17 years residence) may reasonably be treated as UK domiciled for all tax purposes, not just for IHT, even if they have not acquired a domicile of choice in the UK.

1.5 Approaches to reform of foreign domiciliary taxation

It is helpful to distinguish different ways of altering the tax system for foreign domiciliaries:

(1) Alter the definition of domicile for general purposes and so alter the class who qualify for foreign domicile tax treatment. Of course this would have ramifications beyond tax. Those proposing reforms of this kind are not usually motivated by tax – though those objecting to them may be.[31]
(2) Alter the definition of foreign domicile for some or all tax purposes.
(3) Alter tax laws applying to all foreign domiciliaries.
(4) Identify subclasses of foreign domiciliaries with close UK links so as to tax them more heavily than foreign domiciliaries with less close UK links.

One can of course achieve the same end result by more than one technique. There is a lot to be said for approach (4) both on economic and fairness grounds.

1.6 History of reform of foreign domicile taxation[32]

The chequered history reflects the difficulty, or impossibility, of reconciling incompatible policy considerations.

1.6.1 *1974-2002*

The 1974 Finance Bill included a provision (clause 18) that an individual ordinarily resident in the UK for five out of the preceding six years of assessment should be deemed UK domiciled for IT and CGT purposes. This was withdrawn from the Bill.[33]

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31 See 3.5.4 (Proof of intention).

32 See too 10.4 (History of the remittance basis).

33 For an account of the lobbying behind this, see Barnett, *Inside The Treasury* (1982) p.28–9.

The 1988 Consultative Document (Residence in the UK) made radical proposals. The remittance basis would be abolished. Those resident here for less than seven out of 14 years (and, perhaps, who are also not UK domiciled) would qualify for a new "intermediate basis" of taxation. This would require disclosure of worldwide income in order to tax it at an effective rate of 2% or less. This proposal was abandoned.

In the first edition of this work (2001) I said:

> It seems more likely than not that, apart from tinkering changes, the present regime will continue for the foreseeable future. But the major distinguishing feature of the British tax system is its instability.[34] ... If what has been a backwater acquires political prominence, perhaps due to no more than a campaign by a single newspaper, there will certainly be major changes.

1.6.2 *2003 background paper on residence and domicile*

In 2002 a newspaper campaign emerged[35] which pressed the Blair Government into action, or at least into the appearance of action. The Budget of April 2003 delivered a "background paper" called "Reviewing the residence and domicile rules as they affect the taxation of individuals".[36] This was a facile document[37] but it may be unfair to criticise its (unnamed) authors. Their instructions may have been to be uncontroversial; by saying nothing, there was nothing in the document to which anyone could object.

Nothing then happened from 2003 to 2008 except an often repeated statement that:

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34 See 1.8 (The promise# of stability).

35 See for instance, *The Sunday Times*, 1 March 2002; *The Guardian*, 11 and 12 April 2002.

36 *http://webarchive.nationalarchives.gov.uk/20091222074811/http://www.hmrc.gov.uk/budget2003/residence_domicile.pdf*

37 It contained an outline of the law (a rehash of IR20) and one paragraph summaries of the law of 29 other countries (of insufficient detail to be of any use and generally said to be misleading). The paper did not consider any proposals or their possible impact. It (consciously?) ignored every earlier discussion of reform: the Royal Commissions of 1920 and 1955, the 1936 Codification Committee, the 1974 Finance Bill, the 1987 Law Commission Report and the 1988 Consultation Paper.
For an account of the decline in quality of Government white and green papers, see Forster, *British Government in Crisis* (2005), p.134.

> The review of the residence and domicile rules ... is ongoing.[38]

It is clear that the review of foreign domicile tax did not follow the normal course of consultation, decision and implementation. In the absence of a frank explanation of what went on, it is tempting to speculate. The likely explanation is that the Blair Government wanted to do nothing, but prevaricated to avoid an announcement which would have lead to a furore from those in favour of reform.[39] Blair resigned in June 2007. A change of power led to an unannounced U-turn from that unannounced policy.

1.7 2008 reforms: assessment

The 2003 background paper on domicile recited the principle that taxation of foreign domiciliaries:

> [1] should be fair;
> [2] should support the competitiveness of the UK economy; and
> [3] should be clear and easy to operate.[40]

It is naive to recite these principles without noting (as Adam Smith did) that they are to a substantial extent irreconcilable. But subject to that qualification, these are the criteria by which the 2008 reforms, or any tax reforms, are to be assessed.

The 2008 reforms increased the tax burden on foreign domiciliaries in four main ways:

(1) The remittance basis claim charge for long-term residents
(2) The withdrawal of personal allowances for remittance basis claimants
(3) The ITA remittance basis, stricter than before

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38 The history is set out in the 9th edition of this work para 1.3.2. The last outing of (by then extremely tired) statement was Hansard 12 July 2007 Col 1605 by which time almost no-one believed it, but by then it was possibly true.

39 See Oborne, *The Rise of Political Lying* (2005).

40 The paper might have cited Adam Smith *The Wealth of Nations* (1776) Book 5 chapter 2, accessible *http://www.bibliomania.com/2/1/65/112/frameset.html*
In Scotland, Adam Smith is more highly regarded: "As with the entire approach the Government takes ... on taxation, these proposals are firmly founded on principles, Scottish (?) principles, that have stood the test of time. Adam Smith in 1776 in his "Inquiry into the nature and causes of the Wealth of Nations", set out four maxims with regard to taxes; the burden proportionate to the ability to pay, certainty, convenience and efficiency of collection." See Swinney, (Finance Secretary) "The Scottish Government's Approach to Taxation" (2012) *http://www.scotland.gov.uk/News/Speeches/taxation07062012*

(4) The extension of anti-avoidance provisions to remittance basis taxpayers (in particular, the s.720, s.13 and s.87 remittance bases, and the AIP remittance basis)

1.7.1 *Clear and easy to operate*

It will be evident to anyone who skims this book that by this criteria the 2008 rules are a failure. The rules are unclear, often difficult and sometimes impossible to operate. In these respects they are unquestionably worse than the pre-2008 rules.

Government policy normally requires an impact assessment.[41] None was carried out in relation to any of the 2008 reforms. Many features of the reforms could not have survived if it had been.

1.7.2 *Competitiveness of the UK economy*

On one side of the account is the gain of more tax paid by foreign domiciliaries. On the other is:

(1) Tax and investment lost from individuals who leave the UK, and those who (because of the reforms) decide not to come.

(2) The loss to the economy that the 2008 rules in many cases discourage or prevent investment in the UK and prevent use of UK services.

In the 2008/09 edition of this work my initial assessment was as follows:

> Overall it seems to me implausible that the reforms will make a positive contribution to the UK economy. One can test the matter this way. If a wealthy individual, a beneficiary of offshore trusts created by himself or his family, asked for advice on the desirability of choosing the UK as a residence, what would one say? Even now the individual could still do worse; and if enough advance planning and restructuring is possible, the problems may be ameliorated, at an administrative cost. Thus tax may still not prevent an individual from coming to the UK if he wants to sufficiently. Also, the old cliché about the tax tail and the commercial dog still holds good. But all this is a far cry from the pre-2008 position, where one would simply respond that the UK was clearly a desirable place to reside.

This view is now supported by a number of informal surveys (though these may be lacking in rigour and methodology).

A KPMG survey found that as a result of the 2008 changes, 24% of foreign domiciliaries were planning to leave the UK within two years, with

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41 *http://www.berr.gov.uk/files/file44544.pdf*

an additional 24% hoping that the rules will be changed and looking to review their position in the medium term. More than nine out of ten said that the changes had damaged the UK's competitiveness.[42]

A Knight Frank survey found that up to 7% of foreign domiciliaries left UK in the months following the tax announcements and a further 31% were planning or actively considering departure.[43]

Stonehage research suggests that the changes will produce an initial tax gain diminishing to a tax loss beginning from a date between 2014 and 2018.[44]

My own anecdotal experience - consistent with the above - is of a number of individuals who decide - I think wisely - not to come to the UK because of the uncertainties relating to taxation.

It is of course difficult if not impossible to disentangle the 2008 reforms from other disincentives to coming to the UK, such as the increase in income tax rates to 45%, the uncertainties caused by the transfer of asset abroad changes in 2005, and corporation tax changes.

Corporate departures from the UK have been widely publicised; they include WPP, Shire, Regus, Henderson, Charter, Beazley, Brit Insurance, UBM, Shore Capital, Informa and Aureos Capital. Individual departures from the UK are not readily identifiable, and losses from those who decide not to come are almost totally unmeasurable.

HMRC offer the following statistics:[45]

	Non-doms	**Tax paid**		**Remittance basis charge**	
	Total no	*total £billion*	*average per person*	*no. paying*	*total receipt*
2004-05	110,000	3.3	£30,000		
2005-06	111,000	4	£36,036		
2006-07	117,000	5	£42,735		
2007-08	140,000	6.9	£49,286		
2008-09	123,000	5.61	£47,967	5400	£162m

42 March 2009, accessible *http://www.kpmg.co.uk/news/docs/NomDoms_FinanceAct2008_Access3.pdf*

43 *http://www.knightfrank.com* Press Release, 20 June 2009.

44 "Non Doms and the UK Economy", March 2010, accessible *http://www.stonehage.com*.

45 Hansard 14 Feb 2011 Column 556W *http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm110214/text/110214w0002.htm*; Data from 2008-2013 are from private correspondence; these figures may be subject to revision for later tax years.

2009-10	120,300	6.29	£52,286
2010-11	113,700	6.41	£56,376
2011-12	111,700	6.44	£57,645
2012-13	110,700	6.33	£57,181

The figures are interesting but it is impossible to draw any conclusions which relate to UK resident foreign domiciliaries.

In relation to the number of foreign domiciliaries, HMRC say:

> The number of individuals who filed a self-assessment (SA) tax return and indicated that they were non-domiciled. The figures include both individuals who were UK resident and individuals who were not UK resident.

Including non-residents in the figures is alone sufficient to make the statistics useless for the purpose of assessing the taxation of UK resident foreign domiciliaries. For good measure:

> Individuals who complete a SA return are only required to indicate that they are non-domiciled if this affects their tax liability. Therefore the actual number of non-domiciled individuals who complete a return will be greater than the number who indicate their non-domicile status on their SA return.

In relation to the tax paid, HMRC say:

> Figures are not available for the total amount of UK tax paid by non domiciled individuals. However, it is possible to calculate the total amount of UK income tax and CGT paid by individuals who completed an SA return and indicated that they were non-domiciled. These amounts for the past five tax years were as [specified in the table above]. Several taxes are not accounted for via the SA system and some non-domiciled individuals are not required to complete an SA return at all.

1.7.3 *Fairness of 2008 reforms*

The FA 2008 contained a wide ranging package of reforms and any short assessment of its fairness must necessarily be limited to its main features.

The remittance basis claim charge distinguishes between short term and long-term residents, and taxes the latter more heavily, the connecting factor here being the long term residence tests. One cannot categorise those distinctions as unfair.

On the other hand, among long-term foreign domiciliaries, the charge distinguishes between the extremely wealthy (to whom the remittance basis

is still attractive) and others (to whom it is not). This offends against the principle of vertical equity, which suggests that people with higher incomes should pay more tax. That is not fair, it represents a decision to prioritise the economic advantage of tax competition by targeting the remittance basis to the wealthiest. The tax competition consideration conflicts with fairness.

The withdrawal of personal allowances as a quid pro quo of a remittance basis is not unfair (though it comes at a cost in terms of complexity).

Of perhaps greater importance is the other aspects of a package of reforms which affect all foreign domiciliaries, not just long-term residents.

The stricter ITA remittance basis is not unfair, except for the wilder reaches of the relevant person definition[46] and the supposed rule (probably ignored in practice) that the taxable amount remitted may exceed the value of the asset remitted.[47]

The extended 2008 anti-avoidance rules can work unfairly but complete fairness is impossible to achieve in this area.

The transitional rules are another matter. The rules are retroactive in that their impact on individuals depends on income and gains arising before 2008, and unfair in that they impose tax on those income/gains in a manner that no-one before 2008 would have anticipated. These rules were unquestionably unfair. The significance of the transitional rules will fade over time.

All in all, the 2008 reform may be given some limited marks for fairness. This is not to say that the pre-2008 rules should be regarded as unfair: the concept of fairness (especially if viewed through the lense of practicality) is so vague that a very wide range of tax policies may all be categorised as "fair".

Some of the hardest hit are long-term UK resident US citizens, who pay
(1) US tax on a citizenship basis and
(2) substantially greater UK tax liabilities under the 2008 regime.
with only treaty relief to mitigate double taxation, as far as it goes.
That is unfair, but the reason is not that UK unfairly taxes its long-term residents, but that the US (I think, uniquely in the world) imposes US tax on non-resident citizens, so all its non-residents face the burden of double taxation: US tax and tax in their country of residence (subject to limited tax

46 See 11.8.1 (Corporate relevant persons: Commentary) 11.11 (Commentary: let's simplify remittance and relevant person rules).

47 See 11.29.2 (Remittance of derived property).

credit relief).

1.7.4 *Process of implementation*

The manner in which the FA 2008 was introduced deserves to be recorded.

In January 2008, 26 pages of draft clauses were published whose unwritten message to wealthy non-residents was broadly: *do not come to the UK if possible; if you must, do not under any circumstances invest any money here*. The clauses were officially described as work in progress, but this was unfit for publication.

HMRC[48] presumably agreed. On 27 March the Finance Bill was published, containing 54 pages of legislation. The FB clauses bore almost no resemblance to the January draft. One consequence is that the professional time and clients' money spent considering the old clauses was almost entirely wasted. That certainly cost many £millions. Another consequence was that the profession had nine frantic days to scramble around before the end of the tax year. Because of the absence of sensible transitional reliefs, large amounts of tax depended on decisions and actions taken in those days. Sensible consideration of difficult and important matters was rendered impossible.

On the date of publication the Treasury announced that the Finance Bill was incomplete and amendments covering almost every aspect of the rules[49] were made in the course of progress of the Finance Bill.[50] Thirty pages of amendments duly emerged in mid June – far too late in the Finance Bill timetable to give them any serious consideration. Forty eight more Report Stage amendments were published on 26 June. The report stage and third reading (after which no further amendments could be made) were held on 1 and 2 July 2008. John Avery Jones notes that "Report

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48 In this chapter I use the expression HMRC loosely, to include those in HM Treasury and in Government who share the responsibility for tax reform, as it is not easy, or necessary, to identify where tax reform decisions are actually made.

49 Explanatory notes to Schedule 7, para 36 (mixed funds); para 47 (s.87 charge); para 52 (non-resident trusts); para 74 (Schedule 4C); para 91 (ToA provisions; para 106 (works of art); para 107 (employment related securities).

50 In the 2008/09 edition I said:
"This is a new development in tax legislation. While from time to time inadequately drafted clauses have always been found in Finance Bills, this is as far as I am aware the first time that the Government has had to announce that fact at the time of publication of the Finance Bill."
There are similar examples in the FA 2009 but it has not become a trend.

Stage amendments are usually a disaster."[51]

As a result, the final legislation poses problems which will occupy practitioners and HMRC for many years, but it is also noteworthy that during the first three months of 2008/09 taxpayers could not know what laws governed transactions which they might wish to carry out, or what record keeping would be required of them.

The former editor of *Taxation* is blunt:

> The standard of strategic policy making at the Treasury has been unacceptably poor in recent years, but this must surely have been one of its lowest ebbs ever.[52]

The CIOT say:

> when corners are cut, especially under time pressures, there can be serious deficiencies.

and their example to prove the point is the non-domicile rules in the FA 2008.[53]

The House of Lords Economic Affairs Committee comment in measured language:

> Our private sector witnesses would not have used words like "a real shambles" if they did not feel strongly about this. ...
> 176. We recommend that, if they have not already done so, HMT and HMRC should carry out a full review of the reasons why there were so many difficulties in the development of this policy initiative. They should ensure that the lessons are learned so that these problems do not emerge in other initiatives.
> 177. We also recommend that if another policy initiative gets to the point where the legislation cannot be finalised for inclusion in the Finance Bill, that initiative should not be included in the Bill, or, if feasible, the part which is not finalised should not be included. We cannot support the approach of the Finance Bill's still being subject to much amendment at the time it is published, particularly when the proposals come into effect

51 See "Taxing Foreign Income from Pitt to the Tax Law Rewrite—The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law* (Vol 1 2004) accessible *http://www.kessler.co.uk/tfd-archive*.

52 *Taxation* 12 June 2008 Vol 161 No. 4160 p.627 (Malcolm Gunn).

53 The Making of Tax Law, para 3.2, CIOT, June 2010 *http://www.tax.org.uk/resources/CIOT/Documents/2010/09/themakingoftaxlaw.pdf*

> from the beginning of the tax year, as in this case. [54]

No review was carried out.

Does it now matter? Readers may think it pointless to cry "foul" in a game which has no referee, and whose result has now been declared. But I think the story deserves to be recorded as what Lord Howe described as "an object lesson in how not to legislate".[55]

1.8 The promise of stability

There is a long tradition of instability in the UK tax system. In 1981:

> One of the most noticeable characteristics of the British tax system is that it is under continual change.[56]

In 1993:

> The major distinguishing characteristic of the British tax system is its instability. The British tax system changes faster, more frequently, and more radically than any other tax system I have observed.[57]

The development in recent years is a series of promises of stability without any change of practice. In 2008 Alistair Darling (then Chancellor of the Exchequer) said:

> There will be no further changes to this regime [for foreign domiciliaries] for the rest of this Parliament or the next.[58]

No-one seriously believed that.[59] In the 2008/09 edition of this work I said:

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54 Select Committee on Economic Affairs, 2nd Report of Session 2007–08, The Finance Bill 2008 *http://www.publications.parliament.uk/pa/ld200708/ldselect/ldeconaf/117/117i.pdf.*

55 Making Taxes Simpler - The final report of a Working Party chaired by Lord Howe (July 2008) *http://www.tax-news.com/asp/res/makingtaxessimpler.pdf.*

56 James & Nobes, *Economics of Taxation* (1st ed., 1981), p.135.

57 Steinmo, *Taxation and Democracy* (1993), p.44.

58 Budget speech *http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/bud_bud08_speech.htm* *http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/bud_bud08_speech.htm*

59 The House of Lords Economic Affairs Committee said:

> "227. In his Budget Statement, the Chancellor promised that the rules in this area would not be substantially revised for the rest of this or the next Parliament. We do not take this to mean that there will not be legislation in coming Finance Bills to

> The statement is constitutionally wrong, as Parliament cannot bind its successor. But leaving aside (if one can) constitutional fundamentals, it would be rash to rely on it.

In practice there have been changes (often far reaching) in *every* year since 2008.

The 2011 budget had another promise of stability:

> There will be no other substantive changes to these rules for the remainder of this Parliament.[60]

In the 2011/12 edition of this work I commented:

> The coalition government (correctly) does not promise to bind the next Parliament. The promised period of stability is therefore for three years, from 2012 (assuming the proposed 2012 changes are enacted on schedule)[61] until 2015.

In December 2011 the Government continue to promise and indeed to boast about stability:

> 2.2 ... The commitment to making no further substantive changes for the rest of this Parliament was seen as a clear indication that the Government recognises the importance of providing certainty....
> 2.12 The Chancellor made a commitment at Budget 2011 that there would be no further substantive changes to non-domicile taxation for the rest of this Parliament. ... The Government believes this will provide certainty and stability for non-domiciles.[62]

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address defects in the current legislation. We think it inevitable that, given the evident pressure under which this legislation was produced, there will be such defects." 2nd Report of Session 2007–08, The Finance Bill 2008 *http://www.publications.parliament.uk/pa/ld200708/ldselect/ldeconaf/117/117i.pdf*. In the Consultation Document "Modernising Powers, Deterrents and Safeguards: Tackling Offshore Tax Evasion" 9 December 2009 para 4.43 HMRC tactfully misquoted the then Chancellor, saying "At Budget 2008, the Chancellor of the Exchequer gave a commitment that there would be no *significant* changes to the *policy underlying* the remittance basis for the lifetime of that Parliament and the next."

60 HMRC "Overview of Tax Legislation and Rates" (23 March 2011) para 3.7.

61 They were not: Ministerial Statement 6 December 2011 [2011] STI 3355.

62 HMRC & HMT, "Reform of the taxation of non-domiciled individuals: summary of responses to consultation" (December 2011) *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

Budget 2012 broke this commitment with the ATED regime which was not restricted to foreign domiciliaries but will affect them primarily. That might have been an oversight. But Budget 2013 broke the commitment again with changes to the deduction of liabilities for IHT targeted directly at foreign domiciliaries. The rhetoric continued:

> the Chancellor made the point in Budget 2011 that we have no intention of making any further substantive changes to the remittance basis rules for the remainder of this Parliament, and I am happy to reiterate that. We believe that a stable set of rules for non-domiciled individuals will provide certainty and increase the international attractiveness of the UK as a place to live and work.[63]

FA 2014 introduced another substantive change concerning dual contracts.

The promises of stability should be regarded as lip-service to the desideratum of stability. The practice, which lies deep in the culture of government, seems immune to such announcements. A true commitment to stability requires HMRC to refrain from making reforms which they would like to make, and when any actual reforms come to the table, the interest of reform overcomes the interest of stability. It is easier for politicians to talk about stability than to achieve it. Perhaps HMRC have recognised this, as Budget 2014 contains no promise of stability, as far as I can see.

1.9 The tax consultation framework

These have been bad times for tax policy. The CIOT expresses itself strongly: "the way tax law is developed and effected in the UK is deeply flawed."[64]

Two recent publications shed light on what has gone wrong with tax legislation in recent years. Firstly, Demos:

> The centralisation of [tax policy-making power] is a particular problem because of the lack of institutional accountability of the Treasury on taxation policy and the lack of accountability of chancellors themselves in matters of taxation. ... The concept of checks and balances in tax policy

63 David Gauke (Exchequer Secretary to the Treasury) Hansard, 21 May 2013 *http://www.publications.parliament.uk/pa/cm201314/cmpublic/financeno2/130521/pm/130521s01.pdf*

64 Letter from CIOT to George Osborne, 19 May 2010 accessible *http://www.tax.org.uk/Resources/CIOT/Migrated%20Resources/t/to-santos_40.pdf*

> is nonexistent.
>
> ... the current relationship between the Treasury and HMRC was 'very dysfunctional', had 'almost gone as wrong as it could have gone'...
>
> At the moment, pursuing a career only in tax policy is not valued within the Treasury hierarchy. Officials pass through the tax teams rather than making tax policy a career choice. ... High turnover results in a lack of experience in the tax section and little institutional memory...
>
> ... There are traditional areas that are ring-fenced as not for consultation, including tax rates and anti-avoidance measures. ...
>
> ... 'at the moment [anti-avoidance] works like a drive-by shooting. You might hit your objective but you also hit a lot of other people.'
>
> At present, policies are frequently changed without understanding the impact the policy has initially had in practice.[65]

Along with a decision not to consult is an HMRC policy which is not deaf to the tax profession but positively hostile. The Director of the HMRC Tax Avoidance Group 2004-2009 records:

> ... I was never happier than when a new tax avoidance initiative was greeted with howls of protest from the tax avoidance quarter.[66]

In short, preventing avoidance has been a priority that outweighs other considerations, such as certainty, workability and the rule of law; or rather obliterates all consideration; and listening to the tax avoidance quarter – which includes the professional bodies and almost any practitioner who said what HMRC did not want to hear – has been ruled out. The professional bodies are regarded by HMRC and HM Treasury as a pressure group whose vaunted commitment to fairness, practicality and the rule of law is merely a cloak for self-interest.

The consequences of a decade or more of that policy can be seen in seeking to state the law, as this book seeks to do, or in seeking to understand the law, as you the reader will do now.

1.9.1 *The Tax Consultation Framework*

In March 2011 the Government promised a fresh start with The Tax Consultation Framework:

> 2. There are five stages to the development and implementation of tax

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65 Ussher and Walford, *National Treasure* (Demos, 2011) accessible *http://www.demos.co.uk/files/National_treasure_-_web.pdf?1299511925*.

66 Tailby, "Some Reflections on Tax Avoidance" [2011] PCB 41.

policy:
Stage 1 Setting out objectives and identifying options.
Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.
Stage 3 Drafting legislation to effect the proposed change.
Stage 4 Implementing and monitoring the change.
Stage 5 Reviewing and evaluating the change.
3. Where possible, the Government will:
- engage interested parties on changes to tax policy and legislation at each key stage of developing and implementing the policy;
- make clear at what stage (or stages) the engagement is taking place so that its scope is clear;
- carry out at least one formal, written, public consultation in areas of significant reform;
- set out, as the policy develops, its strategy for stakeholder engagement including planned formal consultation periods, informal discussions, working groups and workshops;
- consult, where it can, on the policy design, draft legislation and implementation of anti-avoidance and other revenue protection measures, provided this does not present additional risk to the Exchequer;
- minimise the occasions on which it consults only on a confidential basis. Where confidential consultation has been necessary the Government will be as transparent as possible about its outcome and consult openly if pursuing the policy change further; and
- provide feedback which sets out the Government's response to the views received and makes clear what changes, if any, have been made to the planned approach as a result of those views.

4. At each stage of consultation, the Government will set out clearly:
- the policy objectives and any relevant broader policy context;
- the scope of the consultation, in particular what is already decided and where there is still scope to influence the outcome;
- its current assessment of the impacts of the proposed change and seek to engage with interested parties on this analysis. A final assessment of impacts will be published once the final policy design has been confirmed; and
- which department and official is leading on the consultation (or specific elements for joint HMT and HMRC consultations).

5. Informal consultation will be as transparent as possible, consistent with the need to protect revenue. The best principles of formal consultation will be applied to informal consultation to ensure clarity of scope, impact, accessibility, and meaningful feedback. Comments will

> only be attributed to a representative body when it is clear that the individual consulted is commenting on behalf of that representative body. It is recognised that individuals need time to consult others before they can provide comments on behalf of a representative body. Informal consultation can run alongside formal consultation but will often be most appropriate at the earliest and latest stages of tax policy development to identify options and then to fine-tune the detailed legislation and implementation of change.
>
> **Exceptions**
>
> 8. The Government will generally not consult on straightforward rates, allowances and threshold changes, or other minor measures; recognising, however, that even in these cases some level of consultation can often be informative. It may also adopt a different approach for revenue protection or anti-avoidance measures where following this Framework could present a risk to the Exchequer. In other circumstances where the Government decides not to consult during tax policy development it will explain the reasons for that decision.
>
> 9. There will be times when it will be necessary to deviate from this Framework. In these circumstances the Government will be as open as possible about the reasons for such deviations.[67]

A comprehensive assessment of the extent to which tax reform since 2011 has complied with the Framework would need a volume to itself, there has been so much. In brief, compliance with the Framework has been patchy. It is easier to announce these good intentions than to abide by them. The culture of "ready fire aim" is not easily tackled.

The proposed cap on charitable reliefs in the 2012 budget was announced in breach of the Framework. The editor of *Taxation* commented:

> It seems that the policy has been abandoned, and we are back to the 'rabbit out of a hat' approach.[68]

The ATED regime was introduced in breach of the Framework. The House of Lords Economic Affairs Committee commented:

> ... the Government's response to SDLT avoidance might have been more appropriately designed had it consulted interested parties at the outset as its 'new approach to tax policy making' stipulates. We recommend that the Government adhere to that approach in designing future tax

67 *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/89261/tax-consultation-framework.pdf*

68 Truman, "Taxation" (2 May 2012).

changes.[69]

The 2013 restrictions on deduction of liabilities for IHT were introduced in breach of the Framework. But neither here, nor, as far as I am not aware, in any other case have the Government acknowledged a breach of the Framework or been "as open as possible about the reasons for such deviations."

The City of London Law Society comment:

> A disturbing pattern is emerging where such legislation is introduced: minimal or ineffective consultation, over-draconian legislation and untaxing via HMRC guidance (sometimes even coupled with legislation that is effective immediately). The resultant uncertainty, and on occasion the inadvertent imposition of tax contrary to policy, has been damaging to the UK's competitiveness. We would highlight in particular the Disguised Remuneration legislation, this year's new Salaried Members rules and ... the introduction of the penal 15% SDLT rate for certain high value residential property acquisitions as cases where business confidence in the policy-making and implementation processes has been greatly damaged.[70]

There is one route and one route only to a good tax system: sound tax policy devised by those with a sound understanding of the current tax system; a leisurely timetable of consultation and legislative drafting as envisaged in the Tax Consultation Framework and the 10 tax tenets of the ICAEW.[71]

That is a hard prescription, and it is tempting to look for an easier solution. Past unsuccessful attempts include the tax law rewrite, which achieved little, and the HMRC charter which achieved nothing. The most recent is the GAAR; it will take several decades to assess whether that will yield a consistent case law and reasonable predictability of outcome.

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69 House of Lords Select Committee on Economic Affairs *The Draft Finance Bill 2013* (March 2013) para 210 *http://www.publications.parliament.uk/pa/ld201213/ldselect/ldeconaf/139/139.pdf*

70 Response to Office of Tax Simplification competitiveness review (May 2014) *http://www.citysolicitors.org.uk/attachments/article/105/20140605%20Response%20to%20Office%20of%20Tax%20Simplification%E2%80%99s%20'Competitiveness%20review%20-%20initial%20thoughts%20and%20call%20for%20evidence'.pdf*

71 *http://www.icaew.com/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-02-00-Better-Tax-System.pdf*

1.10 The Future

Budget 2014 has announced important forthcoming reforms:
(1) to extend the scope of CGT to residential property of non-residents
(2) to extend ATED and related taxes to properties above £500k.
More generally, the instability and ever increasing complication of the UK tax system is likely to continue for as long as the HMRC view remains is that the current state of tax reform is good, or if it is not good, nothing can be done to make it better.

CHAPTER TWO

WAKE UP AND SMELL THE COFFEE: THE PUBLIC DEBATE ON TAX AVOIDANCE

2.1 Introduction

The topic of tax avoidance is as old as taxation itself;[1] but it has taken prominence recently, in Parliament and the media.[2]

The topic impinges on many aspects of this book, but it is best to consider it as a subject and in a chapter of its own.

The title of this chapter derives from the splendid admonition of David Cameron:

> Of course there is a difference between tax evasion and tax avoidance. Evasion is illegal. It can and should be subject to the full force of the criminal law.
>
> But what about tax avoidance? Now of course there's nothing wrong with sensible tax planning and there are some things that governments want people to do that reduce tax bills, such as investing in a pension, a start up business or giving money to a charity. But there are some forms of avoidance that have become so aggressive that I think it is right to say these raise ethical issues, and it is time to call for more responsibility and for governments to act accordingly.
>
> In the UK we've already committed hundreds of millions (?) into this effort, but acting alone has its limits. Clamp down in one country and

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1 For examples from 1798 and 1920, see "Tax Avoidance in 1798" and "Vestey: Royal Commission evidence and ensuing debate" both accessible *http://www.kessler.co.uk/tfd-archive*.

2 It is interesting to speculate why that has been the case. I think reasons lie more in the realm of politics and sociology than tax law and practice. The Public Accounts Committee, and some effective pressure groups, have clearly contributed but given the pressure on the front page, why has their work received so enthusiastic a reception? The climate of austerity may be a contributing factor.

> the travelling caravan of lawyers, accountants and financial gurus will just move on elsewhere. ...
> I believe in low taxes, that is why my government is cutting the top rate of income tax, we've cut corporation tax. [*Delete - political]*.[3]
> Individuals and businesses must pay their fair share. And businesses who think they can carry on dodging that fair share, or that they can keep on selling to the UK and setting up ever more complex tax arrangements abroad to squeeze their tax bills right down, well they need to wake up and smell the coffee, because the public who buy from them have had enough.[4]

All the main tropes of the political debate are in this passage:

(1) Everyone should pay a "fair share" of tax.
(2) Some taxpayers fail to do so due to tax avoidance.
(3) Tax avoidance is unethical, immoral or anti-social.
(4) Acknowledgement of the avoidance/evasion distinction;[5] but it does not contradict point (3). In the words of Margaret Hodge: "We're not accusing you of being illegal, we're accusing you of being immoral."
(5) Disparaging references to tax advisors.[6]

On the political left, the same points are made, but more stridently, and of course without David Cameron's approval of low taxes.

2.1.1 *The amounts lost due to avoidance*

Another common thread in public debate is a vast estimate of the amounts involved. HMRC publish figures called "the tax gap":

> It estimated that at 31 March 2012 up to £35 billion of tax was at risk or under consideration due to avoidance or legal interpretation.[7]

The words "or legal interpretation"[8]make the figure meaningless as a measure of avoidance, but for a critique of the methodology, see Oxford

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3 This side note is included in the version of the speech published online; one wonders what happened when the speech was delivered.

4 David Cameron speech to World Economic Forum in Davos, January 2013 *http://www.number10.gov.uk/news/prime-minister-david-camerons-speech-to-the-world-economic-forum-in-davos/*

5 I suspect newspaper libel readers (rightly) insert this if a journalist overlooks it.

6 This feeds on another very ancient trope concerning lawyers.

7 National Audit Office, *Tax avoidance: tackling marketed avoidance schemes* (2012), para 1.14.

8 In HMRC's terminology, a tax loss arises from "legal interpretation" when the taxpayer disagrees with HMRC on an issue of tax law.

University Centre for Business Taxation "The Tax Gap for Corporation Tax".[9]

The IFS say:

> we don't know how much corporate tax is lost to the UK as a result of tax avoidance. This is partly because there is no accepted definition of exactly what constitutes 'avoidance' and partly because we lack full information about the activities of firms.[10]

Of course, the fact that an amount is unknown and unknowable does not mean that it is small or unimportant. There is no doubt that the amounts involved are significant. I doubt if time spent guessing at figures is productive.

The IFS report continues:

> Importantly, even if we knew that information and could calculate the tax lost to avoidance, it would not be right to assume that, were all avoidance opportunities to be completely removed, the UK would be able to collect that full amount. We would expect higher taxes to feed through, at least to some degree, to lower investment and changes in prices such that genuine UK profits may be lower. To the extent that the corporate tax affects prices or wages, or the location of firms' activities (and therefore jobs), there may also be lower receipts from income taxes or VAT.

This is true for all taxes, but particularly so for corporation tax:

> First, corporation tax is a particularly distortionary form of taxation that can work to reduce investment. This is especially the case for internationally mobile investments because firms will consider tax when choosing where to locate real activities. The Mirrlees Review noted that, in principle, it would be efficient to tax relatively mobile activities at a lower rate in order to avoid deterring mobile activities while allowing a higher rate to be supported on less mobile activities.[11] Avoidance behaviours are one way that de facto lower rates on more mobile income are achieved. (The Patent Box ... is one way to try to achieve this

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9 December 2012, accessible *http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/TaxGap_3_12_12.pdf*. The HMRC paper itself concedes that "There are many sources of potential error and uncertainty in these estimated tax gaps."

10 IFS, *Green Budget 2013* p.297 *http://www.ifs.org.uk/budgets/gb2013/gb2013.pdf*

11 [Footnote original] See page 12 of J. Mirrlees et al., *Tax by Design: The Mirrlees Review*, (2011) *http://www.ifs.org.uk/mirrleesReview/design*.

directly.) In this case, there may even be benefits to the UK from avoidance opportunities if the lower tax rates achieved on mobile activities – for example, through profit shifting – mean that more real activity is in the UK than would otherwise be the case. But, of course, there are many costs too, including the inefficiencies that arise from tax planning, the distortions between activities and the potential revenue loss.[12]

Second, the ultimate incidence of corporate tax always lies with households and is borne either by the owners of capital (in the form of lower dividends), by workers (in the form of lower wages) or by consumers (in the form of higher prices). We do not know with any precision who is made worse off as the result of the corporation tax. However, estimates suggest that, because capital tends to be much more mobile than workers or consumers, a significant share of the burden of corporate tax tends to be shifted to domestic factors – and specifically labour.[13] In other words, there is reason to believe that at least a part, and in some cases a large part, of the corporation tax that companies are subject to is ultimately passed on to workers in the form of lower wages.[14]

There is a certain irony in the last point, given the left's enthusiasm for corporation tax.

2.2 The need for analysis

This chapter draws on a paper published by the Oxford University Centre for Business Taxation, ("the OUCBT paper").[15] The OUCBT paper says:

> The question is how to tackle the problems. This requires a clear

12 [Footnote original] There is an academic literature on the costs and possible benefits of tax planning. See for example, D. Dharmapala, "What problems and opportunities are created by tax havens?", Oxford Review of Economic Policy, 2008, 24, 661–79, which considers the role of tax havens, and references therein.

13 [Footnote original] Workers may receive lower wages as a result of the corporation tax because (i) a lower level of capital investment results and this reduces labour productivity and therefore wages and/or (ii) the effect of lower after-tax profits feeds directly into lower wages. See, for example, W. Arulampalam, M. Devereux and G. Maffini, 'The direct incidence of corporate income tax on wages', Oxford University Centre for Business Taxation, Working Paper 07/07, 2007, and references therein.

14 IFS, *Green Budget 2013* p.290 *http://www.ifs.org.uk/budgets/gb2013/gb2013.pdf*

15 "Tax avoidance" (2012) accessible *http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/TaxGap_3_12_12.pdf* (I omit some footnotes from my quotes).

> analysis of their cause and differentiation between different causes. Labelling a whole range of quite different behaviours as "avoidance" without further differentiation is unhelpful. ...

Any differentiation requires terminology. As there is no agreed terminology,[16] it is best not to use any terms at all without some explanation of what is meant.

2.2.1 *The OUCBT categorisation*

The OUCBT paper distinguishes:

(1) **Ineffective avoidance** (no tax saving if the law is correctly applied)
(2) **Effective avoidance** (tax saved by avoidance)
(3) **Non-avoidance** (little tax paid but not due to avoidance).[17]

These are essential distinctions if one is to identify the correct response to the problems:

(1) Ineffective avoidance needs enforcement of the law.
(2) Effective avoidance needs changes in tax law.
(3) In cases of non-avoidance:
    (a) It may be no change in tax law is appropriate.[18]
    (b) If change is needed, the change is one of policy as well as of tax law; and the matter should be considered without the haste and moral outrage that may be associated with effective avoidance.

2.2.2 *Tax practitioners classification*

If one wishes to assess emotional and moral responses to avoidance, and actual or theoretical anti-avoidance rules, we need further vocabulary to discuss the range of tax-motivated behaviour.

We might cover the terrain in four categories:[19]

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16 For instance, Tiley described "tax planning" as a euphemism for avoidance, which is no doubt sometimes (maybe often) the case.

17 The paper adopts the somewhat unhelpful labels "categories A, B, and C". It is difficult to find short labels which neatly sum up the concepts: "Ineffective avoidance" is not ideal as this is not really "avoidance" at all.

18 It may be that a change in public expectation or knowledge is desirable.

19 Different authors draw different distinctions; contrast Barnett, "A baker's dozen" Taxation, 2 August 2012; Lord Walker proposed seven types of tax avoidance (a riff on Empson's *Seven Types of Ambiguity)*: "Ramsay 25 years on" [2004] LQR 120. But one must resist the temptation to taxonomy for its own sake. All classification is (or should be) purposive: a useful taxonomy must draw *useful* distinctions: it should identify categories which call for different responses, and only those.

Uncontroversial tax planning Taking advantage of a tax relief in a manner *everyone* would accept as reasonable and indeed desirable. It is easy to find clear examples: for instance, pension contributions and moderate[20] charity giving.[21]

Ordinary tax planning Using tax legislation in a way which some politicians and commentators do not like, but where the planning is ordinary in the sense that many people have done and continue to do it; it is obvious and foreseeable; the points probably came to the mind of those responsible for the legislation, or should have done, or there is no reason to think that parliament would have done anything different if it had considered the points. Ordinary tax planning is not contrary to the "intention of parliament" as that construct is normally understood.

Examples are:

(1) Advancing or delaying
    (a) disposals for CGT purposes or
    (b) bonuses or pension contributions for IT purposes
    in anticipation of changes of rates or going non-resident.
(2) Transfer of family assets or business to a spouse to equalise income.
(3) Transfer of assets or business to a company to reduce tax rates.
(4) Lifetime giving to avoid IHT.
(5) Going non-resident.

The term "tax mitigation" could be used to cover uncontroversial tax planning and ordinary tax planning.

Tax avoidance Something legal but contrary to the intention of parliament in the sense that had parliament thought about it, it would probably prevent the tax advantage. An example is the transfer of assets to a non-resident company where the transferor has power to enjoy.

Other possible examples are:

(1) The scheme in *Furniss v Dawson*.
(2) Temporary non-residence (if tax-driven).

However one might place these at the upper reaches of the ordinary tax planning spectrum.

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20 In the debate on the Budget 2012, some said that giving more than £50k or 25% of income was excessive.

21 These are the examples which David Cameron called "sensible tax planning" in the quote at the start of this chapter.

Tax abuse Tax avoidance with aggravating features (typically, self-cancelling steps) that make it (more) unreasonable.[22] It is easy to find clear examples: take the schemes in: *Ramsay*, *Fitzwilliam*, *Astall* and *Mayes*.

Thus this terminology raises three distinctions:
(1) Uncontroversial/ordinary tax planning
(2) Tax planning/avoidance
(3) Tax avoidance/ abuse

Before considering whether these distinctions have, or should have, different consequences, it is important to note the two difficulties which they entail:

(1) *The demarcation problem* Except at the extreme ends of the spectrum, the demarcation problem is intractable: the classification of specific examples (if it actually had to be decided) would give rise to endless disagreement (and has done so in the context of tax motive defences). There are two reasons for this:
   (a) The distinctions rely on:
      (i) imponderable hypothetical questions (what would Parliament have done if it had noticed the issue?)
      (ii) vague constructs ("the intention of parliament" and "the spirit of the legislation")
      (iii) identifying tax policy (there may be no clear policy, or it can fluctuate).
   (b) The four distinct categories attempt to impose an order on tax motivated behaviour which exhibits a scale of unreasonableness, without clear divisions. (It might be better to mark out a sliding scale from 1 to 10, recognising finer distinctions, but that would not help for practical purposes.)
(2) *The knowledge problem* Except for the extreme end of the spectrum, (a small part of the total field) a serious discussion of where any particular arrangement should be classified, or graded, can only be carried out by someone who understands the tax background. Few non-practitioners have that understanding. Journalists in the UK do not arrange for their work to be reviewed by someone who understands tax. Politicians are characterised by grandstanding and soundbites.

22 The word sometimes used is "egregious" or "aggressive". That does not clarify anything but it neatly expresses the point.

> Pressure groups grind their axes. If discussing particular taxpayers, one would need to know the facts, which are not usually in the public domain. So public debate is not well-informed. It is a yeasty mingling of dimly understood facts with vague but deep impressions, and images, half real, half fantastic.

2.2.3 *Significance and recognition of these distinctions*

The distinctions I have drawn are not easy, but they are the best that can be achieved.

The ordinary tax planning/tax avoidance dividing line is established in tax law: it marks the point at which tax motive defences begin to bite.

The tax avoidance/tax abuse distinction is new to tax law, but it marks the point at which the GAAR is intended to bite:

> The Government agrees with the Report's recommendation to introduce a rule which is targeted at artificial and abusive arrangements (those that the Report refers to as "egregious", "very aggressive" or "highly abusive contrived and artificial"). It accepts the Report's conclusion that introducing a "broad spectrum" general anti-avoidance rule would not be beneficial for the UK tax system. ... the GAAR should not affect what the Report describes as "the centre ground of tax planning".[23]

There has not been much judicial discussion (the issue has not arisen for decision) but a passage in *Furniss v Dawson* recognises something like a tax avoidance/abuse distinction:

> The scheme [in *Furniss*] has none of the extravagances of certain tax avoidance schemes which have recently engaged the attention of the courts, where the taxpayer who has been fortunate enough to realise a capital profit has gone out into the street and, with the aid of astute advisers, manufactured out of a string of artificial transactions a supposed loss in order to counteract the profit which he has already made. The scheme before your Lordships is a simple and honest scheme which merely seeks to defer payment of tax until the taxpayer has received into his hands the gain which he has made.[24]

The uncontroversial/ordinary tax planning distinction is not relevant in tax law, but it is relevant to the public debate on morality.

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23 HMRC Consultation document "A General Anti-Abuse Rule" (2012) para 2.1.

24 [1984] AC 474 at p.518.

2.3 Views on morality of tax avoidance

This is intended to be a practical book. But the issue of the morality of tax avoidance (and, importantly, an assessment of what views are held as to morality) does have a practical aspect: it affects judicial attitudes and decisions; it is the main motivator for the enactment of the GAAR and will play an important role in its interpretation.

2.3.1 *Some judges views*

Older cases do not appear hostile to tax avoidance. In 1900:

> Bundey J. recognises to the full both the legal *and the moral* right of every man to dispose of his property if he can in a way which does not expose it to be taxed under the existing system of taxation.[25]

In 1965:

> The fact that a settlement is drawn with a view to avoiding particular charging provisions is *neither reprehensible, nor* a proper ground for inclination to a conclusion that it ought to come within those or some other charging provisions. ... If any moral criticism could be levelled at them, then the consciences of the judges of the Chancery Division, in the exercise of their discretionary jurisdiction under the Variation of Trusts Act, 1958, would be in a sorry state.[26]

Lord Diplock expressed the traditional view in 1964:

> Tax law no more lies within the field of morals than does a crossword puzzle.[27]

Likewise in 1982:

> the fact that the purpose of the scheme was tax avoidance does not carry any implication that it was in any way reprehensible or other than perfectly honest *and respectable*.[28]

The same view has been expressed in Australia in 1995:

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25 *Simms v Registrar of Probates* [1900] AC 323 at p.333.

26 *Re Kirkwood* [1965] Ch 286 at p.327.

27 Diplock, "The Courts as Legislators" Address to The Holdsworth Club 1965 accessible *http://www.kessler.co.uk/tfd-archive*.

28 *IRC v Burmah Oil* 54 TC 200 at p.220; followed in 1988 in *Craven v White* 62 TC 1 at p.196.

> The obligation to pay [income tax] is a legal one. Some politicians try to treat it as a moral obligation. But it is not. The citizen is bound to pay no more tax than the statute requires him to pay according to the relevant state of his affairs.
>
> Consistently with this view, it has long been a principle of the law of income taxation that the citizen may so arrange his affairs as to render him less liable to pay tax than would be the case if his affairs were cast in some different form. In the language of the layman, the citizen is entitled to minimise his liability to pay tax. This is sometimes expressed as a right to avoid tax...[29]

The following points can be made in favour of the traditional view.

(1) *The nature of the tax system* The tax system is full of anomalies, artificial, arbitrary, and not based on any consistent principles. That suggests that there is no "right" amount of tax except in the sense of what is due by statute.

(2) *HMRC practice* When the boot is on the other foot, HMRC take advantage of anomalies in their favour. The unfortunate Mr Lobler fell into the trap[30] of a partial surrender of life policies:

> Mr. Lobler invested some US $1.4 million in a series of life assurance policies with Zurich Life on 1 March 2006 and within the next two years withdrew $1.4 million from the policies leaving the policies with comparatively negligible value. The form in which he made the withdrawal was by a partial surrender of each policy. As a result of the tax legislation in Chapter 9 Part 4 ITTOIA... he is treated as having in those years realised taxable income of some $1.3 million. He becomes liable to pay some $560,000 in tax. He made no profit or gain as that term is commonly or commercially understood and yet he becomes liable to pay tax which exhausts his life savings and may bankrupt him. That is an outrageously unfair result....
>
> This is legislation which does not seek to tax real or commercial gains. Thus it makes no sense to say that the legislation must be construed to apply to transactions by reference to their commercial substance….No overriding principle can be extracted from the legislation....
>
> Thus with heavy hearts we dismiss the appeal.[31]

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29 Sir Garfield Barwick, *A Radical Tory* (1995) at p.229.

30 See 33.1 (Policies – Introduction).

31 *Lobler v HMRC* [2013] UKFTT 141 (TC); see Firth, "Sauce for the Goose" Taxation, 4 April 2013.

This is the point made in one of the best known dicta in the whole of taxation:

> No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow - and quite rightly - to take every advantage which is open to it under the taxing Statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is in like manner entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue.[32]

HMRC say that this has changed:

> [The above quote] epitomises the approach which Parliament has rejected in enacting the GAAR legislation. Taxation is not to be treated as a game[33] where taxpayers can indulge in any ingenious scheme in order to eliminate or reduce their tax liability.[34]

At the abuse end of the spectrum the GAAR now applies. so the rules have indeed changed. But I am not sure why it should be said that anything else has changed. *Ayshire* itself was not an abuse case (the issue was whether the taxpayer's children had entered into a valid partnership) and the result would not have been affected by the GAAR. More fundamentally, it continues to be the case that HMRC take advantage of any rules or anomalies in their favour.

(3) *Difficulty of applying moral principles* The view that taxation is governed by moral principles distinct from black letter tax law either:

(a) requires one to enter into the intractable distinction of tax avoidance/abuse; or

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32 *Ayrshire Pullman Motor Services v IRC* 14 TC 754 at p.763.

33 The game metaphor begs an essay to itself. What, in fact, is a game? It is an elastic concept which can be analogised in different ways. What is it in the notion of game which the guidance seeks to identify as significantly different from tax? Is it a notion of non-seriousness? Or an adversarial approach? Or a notion of a rule based activity? or arbitrary rules? In the latter three respects, tax law and general law very much resemble games. These problems suggest that it would help clarity of thinking not to use the word "game": a stale and failed metaphor.
See Midgley, *Heart and Mind* (1981) chapter 8 (The game game).

34 HMRC, "GAAR Guidance" (2013) *http://www.hmrc.gov.uk/avoidance/gaar-part-abc.pdf.*

(b) spreads the net very wide, far wider than any practitioner is likely to accept (and still requires one to enter into the intractable distinction of uncontroversial/ordinary tax planning).

In practice, public debate does not engage with the relevant black letter law and it is difficult to envisage that it ever would, or could. Ethics is a practical subject. If standards are so vague, or so difficult to apply in actual cases, that we cannot see how we could act on them, we become sceptical. That suggests that morality has little if any role to play.

(4) *Tax avoidance sometimes leads to a fair result* There are cases where tax avoidance mitigates unfairness of tax rules. Parliament sometimes admits this by enacting a new relief to allow directly what had previously been achieved by avoidance. Examples are:

(a) Nil rate band discretionary trusts, which allow transferrable nil rate bands before the relief was enacted in 2007.

(b) CGT group relief to obtain loss relief. A company about to realise a gain on an asset would transfer it to a group company that had realised an allowable loss. Alternatively, a company which had realised a gain might acquire from a group company an asset which was to be sold at a loss. That would allow the loss to be set against the gain.

Offshore trusts can mitigate the deleterious lock-in effect of CGT by deferring tax until the profits are received.

2.3.2 *More modern views*

In earlier times there was plenty of tax avoidance but little (if any) activity in the category of tax abuse. When that changed, I think in the 1970's, attitudes changed too. By 2007:

> For many directors, the objection to arrangements that are in their view 'too' artificial may be framed largely in terms of business ethics. Other directors, equally determined to behave in an ethical way, may consider that the degree of artificiality is not an ethical issue provided no attempt is made to misrepresent the facts or to hide them from the tax authorities....
>
> At one time such a view would perhaps have been more widely held than now. At the present time it represents one end of a range of views in a debate where probably most commentators would hold that within the compass of what is legal there is some behaviour that is acceptable and some that is not. What they differ on is precisely where the line between the two is to be drawn and, perhaps more importantly, what criteria are

> to be used to determine the distinction.[35]

In 2011, Aaronson's GAAR study reported (with only a small element of exaggeration):

> There was unanimous disapproval, indeed distaste, for egregious tax avoidance schemes.[36]

Tax practitioners are mostly drawn to the view that opprobrium should only attach at the top end of the scale, in cases of tax abuse; or if any opprobrium attaches to tax motivated behaviours lower down the scale, the amount of opprobrium should vary according to the scale.

This would be consistent with Lord Templeman's views in tax abuse cases, which were expressed trenchantly (some would say, stridently):

> In common with my predecessors I regard tax-avoidance schemes *of the kind invented and implemented in the present case* as no better than attempts to cheat the Revenue.[37]

2.3.3 *Views outside the tax profession*

Outside the tax profession, the line is drawn not at the avoidance/abuse level, but at the uncontroversial/ordinary tax planning level. That is, some quite ordinary tax planning has come under fire. One might dismiss those views as unworthy of consideration. I restrict the following examples to those whose views must carry some weight.

Deferring bonuses to 2013/14 in order to take advantage of the reduction in IT rates: Practitioner-readers are likely to agree that this is ordinary tax planning near the bottom end of the scale. But Mervyn King, then Governor of the Bank of England, is reported to have criticised Goldman Sachs for it.[38] The House of Lords select committee concluded that the GAAR will not apply to the deferral of bonuses from one tax year to

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35 David Williams "Developing the Concept of Tax Governance" (February 2007) *http://www.kpmg.co.uk/pubs/Tax_and_CSR_Final.pdf*

36 Aaronson, *GAAR Study* (2011) *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.pdf*

37 *IRC v. Fitzwilliam* 67 TC 614 at p.756. Lord Templeman's claim that his attitude is in common with his predecessors is untenable.

38 Financial Times, 15 Jan 2013. King is co-author of the excellent *The British Tax System* (1990).

another,[39] but one might infer that they disapproved none the less for that.

The Bump Plan In September 2013 a minor political furore arose after David Heaton was secretly filmed suggesting bonus payments to pregnant employees; if made during the relevant period it would increase the amount of statutory maternity pay.[40] I do not think practitioners would regard that as on the abusive side of the line (though there are many points which need to be made to properly understand the legal and moral analysis, none of were heard in the public debate).[41] The point was not just political hot air: Heaton had to resign from the GAAR panel following criticism from David Gauke (Exchequer Secretary to the Treasury).

Income sharing with a spouse I think practitioners were surprised that HMRC found this unacceptable in their (ultimately unsuccessful) attack in *Jones v Garnett*. But exactly the same planning has been criticised in India:

> While tax evasion is universally condemned, there is a disposition in certain quarters to regard tax avoidance as a permissible course of action. We are unable to endorse this view. The mere fact that the income-tax law is not violated does not mean that the procedure which results in tax avoidance is justified. We might take as an illustration the act of introducing, without adequate consideration, one's wife ... as partner in a business of which the assessee himself is a partner. It is an attempt to fraction income and reduce tax liability under a provision of law meant to apply to genuine partnerships. Conduct of this nature, though legal, cannot but be regarded as anti-social.[42]

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39 Select Committee on Economic Affairs Report on The Draft Finance Bill 2013 *http://www.publications.parliament.uk/pa/ld201213/ldselect/ldeconaf/139/139.pdf* The Select Committee said this was because that "the issue is one concerning the structure of the tax system rather than avoidance involving manipulation of loopholes in the legislation." It would be more accurate to say the reason is that these are not examples of tax abuse (in my terminology).

40 *https://www.youtube.com/watch?v=9rFuhC2ZSEM*

41 In particular: (1) This planning does not give rise to a tax advantage, but to a benefit advantage for the employer; it could not be counteracted by the GAAR. (2) Not every payment to an employee is earnings so it is possible for planning of this kind to fail on the facts. (3) The privacy aspects of secret filming, and the ease with which short clips misrepresent nuanced positions, seem particularly worrying.
For the background, see Johnson, "Tax, Lies and Hypocrisy" (CCH Tax News , Issue 133 25 September 2013); for the law, see the Statutory Maternity Pay (General) Regulations 1986.

42 Government of India Report of the Taxation Enquiry Commission 1953-54 Vol II para 5.

Gift of company to political party A donor who owns a suitable company might arrange that:
(1) The donor gives the company to the political party.
(2) The political party extracts the funds by way of dividend.
The gift at stage (1) qualifies for CGT hold-over relief; and the distribution at stage (2) would not be taxable assuming the party is a company for tax purposes.

It seems that Labour arranged this in 2013, giving rise to a fit of indignation, or purported indignation, from the Conservatives. An open letter from George Osborne to Ed Milliband provided:

> Dear Ed,
> You said in April last year that 'tax avoidance is a terrible thing'. ...
> Yet ... the Labour Party has gone to great lengths to help your biggest donor, ... avoid paying tax on a political donation. ...
> The Labour Party registered a donation of shares in JML worth £1.65 million in January 2013, from Mr John Mills. By making a donation in shares rather than as a single cash dividend, it has been reported that Mr Mills managed to avoid a potential tax charge of £724,710. ...
> As leader of the Labour Party, and given your previous statements on tax avoidance, such actions by your party appear to be directly at odds with your public statements.
> Most importantly, will you now pass the amount of tax that has been avoided to the Exchequer? As you say, this is money that is needed to fund vital public services such as the health service and our schools.
> Yours sincerely,
> George Osborne[43]

What is one to make of this? I think any practitioner, or anyone who understood the tax background, would regard this as in the category of "sensible tax planning" or, perhaps, ordinary tax planning; in either case, well short of avoidance and opprobrium. The letter could be seen as just an example of debased or meaningless political debate, whose object is just to knock the opposition. It could be taken as a case where ordinary tax planning is regarded as immoral. However, it may be regarded as an illustration of the difficulties which arise if one regards taxation as governed by moral principles distinct from black letter tax law. The letter

43 6 June 2013 accessible *http://www.politicshome.com/uk/article/79622/george_osborne_letter_to_ed_miliband_over_donors_taxes.html*

might then be regarded as a rather subtle and well aimed contribution to the political/moral debate. Perhaps there are elements of each of these.

2.4 The rule of law

"The rule of law" is a slogan for a set of standards, the content of which is contested, and discussion of which needs a book to itself. The OUCBT paper provides a summary of the requirements of the rule of law, in relation to taxation:

> Subject to some exceptions, the rule of law requires that taxpayers are able to determine the tax consequences of their actions in advance. This can only be done through legislation and not vague notions of fairness. Also ... the imposition of tax on citizens is the monopoly of Parliament.[44] Tax in the UK must be imposed by Parliament through legislation.

In formulating a response to the problem of tax avoidance, one needs to consider whether cure is worse than the disease. In *Ransom v Higgs* Lord Simon said:

> Disagreeable as it may seem that some taxpayers should escape what might appear to be their fair share of the general burden of national expenditure, it would be far more disagreeable to substitute the rule of caprice for that of law.[45]

In the 6th edition (2007) and earlier editions of this book, I said:

> The UK tax system is largely[46] based on the rule of law rather than informal practice and discretion.

To the extent this is true it is something to boast of,[47] and a feature which makes the UK an attractive choice for anyone choosing where to reside.

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44 [Footnote original] Article 4 of the Bill of Rights 1688 provides: "That levying Money for or to the Use of the Crown by pretence of Prerogative without Grant of Parliament for longer time or in other manner than the same is or shall be granted is illegal." 1 Will. And Mar. Sess. 2, c.2. Art. 4. See also *MacNiven v Westmoreland* [2001] STC 237, at [29] per Lord Hoffmann and *Collector of Stamp Revenue v. Arrowtown Assets Ltd* [2003] HKFCA 46 at [105] per Lord Millett.

45 50 TC 1 at p.94.

46 But see 10.23 (Forward tax agreements).

47 The boast is an old one: Blackstone's Commentaries on the Laws of England (1765) vol 2 chap 37 provides: "a country like this, which boasts of being governed in all respects by law and not by will..."; and contrast John Adams "A government of laws, and not of men" (1780).

By the 13th edition I qualified the boast:

> However, it is less the case than formerly, due to:
> (1) wide, complex, or vague anti-avoidance provisions mitigated by informal practice, HMRC guidance, HMRC discretion or oversight.[48]
> (2) an increasing use of retrospective legislation.[49]

The City of London Law Society say:

> 2.4 We have a broad concern, applicable to all taxes, that tax policymakers are insufficiently conscious of the importance of the rule of law – that is, the constitutional right of a citizen to determine the law applicable to him at any given date. Related to this is a similar problem of lack of respect for legislation as the only proper source of law, and over-reliance on guidance. Over-reliance on guidance is another serious problem. It is clear from the case of *Gray's Timber*[50] that a court will (indeed must) ignore any published guidance in forming its view of the law. This must be correct, as otherwise guidance would effectively have the force of statute despite not passing through Parliament. An extreme example of this problem was the draft Salaried Members legislation within the [2014] Finance Bill. Both law and policy in this field are underdeveloped (we would note the House of Lords' Economic Affairs Committee's recommendation that introduction be deferred for a year, which was regrettably ignored by the Government).
> 2.5 By way of example, the policy view as to whether "costs plus" remuneration – favoured by many fund managers, a business sector which it is express Government policy to attract to the UK – should be subject to employer's NIC under the new rules changed late in the day. This change was reflected not in law but in guidance – the legislation is sufficiently ambiguous that it can be read either way. This is not good enough. The measures themselves were inevitably unpopular with those businesses to which they potentially applied, but the protracted uncertainty created by the heavily-criticised process of their introduction in particular has materially damaged the UK's competitiveness in an area of the economy which the Government has identified as key...
> 2.7 Increasingly in new policy initiatives the taxpayer's right to appeal is being watered down. We would highlight in this context that there is no appeal against an HMRC determination that a bank has breached the

48 Examples include the POA rules (2004); restrictions on allowable losses (2007); the ITA remittance rules (2008); (4) the GAAR.

49 Examples include the IHT reforms (2006); the ITA remittance rules (2008).

50 *Gray's Timber v HMRC* 80 TC 96.

> Banking Code of Practice on Taxation. Similarly, under the current proposals relating to "follower notices", the taxpayer has no right of appeal against the issue of such a notice on a number of important grounds. This absence of a right to appeal lends to a denial of the right to have one's rights and duties determined by law, rather than official discretion. This should not be acceptable in a constitutional democracy, and it erodes confidence in the robustness of the UK's legal system.[51]

2.5 Relationship between morality and taxation

The OUCBT paper provides:

> Relying on the lack of "morality" of particular taxpayers to argue that a "fair share" of tax is not being paid is not helpful, for the simple reason that abstract concepts such as "fairness" cannot be used to determine a taxpayers' tax liability. This is not to say that morality is unimportant or irrelevant to how an individual behaves or a business operates, but simply that it cannot answer the question of how much tax is payable.

The topic of the relationship between morality and taxation should be seen as part of a wider discussion of the relationship between morality and law. Without entering into that contentious topic, it should generally be accepted that not everything which is immoral should be proscribed by law.

2.5.1 *Naming and shaming*

The OUCBT paper provides:

> ... searching for individual or corporate villains will not assist in remedying the underlying problems...
> Even if public naming and shaming influences a few taxpayers in the public eye to impose their own voluntary constraints, it will not necessarily affect the worst avoiders, and may even encourage some non-compliance from those who feel that "everyone is at it". Only understanding the flaws in the tax system and working on serious changes can give long-term results....
> We may well question whether the transfer pricing rules are adequate, or

51 Response to Office of Tax Simplification competitiveness review (May 2014) *http://www.citysolicitors.org.uk/attachments/article/105/20140605%20Response%20to%20Office%20of%20Tax%20Simplification%E2%80%99s%20'Competitiveness%20review%20-%20initial%20thoughts%20and%20call%20for%20evidence'.pdf*

> CFC rules are sufficient or appropriate, but these are considerations relating to tax policy reform and not to tax avoidance. They are not issues that can be remedied by pressure on a particular taxpayer to act in a different way. Even if that were to have an effect on one taxpayer it would not tackle the underlying issues.

Naming and shaming in public debate may quickly lead away from the rule of law. Starbucks paid £20m following the threat to occupy its cafes.[52] If one calls that payment "taxation" at all, it was certainly not taxation imposed by Parliament. A hostile commentator would call this taxation by mob rule. Google and Amazon, who do not have public premises vulnerable to the same threat, have paid nothing.

2.6 Avoidance by multinational companies

Much attention has been given to multinational companies (sensitive ears may detect elements of xenophobia). The Public Accounts Committee looked at Starbucks, Amazon and Google. The verdict was guilty.[53]

It is not possible to comment sensibly on the taxation of multi-national groups without knowing the relevant facts, which are not usually in the public domain.[54] The claim that these companies have avoided UK tax is usually based on the size of their UK sales or UK staff, set against the corporation tax actually paid. But all well-informed commentators know that corporation tax is not a tax on sales, or the size of an establishment. The OUCBT paper provides:

> Starbucks and Facebook ... have been criticized for not paying tax where they are making sales, but sales are not the basis for the corporation tax, so this alone is no cause for criticism of the companies concerned. We could argue that the tax base should change, but unless and until that

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52 Ironically, the post-tax cost of the payment would have been diminished as it should in principle be deductible in computing taxable profits.

53 Or was it? "We were not convinced that their actions, in using the letter of tax laws both nationally and internationally to immorally minimise their tax obligations, are defensible." Public Accounts Committee 19th report 2012, para 12. If the convoluted wording was intended to reflect a note of caution, it was lost in the public debate. But I think the obfuscation is just the dialect of politics.

The PAC returned to this theme in Ninth Report of Session 2013–14 "Tax Avoidance–Google". A PAC hearing is not, perhaps, well suited to ascertaining the facts; it is not possible to ascertain from this whether the complaint of the PAC is that Google have been conducting successful or unsuccessful tax avoidance.

54 See Maas, "Looking for Avoidance" Taxation, 28 February 2013.

> occurs, the fact that there is a high turnover but no taxable profit is not in itself an indicator that the taxpayer is behaving in an unreasonable way.

Likewise the fact that relatively little CT is paid proves nothing. The OUCBT paper provides:

> The fact that there is little or no tax payable is not, however, conclusive evidence that there is effective or ineffective avoidance. In some of these cases, these companies are simply operating in accordance with incentives created by the international tax system and by domestic governments trying to attract economic activity into their jurisdictions. This the governments may do for non-tax reasons, or because this activity gives rise to forms of taxes other than those which are not being collected. ...

HMRC make the same point:

> Globalisation means that multinationals have the opportunity to structure their business to take advantage of beneficial tax rules in different countries. Provided that this results in profits being taxed in line with where genuine economic activity is carried on, this does not amount to tax avoidance. Recent reforms to the UK's corporation tax system mean that the UK has an internationally-competitive corporate tax system, which is designed to attract and retain economic activity here which will be operating in the UK. In broad terms, companies are required to pay corporation tax in the country where they carry on the economic activity that generates their profits, not where their customers are located.[55]

The IFS say:

> A low corporate tax bill is not in itself therefore evidence of tax avoidance. Even if income appears high, there may be genuinely low UK taxable profits if a firm has relatively high current expenditures or can offset the effects of large investment expenditures or losses. The UK tax bill can also be appropriately relatively low compared with declared income if that income is the result of genuinely non-UK activities.

Unusually, the facts are known in relation to Apple as a result of US congressional hearings (I suspect, better conducted than the UK

55 HMRC, "Taxing the profits of multinational businesses" Issue Briefing, October 2012 *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/89030/profits-multinationals.pdf*

equivalent). These have been well analysed by Antony Ting.[56] In short, there is no reason to think that Apple have avoided *UK* tax. The group has avoided tax by Irish/US hybrid companies.

2.6.1 *Impact of the GAAR on international tax planning*

The GAAR guidance provides:

> B5.2 Many of the established rules of international taxation are set out in double taxation treaties. These cover, for example, the attribution of profits to branches or between group companies of multi-national enterprises, and the allocation of taxing rights to the different States where such enterprises operate. The mere fact that arrangements benefit from these rules does not mean that the arrangements amount to abuse, and so the GAAR cannot be applied to them. Accordingly, many cases of the sort which have generated a great deal of media and Parliamentary debate in the months leading up to the enactment of the GAAR cannot be dealt with by the GAAR.[57]

In my terminology, these issues are non-avoidance, and in some cases, tax avoidance, but not tax abuse. But where there is abuse, one country's domestic GAAR cannot resolve the issue. Apple's planning, for instance, turned on a hybrid entity, tax transparent in one jurisdiction and non-transparent in another. The planning was not contrary to the tax policy of either country; it was the result of the gap between the two.[58]

2.6.2 *OECD BEPS project*

It is thus an international problem which only international consensus can resolve.

The OECD has been tasked with doing something in response to the current debate on the taxation of multinational companies, and has produced an "Action Plan on Base Erosion and Profit Shifting".[59] It will be interesting to see what emerges. The difficulty of achieving international consensus is considerable:

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56 Ting, "iTax—Apple's International Tax Structure and the Double Non-Taxation Issue" [2014] BTR 40.

57 HMRC, "GAAR Guidance" (2013) *http://www.hmrc.gov.uk/avoidance/gaar-part-abc.pdf.* The House of Lords Select Committee made the same point

58 See de Boer & Nouwen (eds) *The EU's struglgle with Mismatches and Aggressive Tax Planning* (2013) para 3.5.2 (General anti-abuse rule).

59 (July 2013) *http://www.oecd.org/ctp/BEPSActionPlan.pdf*

> the OECD had a mandate from G-20, whose members include the BRICS countries, which often disagree with OECD tax policies; the United States, which often goes its own way; and from European finance ministers … who generally don't agree on anything but agree on the need for change ...[60]

60 Ault, "Some Reflections on the OECD and the Sources of International Tax Principles" (2013) 70(12) Tax Notes International 1195.

CHAPTER THREE

DOMICILE

3.1 Domicile: Introduction

Domicile is important for many tax purposes, in particular:
(1) The remittance basis for IT and CGT.
(2) IHT on foreign situate assets.
Domicile is also important for many non-tax purposes including aspects of family law, civil jurisdiction and succession law.

3.1.1 *Cross references and further reading*

The following matters are considered elsewhere:
61.1 (IHT Deemed domicile)
69.3 (Interpretation)
4.1 (Residence & domicile of MPs and members of House of Lords).
The RDR Manual has lengthy guidance. For discussion of the general law of domicile, see Dicey, Morris & Collins, *Conflict of Laws*, (15th edition, 2012) ("*Dicey*"); "Mr Dicey's celebrated work"[1] is the one that HMRC and the courts most often cite. For an important reminder of the need for legal realism in this area, see Fawcett, "Result Selection in Domicile Cases" (1985) OJLS vol 5 p.378.[2]

3.2 Accountants duty in relation to domicile

An advisor's duty depends on the terms of their retainer:

> There is no such thing as a general retainer ... The expression "my solicitor" is as meaningless as the expression "my tailor" or "my

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1 *IRC v Cohen* 21 TC 301 at p.309.

2 Concluding that the policy of not allowing individuals with a UK domicile of origin to escape UK taxes is influential in determining the result in tax appeals. Accessible *http://www.ojls.oxfordjournals.org/content/5/3/378.full.pdf*.

> bookmaker" in establishing any general duty apart from that arising out of a particular matter in which his services are retained. The extent of his duties depends upon the terms and limits of that retainer and any duty of care to be implied must be related to what he is instructed to do.[3]

In *Mehjoo v Harben Barker* the judge held that a generalist accountant should:

(1) Raise the topic of domicile with their client, if aware that the client was originally from outside the UK.
(2) Be aware that "non-dom was a favoured status (to be cherished) which brought with it tax advantages... that there was some sort of opportunity there." The opportunity was a bearer share scheme.[4]
(3) Advise the client to take further advice from a non-dom expert.[5]

But the Court of Appeal took a more limited view of the scope of the accountant's retainer:

> 56. The reasonably competent accountant setting out to advise Mr Mehjoo of the tax consequences of the sale would not, in my view, have been under any obligation to raise for discussion the claimant's domicile unless it was relevant to the CGT liability on the disposal. The accountant would have known that it gave Mr Mehjoo no tax advantages in relation to the sale of the [UK registered] shares unless the situs of the shares could be changed. As this was something which [the accountants] neither knew or could have been expected to know was achievable, there was no reason to mention the matter still less a liability in negligence for not having done so...
>
> 59. I take the same view in respect of the claim that [the accountant] should have told Mr Mehjoo that his probable non-dom status carried with it significant tax advantages. Again, these were not advantages which were available to the claimant on the sale of UK registered shares and, in the absence of any claim that [the accountants] should have known and advised Mr Mehjoo that it would or might be possible to

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3 *Midland Bank Trust Co v Hett Stubbs & Kent* [1979] Ch 384 at p.402.

4 There is still scope for IHT planning, and for CGT planning if advice is taken at the time the company to be sold is set up (rather than at the time of disposal): see 83.24 (CGT planning: making UK situate property non-UK situate).

5 [2013] EWHC 1669 (QB) at [183] - [189]. The judge said, correctly, that it is not time-consuming or difficult for a generalist to recommend taking specialist advice. In that case, £800k CGT was at stake; the damages came to £1.2m and the claimant's costs were over £5m. The cost of consulting a specialist (in 2004) was said to be £500 (presumably the cost of an initial enquiry rather than detailed advice).

> change the situs of the shares without triggering a charge to CGT in the process, it is difficult to understand why they were under any legal duty to bring the existence of "very significant tax advantages" to the claimant's attention. The competent accountant would not have believed that they existed.[6]

3.3 The concept of domicile

Domicile is a concept of private international law. The rules are laid down by common law, but modified by statute. These rules apply for tax purposes except so far as modified by tax law.

Scots domicile law is (more or less)[7] the same as English law, and indeed the leading case of *Udny v Udny* is a Scottish case. Northern Ireland domicile law is the same as English law.

"Domicile" has a technical meaning in UK law and should not be confused with:

(1) "Domicile" in civil law jurisdictions.[8]
(2) "Domicile" in EU regulations and international treaties (where a definition generally overrides the UK law sense of domicile).
(3) "Domicile" in ordinary English usage.[9]

On the spelling, Garner states that the word "is spelt both with and without the final *-e* but the better and more common spelling is with it".[10]

Everyone has one and only one domicile. The expression "**non-domiciled**" is in a literal sense inapt, because everyone is domiciled somewhere. It is, however, an acceptable and convenient abbreviation (in context) for non-UK domiciled (just as "non-resident" in context means non-UK resident). I have in the past regarded the abbreviation "non-dom" as slang, but in keeping with the Zeitgeist, the informal but irresistible monosyllables have found their way into the statute book: the FA 2013 uses the heading *Remittance basis restricted to non-doms*.

A person must be domiciled in a single legal jurisdiction. The

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6 [2014] EWCA Civ 358.

7 See 3.14 (Child's domicile of dependency).

8 Article 102 of the French Civil Code provides: "Le domicile de tout Francais est au lieu où il a son principal établissement" (The *domicile* of a French person is where he has his main establishment).

9 e.g. in the lines from Walt Disney's *Lady and the Tramp*:
"Now we lookin' over our new domicile
If we like we stay for maybe quite a while"(!)

10 Garner, *Dictionary of Legal Usage* (3rd ed., 2011) entry under *Domicile*.

expression "**UK domiciled**" is in a literal sense inapt because a person must be domiciled in England, Scotland or Northern Ireland. It is, however, universally used to describe someone who is domiciled in England, Scotland or Northern Ireland.[11] For tax purposes it makes no difference where in the UK one is domiciled, though for non-tax purposes that may be important.

3.4 Domicile of origin

Dicey states:

> (1) Every person receives at birth a domicile of origin:
>
> (a) A legitimate child born during the lifetime of his father has his domicile of origin in the country in which his father was domiciled at the time of his birth;
>
> (b) A legitimate child not born during the lifetime of his father, or an illegitimate child, has his domicile of origin in the country in which his mother was domiciled at the time of his birth; ...[12]

This rule embodies gender assumptions which reflect the time of its origin. This is also one of the few areas of English law where legitimacy still matters. The position in Scotland has been revised and avoids the sex and marital status discrimination.[13] I expect English law will eventually follow.

Dicey continues:

> (2) A domicile of origin may be changed as a result of adoption or by issue of a parental order under the Human Fertilisation and Embryology Act 2008, but not otherwise.[14]

3.5 Domicile of choice

Dicey states:

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11 Section 721(3) ITEPA (somewhat pedantically) states this expressly:
"Any reference in this Act to being domiciled in the UK is to be read as a reference to being domiciled in any part of the UK."
The tax law rewrite team must have realised this was unnecessary as (quite correctly) they did not put an equivalent clause in any subsequent rewrite legislation. Section 721(3) ought to be repealed as otiose.

12 Dicey, Morris & Collins, *Conflict of Laws* (15th ed., 2012), para 6R-025.

13 See 3.14 (Child's domicile of dependency).

14 Dicey, Morris & Collins, *Conflict of Laws* (15th ed.., 2012), para 6R-025.

> Every independent person can acquire a domicile of choice by the combination of residence and intention of permanent or indefinite residence, but not otherwise.[15]

I shall consider "residence" and "intention" separately.

3.5.1 *"Residence"*

"Residence" here means "residence as an inhabitant" which is something more than "presence as a traveller".[16] This is not necessarily the same as residence for tax purposes. In practice it will usually come to the same thing, since tax residence (before and after the SRT) is supposed to represent the ordinary meaning of the word residence. So far as possible it would be best to avoid having two concepts of residence, one for tax and one for domicile. But there are some differences:

(1) For domicile purposes one becomes resident on a particular date, whereas for tax purposes one becomes UK resident for a tax year.

(2) Assuming a person resides as an inhabitant, there is no minimum period of residence required: residence commences immediately on arrival if the intention is to stay.[17]

A peripatetic person whose chief home is in the UK may acquire a UK domicile of choice, even though they do not spend sufficient days here to become UK resident under the statutory residence test (which will often

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15 Dicey, Morris & Collins, *Conflict of Laws* (15th ed., 2012), para 6R-033.

16 In the case of acquisition of a domicile of choice, the precise definition of residence is never a real issue, because a person acquiring a domicile of choice in a country must *ex hypothesi* have the intention to reside there permanently; so if they are present in the country at all, they must be "resident as an inhabitant" and not "present as a traveller". But the definition of residence is important for abandonment of domicile of choice.

17 *Fasbender v AG* [1922] 2 Ch 850 at p.857-8: "I have great doubts whether her domicile at the time of the marriage was English. She had left England, and become resident in Germany at the time, though she had only been there a few days. She had done so with the intention of being married to a German resident in Germany, and of continuing to reside there with him after marriage, and I think this is, at any rate, evidence that she had adopted a German domicile." Likewise *Bell v Kennedy* (1868) LR 1 Sc & Div 307 at p.320: "Now this case was argued at the Bar on the footing, that as soon as Mr. Bell left Jamaica he had a settled and fixed intention of taking up his residence in Scotland. And if, indeed, that had been ascertained as a fact, then you would have had the *animus* of the party clearly demonstrated, and the *factum*, which alone would remain to be proved, would in fact be proved, or, at least, would result immediately upon his arrival in Scotland."

allow a foreigner as much as 119 UK days each year without regarding them as UK resident).

3.5.2 *"Permanent or indefinite" residence*

"Permanent" residence is straightforward but the concept of "indefinite" residence needs comment.

"Indefinite" (in short) requires that the individual intends to reside in a country "until the end of his days". It seems to me that "indefinite" is an unfortunate word to use because in its normal sense it is used to describe any period whose duration is not known exactly, even a short period. For instance the duration of a strike is indefinite;[18] so is the duration of a contract of employment. That is not the meaning here. However there is no single English word which neatly encapsulates the intended meaning. "Unlimited" is sometimes used and is more apt, but this too needs clarification. *IRC v Bullock* 51 TC 522 commented on the classic statement that a domicile of choice is acquired when:

> a man fixes voluntarily his sole or chief residence in a particular place with an intention of continuing to reside there for an *unlimited* time.[19]

Buckley LJ said at p.540:

> I accept that statement ... with this qualification only that the expression "unlimited time" requires some further definition. A man might remove to another country because he had obtained employment there without knowing how long that employment would continue but without intending to reside there after he ceased to be employed. His prospective residence in a foreign country would be indefinite but would not be unlimited in the relevant sense. On the other hand, ... I do not think that it is necessary to show that the intention to make a home in the new country is irrevocable or that the person whose intention is

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18 This is self-evident, but if authority is needed, see *Howard E. Perry v. British Railways Board* [1980] 1 WLR 1375 at p.1380 which described the period of a strike as "clearly ... indefinite. It may be short, or it may be long; but it is plainly uncertain." The Law Commission made the same point in *The Law of Domicile* (1987) Law Com 186 accessible *http://www.scotlawcom.gov.uk/download_file/view/228/* para 5.12: "'Indefinitely' by itself is insufficient: it could, on one view, cover an intention to live in a country for a short time for some temporary purpose, for example a short holiday of indefinite duration."

19 *Udny v Udny* (1869) LR 1 Sc & Div App 441 at p.458. (Emphasis added.)

> under consideration believes that for reasons of health or otherwise he will have no opportunity to change his mind.

And crucially:

> In my judgment, the true test is whether he intends to make his home in the new country until the end of his days unless and until something happens to make him change his mind.[20]

The requirement to intend to reside somewhere "indefinitely" is very strict. In *IRC v Bullock* 51 TC 522 the taxpayer resided in England for 40 years but hoped to return home to Nova Scotia (to which his wife objected) should he survive her or persuade her to change her mind. This contingency had sufficient substance to represent a real determination to return home rather than a vague hope or aspiration. Mr Bullock did not acquire a UK domicile of choice but retained his domicile of origin.[21]

This may be contrasted with *Furse v IRC* where the taxpayer intended to live in England for the rest of his life except that he would return to America in the event that he were to become physically incapable of taking an active interest in his farm. This was held to be too insubstantial:

> That contingency is altogether indefinite. It has no precision at all. A man's idea of an active physical life is likely to contract with the years. At the age of 80, after 40 years in England, the testator was still living at West Hoathly and, although he had been ill, he had no firm plans at all for leaving England.
>
> The testator's expressed intention, it seems to me, depended entirely on his own assessment of whether an ill-defined event had occurred. I think it really amounted to no more than saying, 'I will leave England when I feel I want to leave England'. That is substantially the same as Buckley LJ's example of the man who says he will leave 'when I've had enough of it'.[22]

Accordingly Mr Furse acquired a domicile of choice in England. Again:

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20 This test was reaffirmed in *Barlow Clowes International v Henwood* [2008] EWCA Civ 577 at [10] to [15].

21 There are many examples of long periods of UK residence without acquiring a UK domicile: *Buswell v IRC* 49 TC 334; *Cyganik v Agulian* [2006] ITELR 762; *Ramsay v Liverpool Royal Infirmary* [1930] AC 588 (36 years); *Winans v AG* [1904] AC 287 (37 years).

22 [1980] STC 596 at p.604.

> If a man intends to return to the land of his birth upon a clearly foreseen and reasonably anticipated contingency, e.g., the end of his job, the intention required by law [to acquire a domicile of choice] is lacking; but, if he has in mind only a vague possibility, such as making a fortune (a modern example might be winning a football pool), or some sentiment about dying in the land of his fathers, such a state of mind is consistent with the intention required by law.[23]

3.5.3 *Tax and intention*

Tax may be relevant to intention. For instance if a Swedish tax exile remains in the UK, intending to return home if and when Sweden's tax regime is relaxed, they would not acquire a domicile of choice here. Likewise if an individual intended to remain in the UK only so long as UK tax law continues to allow a remittance basis, they would not acquire a domicile of choice here.

In *Spence v Spence* an individual moved to Spain to avoid CGT. The CGT avoidance motive showed an intention to remain in Spain long enough to lose ordinary residence in the UK (then, some 3 years) but as far as intention to reside permanently was concerned, it was a neutral factor. It shed no light either way. It was argued that if the avoidance of a tax liability was a dominant factor in the move to Spain, this undermined the proposition that it should be inferred that the individual had from the start the intention of making his permanent home there. That was a non-sequitur, as the Judge rightly held:

> ... the mere fact that a person moves to another country in order to avoid liability to tax in the country of origin does not necessarily mean that he cannot or is unlikely to acquire thereby a domicile of choice in that other country. It is plainly a matter which depends upon the facts and circumstances of the particular case.[24]

The acquisition of a foreign domicile which is motivated by tax considerations alone is possible in theory but may be difficult in practice as the intention to live in the territory may prove to be insufficiently firm. Sir Charles Clore is an example:

> ... Sir Charles was ... unhappy in Monaco and often said that he would

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23 [1980] STC 596 at p.604.

24 [1995] SLT 335 at p.339.

> really like to return to England permanently and accept the tax consequences. [A witness] asked him why he had decided to go there when all his interests were elsewhere. Sir Charles said that he did not know and that he was thinking of changing his mind and returning to live in England... he did not feel at home in Monaco.[25]

On those facts the Court found that Clore did not acquire a domicile of choice in Monaco.

3.5.4 *Proof of intention*

In the event of a dispute the court must determine what is or was the individual's intention. In order to do so the court will have regard to every factor which might shed light on the individual's intention – except voting as an overseas elector.[26]

The burden of proof lies on HMRC to show that an individual has acquired a UK domicile of choice. The courts regard the acquisition of a domicile of choice as a serious matter which is to be found only on clear and compelling evidence.[27]

3.5.5 *Commentary: should acquisition of domicile of choice be reformed?*

The reason why the test of acquiring a domicile is so strict is in part a historical one:

> For centuries, people have gone into the world from this country intending ultimately to return and without any intention of severing their connection with the British legal system and the ideas underlying it. It would not be in harmony with the temper of the British people if those who happen to be living abroad had to be told that there was no method whereby they could continue to regulate their lives according to the familiar British conceptions. It should also be remembered that a country which does not apply nationality as a yardstick in matters of private international law is bound to substitute for it a strict test involving a measure of permanence.[28]

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25 *Re Clore (No. 2)* [1984] STC 609 at p.615.

26 See 3.6.1 (Involvement in politics).

27 But just how "clear and compelling" the evidence needs to be depends on the facts of the case in point: *Barlow Clowes International v Henwood* [2008] EWCA Civ 577 at [84] to [96].

28 First Report of the Private International Law Committee (1954) Cmd 9068, para 7; accessible *http://www.kessler.co.uk/tfd-archive*.

The fact that the rules were designed to accommodate the empire builders of the 19th century does not show that they are now unsuitable; but it is often said that they operate too strictly.

In 1954 the Private International Law Committee proposed that if an individual had his home in a country, he should be presumed to have acquired an intention to reside there permanently. A bill to that effect was introduced in 1958 but failed as a result of lobbying by UK resident foreign domiciled individuals. The government argued that the fears of foreign businessmen were groundless, as the reforms would effect them, but that was a damaging defence, as if the reforms did not have much effect, why were they worth making?[29]

A similar reform was proposed by the Law Commission in 1987.[30] The Government initially accepted the 1987 proposals but there was no change in the law. In 1996 the proposals were formally abandoned, probably for the same reason.[31]

Neither of these reforms were tax motivated. If they had any effect, it should have been broadly Revenue neutral, as to the extent that they may have made it easier to acquire a UK domicile of choice, they also made it easier to acquire a foreign domicile of choice. But they suffered from the problem of many tax reforms, that potential losers (UK resident foreign domiciliaries) complain more than potential winners.

In considering this reform one should bear in mind that "the importance of onus of proof is easily exaggerated. While the burden of proof always exists, few substantial cases turn upon it and in making their factual findings the judge is usually expressing their considered judgment as to

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29 The history of the controversy is recorded in Mann "The Domicile Bills"(1959) 8 ICLQ 457.

30 Law Com. No. 168 *The Law of Domicile*, accessible *http://www.scotlawcom.gov.uk/download_file/view/228/*

31 According to Hansard HC, 16 Jan 1996 Col 487:

> "The Government have decided not to take forward these reforms on the basis that, although they are desirable in themselves, they do not contain sufficient practical benefit to outweigh the risks of proceeding with them and to justify disturbing the present long established body of case law on this subject."

This was the right reason for the right decision. However, the true reason for the decision may well have been pressure of the foreign domicile lobby: see "Rules for Determining Domicile", Law Reform Commission of Hong Kong (2005) para 4.28 accessible *http://www.hkreform.gov.hk*.

what in truth occurred".[32] If that is right, the reform of amending the burden of proof in domicile cases would have little if any practical effect, at least as a matter of law. It might have a significant effect in practice, if it spurred HMRC to challenge foreign domicile claims more readily.

3.6 Retaining foreign domicile of origin while UK resident

Suppose an individual with a foreign domicile of origin comes to the UK and wishes to retain their foreign domicile. The concern is not to acquire a UK domicile of choice.

The primary advice to be given is clear: the individual may live in the UK as long as they wish from year to year but should not form the intention to settle here permanently. Unless they do so, the essential condition for the acquisition of a new domicile will not be satisfied.

However, the individual should not be content with this mental step unless their stay here is short or fixed term. They should also take appropriate steps to broadcast the absence of any intention of residing here permanently and to manifest an intention to return elsewhere in due course. This is important because the court will decide for itself the true intention of the individual and will be influenced by the way that the individual conducts their affairs while in the UK.

The individual should if possible retain ties with their country of origin. There are many ways to do so and they need not adopt them all. Possibilities for consideration include regular and extended visits home; local business interests, bank accounts and investments; membership of local social, political and religious organisations. The individual should make a will taking effect under local law.[33] The will should include a declaration that the individual intends to return home in due course or the circumstances in which that is to occur. The will might if appropriate express a desire to be buried in that country. The declaration should be drafted in accordance with the individual's specific circumstances; a standard form declaration of domicile is inadequate.[34]

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32 Bingham, "The Judge as Juror", *Current Legal Problems* (1985) p.2; reprinted in *The Business of Judging*, (2000) p.2 (good holiday reading).

33 A separate UK will may also be appropriate to deal with UK property.

34 For an example of a simple declaration rightly disregarded, see *Reddington v MacInnes* [2002] ScotCS 46 accessible *http://www.bailii.org*. (If those drafting the will had considered domicile more carefully, the litigation might have been avoided.) For precedents, see Kessler & Sartin, *Drafting Trusts & Will Trusts* (11th ed., 2012)

Conversely, the individual's social and business commitments in the UK should be minimised. The purchase of a home in this country might indicate a greater degree of permanence than rented accommodation, but purchasing a property may imply nothing more than an intention of medium-term residence. The development of other long-term commitments to the community, such as changing one's name (or its spelling) to accord with UK usage, are to be avoided.

The purchase of a burial plot provides some indication of an intention to be buried in that country. If that is the country of residence it might indicate an intention to remain in that country for the rest of the individual's life. If the burial plot is in the country of origin it provides some evidence of an intention to return home in due course. However, this is not necessarily a matter which carries much weight and if done at the suggestion of a tax advisor, it carries no weight at all.

The assembling of evidence of an intention to return to the country of origin, while obviously helpful, is not strictly necessary and in some cases will be unnecessary, maybe even inappropriate. The retention of the foreign domicile of origin is not dependent on establishing a positive intention to return home; rather, it is determined negatively by the absence of an intention to stay in the UK. An intention to move from the UK, whether to the country of origin or somewhere else, would be enough to enable the domicile of origin to be retained.

3.6.1 *Involvement in politics*

The general rule is that involvement in UK politics is compatible with a non-UK domicile though it is a factor to be taken into account in ascertaining domicile. However, MPs and members of the House of Lords are deemed UK resident and domiciled[35] and the position of other foreign domiciled politicians is politically fraught.[36]

The rule that (in short) non-resident and foreign domiciled individuals may not make gifts (above a nominal amount) to a political party[37] is a restriction on the rights of non-residents and foreign domiciliaries to

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para 18.26 (Best form of will for foreign domiciled testator).

35 See App 3.1 (Tax status of MPs and members of the House of Lords).

36 This has been the case at least since the 1920's where the peerage given to Lord Vestey (who had been a tax exile) gave rise to some debate: see "*Vestey: Royal Commission evidence and debate*" accessible *http://www.kessler.co.uk/tfd-archive*.

37 Section 54 Political Parties, Elections and Referendums Act 2000.

engage in UK politics.

On the other hand, registration and voting as an overseas elector[38] is (in short) ignored in a domicile tax appeal, unless the taxpayer wishes otherwise.[39] This rule was intended to encourage UK expatriates to vote without imperiling their claim to be non-UK domiciled. There is considerable force in the objection made at the time by Labour MP Mike O'Brien:

> Whereas the American colonies in 1774 cried, "No taxation without representation," it seems that ... overseas voters are now demanding representation without taxation... [Section 200] has all the hallmarks of a cynical amendment motivated by the self-interest of the Tory party. ... registration to vote shows a commitment to one's country. It can be evidence of domicile. In each case, that evidence will have a different weight, depending on the other circumstances of the individual, but it is right that registration should have some weight and show some degree of commitment to one's country.[40]

The rule ought to be repealed, but in the scrabble for political advantage it would be unrealistic to expect cool and impartial reflection, and it does not much matter.[41] Those who are concerned about possible UK domicile would still be best advised not to register or vote.

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38 This is an interesting corner of election law. Before 1985 non-residents could not vote in Parliamentary elections. The Representation of the People Act 1985 extended the franchise to "Overseas electors" who are (in short) non-resident British citizens who had registered, as voters when UK resident; they who may continue to vote until they have been non-resident for 15 years.
See House of Commons Library "Overseas Voters" (2013) SN05923
http://www.parliament.uk/business/publications/research/briefing-papers/SN05923/overseas-voters

39 See s.200 FA 1996; the section was (unhelpfully) rewritten for IT purposes in s.835B ITA 2007.

40 Hansard, HC Deb 27 March 1996 vol 274 cc1106-10.
http://www.publications.parliament.uk/pa/cm199596/cmhansrd/vo960327/debtext/60327-41.htm The subsequent election (1997) was the Blair landslide, and O'Brien was no doubt also right to question whether this provision helped the Tories.

41 There are over 5m overseas British citizens, but only 20,000 are overseas electors; it is open to question whether there has ever been a case where the rule makes any difference for tax purposes.
The US has a similar rule in s.106 [US] Uniformed and Overseas Citizens Absentee Voting Act 1986, but since the US taxes its non-resident citizens, its practical significance must be rather less.

3.7 Acquisition of foreign domicile of choice

The domicile rules are favourable to foreign domiciliaries since they may stay many years in this country without acquiring a UK domicile and becoming exposed to the concomitant tax burden. But the rules are correspondingly unfavourable to the individual who wishes to replace their UK domicile of origin by the acquisition of a foreign domicile of choice. Such a person must not only reside in that other country; they must hold and manifest their intention to remain resident there permanently.

An individual cannot shed their UK domicile of origin without acquiring a domicile of choice in another territory; it is not enough to intend to leave the UK permanently, never to return. The domicile of origin is not lost by abandonment but by replacement. Departure from the UK must therefore be accompanied by permanent residence in the chosen territory. If any time is spent in the UK, the UK must not be the chief residence

In order to acquire a domicile of choice in a jurisdiction, one must *want* to live there. If a UK domiciliary has plans of a business or personal nature which lead them to want to settle abroad, then acquiring a foreign domicile may be feasible. Links with the UK must be kept to a minimum, particularly at first, and the facts must be clear. Fawcett concluded in 1985 that an unspoken policy of not allowing individuals with a UK domicile of origin to escape UK tax was influential in determining the result in domicile tax cases[42] and subsequent cases suggest this is still true.[43]

3.8 Loss of domicile of choice

Dicey states:

> (1) A person abandons a domicile of choice in a country by ceasing to reside there and by ceasing to intend to reside there permanently or indefinitely, and not otherwise.

For the meaning of "reside" and "indefinitely" see 3.5 (Domicile of choice). Dicey continues:

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42 "Result Selection in Domicile Cases" (1985) OJLS vol 5 p.378. Accessible *http://www.ojls.oxfordjournals.org/content/5/3/378.full.pdf*.

43 Cases in which an apparently strong claim of a UK domiciliary to acquire a foreign domicile of choice failed include: *Portland; Plummer; Gaines-Cooper*.

(2) When a domicile of choice is abandoned, either
  (i) a new domicile of choice is acquired; or
  (ii) the domicile of origin revives.[44]

The concern of a person who has a UK domicile of origin but has acquired a foreign domicile of choice is that they may lose their domicile of choice. They must:
(1) maintain their residence in the country of domicile of choice; or
(2) maintain the intention to reside there permanently; or
(3) acquire a new foreign domicile of choice.

3.9 Dual residence and domicile

The tests of residence and intention to reside are straightforward if a person resides (and intends to reside) in only one country. What if the person resides (or intends to reside) in more than one country? Increased mobility makes this a greater problem than in the past.

3.9.1 *Acquisition of domicile of choice by dual resident*

In *Udny v Udny* Lord Westbury said that a domicile of choice is acquired when:

> a man fixes voluntarily his sole *or chief* residence in a particular place, with an intention of continuing to reside there for an unlimited time.[45]

If a person resides in a number of countries, it is considered that they acquire a domicile of choice in country A if and only if:
(1) country A is their chief residence; and
(2) their intention is permanently to reside in country A as their chief residence.

If a person has a secondary residence in a country (for example, a holiday home is used every summer or winter), they do not acquire a domicile in that country even if they intend to retain that residence indefinitely. But if they acquire (and intend to retain) a chief residence in a country they become domiciled there even if they retain a secondary residence elsewhere.

Plummer v IRC 60 TC 452 comments on the *Udny* dictum:

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44 Dicey, Morris & Collins, *Conflict of Laws* (15th ed.), para 6R-074.
45 (1869) LR 1 Sc & Div App 441 at p.458 (Emphasis added).

> ... a person who retains a residence in his domicile of origin can acquire a domicile of choice in a new country only if the residence established in that country is his chief residence. [Counsel for the taxpayer] submitted that a person whose presence in a new country is sufficient to amount to residence may, notwithstanding that his chief residence remains in his domicile of origin, acquire a domicile of choice by evincing an intention to continue to reside permanently in the new country. I think that this submission is inconsistent with the passage which I have quoted from Lord Westbury and which has always been treated as an authoritative statement of the circumstances in which a domicile of choice may be acquired.

This should not be controversial.[46]

3.9.2 *Loss of domicile of choice by dual resident*

The judge continued:

> Rule 13(1) of Dicey and Morris, if read literally, appears to go too far. This says that:
>
> > "A person abandons a domicile of choice in a country by ceasing to reside there and by ceasing to intend to reside there permanently or indefinitely, and not otherwise."
>
> These words might suggest that a domicile of choice (and presumably a fortiori a domicile of origin) cannot be lost unless the person in question has ceased altogether to reside there. I do not think that the rule was framed with dual residence in mind. At any rate, it seems to me that *Udny v Udny* (1869) LR 1 Sc & Div App 441 shows that loss of a domicile of *origin or choice* is not inconsistent with retention of a place of residence in that country if the chief residence has been established elsewhere.
>
> (Emphasis added)

This passage is obiter and has caused confusion. One needs to consider domicile of origin and domicile of choice separately:

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46 "It is possible for a person to have two homes, each in a different territory. In that event, the relevant enquiry is which of the two homes is the chief residence": *Re Shaffer* [2004] WTLR 457 at [11]. The same point is made in *IRC v Bullock* 51 TC 522 at p.539F where the expression used is "principal home".
In *IRC v Duchess of Portland* 54 TC 648, Nourse J said that the test was, in which of the two countries did the individual reside "as an inhabitant". That comes to the same thing, but to ask which of the two countries is the chief or principal residence is a clearer and more direct way to approach the question.

(1) *Loss of domicile of origin.* The only way to "lose" a domicile of origin is to acquire a domicile of choice. This passage (so far as it concerns a domicile of origin) is correctly stating the point made at 3.9.1 (Acquisition of domicile of choice by dual resident).
(2) *Loss of domicile of choice.* There are two ways to "lose" a domicile of choice:
    (a) by acquiring a new domicile of choice;
    (b) by abandonment without acquiring a new domicile of choice.

The judge here is considering acquisition of a new domicile of choice.[47] The passage (so far as it relates to a domicile of choice replaced by a new domicile of choice) correctly states the point made at 3.9.1 (Acquisition of domicile of choice by dual resident) above.

What is the test for abandonment of a domicile of choice (without acquiring a new domicile) in a dual residence context? It is considered that Hoffmann is correct to say that T abandons his domicile of choice where:

(1) T acquires a domicile of choice in country A.
(2) T continues to reside in country A but
    (a) they cease to reside there as their chief residence; and
    (b) they cease to intend to reside there as their chief residence.
(3) T does not acquire a domicile of choice elsewhere.

This is consistent with the test of acquisition of domicile: see 3.9.1 (Acquisition of domicile of choice by dual resident).

3.9.3 *Which is the "chief" residence?*

The next question is exactly how one ascertains which of two competing residences is the chief one. The test is multifactorial: no single factor is decisive. In *Barlow Clowes International v Henwood* the Court said:

> [The] test of chief residence ... cannot simply be a reference to the main home in terms of size or amenities. Nor can it be a reference to the home in which the subject spends the most time. The court has to look at the quality of the residence in order to decide in which country the subject has an intention to reside permanently.[48]

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47 Hence the words at the end of the passage ("if the chief residence has been established elsewhere").

48 [2008] EWCA Civ 577 at [104].

There is guidance in *Plummer v IRC* 60 TC 452. Here, Miss Plummer had a domicile of origin in England. She intended to live in Guernsey, but was studying at university in London, so she spent only some weekends and holidays in Guernsey. In all, two-thirds of her time was spent in England and one-third in Guernsey. It was held that England remained her chief residence so she did not acquire a domicile of choice in Guernsey. However the test was not just a matter of counting days:

> [Counsel for the taxpayer] submitted that the commissioners paid no regard to anything except the relative amounts of time which the taxpayer spent in England and Guernsey during the years in question. They ignored the quality of her presence in each country: the fact that she was in England solely for the purpose of education and in Guernsey because it was her family home. I do not think that this is a fair reading of the commissioners' decision. They set out at length the taxpayer's ties with Guernsey and her reasons for remaining in England. In deciding whether the house in St. Peter Port had become her chief residence, they said:
>
> > "We accept the [taxpayer's] evidence that she likes Guernsey and enjoys the amenities of the island when she is there, quite apart from enjoying the company of her family ... We do not underestimate the part which Guernsey plays in her thinking.."
>
> Nevertheless they said that these considerations did not outweigh the fact that the taxpayer had resided for the greater part of the year in England and that there had been no "break in the pattern" which would justify a finding that she had ceased to have her chief residence in England. She had not, to use the language of Lord Hatherley in *Udny v Udny*,[49] settled in Guernsey.
>
> I think that this was a conclusion to which the commissioners were on the evidence entitled to come. I go further and say that in my judgment it was the right conclusion. If the taxpayer had ... broken altogether with England and settled in Guernsey like her mother and sister and then, even after a relatively short interval, returned to England for study, the quality of her presence here might have been such as to prevent a revival of her domicile of origin. But the fact is that she has not yet settled in Guernsey, and the reasons why she has been unable to do so are in my view irrelevant. ... To treat the house in Guernsey as her chief residence simply because it is the sole residence of her mother and sister would in

49 LR 1 Sc & Div 441.

> my view be attributing to her a kind of quasi-dependent domicile for which there is no legal justification. And the fact that the taxpayer may intend to settle in Guernsey after her education and training are completed and then to remain permanently is not sufficient to give her a proleptic domicile of choice.

The concept is similar to the OECD tie-breaker test of "centre of vital interests" and some guidance can be had from discussion of that test; see 6.10 (Centre of vital interests).

The concept is also similar to the question of which of two private residences is the main residence. This point arose in *Frost v Feltham* where Mr Feltham spent two or three days a month at his property "Mount Severn". He spent the rest of the time in "The White Horse", a public house of which he was licensee. The judge noted that "viewed in isolation those are not long periods of time to spend at a house which can properly be described as the principal or more important residence of the persons concerned". Nevertheless, Mount Severn was his main residence:

> A residence is a place where somebody lives, and it is clear that Mr Feltham lived for the greater part of the year at the White Horse, Roydon. Therefore, he could not have used Mount Severn as his only residence. But that does not at all mean that he could not have used it as his principal or more important residence, even though he spent very little time there. If someone lives in two houses the question, which does he use as the principal or more important one, cannot be determined solely by reference to the way in which he divides his time between the two. I can test that by reference to an example far removed from the facts of this case and the conditions of our own times. In his "Lives of the Lord Chancellors" Lord Campbell tells how Lord Eldon was often prevented by the burdens of his office from visiting his estate at Encombe in Dorset for long periods at a time. Sometimes he was only able to get down there for three weeks or so in the year, for the partridge shooting in September. True it was that Lord Eldon also had a good house in Hamilton Place, but it could not really have been suggested that he did not use Encombe as his principal or more important residence.[50]

3.10 Presence in UK because of illness

In *Moorhouse v Lord,* Lord Kingsdown said:

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50 55 TC 10 at p.13.

> Take the case of a man labouring under a mortal disease. He is informed by his physicians that his life may be prolonged for a few months by a change to a warmer climate and that at all events his sufferings may be mitigated by such a change. Is it to be said that if he goes out to Madeira he cannot do that without losing his character as an English subject, without losing his right to the intervention of the English laws as to the transmission of property after his death, and the construction of his testamentary instruments. My lords, I apprehend that such a proposition is revolting to common sense, and the common feelings of humanity.[51]

Someone who comes to or stays in the UK for medical treatment only will not acquire a domicile of choice here. This is so even if the individual comes or stays for treatment of a final illness and knows that they will not recover to return home. Nor will such a person lose their domicile of choice.

However, that applies only to one who stays here purely for medical treatment or palliative care.[52] If, say, an individual comes to England who is housebound and needs long-term care, or because the weather in Bournemouth is better for their health than Falkirk,[53] the individual may acquire an English domicile; it depends of course on intention in each case.

3.11 Domicile and citizenship

3.11.1 *Retention of existing citizenship*

In *IRC v Bullock*, the court said:

> Domicile is distinct from citizenship. The fact that the taxpayer chose to retain his Canadian citizenship and not to acquire UK citizenship would not be inconsistent with his having acquired a domicile in the UK, but his adherence to his Canadian citizenship is, in my opinion, one of the circumstances properly to be taken into consideration in deciding

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51 (1863) 10 HLC 272 at p.292. Similarly *Udny v Udny* (1869) 1 LR Sc & Div 441 at p.458: "There must be a residence freely chosen, and not prescribed or dictated by any external necessity, such as ... the relief from illness ..."

52 Citation of Tribunal or Special Commissioners' decisions on domicile is not generally appropriate, as there are more than enough cases of higher authority. However, *Allen v HMRC* [2005] STC (SCD) 614 offers a convenient illustration.

53 As in *Reddington v MacInnes* [2002] ScotCS 46.

whether he acquired a UK domicile.[54]

3.11.2 *Change of citizenship*

The acquisition of citizenship is known as naturalisation. The House of Lords have said:

> Naturalisation is one thing; change of domicile is another: it is not the law either that a change of domicile is a condition of naturalisation, or that naturalisation involves necessarily a change of domicile.[55]

This is correct. However when British citizenship is acquired, it is necessary to look in a little detail at the circumstances of the case.

3.11.3 *Acquisition of British citizenship where home must be in the UK*

The current legislation is the British Nationality Act 1981. In order for a person to become a British citizen under this Act, it is often a requirement that:

> his intentions are such that, in the event of a certificate of naturalisation as a British citizen being granted to him, his home or (if he has more than one) his principal home will be in the UK.[56]

A person whose intention is that *their home will be in the UK* will generally acquire a UK domicile of choice. Although conceptually the requirement that ones "home is in the UK" is distinct from, and can fall short of, an intention to reside in the UK "indefinitely" (in the domicile sense) the gap is exiguous and for practical purposes someone who has the one intention will have the other.

There are exceptions where a person who is naturalised on the basis that they intend their home to be in the UK may nevertheless not acquire a UK domicile of choice:

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54 51 TC 522 at p.540. The point was also made in *Udny v Udny* 1 Sc & Div 441 at p.452: "The question of naturalization and of allegiance is distinct from that of domicile;" likewise at p.457. Similarly, in *Gaines-Cooper v HMRC* the Special Commissioners noted that the taxpayer retained British citizenship, and did not apply for citizenship in the Seychelles. Perhaps more significantly, his wife applied for British citizenship: [2008] STC 1665 at [141].

55 *Wahl v Attorney-General* (1932) 147 LT 382; [1938] All ER 922 at p.926 accessible *http://www.kessler.co.uk/tfd-archive*.

56 See Sch 1 British Nationality Act 1981.

(1) In *F v IRC*[57] the individual lied in his naturalisation application; in the circumstances he did not acquire a UK domicile of choice.
(2) A person who intends their home to be in the UK might not have decided whether to reside in England, Scotland or Northern Ireland: one cannot acquire a UK domicile of choice unless and until one intends to reside in one specific jurisdiction. However, in practice this will rarely if ever arise, since a person who intends their home to be in the UK (and by the time that they have made an application for naturalisation) will normally have decided where in the UK that home is to be.

A naturalised citizen may of course later change their intention and lose their UK domicile of choice.

3.11.4 *Acquisition of British citizenship where home need not be in the UK*

In some cases an applicant for naturalisation is not required to intend that their home will be in the UK. This was the case under the pre-1981 law and is sometimes the case under the present law.[58] In these cases it is strictly speaking correct to say that the individual who becomes a naturalised citizen does not necessarily acquire a UK domicile of choice. However the fact of naturalisation still tends to suggest that the individual has formed the intention to live in the UK permanently: the issue is one for the Tribunal to decide in the light of all the facts.

The case law in this area needs some care as a cursory reading will mislead.

Wahl v Attorney-General concerned an individual naturalised under the Naturalization[59] Act 1870. Naturalisation then required an intention to reside in the UK. However in his application he went further and declared

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57 [2000] STC (SCD) 1.

58 A full discussion of naturalisation law is not possible here, but one alternative requirement is that the person intends, in the event of naturalisation, "to enter into, or continue in,

[a] Crown service under the government of the UK, or

[b] service under an international organisation of which the UK or Her Majesty's government therein is a member, or

[c] service in the employment of a company or association established in the UK."

See Sch 1 British Nationality Act 1981. In some cases a person may become a British citizen by registration without any intention as to residence.

59 This is the spelling of the 1870 Act.

that he intended to reside permanently in the UK and had no intention of permanently leaving the UK. The House of Lords somewhat implausibly[60] found nevertheless that he did not intend to make his home in the UK and did not acquire a UK domicile of choice. But that was a finding of fact (not law) which depended on all the facts of the case.[61]

The point was reargued in *Steiner v IRC* concerning an individual naturalised under the British Nationality and Status of Aliens Act 1914. Here the statutory naturalisation requirement was merely "to reside in His Majesty's dominions" but the individual went further and stated in his application that he intended "to reside *permanently* in His Majesty's dominions" (which, in the context, meant England). The Court rightly brushed *Wahl* aside:

> The Special Commissioners attached some importance to the declaration associated with the naturalisation application, and so do I ... I bear in mind, of course, the views expressed in the House of Lords in *Wahl v Attorney-General*. But the significance of such matters must be judged in the context of any particular case and the background against which the application for naturalisation and the statements therewith is to be viewed. ... I think it would be quite wrong for this Court to dismiss the view of the Special Commissioners ...

And again:

> Now, it is true that in *Wahl v Attorney-General* a similar application and a statement in somewhat similar terms were regarded by the majority of the House of Lords as not affording any strong evidence of intention to reside permanently in England; but Lord Macmillan, in a dissenting speech, was of opinion that considerable weight should be attached to these matters, and Lord Atkin, who was one of the majority, said, at page 385: "I am far from saying that an application for naturalisation is not a matter to be carefully considered as part of the evidence in a case of domicile"; and the opinion of Lord Atkin was entirely concurred in by Lord Dunedin. In those circumstances, it appears to me that the Special Commissioners acted entirely properly in taking into account the fact of the application for naturalisation, to which they indicated that they did not attach great weight, and further in taking into account the statement

60 (1932) 147 LT 382; [1938] All ER 922 accessible *http://www.kessler.co.uk/tfd-archive*. Lord Macmillan dissented and the failure of the mainstream law reports to report the case may be taken as tacit disapproval.

61 Nowadays the Supreme Court would not concern itself with issues of fact.

made as to the applicant's intentions as to residence.[62]

3.11.5 *Commentary*

Citizenship is a status which confers a bundle of rights and responsibilities, the nature of which may be the subject of an interesting debate. But naturalisation does involve entering into a reciprocal relationship by which an individual offers loyalty to a state in exchange for protection.[63] It is suggested that there should be a rule that naturalised citizens are deemed to be UK domiciled for UK tax purposes.[64] On this point the lighter fiscal regime for foreign domiciliaries could be better targeted. Of course this would only affect naturalised citizens (I expect only a small minority, but there are apparently some[65]) who are not UK domiciled under general principles; and their children who should have a deemed UK domicile of origin.

This would also reverse the unsatisfactory result in *F* (who was held not UK domiciled because he lied about his intentions in his naturalisation application).[66]

3.12 Refugees, illegal immigrants and temporary visas

Refugees may be forced to sever most of their links with their country of origin. But while that may show they had no intention to return to their

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62 49 TC 13. Likewise *Gulbenkian v Gulbenkian* [1937] 4 All ER 618 at p.627: " When ... Gulbenkian expressed upon oath that he intended to reside permanently in Great Britain, I can see no reason why that declaration should not be taken at its full value as a desire to acquire a domicile of choice in this country."
For completeness, *Wahl* was cited in *F v IRC* [2000] STC (SCD) 1 but *Steiner* was not cited and *F* has nothing to add.

63 See *Citizenship: Our Common Bond* (the Goldsmith report), 2008, accessible *http://www.kessler.co.uk/tfd-archive*; *Theorizing Citizenship* (ed Beiner) 1995.

64 The deeming would cease if citizenship was renounced.
An alternative would be to say that a naturalised citizen is deemed UK domiciled for all purposes. But then the legislation would need to specify whether the deemed domicile was in England, Scotland or Northern Ireland which might occasionally be problematic.
This reform would not involve the contrary rule, that a person who becomes naturalised outside the UK automatically ceases to be UK domiciled: in such a case the usual rules of domicile can be left to apply.

65 *Al Fayed v Advocate General* [2002] STC 910 at [23] records the HMRC view in 1985 that naturalisation would have no effect on Mr Fayed's domicile.

66 *F v IRC* [2000] STC (SCD) 1.

country of origin, it would not, by itself, show that they had acquired an intention to reside in the UK permanently.

A person in a country illegally may become domiciled there, though the illegality is a factor in deciding whether they have a genuine intention of remaining there.[67]

In *Barlow Clowes International v Henwood*:

> He was not able to live there on a permanent basis without the permission of the Mauritian government. His residence was ... in that sense precarious. This does not make it impossible for him to acquire a domicile of choice in Mauritius but makes it less likely that he did so.[68]

3.13 Married women

3.13.1 *Marriage after 1 January 1974*

Until 1 January 1974, a married woman had the domicile of her husband (a "domicile of dependency"). However, s.1 Domicile and Matrimonial Proceedings Act 1973 now provides:

> (1) Subject to subsection (2) below, the domicile of a married woman as at any time after the coming into force of this section shall, instead of being the same as her husband's by virtue only of marriage, be ascertained by reference to the same factors as in the case of any other individual capable of having an independent domicile. ...
> (3) This section extends to England and Wales, Scotland and Northern Ireland.[69]

Although a wife does not automatically acquire the domicile of her husband, the decision to marry and set up a home in the UK may be evidence of an intention to reside in the UK permanently, but of course that depends on all the facts.[70]

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67 *Mark v Mark* [2006] AC 98.

68 [2008] EWCA Civ 577 at [119].

69 For the background to this provision, see Law Commission report no. 48, *Family Law Report on Jurisdiction in Matrimonial Causes* (1972) accessible *http://www.bailii.org/ew/other/EWLC/1972/48.pdf*

70 This is obvious but if authority is needed, see *Cyganik v Agulian* 8 ITELR 762 at [46]. Likewise the fact that T's spouse is UK resident may tend to suggest that T has not acquired a foreign domicile of choice; see (if authority is needed) *Gaines-Cooper v HMRC* [2008] STC 1665 at [46] [47].

3.13.2 *Marriage existing on 1 January 1974*

The position of women who married before 1 January 1974 is more complex. Section 1(2) Domicile and Matrimonial Proceedings Act 1973 provides:

> Where immediately before this section came into force a woman was married and then had her husband's domicile by dependence, she is to be treated as retaining that domicile (as a domicile of choice, if it is not also her domicile of origin) unless and until it is changed by acquisition or revival of another domicile either on or after the coming into force of this section.

In *IRC v Duchess of Portland* 54 TC 648, a foreign domiciled wife married a UK domiciled husband before 1974, and so she acquired a UK domicile of dependency. She resided in the UK but never intended to reside in the UK permanently. After 1974 she continued to reside in the UK. She therefore retained her former domicile of dependency ("as a domicile of choice"). That domicile could only be abandoned by ceasing to intend to reside in the UK permanently (which she did) *and* ceasing to reside in the UK (which she did not).

In Ireland the wife's domicile of dependency was held unconstitutional[71] and it is an interesting question whether the UK transitional provision is consistent with the Human Rights Act 1998. In practice the issue may never arise.

3.13.3 *Marriage ended before 1 January 1974*

In *Re Wallach*[72] a widow died five days after the death of her husband. The judge held that a married woman retained her domicile of dependency when the marriage ceased, unless and until she changed it (by abandonment or by acquisition of a new domicile of choice).

It has been said that the test for abandonment of a domicile of dependency is more lenient than the test for abandonment of a domicile of choice.[73] However, it is considered that the *test* is the same: the individual must (1) cease to reside in the place of domicile of dependency and (2) cease to intend to reside there permanently. However, in the case of a domicile of dependency the individual may never have intended to

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71 *JW v JW* (1992) 4 Irish Tax Reports p.437.

72 [1950] All ER 199.

73 *IRC v Duchess of Portland* 54 TC 648 at p.655.

reside there permanently, so requirement (2) may in practice be easier to satisfy. The test is more lenient in that the onus of proof is more easily satisfied.

3.13.4 *Woman a US national*

The US/UK DTA[74] undoes the effect of a UK domicile of dependency for a woman who is a US national. Article 4(6) of the treaty provides:

> A marriage before January 1st, 1974 between a woman who is a United States national and a man domiciled within the UK shall be deemed to have taken place on January 1st, 1974 for the purpose of determining her domicile for UK tax purposes, on or after the date on which this Convention first has effect in relation to her.

The US Technical Explanation of the Convention provides:

> under UK law, a female US citizen who married a UK domiciliary male before January 1, 1974, does not have the same opportunity to prove a domicile outside the UK as does a male US citizen who married a UK domiciliary female before January 1, 1974. Paragraph 6 of the Convention equalizes the treatment of male and female US citizens in this situation.[75]

As far as I am aware, the US Treaty is the only one which does this. Perhaps this reflects a cultural difference, a greater sensitivity to gender equality issues in the US.[76] This rule does not however apply where a *UK* woman marries a *US* man before 1 January 1974. In that case the woman keeps her domicile of dependency. In this situation a woman is in a better position than a man.

3.14 Child's domicile of dependency: England and Northern Ireland

The domicile of children is not usually important during their minority. However if a child acquires a domicile of dependency during their minority that domicile will continue until lost by abandonment or by acquisition of a new domicile of choice, so the issue occasionally arises

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74 That is, the IT/CGT treaty of July 2001. The USA IHT DTA does not contain the same rule.

75 Department of the Treasury Technical Explanation of the Convention, accessible *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

76 The English common law rule that a married woman had the domicile of her husband was rejected by US case law.

long after a child has become an adult.

3.14.1 *Age at which independent domicile can be acquired*

Section 3 Domicile and Matrimonial Proceedings Act 1973 provides:

> (1) The time at which a person first becomes capable of having an independent domicile shall be when he attains the age of sixteen or marries under that age; and in the case of a person who immediately before 1st January 1974 was incapable of having an independent domicile, but had then attained the age of sixteen or been married, it shall be that date.
> (2) This section extends to England and Wales and Northern Ireland (but not to Scotland).

The time at which a person first becomes capable of having an independent domicile has gradually been reduced: it started at 21 (the common law age of majority), it reduced to the age of 18 on 1 January 1970[77] and to 16 on 1 January 1974. The age of 16 was set as the age at which a person may marry, and it was thought that a person old enough to marry should be regarded as old enough to acquire a domicile of choice.[78]

3.14.2 *Domicile of dependency: General rule*

Dicey states:

> Subject to [s.4 Domicile and Matrimonial Proceedings Act 1973 discussed below] the domicile of an unmarried child under 16 is determined as follows:
> (1) the domicile of a legitimate child is, during the lifetime of his father, the same as, and changes with, the domicile of his father;
> (2) the domicile of a legitimated child is, from the time at which the legitimation takes effect, during the lifetime of his father, the same as, and changes with, the domicile of his father;
> (3) the domicile of an illegitimate child and of a child whose father is dead is, in general, the same as, and changes with, the domicile of his mother;
> (4) the domicile of a legitimate or legitimated child without living parents, or of an illegitimate child without a living mother, probably

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77 Section 1 Family Law Reform Act 1969.

78 See Law Commission report no. 48, *Family Law Report on Jurisdiction in Matrimonial Causes* (1972) accessible *http://www.bailii.org/ew/other/EWLC/1972/48.pdf*

cannot be changed;
(5) the domicile of an adopted child is determined as if he were the legitimate child of the adoptive parent or parents.[79]

A child's domicile of dependency (like a former wife's domicile of dependency)[80] can be abandoned, after the age of independence, by (1) ceasing to reside in the place of domicile of dependency and (2) ceasing to intend to reside there permanently.

3.14.3 *Parents living apart*

Section 4 Domicile and Matrimonial Proceedings Act 1973 provides:

> **Dependent domicile of child not living with his father**.
> (1) Subsection (2) of this section shall have effect with respect to the dependent domicile of a child as at any time after the coming into force of this section when his father and mother are alive but living apart.
> (2) The child's domicile as at that time shall be that of his mother if—
> (a) he then has his home[81] with her and has no home with his father; or
> (b) he has at any time had her domicile by virtue of paragraph (a) above and has not since had a home with his father.
> (3) As at any time after the coming into force of this section, the domicile of a child whose mother is dead shall be that which she last had before she died if at her death he had her domicile by virtue of subsection (2) above and he has not since had a home with his father.
> (4) Nothing in this section prejudices any existing rule of law as to the cases in which a child's domicile is regarded as being, by dependence, that of his mother.
> (5) In this section, "child" means a person incapable of having an independent domicile.
> (6) This section extends to England and Wales, Scotland[82] and Northern Ireland.

Prior to 1/1/1974 what was the test of domicile of a child whose parents were divorced, and who was living with the mother? Dicey records that

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79 *Conflict of Laws* (15th ed., 2012), para 6R-090. Some tie-breaker rule will be needed in case of a child adopted by a same-sex couple within a civil partnership if the couple have different domiciles.

80 See 3.13.3 (Marriage ended before 1 January 1974).

81 See 6.9.1 ("Home").

82 Schedule 3 Family Law (Scotland) Act 2006 repeals this section in relation to Scotland. However see below on whether this has effect for tax purposes.

the position in Scotland was that domicile followed the father; in Northern Ireland, it followed the mother; Dicey suggested English law should follow the Northern Ireland decision.[83]

3.15 Child's domicile in Scotland

The position is different in Scotland. Section 22 Family Law (Scotland) Act 2006 provides:

> **Domicile of persons under 16**
> (1) Subsection (2) applies where—
> (a) the parents of a child are domiciled in the same country as each other; and
> (b) the child has a home with a parent or a home (or homes) with both of them.
> (2) The child shall be domiciled in the same country as the child's parents.
> (3) Where subsection (2) does not apply, the child shall be domiciled in the country with which the child has for the time being the closest connection.
> (4) In this section, "child" means a person under 16 years of age.

Scots law (like most countries but not, yet, England) has abolished the status of illegitimacy and this provision reflects that principle.

It is an interesting question whether this reform of the law of domicile applies for tax purposes. Taxation is (in general) a reserved matter over which the Scottish Parliament has no competence. A full discussion of Scottish Parliament competence would need a long chapter, which the importance of the issue here does not justify; it is however suggested that a reform of domicile law, which has a merely incidental consequential effect on taxation, should be within the power of the Scottish Parliament.[84] HMRC agree: the RDR Manual provides:

> **RDRM22120 The Family Law (Scotland) Act 2006** [Mar 2014]
> The Family Law (Scotland) Act 2006 [FL(S)A 2006] came into effect on 4 May 2006. Section 22 of the Act creates a new form of domicile in Scotland for individuals under the age of sixteen. Legitimacy has ceased to be a factor in determining domicile in Scots law under the FL(S)A 2006, section 21 of the Act having abolished the status of illegitimacy.

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83 Dicey & Morris, *Conflict of Laws* (9th ed., 1973) p.119. This passage is not in later editions of this book.

84 See *Martin v HM Advocate* [2010] UKSC 10.

> In Scotland only, since 4 May 2006, where a child's parents share a domicile and the child has a home with either or both of them, the child is domiciled in the same country as its parents.
> Where a child's parents are domiciled in different countries, or the child has a home with neither parent, the child is domiciled in the country with which he or she has 'for the time being the closest connection'.
> The wording of FL(S)A 2006 indicates that in any proceedings commenced on or after 4 May 2006 the legislation should be applied retrospectively in order to determine the domicile of an individual under the age of sixteen.

But then what is the position of a person where English and Scots law produce a different answer as to domicile? The solution to the conundrum is to remember that when statute refers to domicile in the UK, that is a shorthand for domiciled in England Scotland or Northern Ireland. A person should be regarded as domiciled in the UK if they are:

(1) domiciled in England according to English law
(2) domiciled in Scotland according to Scots law, or
(3) domiciled in Northern Ireland according to NI law.[85]

It could then happen that (say) an English tribunal has to apply Scots law principles. But that is inevitable; one should avoid so far as possible a situation under which the selection of a tribunal leads to a difference as to applicable law and so to a different outcome.

It is suggested that the law of domicile ought to be as similar as possible in each jurisdiction, and in this case, the law of England and Northern Ireland ought to be amended to adopt the Scots law approach.

3.16 Division of territory

3.16.1 *Republic of Ireland/Northern Ireland*

Para 8 Government of Ireland (Adoption of Enactments) (No. 1) Order, 1922 provides:

> For the purpose of determining the domicile of any person, Northern Ireland shall be deemed always to have been a separate part of the UK.

In *Re M*[86] the question arose concerning a person's domicile prior to the partition of Ireland in 1922. A person who lived all their life in what is

85 See too 82.18.2 (Situs in Scots law).

86 [1937] NI 159. This was followed in *Re P* [1945] Ir Jur Rep 17.

now Northern Ireland was held to be domiciled in the part of the divided territory in which they had resided.

The RDR Manual provides:

> **RDRM20060 - Domicile: Introduction and Background: Domicile and Law Territories** [June 2010]
> The last two centuries have seen many changes in national and political boundaries. Any new territories should be regarded as having existed for the purposes of ascertaining domicile prior to their creation. Authority for this approach is provided by cases in which the 1921 division of Ireland into its present parts was considered.

3.16.2 *Guernsey, Aldernay, Sark*

The RDR Manual provides:

> **RDRM20060 - Domicile: Introduction and Background: Domicile and Law Territories** [June 2010]
> ... the Bailiwick of Guernsey includes Guernsey, Alderney and Sark, are all separate law territories.

That is, a person is domiciled in one of these three jurisdictions, not in "the Bailiwick of Guernsey".

3.17 HMRC rulings and domicile investigations

HMRC formerly provided rulings on domicile, but that was abolished in 2010.[87] The reason was no doubt that the former rulings procedure was judged not to be efficient use of limited HMRC resources.

Domicile rulings are obtainable on a death. The form is IHT401 (Domicile outside the UK). IHT Manual 13011 explains HMRC practice on receipt of this form.

3.17.1 *Effect of old HMRC rulings*

HMRC Brief 17/09 provides:

> Where an individual has already submitted a form DOM 1 or P86 and obtained an initial view from HMRC about their domicile status it will be unusual for us to open an enquiry into domicile status in the few years after that, unless new information becomes available that indicates our initial view was incorrect or there has been a change in circumstances.

87 HMRC Brief 34/10.

However with the passage of time, circumstances and intentions change and so that initial view from HMRC can become less and less useful as an indicator of domicile status. For example if an individual had advised HMRC on their arrival in England a decade or so ago that they planned to leave the UK after five years but had since married, had a family and decided to make England their permanent home then they will have adopted a domicile of choice within the UK.

Domicile and Inheritance Tax

... As is currently the case, where HMRC has expressed an opinion on the domicile status of a settlor for Inheritance Tax purposes we will not normally seek to reconsider that opinion unless new information becomes available that indicates our initial opinion was incorrect or there has been a material change in the circumstances of the settlor. However, when we make a decision it applies only to the date of the transaction concerned. So if circumstances change, the individual returns to the UK for example, that individual's domicile may need to be considered again at another point in time. Domicile is not a static thing, it can change as people's circumstances and intentions change.

... Where HMRC has expressed a view on an individual's domicile status for income tax or capital gains tax purposes, as a result of an enquiry, then that view will also apply for Inheritance Tax purposes at that time. Likewise a HMRC view expressed for Inheritance Tax purposes, following a Part VIII IHTA enquiry, will also apply for income tax and capital gains purposes at that time. However, it is important to remember that each decision on domicile will be made at a certain point in time, if circumstances have changed since the time of the relevant decision, the domicile of the taxpayer may also have changed.

3.17.2 *When will HMRC make domicile enquiries?*

In the absence of a ruling, the usual enquiry system applies. HMRC Brief 17/09 provides:

Enquiries into domicile status

... if HMRC decides to enquire into an individual's domicile status this will be by way of a section 9A TMA enquiry into their Self Assessment tax return. (Alternatively in appropriate cases HMRC may enquire into an individual's domicile status by way of a Part VIII IHTA enquiry into an Inheritance Tax return.) Where a claim to the remittance basis is not challenged for that year it does not mean HMRC necessarily accepts the individual's domicile is outside the UK and does not prevent HMRC from later opening an enquiry to consider the domicile status of the individual in relation to that, or any earlier year.

HMRC Brief 34/10 provides:

> HMRC will consider opening an enquiry where domicile could be an issue, or making a determination of Inheritance Tax in such cases, only where there is a significant risk of loss of UK tax.
> The significance of the risk will be assessed by HMRC using a wide range of factors. The factors will depend very much on the individual case but will include, for example:
> - a review of the information available to HMRC about the individual on HMRC databases
> - whether there is a significant amount of tax (all taxes and duties not just Inheritance Tax) at risk
>
> HMRC does not consider it appropriate to state an amount of tax that would be considered significant, as the amount of tax at stake is only one factor.[88] It should be borne in mind that HMRC will take into account the potential costs involved in pursuing an enquiry, and also those of potential litigation should the enquiry not result in agreement between HMRC and the individual; clearly such costs can be substantial.
> Where HMRC does open an Inheritance Tax enquiry in any of these cases, it will keep the factors in view and may stop the enquiry at any stage if it considers the continuation of the enquiry is not cost effective. The outcome of such an enquiry may be that HMRC does not consider it appropriate to make a determination of the Inheritance Tax.

It has been said in relation to those with a foreign domicile of origin:

> with the exception of the one case of *Steiner v IRC* [1973] STC 547 and perhaps another one, HMRC had never won a case on domicile against a living taxpayer and that they rarely take on such cases.[89]

It is of course possible that HMRC policy may change.

3.17.3 *How HMRC investigates domicile*

HMRC Brief 17/09 provides:

> Enquiries aimed at establishing an individual's domicile are, by their very nature, examinations of an individual's background, lifestyle, habits and intentions, possibly over the course of a lifetime. Consequently, any

88 [Author's footnote] This is obviously less than frank; the true (and proper) reason to withhold this information is no doubt to prevent fraud.

89 *Mehjoo v Harben Barker* [2013] EWHC 1500 (QB) at [258]. The point was not considered on appeal.

such enquiries conducted by HMRC will, where necessary, extend to areas of individuals' and their families' affairs that may not normally be regarded as relevant to their UK tax position. ...

The RDR Manual provides:

RDRM23080 - Domicile: Enquiries into domicile status: Schedule of useful information and documents [June 2010]

The list below shows the types of information that might be requested during an enquiry. It should not be regarded as either prescriptive or comprehensive, and the individual may offer other relevant information or evidence for consideration too.

Any information request should be tailored to the particulars of the individual's claim, and their present circumstances. It is always important to think about the relevance of particular items of information to the detailed subject matter of each enquiry. An information request need not be limited only to the items listed here, nor will all items listed necessarily be appropriate in all cases. It may not be possible for some individuals to provide some of the items on the list, even if they would be useful to an understanding of their domicile status. Given the inevitable passage of time in many cases, HMRC and the individual may need to consider how best the facts can be checked and tested.

Information

Date of birth.

Full name at birth.

Parents' full names, including mother's maiden name, and places of birth.

Place of birth, identifying the relevant law territory.

Background to the place of birth, if this was not in the same territory as the parental home at the time.

Details of any name changes, and where, if at all, such changes were registered.

Nationality (citizenship) at birth, including an explanation of its basis where this is not obvious from the context.

Details of any changes in or additions to the nationality (citizenship) at birth, with explanations of the relevant background.

Family background, including marital status of parents during the period of derived domicile.

Information about any adoption proceedings.

If parents were not living together at any time during the period of derived domicile, an explanation of the background to this matter and how parental responsibilities were exercised.

Information about relationships entered into by parents following their separation during the period of derived domicile.

Details of siblings

List of places of residence from birth to the time of the enquiry, including home addresses.

An explanation of the reason for residence at each place on the list.

Details of legal rights of residence in respect of each place and a summary of any visas, permits or other official documents required.

Summary of educational background, including places of education, periods of attendance and qualifications obtained.
Details of military service.
Details of governmental or diplomatic service.
Summary of employment and/or business history.
Explanation of employment and/or business plans, including anticipated retirement, and any arrangements that are in place in respect of these matters.
A detailed summary of properties that have been available for use other than as short-term holiday lettings. This should include the addresses of all the properties, a description of them, details of their ownership, the periods during which the properties have been available, and an explanation of how they have been used when not occupied by the individual.
Details of all marriages, civil partnerships, separations and divorces, including information relating to other relationships involving long-term cohabitation. These should cover the full names of any relevant parties, their dates, places of birth and nationalities, the periods during which the relationships existed, the dates of any formal acts or ceremonies, information relating to the domicile of the other parties, and explanations of any periods during which the parties to the relationship did not live together.
Information about transfers of property, including those between spouses or civil partners.
A summary of the names, dates of birth and nationalities of the children of the individual.
Details of where any children were educated.
The current locations of any children and the relevant background.
Information relating to the exercise of political rights in any territory, as either a voter or a representative.
Membership of any political parties, or participation in campaigns or lobbying groups, and the extent of any activities.
Details of professional qualifications, membership of professional bodies and active participation in these, including offices held.
Summary of membership of clubs, societies, associations, organisations and other bodies, and details of the level of participation in these.
Information about any representative activities undertaken on behalf of a country, territory, or any political, territorial or other sub-division thereof.
The location of personal papers and any items of financial, sentimental or other value. If such items are moveable, the place where they are usually kept and details of any insurance policies in respect of them.
Details of any wills, including an explanation of the law by which the will is intended to be construed and upon which it relies for its formal validity.
Summary of any deeds, declarations, covenants and similar documents created, including those relating to dependants.
Information relating to any legal proceedings or other matters in which domicile was relevant, either as a basis for any action or as an evidential point.
Locations of members of the extended family, including a description of the relationship between the individuals.
Details of religious, cultural and social connections, including the degree of

religious observation, the level of participation in social and cultural life, and ability to speak, read and write relevant languages.

Information about charitable and voluntary activities, including the foundation of charitable trusts, donations to charities and good causes, and active participation in the administration or fund-raising activities of third-sector organisations.

Summary of professional and personal advisers, including their locations and details of the nature and extent of the services that they provide.

An explanation of the individual's intentions for the future. What plans have been made? What contingencies have been taken into account? What would cause a change of residence? What provision has been made for the future? What has the individual actually done that provides evidence for the answers to these questions?

A summary of any connections not specifically mentioned above that the individual has with various territories. When did these begin and precisely what form have they taken over the years? How much time has the individual spent in each territory during the relevant period? What was the reason for such presence?

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The list in this paragraph deals with the types of documentary evidence that might be requested during an enquiry.

In some cases it might be necessary to request applications and other documents relating to the acquisition, loss or withdrawal of the items listed below.

Birth certificates

Adoption papers

Registrations of name changes

Marriage certificates

Civil Partnership certificates

Passports and identification documents

Social security documents

Applications for nationality (citizenship)

Documents renouncing nationality (citizenship)

Visas, residence permits, work permits and similar documents

Driving, firearms and other licences

Practising certificates and authorisations from professional or regulatory bodies

School records and reports

Examination certificates

Military service records

Employment contracts

Business accounts, reports and planning documents

Conveyances, leases, tenancy agreements and other documents relevant to the ownership, occupation or use of property

Mortgage and loan agreements

Health insurance policies

Property, motor and other insurance policies

Life assurance policies

Documents relating to savings, retirement and pension plans

Wills, expressions of wishes, deeds of covenant and other legal documents
Personal financial records, including bank account and credit card statements and documents relating to investments
Documents confirming membership of or participation in organisations and activities
Personal correspondence, photographs or electronic records relating to an individual's background, lifestyle and intentions

This is a daunting list, but forewarned is forearmed.

3.18 Domicile of company

A company is domiciled where it is registered, which is the place of incorporation.[90] But (after the 2013 reforms of the ToA rules) I cannot think of a case where domicile of a company matters, for tax or any other purpose.

90 *Gasque v IRC* 23 TC 209; Dicey, Morris & Collins, *Conflict of Laws*, (15th ed., 2012), para 30-002.

CHAPTER FOUR

RESIDENCE OF INDIVIDUALS

4.1 Residence – Introduction

This chapter discusses the statutory residence test ("SRT").[1]

HMRC have issued a guidance note **("RDR3")**.[2]

HMRC have also published a general guide **("RDR1")**[3] which covers the meaning of residence, domicile and their tax implications. Keith Gordon gives this a poor review.[4] To be fair, if one attempts to cover many vast topics in 88 pages, oversimplification and omission is inevitable. RDR1 is aimed at the nonprofessional reader, and practitioners will not usually need to read it.

HMRC have also published an online Tax Residence Indicator.[5] I suspect that this is also aimed at the nonprofessional user and practitioners will not usually find it useful.

The development of the SRT can be traced through 3 HMRC papers:
(1) Consultation paper (**"the Residence Consultation Paper"**)[6]

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1 This is the statutory term. Para 1(2) Sch 45 FA 2013 provides: The rules are referred to collectively as "the statutory residence test".

2 HMRC, "Guidance Note: Statutory Residence Test" (December 2013) *http://www.hmrc.gov.uk/international/rdr3.pdf*. This is now in its third edition; earlier versions were published May and August 2013.

3 HMRC "Guidance Note: Residence, Domicile and the Remittance Basis (October 2013) *http://www.hmrc.gov.uk/cnr/rdr1.pdf*.

4 Taxation (24 October 2013) p.5: "The new RDR1 goes so far out of its way to avoid making any promises that a taxpayer could rely on, that it puts caveats on propositions that are actually provided for by the statute. ... RDR1 will be an inadequate guide for anyone wishing to determine their residence status, whereas anyone who does rely on it will risk being misled."

5 *http://www.hmrc.gov.uk/calcs-tools/*

6 HM Treasury/HMRC, "Statutory Definition of Tax Residence" (June 2011) *http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81588/consult_condoc_statutory_residence.pdf*

(2) Response to consultation (**"the Residence Response Paper"**)[7]
(3) A further response paper[8]

These are now of historic interest only.

The statutory residence test applies from 2013/14. For the rules before then, see chapter 3 of the 2012/13 edition of this work.[9]

4.2 Scope of statutory residence test

Para 1 Sch 45 FA 2013 provides:

> (1) This Part of this Schedule sets out the rules for determining for the purposes of relevant tax whether individuals are resident or not resident in the UK....
> (4) "Relevant tax" means-
> (a) income tax,
> (b) capital gains tax, and
> (c) (so far as the residence status of individuals is relevant to them) inheritance tax and corporation tax.

The SRT does not apply for VAT[10] or NIC.

The rules apply to individual residence and not corporate residence. Para 1(3) Sch 45 FA 2013 provides an exclusion:

> The rules do not apply in determining for the purposes of relevant tax whether individuals are resident or not resident in England, Wales, Scotland or Northern Ireland specifically (rather than in the UK as a whole).

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7 HM Treasury/HMRC, "Statutory definition of tax residence and reform of ordinary residence: a summary of responses" (June 2012) *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_srt_or_summary.pdf*

8 HM Treasury, "Statutory definition of tax residence and reform of ordinary residence: summary of responses to the June 2012 consultation" (December 2012) *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/consult_responses_statutory_definitions_of_tax_residence_reform_of_ordinary_residence_responses.pdf*

9 The pre-2013 law was hopelessly uncertain, and following changes of HMRC practice, in recent years it generated more litigation than any other topic. So cases on pre-2013 residence continue to roll in: see *Glyn v HMRC* [2013] UKFTT 645; *Rumbelow v HMRC* [2013] UKFTT 637; *Daniel v HMRC* [2014] UKFTT 173. Likewise in Australia, which follows pre-2013 UK case law on residence: *Dempsey v Commissioner of Taxation* [2014] AATA 335.

10 For residence for VAT purposes, see *1st Contact v HMRC* [2012] UKFTT 84.

But it is a very rare case where that applies.

In practice I expect that the tax definition will be influential in other contexts where practical. That would be sensible. The fewer residence tests we have the better.

Para 2(1) Sch 45 FA 2013 dots *I*'s and crosses *T*'s:

> In enactments relating to relevant tax, a reference to being resident (or not resident) in the UK is, in the case of individuals, a reference to being resident (or not resident) in the UK in accordance with the statutory residence test.

4.2.1 *Residence of trustees and personal representatives*

Para 145 Sch 45 FA 2013 provides an non-standard definition of individual:

> In this Schedule ... "individual" means an individual acting in any capacity (including as trustee or personal representative);

Para 2(2) Sch 45 FA 2013 makes a similar point; it needs to be read with para 2(1) to follow the sense:

> (1) In enactments relating to relevant tax, a reference to being resident (or not resident) in the UK is, in the case of individuals, a reference to being resident (or not resident) in the UK in accordance with the statutory residence test.
> (2) Sub-paragraph (1) applies even if the reference relates to the tax liability of an actual or deemed person who is not an individual (for example, where the liability of another person depends on the residence status of an individual).

I think the point is that where an individual is trustee or PR, the residence of the PRs or trustees may depend on the residence of the individual in their private capacity; and for that purpose the SRT applies.

4.3 Outline of statutory residence test

Schedule 45 FA 2013 provides:

> 3 An individual ("P")[11] is resident in the UK for a tax year ("year X") if–
>
> (a) the automatic residence test is met for that year, or

11 "P" stands for "person".

(b) the sufficient ties test is met for that year.

4 If neither of those tests is met for that year, P is not resident in the UK for that year.

This suggests a two-stage test, but it is better to regard the SRT as having three stages:

1. Automatic overseas tests: First are 5 overseas tests; if one of these tests are met the individual is not UK resident:

(1) Overseas test 1: Less than 16 UK days
(2) Overseas test 2: 3 years non-residence and less than 46 UK days
(3) Overseas test 3: Overseas work
(4)(5) Overseas test 4,5: Death in year

2. "Automatic" UK tests: Subject to that, there are four UK tests, if one these tests are met the individual is UK resident:

(1) UK test 1: 183 UK days
(2) UK test 2: UK home
(3) UK test 3: UK work
(4) UK test 4: Death in year

3. Sufficient ties test: Then comes the sufficient ties test, with 4 or 5 connecting ties. If the individual has sufficient UK ties (the number depending on the number of UK days) the individual is UK resident, and otherwise, not UK resident. The ties are:

(1) a family tie
(2) an accommodation tie
(3) a work tie
(4) a 90-day tie
(5) a country tie

4.4 Automatic overseas tests

Schedule 45 FA 2013 first sets out the "automatic" UK tests in paras 6-10, and then the automatic overseas tests in paras 12-16. I consider the overseas tests first as if they apply, they have priority over the UK test. An overseas test trumps an "automatic" UK test and leads to a conclusion of non-residence.

Para 11 Sch 45 FA 2013 provides:

There are 5 automatic overseas tests.

I refer to these as **"overseas tests 1-5"**.

4.5 Overseas test 1: Less than 16 UK days

Para 12 Sch 45 FA 2013 provides:

> The first automatic overseas test is that–
> (a) P was resident in the UK for one or more of the 3 tax years preceding year X,
> (b) the number of days in year X that P spends in the UK is less than 16, and
> (c) P does not die in year X.

4.6 Overseas test 2: Established non-resident, less than 46 UK days

Para 13 Sch 45 FA 2013 provides:

> The second automatic overseas test is that–
> (a) P was resident in the UK for none of the 3 tax years preceding year X, and
> (b) the number of days that P spends in the UK in year X is less than 46.

This applies even if P dies in the year.

4.7 Overseas test 3: Overseas work

4.7.1 *Overseas test 3: Introduction & terminology*

Test 3 is more complicated. Para 14(1) Sch 45 FA 2013 provides:

> The third automatic overseas test is that—
> (a) P works sufficient hours overseas, as assessed over year X,
> (b) during year X, there are no significant breaks from overseas work,
> (c) the number of days in year X on which P does more than 3 hours' work in the UK is less than 31, and
> (d) the number of days in year X falling within sub-paragraph (2) is less than 91.

Year X must satisfy 4 conditions: I refer to **"overseas work conditions (a) to (d)"**.

I refer to days within (c) as **"3-hour UK work days"** and days within (d) as **"UK days".**

Overseas test 3 is the approximate equivalent of the pre-SRT full-time work abroad rule. Paragraphs (a) and (b) reflect the requirement of full-time work. Para (c) reflects the requirement that the work is "abroad".

4.7.2 *Overseas work condition (a): "Sufficient hours overseas"*

Para 14(1) Sch 45 FA 2013 requires:

> (a) P works sufficient hours overseas, as assessed over year X.

This takes us to para 14(3) sch 45 FA 2013, which provides:

> Take the following steps to work out whether P works "sufficient hours overseas" as assessed over year X—
> *Step 1 [disregard 3-hour UK work days]*
> Identify any days in year X on which P does more than 3 hours' work in the UK, including ones on which P also does work overseas on the same day.
> The days so identified are referred to as "disregarded days".
> *Step 2 [net overseas hours]*
> Add up (for all employments held and trades carried on by P) the total number of hours that P works overseas in year X, but ignoring any hours that P works overseas on disregarded days.
> The result is referred to as P's "net overseas hours".
> *Step 3 [reference-period days]*
> Subtract from 365 (or 366 if year X includes 29 February)—
> (a) the total number of disregarded days, and
> (b) any days that are allowed to be subtracted, in accordance with the rules in paragraph 28 of this Schedule, to take account of periods of leave and gaps between employments.[12]
> The result is referred to as the "reference period".

Armed with the figures from steps 2 and 3, we proceed to the computation. This is set out in the remaining two steps:

> *Step 4 [reference-period weeks]*
> Divide the reference period by 7. If the answer is more than 1 and is not a whole number, round down to the nearest whole number. If the answer is less than 1, round up to 1.

Division by 7 reflects the number of weeks in the reference period. One might question whether rounding is appropriate at this preliminary stage; though in this case rounding down slightly helps the taxpayer; it does not matter much.

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12 See 4.16 (Reference period: deduction of non-work days).

Step 5 [compute net overseas hours ÷ no. of reference-period weeks]
Divide P's net overseas hours by the number resulting from step 4.
If the answer is 35 or more, P is considered to work "sufficient hours overseas" as assessed over year X.

The computation set out in steps 4 and 5 could have been more easily expressed algebraically, but the drafter of the SRT was somewhat algebra-phobic.

RDR3 provides two examples:

Example 2 (Anne)
A is working overseas, has had a period of maternity leave and is considering her UK residence status. She finds she needs to consider whether she has worked sufficient hours overseas in the tax year to be treated as working full-time overseas for the purposes of the third automatic overseas test.
Step 1: A has no disregarded days.
Step 2: A has no sickness absence or gaps between employments. Her normal pattern of employment is for seven hours and 40 minutes, Monday to Friday. During the tax year she:
- worked as normal between 6 April and 2 June
- started her maternity leave on 3 June, returning to work after 26 weeks, on 2 December
- worked from 2 to 20 December
- took annual leave across the Christmas period from Monday, 23 December through to Wednesday, 1 January, returning to work on 2 January
- worked as usual from 2 January to 5 April; taking five days of leave from Monday, 3 February to Friday, 7 February and another three days from Thursday, 13 March to Monday, 17 March (dates are inclusive).

A calculates her net overseas hours (Step 2)
- between 6 April and 2 June, she worked on 38 days (6 and 27 May were bank holidays)
- between 2 December and 20 December she worked on 15 days
- between 2 January and 5 April she worked on 59 days
- total days worked = 38+15+59=112.
- on each day she worked for seven hours and 40 minutes, therefore her total net overseas hours = 112 × 7 hours 40 minutes = 858 hours 40 minutes.

Step 3: To calculate her reference period, A starts with the 365 days of the tax year and subtracts
- maternity leave, including embedded weekends from Monday, 3

June to Friday, 29 November - 180 days (30 November and 1 December do not meet the rules about embedded non-working days).

- annual leave on 23, 24, 27, 30 and 31 January, 3-7 February and 13, 14 and 17 March - 13 days.

As 25 and 26 December and 1 January and all the weekend dates are non-working days that do not meet the rules about embedded non-working days, she makes no adjustment for them.

A calculates her reference period: = 365–180–13 = 172 days

Step 4: divide number from Step 3 by 7 = 172÷7 = 24.57, which is rounded down to 24.

Step 5: divide net overseas hours by result from Step 4 = 858 hours 40 minutes ÷ 24 = 35.78.

A meets the sufficient hours test. She will need to consider whether she meets all other parts of the third automatic overseas test, in particular that the number of days spent in the UK in the tax year is less than 91.

Example 3 (MayLing)

ML is considering whether she meets the third automatic overseas test in respect of her work in Italy in the last tax year. She worked for her first employer there for an average of eight hours a day, five days a week, between 6 April and 23 August (20 weeks). During that period she took nine days annual leave (there were no embedded non-working days); consequently ML had worked for 18 full weeks and for only one day in another week. She ceased that employment and took a break of 30 days to tour around Italy.

She then took up a new employment, again in Italy, between 23 September and 5 April (27 weeks and six days – amounting to 28 working weeks). During that period she worked for nine hours and 30 minutes from Monday to Thursday and for four hours on a Friday. She took:

- five days of annual leave; for three weeks she only worked three long days and a short day, and for one week she worked two long days and a short day, reducing her number of full working weeks by five weeks
- 10 days of annual leave, with two embedded non-working days (the Saturday and Sunday in the middle of this two-week period), reducing her number of full working weeks by two
- five days, continuous, sick leave (with no embedded non-working days), reducing her number of full working weeks by one.

She therefore worked for only 20 full working weeks in this part of the year. ML spends no time in the UK in the tax year.

Step 1 ML has no disregarded days.
Step 2 Net overseas hours:
Employer 1: 18 weeks and one day at (5 days × 8 hours) = 728 hours
Employer 2: 20 weeks at ((4 days × 9.5 hours) + 4 hours) = 840 hours
3 weeks at ((3 days × 9.5 hours) + 4 hours) = 97.5 hours
1 week at ((2 days × 9.5 hours) + 4 hours) = 23 hours
Total net overseas hours: = 728+840+97.5+23 = 1688.5 hours.
Step 3 The statutory residence test Reference period:
Subtract from 365 days
Disregarded days 0 days
Other days that can be deducted:
- 9 days leave Employer 1
- 15 days leave employer 2
- 2 embedded days
- 5 sick days

= 9+15+2+5 = 31 days
Gap between employments 15 days (total gap 30 days but the amount deducted is limited to 15 days)
Reference period is: 365−31−15 = 319 days.
Step 4
Divide reference period by 7 = 319÷7= 45.57 which is rounded down to 45.
Step 5
Divide net overseas hours by figure at Step 4 = 1688.5÷45= 37.52.
ML meets the sufficient hours test. She will need to consider whether she meets all other parts of the third automatic overseas test, in particular that the number of days spent in the UK in the tax year is less than 91.

4.7.3 *Sufficient hours test: Analysis and planning*

Peter Ashby has done the maths:

> The good news here is that you exclude from the days that qualify sick days and paternity or maternity leave. You also exclude holidays – which is fair enough as you don't work any hours then. But you do not exclude weekends (or more correctly non-working days because these include public holidays – and for shift workers it may not be the weekend that is a non-working day) unless they are 'embedded' in a holiday. So one week of holiday excludes five days and a two-week holiday means 12 days are excluded – unless you start your holiday midweek because you need at least three days before and after the weekend to qualify that weekend. As you divide the denominator by

seven to calculate a weekly amount, you do lose out by including these 'non-qualifying embedded days'. The answer of course is to work longer hours. If you can!
Say I usually work 37 hours per week and take three two-week holidays, the average hours would be:

$$\frac{37 \times (52-6)}{(365 - (3\times12))/7} = 36.2 \text{ hours}$$

If you work 40 hours a week it will probably make no difference. If you work 36 hours a week you may be borderline and fail. If you work 35 hours a week you will almost certainly not get [sufficient hours overseas] without doing some overtime.
I suppose it does at least encourage a work mentality so [foreign] employers may be happy with this![13]

The minutes of the Joint Forum on Expatriate Tax and NICs provide:

Sufficient hours – interaction with significant breaks
Question: Can a non-working period of up to 31 days (i.e. a lesser period than a significant break) preceding or following a period of full-time work can be included as part of that period (assuming that the 35 hours test is met)?
HMRC Answer: Provided the FTW test is met over the period by the calculations that are set out, it does not matter if there is a non-working period of up to 31 days at the start or end of the period. An individual would need to work significantly more than 35hrs a week in order to do enjoy periods off from work (which were not annual, sick or parenting leave) and still meet the FTW tests.[14]

4.7.4 *Overseas work condition (b): No significant breaks from work*

Para 14(1) Sch 45 FA 2013 requires:

(b) during year X, there are no significant breaks from overseas work

See 4.17 "Significant break from work".

4.7.5 *Overseas work condition (c): Less than 31 UK work days*

Para 14(1) Sch 45 FA 2013 requires:

13 Ashby, "Employees working abroad" [2013] Tax Adviser 38.
14 29 January 2014
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf

(c) the number of days in year X on which P does more than 3 hours' work in the UK is less than 31

4.7.6 *Overseas work condition (d): Less than 91 UK days*

Para 14(1) Sch 45 FA 2013 requires:

> (d) the number of days in year X falling within sub-paragraph (2) is less than 91.
>
> (2) A day falls within this sub-paragraph if—
>
> (a) it is a day spent by P in the UK, but
>
> (b) it is not a day that is treated under paragraph 23(4) as a day spent by P in the UK.

Para 2(b) excludes the deeming rule (frequent visits) in computing UK days.[15] Why?

4.7.7 *FTWO and FTWUK*

The minutes of the Joint Forum on Expatriate Tax and NICs provide:

> **Sufficient hours - simultaneous FTWUK and FTWO**
> Question: Because of the way in which working days are disregarded for both the numerator and denominator of the sufficient hours test where the employee has worked for more than three hours in the "wrong" country (e.g. worked for more than three hours in the UK on some days when working all day abroad on most other days) it is possible to be employed full-time simultaneously in both the UK and an overseas work country for a period. This might happen where an individual transitions into a new cross-border ro le over a short period. This is not an intuitive outcome and will confuse taxpayers. Could there be a rule to prevent it?
> HMRC answer: Because the FTW tests are mechanical, HMRC agrees it is possible to be simultaneously FTWUK and FTWO. In reality this is likely to happen in a small number of cases and for a very short period of time. The SRT provides a tie-breaker in this scenario, with those meeting automatic overseas tests becoming definitively non resident. The split year cases have also been drafted so there is a priority rule between Case 5 (starting FTWUK) and Case 6 (ceasing FTWO).[16]

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15 See 4.13.5 (The deeming rule (frequent visits)).

16 29 January 2014
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf

4.8 "Automatic" UK tests

Sch 45 FA 2013 provides:

> 5 The automatic residence test is met for year X if P meets–
>
> (a) at least one of the automatic UK tests, and
>
> (b) none of the automatic overseas tests.
>
> 6 There are 4 automatic UK tests.

I refer to these as **"UK tests 1-4"**. "Automatic" residence tests is not a particularly apt label for this set of tests; I add scare quotation marks.

4.9 UK test 1: 183 UK days

Para 7 Sch 45 FA 2013 provides:

> The first automatic UK test is that P spends at least 183 days in the UK in year X.

4.10 UK test 2: UK home

4.10.1 *UK test 2: Introduction and terminology*

This is complicated. Para 8(1) Sch 45 FA 2013 provides:

> The second automatic UK test is that–
>
> (a) P has a home in the UK during all or part of year X,
>
> (b) that home is one where P spends a sufficient amount of time in year X, and
>
> (c) there is at least one period of 91 (consecutive) days in respect of which the following conditions are met—
>
> (i) the 91-day period in question occurs while P has that home,
>
> (ii) at least 30 days of that 91-day period fall within year X, and
>
> (iii) throughout that 91-day period, condition A or condition B is met or a combination of those conditions is met.

I refer to **"UK-home conditions (a) to (c)"**.

4.10.2 *UK-home condition (a)*

Para 8(1) Sch 45 FA 2013 requires:

> (a) P has a home in the UK during all or part of year X

See 4.14 ("Home").

4.10.3 *UK-home condition (b): Sufficient amount of time in UK home*

Para 8(1) Sch 45 FA 2013 requires:

> (b) that home [the UK home] is one where P spends a sufficient amount of time in year X

Para 8(4) Sch 45 FA 2013 provides:

> In relation to a home of P's in the UK, P "spends a sufficient amount of time" there in year X if there are at least 30[17] days in year X when P is present there on that day for at least some of the time (no matter how short a time).

4.10.4 *"Present at the home"*

Para 8(6)(b) Sch 45 FA 2013 provides:

> In sub-paragraphs (4) and (5)...
> (b) a reference to P being present at the home is to P being present there at a time when it is a home of P's (so presence there on any other occasion, for example to look round the property with a view to buying it, is to be disregarded).

Thus "present at the home" means present at a time when the property is a home.

4.10.5 *UK-home condition (c): UK-home period*

Para 8(1) Sch 45 FA 2013 requires:

> (c) there is at least one period of 91[18] (consecutive) days in respect of which the following conditions are met—
> (i) the 91-day period in question occurs while P has that home,
> (ii) at least 30 days of that 91-day period fall within year X, and
> (iii) throughout that 91-day period, condition A or condition B is met or a combination of those conditions is met.

---

17 Para 8(6)(a) Sch 45 FA 2013 explains how to count to 30: "In sub-paragraphs (4) and (5)—
(a) a reference to 30 days is to 30 days in aggregate, whether the days are consecutive or intermittent".

18 Para 8(7) Sch 45 FA 2013 explains that numbers do not stop at 91: "Sub-paragraph (1)(c) is satisfied so long as there is a period of 91 days in respect of which the conditions described there are met, even if those conditions are in fact met for longer than that."

It is UK-home condition (c) which makes the UK home test complicated. Condition (c) is in fact a set of conditions, which I call **"conditions (c)(i), (c)(ii), and (c)(iii)A and C(iii)B"**. I refer to the 91-day period in condition (c) as **"the UK-home period"**.

4.10.6 *UK-home condition (c)(iii)A (no overseas home)*

Para 8(2) Sch 45 FA 2013 provides:

> Condition A is that P has no home overseas.

4.10.7 *UK-home condition (c)(iii)B: permitted amount of time in overseas home*

Para 8(3) Sch 45 FA 2013 provides:

> Condition B is that—
> (a) P has one or more homes overseas, but
> (b) each of those homes is a home where P spends no more than a permitted amount of time in year X.

Para 8(5) Sch 45 FA 2013 provides:

> In relation to a home of P's overseas, P "spends no more than a permitted amount of time" there in year X if there are fewer than 30 days in year X when P is present there on that day for at least some of the time (no matter how short a time).

4.10.8 *HMRC examples*

RDR3 provides some examples of UK test 2 (UK home).

The first example is an individual becomes UK resident by acquiring a UK home. The facts (stripping out irrelevancies) are as follows:[19]

> **Example 4 (Stan)**
> S ceases to have an overseas home on 10 January 2014.

---

19 The example including all its irrelevant detail in full is as follows:
"S has lived in Australia all his life. In June 2012 he takes a holiday in London and likes it so much he decides to emigrate to the UK. He spends the next few months preparing for the move. He sells his Australian house (his only home) on 10 January 2014 and arrives in the UK on 25 January 2014. He finds a flat in London and moves in on 1 February 2014. The London flat is now his only home and he lives there for a year.
During tax year 2013-14 S is present in his Australian home on 250 days, and he is present in his London flat on 55 days."

S acquires a UK home on 1 February 2014 and remains there for a year.

The HMRC analysis is as follows:

In 2013-14 S has a home in the UK ... and is present in it on at least 30 days.

Thus UK-home conditions (a) and (b) are met.

Also from 1 February 2014 there is a period of 91 consecutive days at least 30 of which fell in 2013-14 (the tax year under consideration) when S has a UK home and no overseas home.

Thus UK-home condition (c) is met. The UK-home period is 1 February - 3 May 2014. UK-home condition (c)(iii)A is met.

As S does not meet any of the automatic overseas tests, he is resident under the second automatic UK test for tax year 2013-14.

There are several points to note from this example:

(1) The UK-home period extends well into 2014/15, so S does not know on 6 April 2014 whether he was resident in 2013/14. If he had left, or died, before 3 May 2014, he would not have been UK resident.

(2) S is UK resident in 2013-14 even though he is present in his overseas home on 250 days, and present in his UK home on only 55 days. But DT relief should be available for the period when S was treaty-resident overseas.

(3) A little planning would have avoided UK residence. For instance, if S had kept his overseas home until 7 March, rather than selling on 10 January, he would not have been UK resident.

The next example is an individual who fails to become non-resident despite acquiring an overseas home:

Example 5 (Jane)
J has a home in the UK throughout tax year 2013-14 and tax year 2014-15. She is present in that home on more than 30 days during tax year 2013-14.

Thus UK-home conditions (a) and (b) are met.

J acquires an overseas home on 1 March 2014 and is present there on 30 days in tax year 2013-14.

The HMRC analysis is as follows:

Although there is a period of 91 consecutive days, 30 of which fall in

2013-14 (the tax year under consideration), when J had both a UK home and an overseas home, there is also a period of at least 91 consecutive days (6 April 2013 to 28 February 2014) when she had a UK home (in which she spent sufficient time in 2013-14) but no overseas home.

Thus UK-home condition (c) is met. The UK-home period is 6 April - 28 February 2014. UK-home condition (c)(iii)A is met.

J is therefore resident in the UK for 2013-14 under the second automatic UK test.

The next example is an individual who retains a UK home and does not acquire an overseas home:

Example 6 (Edith)
E has had a home in Cheshire for many years. It is her only home. E retires towards the end of tax year 2014-15 and decides to use her retirement lump sum to see the world.
During tax year 2015-16 she takes three long holidays, visiting 22 different countries. She moves around and does not establish a home overseas. She keeps her Cheshire home throughout, returning to it briefly between trips, and is present there on 41[20] days in tax year 2015-16.

The HMRC analysis is as follows:

In 2015-16 E has a home in the UK in which she is present on at least 30 days in the tax year.

Thus UK-home conditions (a) and (b) are met.

During the year E has no overseas home.

Thus UK-home condition (c) is met. The UK-home period is the whole of 2015/16. UK-home condition (c)(iii)A is met.

E does not meet any of the automatic overseas tests and therefore she is resident under the second automatic UK test for tax year 2015-16.

Next, another example of passing the UK home test by ceasing to have an overseas home:

Example 7 (Berni)
At 6 April 2014 B considers whether she meets the second automatic UK

20 The significance of the 41 day figure is that E would need 4 UK ties to be resident under the sufficient ties test; in the absence of a family tie, E would not be UK resident under the sufficient ties test.

test for 2013-14:

- She bought a home in the UK on 1 January 2013. It was her home throughout 2013-14.
- She was present in that home on at least 30 days in the tax year 2013-14.
- She came to the UK on 10 April 2013 and rented out her overseas home (which she had owned for many years) from 11 April 2013 to 10 March 2014.

Therefore, during 2013-14 there was a period of 91 days, 30 of which fell in the tax year during which B had a UK home in which she was present for a sufficient amount of time, and had no overseas home. As B did not meet any of the automatic overseas tests she is resident under the second automatic UK test.

If B had not let out the overseas home, and had been present there 30 days or more, she would not have been resident under the UK home test.

The last example is designed to illustrate the scope for tax planning. The facts (stripping out irrelevancies) are as follows:[21]

Example 8 (Rosa)

R rents a house in the UK for four months commencing 1 May 2015. She is present in her UK home on 100 days in 2015-16.

Throughout 2015-16 R owns an overseas home. She is present in that house on 200 days in 2015-16.

While she is in the UK, R lets out her overseas home from 1 June to 31 August 2015 (92 days). For that period the New Zealand house is not R's home.

The HMRC analysis is as follows:

There is a period of 91 consecutive days, at least 30 of which fall in 2015-16, when R had a UK home where she spends a sufficient amount of time, and when she does not have an overseas home. R meets the

21 The example including its irrelevant detail in full is as follows:
"R is a professional cricketer who lives in New Zealand. She comes to the UK for the summer of 2015 to play for Trinity Bridge Ladies. She rents a house in Dorking for four months commencing 1 May 2015. She is present in her Dorking home on 100 days in 2015-16. After the English cricket season ends she returns to New Zealand. Throughout 2015-16 R owns a house in New Zealand. She is present in that house on 200 days in 2015-16.
While she is in the UK, R lets out her New Zealand home on a commercial basis to a third party, from 1 June to 31 August 2015 (92 days). For that period the New Zealand house is not R's home."

second automatic UK test for 2015-16.

HMRC then draw the moral:

> If R had not let out her New Zealand house and it had remained available for R to use throughout the summer, it would have remained her home and R would not meet the second automatic UK test.

It may make no difference whether R is resident or not, once one has allowed for DT relief and that UK source income earned as an sportswoman while in the UK would be subject to UK tax anyway. But R's costs of dealing with UK tax returns and the DT claim may well exceed the rent R received from the short let of the overseas home.

4.10.9 *More than one UK home*

Para 8(8) Sch 45 FA 2013 provides:

> If P has more than one home in the UK—
> (a) each of those homes must be looked at separately to see if the second automatic UK test is met, and
> (b) the second automatic UK test is then met so long as it is met in relation to at least one of those homes.

RDR3 provides a straightforward (if implausible) example:

> **Example 9 (Fatima)**
> F has had four UK homes for several years. In the tax year under consideration, F is present in her home in Swansea on 15 days, 20 days in her home in Loch Lomond, 29 in her London flat and 29 in her Newcastle flat.
> F has been present on 91[22] days in total in those UK homes. However, as she was not present in any individual home on at least 30 days, she will not have spent a sufficient amount of time in any single UK home. She will not meet the second automatic UK test for the tax year under consideration.

4.11 UK test 3: UK work

4.11.1 *UK work: Introduction and terminology*

This is complicated. Para 9(1) sch 45 FA 2013 provides:

> The third automatic UK test is that–

22 The correct figure is 83, but this does not affect the conclusion of the example.

(a) P works sufficient hours in the UK, as assessed over a period of 365 days,
(b) during that period, there are no significant breaks from UK work,
(c) all or part of that period falls within year X,
(d) more than 75% of the total number of days in the 365-day period on which P does more than 3 hours' work are days on which P does more than 3 hours' work in the UK, and
(e) at least one day which falls in both that period and year X is a day on which P does more than 3 hours' work in the UK.

I follow the terminology of RDR3 and refer to **"the 365-day reference period"**. This period must satisfy the five conditions, which I refer to as **"UK-work conditions (a) to (e)"**.

4.11.2 *UK-work condition (a): Sufficient hours in the UK*

Para 9(1) sch 45 FA 2013 requires:

(a) P works sufficient hours in the UK, as assessed over a period of 365 days...

Para 9(2) sch 45 FA 2013 provides:

Take the following steps to work out, for any given period of 365 days, whether P works "sufficient hours in the UK" as assessed over that period—
Step 1 [disregarded days]
Identify any days in the period on which P does more than 3 hours' work overseas, including ones on which P also does work in the UK on the same day.
The days so identified are referred to as "disregarded days".
Step 2 [net UK hours]
Add up (for all employments held and trades carried on by P) the total number of hours that P works in the UK during the period, but ignoring any hours that P works in the UK on disregarded days.
The result is referred to as P's "net UK hours".
Step 3 [reference-period days]
Subtract from 365—
(a) the total number of disregarded days, and
(b) any days that are allowed to be subtracted, in accordance with the rules in paragraph 28 of this Schedule, to take account of periods of leave and gaps between employments.[23]

23 See 4.16 (Reference period: deduction of non-work days).

The result is referred to as the "reference period".
Step 4 [reference-period weeks]
Divide the reference period by 7.
If the answer is more than 1 and is not a whole number, round down to the nearest whole number.
If the answer is less than 1, round up to 1.
Step 5 [compute net UK hours ÷ no. of reference-period weeks]
Divide P's net UK hours by the number resulting from step 4.
If the answer is 35 or more, P is considered to work "sufficient hours in the UK" as assessed over the 365-day period in question.

This is the same approach as overseas test 3 (overseas work): see 4.7.2 (Overseas work condition (a): "Sufficient hours overseas").
RDR3 provides an example:

Example 12 (Sam)
S has never been resident in the UK. On 3 March 2014, he starts a two-year contract to work on a North Sea Oil platform in UK waters. S is contracted to work two weeks off-shore, working 12 hours a day over 14 days, followed by two weeks onshore field break.
Unfortunately, half-way through his shift on 9 April 2014, S has an accident at work and is medically unfit to work up to 30 April 2014. The doctor certifies that he is fit enough to return to work from 1 May 2014.
From 10 April to 30 April 2014 (21 days), when S was unfit to work, there is a period of 14 days (14 – 27 April) which were scheduled non-working days when S was on his onshore field break.
For the purpose of calculating whether he meets the third automatic UK test, S considers whether he worked sufficient hours in the UK. Usually, his non-working days cannot be deducted from the 365-day period over which his average weekly hours are calculated as they do not meet the rules about embedded non-working days.
However, when calculating whether S works sufficient hours in the UK over a 365-day period, the 14 non-working days between 14 and 27 April 2014 can be subtracted from the 365-day period when calculating the 'reference period' at Step 3 of the calculation.
This is because the 14 non-working days are embedded within a period
- where S was unfit to work, from 10-30 April 2014 and
- there were at least three consecutive days of sick leave before the non-working period and
- there were at least three consecutive days of sick leave after the non-working period.

For the purpose of this example we will look at the 365-day period starting on 3 March 2014, the date S started work in the UK.

Step 1: there are no disregarded days on which S worked more than three hours overseas
Step 2: net UK hours
S works for 23.5 days (between 3 March and midway through 9 April) and then for a total of 22 weeks and five days between1 May and 2 March 2015.
Hours worked = ((22 × 7) + 23.5 + 5) × 12 = 2190 hours
Step 3: calculate the reference period, subtract from 365 the disregarded days and other days that can be subtracted = 365–21= 344
Step 4: divide reference period by 7 = 344 ÷ 7 = 9.14, rounded down to 49
Step 5: divide net UK hours by result of Step 4 = 2190÷49 = 44.69
S works sufficient hours in the UK because he works an average of more than 35 hours a week calculated over the 365-day period. He would have to consider other aspects of the third automatic UK test to determine his residence status.

4.11.3 *UK-work condition (b): No significant breaks from work*

Para 9(1) sch 45 FA 2013 requires:

> (b) during that period, there are no significant breaks from UK work

See 4.17 ("Significant break from work").

4.11.4 *UK-work condition (c): 365-day reference period overlaps tax year*

Para 9(1) sch 45 FA 2013 requires:

> (c) all or part of that period falls within year X

4.11.5 *UK-work condition (d): 75% UK work days*

Para 9(1) sch 45 FA 2013 requires:

> (d) more than 75% of the total number of days in the 365-day period on which P does more than 3 hours' work are days on which P does more than 3 hours' work in the UK

I refer to days on which P does more than 3 hours' work in the UK as **"3-hour UK work days"**.

4.11.6 *UK-work condition (e): UK workday in year and in 365-day reference period*

Para 9(1) sch 45 FA 2013 requires:

(e) at least one day which falls in both that period and year X is a day on which P does more than 3 hours' work in the UK.

Para (e) ensures that at least one day of more than 3 hours' work must fall within both year X and the 365-day period. Without it, the test could be satisfied if the 365-day period ended in, for example, May (with no days of working more than 3 hours in the UK in that tax year), but there was a solitary 7 hour UK workday in the following March.

4.11.7 *HMRC examples*

RDR3 provides some examples. The first is straightforward:

> **Example 10 (Henri)**
> H travels to the UK on 1 July 2013 to start a new job on the following day. His posting finishes on 1 July 2014 and he leaves the UK on 6 August 2014, 400 days after he arrived in the UK. Over the 365-day period to 30 June 2014 H calculates that he worked full-time in the UK and has not taken a significant break from his UK work during this period. Part of the period of 365 days falls within the tax year 2013-14 and part falls within the tax year 2014-15.

The reference period is 1 July 2013 - 30 June 2014. UK-work conditions (a) and (b) are satisfied for that period. The period falls within 2012/13 and 2013/14 so condition (c) is satisfied for those years.

> Over the period of 365 days ending 30 June 2014 H works for over three hours on 240 days, 196 (80%) of which are days when H worked for more than three hours in the UK.
> At least one day when H does more than three hours work in the UK falls within the tax year 2013-14 therefore H is resident in the UK under the third automatic UK test for tax year 2013-14.

So UK-work condition (e) is satisfied for 2013/14.

> There is also at least one day when H does more than three hours work in the UK within the tax year 2014-15, so H also meets the third automatic UK test for that year.

So UK-work condition (e) is satisfied for 2014/15.

The next example is a case where one 365-day reference period does not satisfy the conditions, but another does (resulting in UK residence):

> Example 11 (Frank)
> F works full-time in Paris for a branch of a multi-national export company. He comes to work in the UK every month for two days each

month; on both days he works for more than three hours in the UK. On 1 September 2013 F is seconded to work in the UK for a period of two years. F returns to the Paris office and works there for more than three hours on two days each month.

In the period of 365 days ended 5 April 2014 F calculates he worked full-time in the UK (the days worked overseas are identified and disregarded at Step 1 of the calculation of full-time work overseas).[24] As F worked for more than three hours on two days each month in the UK prior to September 2013, F did not have a significant break from UK work.

In the 365-day period ending 5 April 2014 F worked for more than three hours on 240 days. However only 150 days (62%) were days when F worked for more than three hours in the UK. Using that 365-day reference period F would not be resident in the UK under the third automatic UK test for 2013-14.

So it seems that the UK work test is not satisfied. But no:

F needs to check the 75% test against another 365-day period.

In the 365-day period ending 31 August 2014, F calculates he worked full-time in the UK. Again days worked overseas are identified and disregarded at Step 1 of the calculation of full-time work overseas. In the 365-day reference period ending 31 August 2014 F worked for more than three hours on 230 days; 210 days (91%) were days when F worked for more than three hours in the UK. Part of this 365-day period falls within tax year 2013-14 and at least one day in 2013-14 is a day on which F worked for more than three hours in the UK. Therefore, using the 365-day reference period ending 31 August 2014 F is resident in the UK under the third automatic UK test for 2013-14.

4.12 The sufficient ties test

Para 17(1) Sch 45 FA 2013 provides:

> The sufficient ties test is met for year X if–
>
> (a) P meets none of the automatic UK tests and none of the automatic overseas tests, but
>
> (b) P has sufficient UK ties for that year.

4.12.1 *"Sufficient" ties*

Para 17(3) Sch 45 FA 2013 defines "sufficient":

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24 See 4.11.2 (UK-work condition (a): Sufficient hours in the UK).

Whether P has "sufficient" UK ties for year X will depend on–

(a) whether P was resident in the UK for any of the previous 3 tax years, and

(b) the number of days that P spends in the UK in year X.

The SRT distinguishes between:

(1) **"Leavers":** Those who have been UK resident for one or more of the previous 3 years

(2) **"Arrivers":** Those who have not been UK resident for any of the previous 3 years

Para 18 Sch 45 FA 2013 defines sufficient ties for leavers:

> The Table below shows how many UK ties are sufficient in a case where P was resident in the UK for one or more of the 3 tax years preceding year X–

Days spent by P in the UK in year X	**Number of ties that are sufficient**
More than 15[25] but fewer than 45	At least 4
More than 45 but fewer than 90	At least 3
More than 90 but fewer than 120	At least 2
More than 120	At least 1

Para 19 Sch 45 FA 2013 defines sufficient ties for arrivers:

> The Table below shows how many UK ties are sufficient in a case where P was resident in the UK for none of the 3 tax years preceding year X–

Days spent by P in the UK in year X	**Number of ties that are sufficient**
More than 45 but fewer than 90	All 4
More than 90 but fewer than 120	At least 3
More than 120	At least 2

4.13 Days spent in UK

"Days spent" matters for many SRT purposes, of which the most important are:

(1) Overseas test 1: Less than 16 UK days

(2) Overseas test 2: 3 years non-residence, less than 46 UK days

(3) UK test 1: 183 UK days

(4) The sufficient ties test:

(a) The number of "sufficient" UK ties depends on the number of UK

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25 The words "More than 15" are otiose since if P spends less than 16 days in the UK automatic overseas test 1 will be satisfied and P will not be UK resident.

days
(b) The 90 day tie
(c) The country tie

Para 24 Sch 45 FA 2013 tries to explain the word "in":

> Any reference to a number of days spent in the UK "in" a given period is a reference to the total number of days spent there (in aggregate) in that period, whether continuously or intermittently.

In most cases what matters is days spent in the UK but for the country tie, days spend in the foreign country must also be counted. A day spent in the UK is defined, but a day spent overseas is not defined. Presumably it is a day not spent in the UK.

4.13.1 *The midnight test*

Schedule 45 FA 2013 provides the general rule:

> 22(1) If P is present in the UK at the end of a day, that day counts as a day spent by P in the UK...
> 23(1) If P is not present in the UK at the end of a day, that day does not count as a day spent by P in the UK.

There are three exceptional cases:

(1) A day may count as not spent in the UK even though the individual is present at midnight:
   (a) Transit passenger exemption
   (b) Exceptional circumstances
(2) A day may count as a day spent in the UK even though the individual is not present at midnight: the deeming rule (frequent visits)

4.13.2 *Transit days*

Para 22(2) introduces two exceptions; it needs to be read with para 22(1):

> (1) If P is present in the UK at the end of a day, that day counts as a day spent by P in the UK.
> (2) But it does not do so in the following two cases.

Para 22(3) Sch 45 FA 2013 provides:

> The first case is where–
>
> (a) P only arrives in the UK as a passenger on that day,
> (b) P leaves the UK the next day, and
> (c) between arrival and departure, P does not engage in activities that

> are to a substantial extent unrelated to P's passage through the UK.[26]

This is vague, but RDR3 provides a gloss:

> 3.9... Merely taking dinner or breakfast at your hotel, in the normal course of events, would be related to your passage. In contrast enjoying a film at the local cinema or catching up with friends would be considered substantially unrelated to your passage through the UK.

> **Example 17 (Holly)**
> S regularly visits the UK for work and social engagements. She also travels widely. She is planning to visit her Aunt in Philadelphia, and will be flying in from Rome to connect with her continental flight at Heathrow.
> S's flight lands at 23:05 on Monday evening. Her flight to Philadelphia does not depart Heathrow until 11:05 on Tuesday. S decides to stay at an airport hotel to catch some sleep, before returning to board the plane for her onward journey. She merely leaves the airport, catches a taxi to the hotel, sleeps, and snatches a quick breakfast before returning to the airport.
> The transit arrival day (Monday) spent in the UK would not count as a day for S when she considers how many days she spent in the UK at the end of the tax year. The departure day (Tuesday) may count as a qualifying day under the deeming rule.

> **Example 18(a)** (Lawrence)
> S's brother, L, has a similarly itinerant lifestyle. He too is visiting their Aunt in Philadelphia, and will be flying in from Toulouse to connect with their continental flight at Heathrow.
> L's flight lands at 17:20 on Monday evening. Their flight to Philadelphia does not depart Heathrow until 11:05 on Tuesday. L decides to stay at an airport hotel to catch some sleep before returning to board the plane on Tuesday. In this scenario the midnight spent in the UK will not count as a day spent in the UK for SRT purposes. The departure day (Tuesday) may count as a qualifying day under the deeming rule.

> **Example 18(b)**
> The circumstances are as for 18(a) but L decides that as he has a long transit period in the UK he will meet up with some friends and go to the theatre.

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26 The drafting is, exceptionally for the SRT, from the pre-2013 legislation: s.831(1B)(b) ITA.

In this scenario L's meeting friends and visiting the theatre is regarded as being to a substantial extent unrelated to his passage through the UK and therefore the midnight spent in the UK will count as a day spent in the UK for SRT purposes. The following day (Tuesday) may also count as a qualifying day under the deeming rule.

Example 18(c)

The circumstances are as for 18(a) but L meets his team leader for dinner to discuss work related issues. Their meeting lasted for an hour and a half.

In this scenario the meeting with his team leader is regarded as being to a substantial extent unrelated to his passage through the UK and the midnight spent in the UK will count as a day spent in the UK for SRT purposes. The following day (Tuesday) may also count as a qualifying day under the deeming rule.

EN FB 2008 provides some unexceptionable examples:

Example 1 – Peter works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt. He flies from Jersey to Gatwick and will catch his onward flight the next day to Frankfurt from London City airport. He travels from Gatwick to Canary Wharf for a meeting with several other HSBC colleagues before staying overnight in a nearby hotel.

The meeting with colleagues is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Example 2 – John works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt via Gatwick and London City airport. In lobby of his hotel near London City Airport, he unexpectedly spots another colleague who has just arrived from Paris. They have a couple of pints together and their conversation covers a number of business-related issues. [John][27] then travels to London City airport to catch his onward connection.

This meeting was not planned and therefore it can be considered that John's activities in the UK substantially related to completing travel to a foreign destination. The transit passenger provisions will apply.

Example 3 – Shirley lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. She has planned to spend most of the day with her daughter and grandchildren, who live in Crawley and will also spend the night there before travelling to Heathrow for her onward flight.

Her visit is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Example 4 – Phil lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. His flight from Guernsey is delayed by fog and he arrives too late to make his onward connection to New Zealand that day. His son had

27 The original erroneously reads: Peter.

already arranged to meet him at Gatwick and drive him to Heathrow, now he drives him to a hotel near Heathrow instead where Phil will stay overnight before catching his rearranged flight. At the hotel they have a snack together.

These activities are substantially related to completing travel to a foreign destination – Phil would have eaten in the hotel even if he had been unaccompanied. The transit passenger provisions will apply.

Example 5 – George lives in the Isle of Man and is flying to New York on business via Manchester. He has made an appointment with a consultant orthopaedic surgeon based in Manchester to carry out a number of tests. He will stay in the clinic overnight before travelling on to New York the following afternoon.

The appointment is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Example 6 – George lives in Jersey and is travelling to Stavanger. He does not fly and travels to the UK by ferry before continuing to London by train. He stays overnight at a West End hotel, having prearranged dinner and a trip to the theatre with friends. The next day he travels to Newcastle by train, where he boards a ferry to Stavanger. His activities in the UK are not substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Formal review of the SRT

Will the Government commit to formally reviewing the SRT legislation? Taxpayers and advisors are struggling with the complexity of the legislation and the administration burden that it produces.

Ultimately, this is a matter for Ministers. At present, the Government has no plans for further changes to residence rules. But it will keep them under review as with any other tax policy. The legislation will be kept under review both in terms of its effect on Exchequer yield and taxpayer behaviours as well as in terms of the effect on administration burdens for individuals and for employers. This will be done by HMRC working with advisers, employers and representative bodies in the normal course of their communications.

What records?

Would it be possible to get an indication of what records are going to be acceptable for the purpose s of residence enquiries?

HMRC has issued guidance on record keeping at page 80 of RDR3.

The minutes of the Joint Forum on Expatriate Tax and NICs provides:

Transit days and "substantially related" – general clarification

Question: If the statutory phrasing is viewed narrowly, whatever [an individual] is likely to do, whether watching a film in his hotel room, telephoning family, reviewing work e-mails, catching up with friends on

Facebook or going to the hotel gym or pool could be viewed as "substantially unrelated" to passage through the UK because it is not an intrinsic part of the journey.
HMRC answer: HMRC confirms that it will not interpret "substantially related" narrowly. It is reasonable to expect that, for example, anyone who chose to stay in a hotel to avail themselves of the facilities, to check Facebook and so on. The facts in each case will be important. In the final analysis we would consider whether a person was in fact enjoying the benefit of being in the UK – for example by going to t he theatre – which is out with the spirit of a transit day. However it is true that doing any work, including reviewing emails, is unrelated to P's passage through the UK and the day would result in a day spent in the UK.

Transit days and "substantially related" – work of any sort andalternative approaches
Question: A restriction on doing work of any so rt means individuals cannot check work emails (e.g. on smartphones and tablets) which is unreasonable. Can a more pragmatic interpretation be struck? e.g. US Treasury Regulations 301.7701(b)-3(d) covering Days in Transit, which hinges on whether or not there has been a business meeting.
HMRC answer: HMRC interprets the term "substantially unreated" with reference to what the transit day provisions are there to achieve – to allow leeway for day counting purposes for those passing through the UK who carry out no work. A simple reading means there is can be no debate around the degree and nature of work done.

Departure days and deemed days
Question: Are departure days that are disregarded under the transit rule counted for the deeming rule? In other words, do transit departure days count towards an excess over 30 days, as per in para 23(3)?
HMRC answer: Departure days, following a day in transit, are not disregarded under the transit rules and may count towards the deemed days rule. A day of departure may be a "qualifying day" under the terms of para 23(3)(b). The intention is to minimises the scope for the deemed days rule to be circumvented.[28]

If the individual arrives in the UK and leaves on the *same* day, that day will not count even though work or other matters are done in between. The individual does not need to rely on the transit passenger exemption.[29]

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28 29 January 2014 *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf*

29 Unless the deeming rule (frequent visits) applies.

The transit passenger rule is essential to the role of Heathrow airport as an international hub. Heathrow relies on transit passengers for the viability of its hub status. Transit passengers facilitate network diversity and frequency. Passengers would not arrange to change planes in the UK if that might make them UK resident.

4.13.3 *Exceptional circumstances*

Para 22(4) Sch 45 FA 2013 provides:

> The second case is where–
>
> (a) P would not be present in the UK at the end of that day but for exceptional circumstances beyond P's control that prevent P from leaving the UK, and
>
> (b) P intends to leave the UK as soon as those circumstances permit.

Para 22(5) Sch 45 FA 2013 tries to explain the word "exceptional":

> Examples of circumstances that may be "exceptional" are–
>
> (a) national or local emergencies such as war, civil unrest or natural disasters, and
>
> (b) a sudden or life-threatening illness or injury.

RDR3 provides:

> **B13** In order to be ignored as days spent in the UK, there must be exceptional circumstances beyond the control of the individual. In other words, the event or situation in question must be one over which the individual has no control or influence and which cannot reasonably have been foreseen.
>
> **B14** For example, if an individual is a passenger on a commercial aircraft that is forced to make an emergency landing in the UK and there is no available onward flight to their original destination for two days afterwards, the two days that would otherwise count as spent in the UK would be ignored due to exceptional circumstances.

Example B3 (Claude)

C is retired and came to the UK for the first time on 1 June for a five month extended travelling holiday, intending to leave on 31 October.

On 29 September while travelling to Scotland he is involved in a car crash suffering multiple injuries. He is in hospital for a total of 14 weeks and arranges to travel back to his home in France on the day he is discharged.

C has been in the UK for 220 days

The time C spent in hospital is an exceptional circumstance. The maximum number of days in the tax year that can be ignored is 60. C has

160 days counted as spent in the UK.

B15 For days spent in the UK due to exceptional circumstances to be ignored, an individual must intend to leave the UK as soon as those circumstances permit. If an individual does leave the UK once the exceptional circumstances have ended HMRC will usually accept this as evidence of such an intention.

Example B4
The circumstances are as in Example B3.
However, C's nephew who lives in Wales writes to him in hospital and suggests C should visit him when he leaves hospital. C writes back on 1 December agreeing.
From 1 December it is no longer C's intention to leave the UK as soon as the exceptional circumstance has come to an end and so only the period 29 September to 30 November can be discounted as exceptional circumstances for SRT day counting purposes.

Someone in the UK might have been prevented from going back due (say) to civil war there. However there would be nothing to stop them going to France. It is considered that that still counts as exceptional circumstances which prevented P leaving the UK. RDR3 provides:

Example B1 (Anna)
A is returning to her home in Denmark having spent her seven week summer holiday working in the UK. This was her first visit to the UK.
On her boat journey home there is an explosion in the engine room. Emergency rescue services attend the vessel and A is found unconscious and badly burned. The emergency services make the decision to airlift A to a specialist burns unit in the UK where she remains for five months. A returns to Denmark as soon as she is discharged from hospital.
A has been in the UK for 202 days.
This disaster would be considered to be an exceptional circumstance beyond A's control. However, the maximum number of days that can be ignored towards days spent in the UK is 60. So A has 142 days which count as days spent in the in the UK.

Exceptional circumstances and Foreign and Commonwealth Office (FCO) advice
B16 Exceptional circumstances will generally not apply in respect of events that bring you back to the UK. However, there may be circumstances such as civil unrest or natural disaster where associated FCO advice is to avoid all travel to the region.
B17 Individuals who return to and stay in the UK while FCO advice

remains at this warning level would normally have days spent in the UK ignored under the SRT, subject to the 60-day limit.

Example B5 (Philip)

P is a structural engineer and has worked full-time abroad for many years. He is currently working on a project in Africa. His wife and children live in the UK.

In May the Government of the country in which he is working is overthrown in a military coup. This initially gave rise to peaceful protests but soon developed into increasing levels of civil unrest. In early July the Foreign and Commonwealth Office (FCO) issued advice against all but essential travel to the country. P continued to work there.

By mid-October the country was on the verge of civil war and the FCO upgraded their advice, advising against all travel to the country. P returned to the UK on 21 October.

Due to international intervention, by the end of January the following year political stability had returned to the country. On 29 January the FCO downgraded their advice to avoid all but essential travel to the country. P took the first available flight back and resumed work on 31 January.

The days P spent in the UK were due to an exceptional circumstance beyond his control and can be ignored for the purpose of the day counting tests of the SRT. However, the maximum period that can be ignored due to exceptional circumstances is 60 days. P was in the UK for 103 days during this period which means P must count 43 days as days spent in the UK for the purposes of the SRT day counting tests.

Examples of circumstances not normally considered to be exceptional circumstances.

B18 Days spent in the UK will not be considered exceptional where the circumstances are not beyond the individual's control, or where they could reasonably have been foreseen or predicted.

B19 Life events such as birth, marriage, divorce and death are not routinely regarded as exceptional circumstances. Choosing to come to the UK for medical treatment or to receive elective medical services such as dentistry, cosmetic surgery or therapies will not be regarded as exceptional circumstances.

B20 Travel problems, for example a delayed or missed flight due to traffic disruption, train delays or cancellations, or a car breakdown, will not be considered as exceptional circumstances.

The illness/injury need not be the taxpayer's, but may be their spouse or family members. RDR3 provides:

B11 There may also be limited situations where an individual who needs to stay in the UK to deal with a sudden life threatening illness or injury to a spouse, person with whom they are living as husband and wife, civil partner or dependent child can have those days spent in the UK ignored under the SRT subject to the 60-day limit.

B12 There may also be limited situations where an individual who comes back to the UK to deal with a sudden life threatening illness or injury to a partner or dependent child can have those days spent in the UK ignored under the SRT subject to the 60-day limit.

Para 22(6) sch 45 FA 2013 limits the number of exceptional days:

For a tax year–

(a) the maximum number of days to which sub-paragraph (2) may apply in reliance on sub-paragraph (4) is limited to 60, and

(b) accordingly, once the number of days within sub-paragraph (4) reaches 60 (counting forward from the start of the tax year), any subsequent days within that sub-paragraph, whether involving the same or different exceptional circumstances, will count as days spent by P in the UK.

RDR3 provides:

B7 The maximum number of days spent in the UK in any tax year that may be ignored due to exceptional circumstances is 60. This is a limit, not an allowance or entitlement, and it applies whether there is one event or several events in the same tax year. Days spent in the UK over the 60-day limit count for the purposes of the SRT.

4.13.4 *Tests where exceptional circumstances not taken into account*

RDR3 provides:

B6 SRT day counting tests where exceptional circumstances cannot be taken into account when an individual is determining whether they satisfy the test

- Second automatic UK test
  - an individual is present in their home on at least (for UK homes) or fewer than (for overseas homes) 30 separate days
  - period of 91 consecutive days, at least 30 of which fall within the tax year
- Third automatic UK test
  - an individual works sufficient hours in the UK, as assessed over a period of 365 days
  - 75% of the total number of days

  - at least one day in the tax year is a day on which an individual does more than three hours of work in the UK
  - significant break –31 days go by
- Third automatic overseas test
  - significant break – 31 days go by
  - number of days on which an individual does more than three hours of work in the UK is fewer than 31
- Full-time work - 129 January 20145 day gap between employments (and 30 day maximum number of days that may be subtracted for gaps between employments)
- Family tie - an individual spends time with their child in person on 60 days or fewer, for all or part of a day
- Family tie - an individual's child spends fewer than 21 days in the UK outside term-time
- Accommodation tie
  - continuous period of 91 days
  - gap of 15 days or fewer
- Work tie - an individual works in the UK for at least 40 days
- Country tie - midnight test – greatest number of midnights.
- Deeming rule – if an individual has more than 30 qualifying days, the excess are treated as if the individual were in the UK at the end of the day, subject to the conditions set out in paragraph 3.5.

4.13.5 *The deeming rule (frequent visits)*

Para 23 sch 45 FA 2013 provides:

(1) If P is not present in the UK at the end of a day, that day does not count as a day spent by P in the UK.
(2) This is subject to the deeming rule.

Para 23 sch 45 FA 2013 provides:

(3) The deeming rule applies if—
  (a) P has at least 3 UK ties for a tax year,
  (b) the number of days in that tax year when P is present in the UK at some point in the day but not at the end of the day ("qualifying days") is more than 30, and
  (c) P was resident in the UK for at least one of the 3 tax years preceding that tax year.

(4) The deeming rule is that, once the number of qualifying days in the tax year reaches 30 (counting forward from the start of the tax year), each subsequent qualifying day in the tax year is to be treated as a day spent by P in the UK.

> (5) The deeming rule does not apply for the purposes of sub-paragraph (3)(a) (so, in deciding for those purposes whether P has a 90-day tie, qualifying days in excess of 30 are not to be treated as days spent by P in the UK).

The label "the deeming rule" is not helpful; I adopt the statutory term but add in brackets: "frequent visits".

4.14 "Home"

Home matters for several tax purposes:

(1) For the SRT, in particular UK test 2 (UK home) and the accommodation tie

(2) For other purposes, in particular:
  (a) Treaty-residence[30]
  (b) Child's domicile if parents living apart[31]

The meaning of the word "home" is discussed in *Re Y*:

> 'Home' is defined thus in the Shorter Oxford English Dictionary:
>
> > "A dwelling-place, house, abode: the fixed residence of a family or household; one's own house; the dwelling in which one habitually lives, or which one regards as one's proper abode."
>
> It is a definition which, in my judgment, contains the essential elements of a "home" as it is to be understood for present purposes.[32]

The Law Commission observes:

> "Home" conveys ... the combined ideas of physical presence and emotional link.[33]

The folk-saying is true that "home is where the heart is". In the dictionary definition set out above, home is a place which one *regards* as one's proper abode. The views of the individual himself are therefore highly relevant. It would be surprising if a place which an individual regarded as home was not in fact their home. The views of the parties as to which property was the main residence were held to be relevant in *Frost v Feltham*; see 55 TC at p.16; the same applies *a fortiori* in determining whether a property is a

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30 See 6.9 (Permanent home).

31 See 3.14 (Child's domicile of dependency).

32 [1985] Fam 136 at p.140.

33 *The Law of Domicile* (1987) Law Com 186 at para 4.20 *http://www.scotlawcom.gov.uk/download_file/view/228/*

"home".

The fact that one does not have a room set aside for oneself in a "home" does not shed much light on whether it is a "home". The more important question is whether space is available when one wishes to use it. In Robert Frost's epigram, "home is the place where, when you have to go there, they have to take you in".

Fox discusses "home" from an interdisciplinary viewpoint, and concludes that the word "represents a complex amalgam of financial, practical, social, psychological, cultural, politico-economic, and emotional interests to its occupiers".[34]

Also see 4.28.1 (Record keeping: home).

4.14.1 *Para 25 and HMRC examples*

RDR3 provides:

> **A3** As the meaning of 'home' can vary according to its context it is not possible for this guidance to provide an absolute definition of the term. What this guidance does is to give indicators outlining the characteristics that a home will generally have. We give some general examples of what a home may or may not be; whether a place is or is not a home will always be dependent on the facts and circumstances of its use by the individual. HMRC may choose to enquire into those facts and circumstances.

4.14.2 *Caravans, house boats*

Para 25(1) Sch 45 FA 2013 provides:

> A person's home could be a building or part of a building or, for example, a vehicle, vessel or structure of any kind.

RDR3 gives a straightforward example of a caravan:

> **Example A1 (Jim)**
> J lives in a mobile home with his wife. They travel extensively throughout the UK to wherever J can find work. They keep their personal belongings in the mobile home, take most of their meals there, and with the exception of their annual holiday abroad, sleep in it every night. It is where J and his wife spend most of their time when J is not working. It is their home.

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34 Fox, "The meaning of home: a chimerical concept or a legal challenge?" [2002] JLS p.580.

The OECD commentary provides:

> 13 As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room).

This is making a similar point in the context of treaty-residence, and it reflects the general meaning of the word.

4.14.3 *Permanence of occupation*

One characteristic of a "home" is that one lives there. As the Court said in *Re Y*:

> I have no doubt that any individual may have two homes; but each, in my judgment, to be properly so called, must comprise some element of regular occupation (whether past, present, or intended for the future, even if intermittent), with some degree of permanency, based upon some right of occupation whenever it is required, where ... "You find the comforts of what is known as home"; the fixed residence of a family or household.

However, the *amount* of time that one spends in a place may not shed much light on whether that place is a "home". One can spend relatively little time in a place which is still a home, or even a main or principal residence.[35] Para 25(1) Sch 45 FA 2013 acknowledges the point without providing much further guidance:

> Whether, for a given building, vehicle, vessel, structure or the like, there is a sufficient degree of permanence or stability about P's arrangements there for the place to count as P's home (or one of P's homes) will depend on all the circumstances of the case.

RDR3 gives an example of an international commuter:

> **Example A3 (William)**
> W has business interests in both Switzerland and the UK. He flies to Switzerland each Monday returning to the UK every Thursday. In Switzerland he lives in a rented flat. When in the UK he lives with his family at the family home which he has owned for many years. In this situation both properties are his homes.

35 *Frost v Feltham* 55 TC 10, see 3.9.3 (Which is the "chief" residence?).

W subsequently decides he does not need to spend so much time in Switzerland and starts to travel there less frequently. He sub-lets his flat in Switzerland retaining no rights to use it, choosing instead to stay in whatever hotel can accommodate him. He now has only one home, which is in the UK.

The next example concerns a short temporary absence:

Example A4 (Elizabeth)
E is seconded to New York for two months by her UK employer. She stays in a hotel when she is there. Prior to her secondment she lived with her husband in their home in London. Her husband continues to live and work in the UK. When E returns to the UK after her secondment she returns to live with her husband in their London home. The London house was E's home throughout the period of her secondment.

The next example concerns a longer and more indefinite absence:

A13 If an individual moves out of their home temporarily it may still remain their home.
Example A5 (Asif)
A has lived and worked in the UK for many years, occupying the same apartment in Liverpool since the day he arrived here. A's father lives in Sweden and is seriously ill. Ten months ago A decided to take a career break to care for his father and moved to Sweden. He does not know how long he will be out of the UK.
Since moving to Sweden A has not returned to Liverpool, but his apartment remains empty and available for him to return to whenever he wants. In this situation A will have a home in both Liverpool and Sweden even though he is spending all of his time in Sweden.

The next example concerns absence during temporary building work:

A14 A place that is used as a home will remain a home even if it is temporarily unavailable, for example, because of damage or renovation.
Example A6 (Rachel and Tom)
R and T's kitchen and dining room have suffered flood damage. The estimated clean-up and repair operation will take six weeks, so they stay with R's parents while the work is being done. The property will remain their home even though R and T are unable to stay there for the time being.

Building work before moving into a home is different:

A15 Your home starts to be your home as soon as:
- it is capable of being used as your home, for example, you have taken

ownership of it, even if it is temporarily unavailable because of renovation

- you actually use it as your home.

If the first point above is satisfied, but in fact you never actually use it as your home, then it will not be your home.

Example A7 (Aneta)

A moved from Poland to the UK and completed the purchase of her new house on 1 June. Whilst it was empty she stayed with friends, until her belongings arrived. These were moved in by the removal firm on 15 June. A stayed in her new home overnight that night. However, as she had arranged to have some extensive refurbishment done to her bathrooms and kitchen, she stayed in a local hotel and with colleagues whilst the main works were carried out. She moved into her home on a permanent basis on 15 July.

For SRT purposes we would consider that the house became A's home from 15 June.

A16 The key points are that:

- a place must be capable of being used as a home, even if it is temporarily unavailable, and
- an individual must actually use it as a home.

4.14.4 *Holiday home*

Para 25(3) Sch 45 FA 2013 provides:

> But somewhere that P uses periodically as nothing more than a holiday home or temporary retreat (or something similar) does not count as a home of P's.

RDR3 provides:

> **A20** [The text sets out para 25(3) and continues:] So a holiday home where an individual spends time for occasional short breaks, and which clearly provides a distinct respite from their ordinary day to day life will not be a home. However if there comes a time when an individual's use of a holiday home or temporary retreat changes so that it is used as a home it will become a home from the time of the change. It will then continue to be a home until such time as circumstances change again and it ceases to be used as a home.
>
> **Example A11 (Jenny)**
>
> J lives in Birmingham and works from home. She also owns an apartment in Spain which she rents out apart from two to three weeks a year when she takes her holiday there. The Spanish property is not her home.

However, J then decides to live in the Spanish apartment throughout the British winter time, from October to March. Her use of the property has changed from being somewhere she used for an occasional short break to somewhere she uses as a home for part of the year. The property is her home from the point she commences using the property as her home.

4.14.5 *No ownership requirement*

Para 25 Sch 45 FA 2013 provides:

> (4) A place may count as a home of P's whether or not P holds any estate or interest in it (and references to "having" a home are to be read accordingly).
> (5) Somewhere that was P's home does not continue to count as such merely because P continues to hold an estate or interest in it after P has moved out (for example, if P is in the process of selling it or has let or sub-let it, having set up home elsewhere).

A house belonging to parents will be the home of children who live there:

> **Example A2 (Mary)**
> M comes back to the UK to take up employment after spending three years studying abroad. She has given up the tenancy on the flat she occupied abroad and moves into her parents' house. Her parents' house is her home.

RDR3 provides:

> **What is not considered to be a home for the purpose of the statutory residence test?**
> **A17** If an individual moves out of their home completely and makes it available to let commercially on a permanent basis it will not be their home during the period it is let unless they or their family retain a right to live there. This can happen, for example, where the rental agreement permits the individual to use the property or part of the property as living accommodation.
> **Example A9 (Ivan)**
> I left the UK to work in Germany. He lets the flat he previously lived in to a tenant on a two-year lease. After 18 months he was made redundant and returned to the UK. The rental agreement on his flat gave exclusive use of the property to the tenant so Ivan arranged to stay with relatives and friends until the lease expired. For the period his property was let it is not his home.

However, if the rental agreement had allowed I to use the flat and he had stayed there when he visited the UK it would have remained his home throughout.

A18 A place that has never been capable of functioning as a home cannot be a home. For example, a property purchased in such a state of disrepair that it is not capable of being lived in as a home, is not a home until such time as it becomes habitable.

A19 If an individual completely moves out of a property and makes no further use of it whatsoever it will no longer be their home.

Example A10 (Harry)

H's new job requires him to travel extensively around Europe. He spends some time working in the UK but most of his work is carried out in other countries. He decided to sell his UK property. On 3 June he put his furniture and belongings in storage and two weeks later he handed the keys to his estate agent. He did not return to his UK property after 3 June and stayed in hotels or with friends on the occasions when he came back to the UK. The property is not his home from 3 June, the date he put his furniture and belongings in storage.

4.14.6 *"Home" in DTAs*

According to RDR3, "home" has a different meaning in DTAs:

> **A5** The concept of home as described in this guidance relates only to the SRT. The guidance does not apply for the purpose of applying the residence Article under a double taxation agreement. Double taxation agreements have additional qualifiers that are not included as part of the SRT and so the two terms do not have the same meaning.

The expression in the OECD model is "permanent home" but "permanent" does not add much. It reflects the point that a temporary abode does not constitute a "home" at all.

4.15 Work

"Work" matters for:
(1) UK test 3: UK work
(2) Overseas test 3: Overseas work
(3) The work tie
Para 26(1) Sch 45 FA 2013 provides:

> P is considered to be "working" (or doing "work") at any time when P is doing something–

(a) in the performance of duties of an employment held by P, or
(b) in the course of a trade[36] carried on by P (alone or in partnership).

If P is a director of a charitable company, time spent on directors duties (eg directors meetings) is "work" even though unpaid. But if P is a trustee of a charitable trust, time spent on duties is in principle not "work".

Para 26 Sch 45 FA 2013 provides:

> (2) In deciding whether something is being done in the performance of duties of an employment, regard must be had to whether, if value were received by P for doing the thing, it would fall within the definition of employment income in section 7 of ITEPA 2003.
> (3) In deciding whether something is being done in the course of a trade, regard must be had to whether, if expenses were incurred by P in doing the thing, the expenses could be deducted in calculating the profits of the trade for income tax purposes.

HMRC guidance provides:

> 2.13 Your time spent working includes:
> • instances where your employer instructs you to stay away from work, for example while serving a period of notice while you remain on the payroll
> ...
> 2.16 Being on-call or stand-by may count as time spent working depending on the conditions of your employment and the nature of your duties.
>
> **Example 20 (Paula)**
> P works as an engineer and is contractually required to be on-call for four nights a month in addition to her normal full-time attendance. She is paid a retainer for those four nights, in addition to being paid for any work done if she is called out. The four nights are counted as working time.
>
> **Example 21 (Franek)**
> F is a self-employed locksmith who keeps his mobile phone switched on 24 hours a day to receive customer calls. For the purposes of calculating

36 Para 145 FA 2013 provides a wide definition:
"trade" also includes–
(a) a profession or vocation,
(b) anything that is treated as a trade for income tax purposes, and
(c) the commercial occupation of woodlands (within the meaning of section 11(2) of ITTOIA 2005).

working time, F should only include the time spent carrying out his jobs and the related travelling time.

4.15.1 *Travelling*

Para 26(4) sch 45 FA 2013 provides:

> Time spent travelling counts as time spent working–
>
> (a) if the cost of the journey could, if it were incurred by P, be deducted in calculating P's earnings from that employment under section 337, 338, 340 or 342 of ITEPA 2003, or, as the case may be, in calculating the profits of the trade[37] under ITTOIA 2005, or
>
> (b) to the extent that P does something else during the journey that would itself count as work in accordance with this paragraph.

Para (a) raises the pleasing possibility of a case where HMRC argue *for* deductibility of the expenses, and the taxpayer argue against. But answering emails will count as work, so in practice most public transport will involve work unless the employee deliberately chooses not to work.

Para (b) is strict: if the individual spends 5 minutes working during a six hour journey the whole period of the journey will be classified as work. I wonder if that was intended.

What is "travelling" is not always clear. A person who stops at a traffic light is still travelling. A person who stops for lunch has stopped travelling. What about queuing at immigration or for luggage? Perhaps it depends on whether the queue is an ordinary one or unusually long.

4.15.2 *Training*

Para 26 Sch 45 FA 2013 provides:

> (5) Time spent undertaking training counts as time spent working if–
>
> (a) in the case of an employment held by P, the training is provided or paid for by the employer and is undertaken to help P in performing duties of the employment, and

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37 Para 145 sch 45 FA 2013 provides a wide definition:
"trade" also includes–
(a) a profession or vocation,
(b) anything that is treated as a trade for income tax purposes, and
(c) the commercial occupation of woodlands (within the meaning of section 11(2) of ITTOIA 2005).

(b) in the case of a trade[38] carried on by P, the cost of the training could be deducted in calculating the profits of the trade for income tax purposes.

(6) Sub-paragraphs (4) and (5) have effect without prejudice to the generality of sub-paragraphs (2) and (3).

4.15.3 *Location of work*

Para 27(1) Sch 45 FA 2013 provides a commonsense rule:

> Work is done where it is actually done, regardless of where the employment is held or the trade is carried on by P.

Travelling usually counts as work,[39] but there is special rule for the location of travelling work. Para 27 Sch 45 FA 2013 provides:

> (2) But work done by way of or in the course of travelling to or from the UK by air or sea or via a tunnel under the sea is assumed to be done overseas even during the part of the journey in or over the UK
> (3) For these purposes, travelling to or from the UK is taken to–
> (a) begin when P boards the aircraft, ship or train that is bound for a destination in the UK or (as the case may be) overseas, and
> (b) end when P disembarks from the aircraft, ship or train..

This may make flying directly to or from a regional airport more attractive as the UK work day would not start until the individual disembarks at the regional airport rather than at Heathrow/Gatwick before taking a connecting flight or other transport to the destination. The use of cross channel ferries may be disadvantageous when compared with travel by Eurostar given the point at which UK work is deemed to begin and end. But I suspect that however the journey is organised, it will be rare for a business trip to the UK not to involve 3-hour UK work days.

4.16 Reference period: deduction of non-work days

The reference period matters for computing the sufficient hours tests for
(1) Automatic overseas test 3 (Overseas work) and
(2) "Automatic" UK test 3 (UK work).
Para 28(1) sch 45 FA 2013 provides:

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38 Para 145 FA 2013 provides a wide definition set out in the FN above.

39 See 4.15.1 (Travelling).

This paragraph applies in calculating the "reference period" (which is a step taken in determining whether P works "sufficient hours in the UK" or "sufficient hours overseas" as assessed over a given period of days).

4.16.1 *Reduction for non-work days*

There are three reductions. Para 28(2) sch 45 FA 2013 provides:

> The number of days in the given period may be reduced to take account of—
>
> (a) reasonable amounts of annual leave or parenting leave taken by P during the period (for all employments held and trades carried on by P during the period, whether in the UK or overseas),
>
> (b) absences from work at times during the period when P is on sick leave and cannot reasonably be expected to work as a result of the illness or injury in question, and
>
> (c) non-working days embedded within a block of leave for which a reduction is made under paragraph (a) or (b).

4.16.2 *Disregarded days*

Para 28(3) sch 45 FA 2013 provides:

> But no reduction may be made in respect of any day that is a "disregarded day" (see paragraphs 9(2) and 14(3) in Part 1 of this Schedule).

For overseas test 3 (overseas work), "disregarded days" are 3 hour UK work days.[40]

For UK test 3 (UK work), "disregarded days" are 3 hour overseas work days. [41]

4.16.3 *Reduction (a): reasonable leave*

Para 28(4) sch 45 FA 2013 attempts to define "reasonable":

> For any particular employment or trade, "reasonable" amounts of annual leave or parenting leave are to be assessed having regard to (among other things)—
>
> (a) the nature of the work, and
>
> (b) the country or countries where P is working.

40 See 4.7.2 (Overseas work condition (a): Sufficient hours overseas).

41 See 4.11.2 (UK-work condition (a): Sufficient hours in the UK).

4.16.4 *"Embedded within a block of leave"*

Para 28(5) sch 45 FA 2013 provides:

> Non-working days are "embedded within" a block of leave only if there are, as part of that block of leave—
>
> (a) at least 3 consecutive days of leave taken before the non-working day or series of non-working days in question, and
>
> (b) at least 3 consecutive days of leave taken after the non-working day or series of non-working days in question.

4.16.5 *"Non-working day"*

Para 28(6) sch 45 FA 2013 provides:

> A "non-working day" is any day of the week, month or year on which P—
>
> (a) is not normally expected to work (according to P's contract of employment or usual pattern of work), and
>
> (b) does not in fact work.

4.16.6 *Rounding*

Para 28(7) sch 45 FA 2013 deals with rounding:

> In calculating the reductions to be made under sub-paragraph (2)—
>
> (a) if it turns out, after applying sub-paragraph (3), that the reasonable amounts of annual leave or parenting leave or, as the case may be, the absences from work on sick leave do not add up (across the period) to a whole number of days, the number in that case is to be rounded down to the nearest whole number, but
>
> (b) any such rounding is to be ignored for the purposes of subparagraph (2)(c).

4.16.7 *Change of employment*

Para 28 sch 45 FA 2013 provides:

> (8) If—
>
> (a) P changes employment during the given period,
>
> (b) there is a gap between the two employments, and
>
> (c) P does not work at all at any time between the two employments,
>
> the number of days in the given period may be reduced by the number of days in that gap.
>
> (9) But—

(a) if the gap lasts for more than 15 days, only 15 days may be subtracted, and
(b) if there is more than one change of employment during the period, the maximum number of days that may be subtracted under subparagraph (8) for all the gaps in total is 30.

RDR3 gives a straightforward example:

> **Example 1 (Jack)**
> J is calculating his reference period and has two gaps between employments within the 365-day period he is considering.
> The first gap was of 21 days and the second one was of five days. J does not work at all in either gap. As the first gap exceeded the maximum number of days for a single gap, Jack can only subtract 15 days from his reference period in relation to this gap between employments. He can subtract the full five days of the second gap.
> J therefore subtracts a total of 20 days for gaps between employments from his 365-day period under Step 3 of the sufficient hours calculation.

The provisions about gaps between employments do not apply for the self-employed; there is no deduction for gaps between self-employed work periods.

4.17 "Significant break from work"

"Significant break from work" matters for:
(1) Overseas test 3 (Overseas work)
(2) UK test 3 (UK work)
Para 29 Sch 45 FA 2013 provides:

> (1) There is a "significant break from UK work" if at least 31 days go by and not one of those days is—
> (a) a day on which P does more than 3 hours' work in the UK, or
> (b) a day on which P would have done more than 3 hours' work in the UK but for being on annual leave, sick leave or parenting leave.
> (2) There is a "significant break from overseas work" if at least 31 days go by and not one of those days is—
> (a) a day on which P does more than 3 hours' work overseas, or
> (b) a day on which P would have done more than 3 hours' work overseas but for being on annual leave, sick leave or parenting leave.

4.18 Minor definitions

4.18.1 *Employment*

Para 145 sch 45 FA 2013 provides the standard definition.[42]

Para 26(8) sch 45 FA 2013 provides an unnecessary comment on the word "employment":

> A voluntary post for which P has no contract of service does not count as an employment for the purposes of this Schedule.

A contract of service is simply another expression for an employment contract. A voluntary post for which P does have a contract is not likely to be an employment, as the contract will not be a contract of service.

4.18.2 *Annual leave and parenting leave*

Para 146 sch 45 FA 2013 provides:

> In relation to an individual who carries on a trade—
>
> (a) a reference in this Schedule to annual leave or parenting leave is to reasonable amounts of time off from work for the same purposes as the purposes for which annual leave or parenting leave is taken, and
>
> (b) what are "reasonable amounts" is to be assessed having regard to the annual leave or parenting leave to which an employee might reasonably expect to be entitled if doing similar work.

4.18.3 *"Overseas"*

Para 145 sch 45 FA 2013 provides a definition:

> "overseas" means anywhere outside the UK;

One might have thought "abroad" was more apt. Northern Ireland is not "overseas" but if one crosses the land border to the Republic of Ireland, one finds oneself "overseas"! But it does not matter.

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42 "employment"—
(a) has the meaning given in section 4 of ITEPA 2003, and
(b) includes an office within the meaning of section 5(3) of that Act.
(If these were taxes-act-wide definitions that would not be necessary).

4.18.4 *Zero is a number (!)*

Para 147 sch 45 FA 2013 provides:

> A reference in this Schedule to a number of days being less than a specified number includes a case where the number of days is zero.

The drafter's concern that zero may not be considered a number seems somewhat misconceived.

4.19 UK ties

Para 31(1) Sch 45 FA 2013 provides:

> What counts as a "UK tie" depends on whether P was resident in the UK for one or more of the 3 tax years preceding year X.

Thus there are different rules for leavers and for arrivers. Para 31(2) sets out the ties for leavers:

> If P was resident in the UK for one or more of those 3 tax years, each of the following ties counts as a UK tie.
>
> (a) a family tie,
> (b) an accommodation tie,
> (c) a work tie,
> (d) a 90-day tie, and
> (e) a country tie.

Para 31(3) sets out the ties for arrivers:

> Otherwise, each of the following ties counts as a UK tie.
>
> (a) a family tie,
> (b) an accommodation tie,
> (c) a work tie, and
> (d) a 90-day tie.

These are the same factors with the deletion of the country tie.

4.20 Family tie

Para 32(1) Sch 45 FA 2013 provides:

> P has a family tie for year X if–
>
> (a) in year X, a relevant relationship exists at any time between P and another person, and
> (b) that other person is someone who is resident in the UK for year X.

If a couple split up at any time during the year, or a child attains 18, the family tie can still be met until the next tax year.

4.20.1 *Relevant relationship*

Para 32(2) Sch 45 FA 2013 provides:

> A relevant relationship exists at any time between P and another person if at the time–
>
> (a) P and the other person are husband and wife or civil partners and, in either case, are not separated,[43]
>
> (b) P and the other person are living together as husband and wife or, if they are of the same sex, as if they were civil partners, or
>
> (c) the other person is a child of P's and is under the age of 18.

4.20.2 *Limited contact with child in UK*

Para 32(3) sch 45 FA 2013 provides:

> P does not have a family tie for year X by virtue of sub-paragraph (2)(c) if P sees the child in the UK on fewer than 61 days (in total) in–
>
> (a) year X, or
>
> (b) if the child turns 18 during year X, the part of year X before the day on which the child turns 18.

RDR3 provides examples:

> **Example C2 (Jurgen)**
> Between May and November J visited the UK for 125 days, 104 of which were days on which he worked for more than three hours in the UK. When in the UK he stayed in a number of different hotels, so has no accommodation tie. He was not resident in the UK for any of the last three years. J's 17-year-old son lives and works full-time in the UK and is UK resident.
> Under the sufficient ties test of the SRT J will be resident if he has two or more UK ties. He has a work tie. However the only time J and his son spent together in the UK during his visit was three weeks in the summer. Therefore J has no family tie and, having only one tie, is not resident in

43 Para 32(5) sch 45 FA 2013 provides the common form definition of "separated":
"Separated" means separated–
(a) under an order of a court of competent jurisdiction,
(b) by deed of separation, or
(c) in circumstances where the separation is likely to be permanent.

the UK for that tax year.

Example C3 (Pierre)
P has a company flat in the UK which is permanently available to him and which he always uses when he comes here. This year P has been in the UK for 75 days, 41 of which were days on which he worked for more than three hours in the UK. He was resident in the UK the year before last.
P's ex-wife lives in the UK with their 15-year-old daughter. P has spent 70 days with his daughter this year.
Under the sufficient ties test of the SRT P will be UK resident if he has three or more UK ties. He has an accommodation tie and a work tie.
However, although P has spent 70 days with his daughter this year, 21 of these days were spent at P's home in Paris and 14 were spent in Spain. Only 35 of the days P has spent with his daughter were spent in the UK.
So, P does not have a family tie and is not UK resident for this tax year.

It is a sign of the times that the drafter clarifies the word "see". Para 32(4) sch 45 FA 2013 provides:

> A day counts as a day on which P sees the child if P sees the child in person for all or part of the day.

Seeing one's child on Skype does not count.

A blind person cannot satisfy the family tie.

In some circumstances, a parent may need to instruct a child to stay in bed and not get up until they leave the house!

4.20.3 *Ascertaining residence of family member for family tie test*

In order for an individual to apply the family tie test, it is necessary to decide whether the spouse/child is resident in the UK. But in order to decide whether an individual's spouse is resident under the SRT, it may be necessary to decide whether the individual is resident in the UK.

Para 33 Sch 45 FA 2013 solves that problem by amending the residence test:

> (1) This paragraph applies in deciding for the purposes (only) of paragraph 32(1)(b) whether a person with whom P has a relevant relationship (a "family member") is someone who is resident in the UK for year X.
> (2) A family tie based on the fact that a family member has, by the same token, a relevant relationship with P is to be disregarded in deciding whether that family member is someone who is resident in the UK for year X.

RDR3 provides:

> **Example C1 (George)**
> G and his wife Mary both spend 140 days in the UK (a fewer number of days than the 183 day threshold in the automatic UK test). Neither of them was resident in any of the three previous tax years. Under the sufficient ties test of the SRT they will each be resident if they have two or more UK ties.
> Both G and Mary have an accommodation tie. They also have a relevant relationship to each other because they are man and wife. Therefore, if they have a family tie they will both be regarded as resident in the UK. However, because the family tie only exists because of their relevant relationship, the tie can be ignored.
> As each of them now only has one UK tie neither of them is UK resident.

4.20.4 *Children in full-time education*

Para 33(3) Sch 45 FA 2013 provides a special rule for residence of children:

> A family member falling within sub-paragraph (4) is to be treated as being not resident in the UK for year X if the number of days that he or she spends in the UK in the part of year X outside term-time is less than 21.

RDR3 provides:

> **C13** For the purpose of the SRT half-term breaks are regarded as term-time.

Para 33 Sch 45 FA 2013 provides:

> (4) A family member falls within this sub-paragraph if he or she–
> (a) is a child of P's who is under the age of 18,
> (b) is in full-time education in the UK at any time in year X, and
> (c) is resident in the UK for year X but would not be so resident if the time spent in full-time education in the UK in that year were disregarded.
> (5) In sub-paragraph (4)–
> (a) references to full-time education in the UK are to full-time education at a university, college, school or other educational establishment in the UK, and
> (b) the reference to the time spent in full-time education in the UK is to the time spent there during term-time.

RDR3 provides examples:

Example 31 (Yok Lin)
YL attends a boarding school in the UK. Term dates are:
Saturday 6 April to Friday 5 July
Sunday 3 September to Friday 15 December
Sunday 7 January to Friday 23 March
Sunday 15 April to Friday 6 July
She remains in the UK for the half-terms, staying with various friends and relatives but returns to the family home in Thailand during the Christmas and Easter holidays. She spends two weeks of the summer break with her friends but travels home to Thailand on 21 July.
As YL is only in the UK for 14 days outside term-time, her parents will not have a family tie with YL for the purposes of the SRT.

Example C4 (Clara)
C is 14 years-old and her parents, who reside in Dubai because of her father's work, send her to boarding school in the UK. She spends ten days of her summer break on a school trip to Scotland and one week (seven days) of her Christmas break staying with friends in London. C has therefore spent 17 days in the UK outside term-time but will not be regarded as resident in the UK for the purposes of the family tie even though C herself is resident for tax purposes in the UK.

4.21 Accommodation tie

Para 34(1) Sch 45 FA 2013 provides:

P has an accommodation tie for year X if–
(a) P has a place to live in the UK,
(b) that place is available to P during year X for a continuous period of at least 91 days, and
(c) P spends at least one night at that place in that year.

4.21.1 *Place to live*

Para 34(3) Sch 45 FA 2013 provides a commonsense definition:

P is considered to have a "place to live" in the UK if–
(a) P's home or at least one of P's homes (if P has more than one) is in the UK, or
(b) P has a holiday home or temporary retreat (or something similar) in the UK, or
(c) accommodation is otherwise available to P where P can live when P is in the UK.

4.21.2 *Accommodation "available"*

Para 34(4) Sch 45 FA 2013 provides:

> Accommodation may be "available" to P even if P holds no estate or interest in it and even if P has no legal right to occupy it.

RDR3 provides:

> **Example A13 (Peter)**
> P left the UK last year to travel the world. He let his UK property on a two year lease and has no rights to use the property. P has no home in the UK.
> Before leaving the UK P agreed with his cousin that he could stay with her on any occasion he was in the UK. This is more than a casual offer; P's cousin is fully prepared to put P up for several months at a time should he need it. He made two visits to the UK this year, each for ten days, and stayed with her. P has an accommodation tie this year.
>
> **A27** The main difference between the term 'home' for SRT purposes and available accommodation is that accommodation can be transient and does not require the degree of stability or permanence that a home does.
> **A28** If an individual does not have a home in the UK they may still have an accommodation tie if they have a place to live in the UK.
> **The principles and characteristics of accommodation as a UK tie**
> **A29** Although this guidance gives some general examples of what an accommodation tie may or may not be, whether somewhere is or is not an accommodation tie will always be dependent on the facts and circumstances of its use by the individual. HMRC may choose to enquire into those facts and circumstances.
>
> **Example A14 (Mary)**
> M has lived and worked in the USA for many years. Her uncle has a holiday houseboat in the UK where he has agreed M can stay any time she wishes, for as long as she wishes, when she comes here. M's uncle does not allow other people to stay in the houseboat.
> Last year M came to the UK twice. She made arrangements to stay for three weeks with a friend and for four weeks with her brother. Although the houseboat was available for a continuous period of at least 91 days, M did not use it at all. Therefore, she had no accommodation tie in respect of the houseboat last year.
> This year M again visited the UK twice, spending her five-week summer holiday on her uncle's houseboat. This year M has an accommodation tie as the houseboat is available for a continuous period of at least 91 days and she has stayed on it for at least one night.

Example A15 (Simone)
S has lived and worked in France all her life. She and her brother purchased a cottage in the UK several years ago as a holiday home. The cottage is let for most of the year but June, July and August are always kept free so that S or her brother can stay there. There is sufficient accommodation in the cottage to ensure that S is able to stay there, even when her brother and his family are also there.
S spent two weeks in the cottage last year and three weeks this year. S has an accommodation tie both last year and this year.
A33 Accommodation is regarded as available to you for a continuous period of 91 days if you are able to use it, or it is at your disposal, at all times throughout that period (subject to the 16 day gap rule covered below). If a relative were to make their home available to you casually, for a social visit, say, it will not mean that the accommodation would be regarded as being available to you. However, if it is available to you for a continuous period of 91 days and you use it casually, it will be a tie.
A34 Similarly, a casual offer from a friend to "stay in my spare room any time" will not constitute an accommodation tie unless your friend really is prepared to put you up for 91 days at a time (whether he actually does so or not).

Example A16 (Sacha)
S visits the UK on business and usually stays in different hotels. On one of these visits he takes an opportunity to attend the Wimbledon Tennis Championships. A business associate who lives in Wimbledon invites S to stay at his flat for three nights rather than use a hotel. The arrangement is a one-off invitation and the accommodation is not available to S for 91 days. It is not an accommodation tie.

The minutes of the Joint Forum on Expatriate Tax and NICs provide:

Question: It would be useful to have some guidance as to what arrangements HMRC perceive to be continuously available for a consecutive period of 91 days – e.g. a situation where "your room" in your parents' home is always potentially available but is not maintained for your exclusive use. If the parent has other visitors, they may also be put in that room. Consequently, it will always necessary to check in advance of each visit whether it will be possible to stay on specific dates. Can HMRC confirm this type of arrangement would not constitute continuously available accommodation for purposes of the SRT?
HMRC answer: HMRC can confirm that accommodation availability has to be more than ad hoc or casual. Arrangement can be tacit, verbal or written but the availability itself will be a question of fact and every case

will be determined by reference to the available facts and circumstances of each case. Situations where availability is agreed but on a particular occasion it cannot be used - perhaps because some else is using it – will often be rendered irrelevant by the 'gaps of fewer than 16 days are ignored' rule at 34(2).[44]

4.21.3 *Continuous period of 91 days*

Para 34(2) Sch 45 FA 2013 provides:

> If there is a gap of fewer than 16 days between periods in year X when a particular place is available to P, that place is to be treated as continuing to be available to P during the gap.

This would be a problem for those who visit and stay in hotels every fortnight, because one ignores the gap of 15 days. RDR3 provides:

> **Example A17 (Hyo)**
> H lives and works in Poland. He is his company's European sales manager. This year he will be responsible for launching a new product in the UK and will need to spend time here. His sales force are on the road the last week of every month so he books a room in the same hotel for the first three weeks of June, July, August, and September.
> H has an accommodation tie this year.
>
> **A42** Short stays at hotels and guesthouses will not usually be considered to be an accommodation tie. However, if an individual books a room in the same hotel or guesthouse (and does not cancel those bookings) for at least 91 days continuously in a tax year, bearing in mind that short gaps may be discounted, it will be an accommodation tie (see Example A17).

4.21.4 *Accommodation is home of close relative*

Para 34(5) Sch 45 FA 2013 provides:

> If the accommodation is the home of a close relative of P's, sub-paragraph (1)(c) has effect as if for "at least one night" there were substituted "a total of at least 16 nights".

Amended as para 34(5) directs, para 34(1) provides:

> P has an accommodation tie for year X if–

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44 29 January 2014
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf

(a) P has a place to live in the UK [in the form of accommodation which is the home of a close relative of P],
(b) that place is available to P during year X for a continuous period of at least 91 days, and
(c) P spends ~~at least one night~~ a total of at least 16 nights at that place in that year.

The relief is that one can stay up to 15 nights at a close relative without satisfying the accommodation tie. If someone is in a position where night 16 could trigger an accommodation tie, they may have to move to a hotel.

Para 34(6) Sch 45 FA 2013 provides:

> A "close relative" is–
> (a) a parent or grandparent,
> (b) a brother or sister,
> (c) a child aged 18 or over, or
> (d) a grandchild aged 18 or over,
> in each case, including by half-blood or by marriage or civil partnership.

The words "by marriage or civil partnership" do not make sense; maybe they come from an earlier draft; maybe the intention is to include close relatives of a spouse/civil partner or the spouse/civil partner of a close relative?

RDR3 gives a straightforward example:

> **Example A18 (Ravi)**
> R can stay with his grandparents whenever he is in the UK. They will put him up for more than 91 days if he wishes. He usually comes from India every year to visit them and stays with them for the whole summer.
> Last year R spent only the first two weeks with his grandparents then went on a one-off visit to his uncle (who would not be regarded as a close relative for the purposes of the SRT) for two months before returning home. So, although accommodation at his grandparents, who are regarded as close relatives, was available for more than 91 days, R stayed with his grandparents for only 14 days, and therefore had no accommodation tie.
> This year R spent the whole summer with his grandparents.
> This year R has an accommodation tie.
>
> **A38** If an individual stays in UK accommodation held by a spouse, partner or minor children then they will be considered to have an accommodation tie if they spend at least one night there.
>
> **Example A19 (P and Andrew)**
> P and his civil partner A share an apartment in London. Last year A

moved to the USA to take up a university place to study marine biology. This year A came back to the UK for a three-week holiday which he and P spent in Scotland. A spent the first night and last night of his holiday in their London apartment.
This year A has an accommodation tie.

A39 It is possible to have more than one place in the UK that counts as available accommodation. However this would still represent only one accommodation tie no matter how many different places of accommodation are available.

Example A20 (Julie)
J has lived in Canada with her husband for many years.
J and her husband own a holiday home in the UK which they do not let out and in addition J can stay with her parents whenever she is in the UK, for as long as she wishes.
This year J visits the UK and stays with her parents for four weeks and then spends a further three weeks in her holiday home before returning to Canada.
This year although J has two places that count as available accommodation she has only one accommodation tie.

4.22 Work tie

Para 35(1) Sch 45 FA 2013 provides:

> P has a work tie for year X if P works in the UK for at least 40 days (whether continuously or intermittently) in year X.

Para 35(2) Sch 45 FA 2013 defines "works in the UK for a day":

> For these purposes, P works in the UK for a day if P does more than 3 hours' work in the UK on that day.

4.23 90-day tie

Para 37 Sch 45 FA 2013 provides:

> P has a 90-day tie for year X if P has spent more than 90 days in the UK in–
>
> (a) the tax year preceding year X,
> (b) the tax year preceding that tax year, or
> (c) each of those tax years separately.

4.24 Country tie

Para 38 Sch 45 FA 2013 provides:

(1) P has a country tie for year X if the country in which P meets the midnight test for the greatest number of days in year X is the UK.
(2) If–
(a) P meets the midnight test for the same number of days in two or more countries, and
(b) that number is the greatest number of days for which P meets the midnight test in any country in year X,
P has a country tie for year X if one of those countries is the UK.

The country tie applies to leavers but not to arrivers. Presumably the object is that HMRC can notify tax authorities of the country where the individual spends most time, to see if tax should be paid there.

The question will sometimes arise as to what constitutes a single country. If an individual spends time in different states of a federal country, such as the USA, then the time counts as spent in one country. Eg if P spends 100 days in Florida, 100 days in California, and 165 days in the UK, that counts as 200 days in the USA and P will not satisfy the country tie.

Some constitutional research will occasionally be necessary. Are Spain and Majorca one country? Or Guernsey, Alderney and Sark? Or are they separate countries?

Para 145 Sch 45 FA 2013 provides:

"country" includes a state or territory;

I am unable to see the need for that.

4.25 International transport workers

4.25.1 *"Relevant job"*

Para 30(1) Sch 45 FA 2013 provides:

P has a "relevant" job on board a vehicle, aircraft or ship if condition A and condition B are met.

"Relevant job" is not a helpful label: I refer to a person with a relevant job as an **"international transport worker"**.

I refer to **"international transport conditions A and B."**

4.25.2 *International transport condition A*

Para 30(2) Sch 45 FA 2013 provides:

Condition A is that P either—
(a) holds an employment, the duties of which consist of duties to be

performed on board a vehicle, aircraft or ship while it is travelling, or

(b) carries on a trade, the activities of which consist of work to be done or services to be provided on board a vehicle, aircraft or ship while it is travelling.

Para 30(4) Sch 45 FA 2013 provides:

> Sub-paragraph (2)(b) is not satisfied unless, in order to do the work or provide the services, P has to be present (in person) on board the vehicle, aircraft or ship while it is travelling.

4.25.3 *International transport condition B*

Para 30(3) Sch 45 FA 2013 provides:

> Condition B is that substantially all of the trips made in performing those duties or carrying on those activities are ones that involve crossing an international boundary at sea, in the air or on land (referred to as "cross-border trips").

4.25.4 *Incidental duties*

RDR3 provides:

> 3.18 Being on-call or stand-by may count as time spent working depending on the conditions of your employment and the nature of your duties.
>
> **Example 21 (Paula)**
> P works as an engineer and is contractually required to be on-call for four nights a month in addition to her normal full-time attendance. She is paid a retainer for those four nights, in addition to being paid for any work done if she is called out. The four nights are counted as working time.
>
> **Example 22 (Franek)**
> F is a self-employed locksmith who keeps his mobile phone switched on 24 hours a day to receive customer calls. For the purposes of calculating working time, F should only include the time spent carrying out his jobs and the related travelling time.

Para 30(5) Sch 45 FA 2013 provides:

> Duties or activities of a purely incidental nature are to be ignored in deciding whether the duties of an employment or the activities of a trade consist of duties or activities of a kind described in sub-paragraph (2)(a) or (b).

RDR3 provides:

> **3.27** In deciding whether or not you fall within one of the categories of relevant job you should ignore duties or activities of a purely incidental nature. For instance, where a pilot whose job consists of making long haul international flights also attends a training course, the duties spent undertaking training are incidental to the duties of flying the plane and so can be ignored.
> **Example 27 (Preeya)**
> P is a member of a cabin crew on board flights between London and Switzerland for a short haul airline. For one month during the year, she changes her shifts and works on UK domestic flights. However, substantially all of the trips she makes in performing her duties are cross border ones; P does have a relevant job.
>
> **3.28** You will not have a relevant job simply because you occasionally work during a journey from one country to another, for example, if you catch up on business emails during a flight from your base in one country to visit a client in another country.

4.25.5 *Significance of having a relevant job*

Para 9(3) Sch 45 FA 2013 disapplies UK test 3 (UK work):

> This paragraph does not apply to P if—
> (a) P has a relevant job on board a vehicle, aircraft or ship[45] at any time in year X, and
> (b) at least 6 of the trips that P makes in year X as part of that job are cross-border trips that either begin in the UK, end in the UK or begin and end in the UK.

Para 14(4) Sch 45 FA 2013 disapplies overseas test 3 (Overseas work). The wording is identical.

The work tie is different for international transport workers. The rules in para 35, 36 Sch 45 FA 2013 need to be read together:

> 35 (1) P has a work tie for year X if P works in the UK for at least 40 days (whether continuously or intermittently) in year X.
> (2) For these purposes, P works in the UK for a day if P does more than 3 hours' work in the UK on that day.
> 36 (1) This paragraph applies for the purposes of paragraph 35.

---

45 Defined para 145 sch 45 FA 2013: "'ship' includes any kind of vessel (including a hovercraft)".

(2) It applies in cases where P has a relevant job on board a vehicle, aircraft or ship.

(3) When making a cross-border trip as part of that job—

(a) if the trip begins in the UK, P is assumed to do more than 3 hours' work in the UK on the day on which it begins,

(b) if the trip ends in the UK, P is assumed to do fewer than 3 hours' work in the UK on the day on which it ends.

(4) Those assumptions apply regardless of how late in the day the trip begins or ends (even if it begins or ends just before midnight).

(5) For the purposes of sub-paragraph (3)(a), it does not matter whether the trip ends on that same day.

(6) A day that falls within both paragraph (a) and paragraph (b) of sub-paragraph (3) is to be treated as if it fell only within paragraph (a).

(7) In the case of a cross-border trip to or from the UK that is undertaken in stages—

(a) the day on which the trip begins or, as the case may be, ends is the day on which the stage of the trip that involves crossing the UK border begins or ends, and

(b) accordingly, any day on which a stage is undertaken by P solely within the UK must (if it lasts for more than 3 hours) be counted separately as a day on which P does more than 3 hours' work in the UK.

4.26 Year of death

4.26.1 *Death and the SRT*

Many of the residence tests depend on the number of days that some condition is satisfied during the year. This assumes that the individual lives for the whole of the year; the rules are not apt if the individual dies during the year. For instance, overseas test 1 requires less than 16 UK days. There has to be some amendment for death during the year, or anyone who died between 6 and 20 April would be non-resident.

Death has the following consequences for the SRT:

(1) Death disapplies overseas test 1: instead overseas tests 4 and 5 and UK test 4 apply.

(2) Death alters the day count requirements for the sufficient ties test.

4.26.2 *Overseas test 4: Year of death (established non-resident)*

Para 15 Sch 45 FA 2013 provides:

(1) The fourth automatic overseas test is that—

(a) P dies in year X,
(b) [i] P was resident in the UK for neither of the 2 tax years preceding year X or, alternatively,
[ii] P's case falls within sub-paragraph (2), and
(c) the number of days that P spends in the UK in year X is less than 46.

(2) P's case falls within this sub-paragraph if—
(a) P was not resident in the UK for the tax year preceding year X, and
(b) the tax year before that was a split year as respects P because the circumstances of the case fell within Case 1, Case 2 or Case 3 (see Part 3 of this Schedule) [that is, a leaver's split year].

4.26.3 *Overseas test 5: Year of death (working overseas)*

Para 16 Sch 45 FA 2013 provides:

(1) The fifth automatic overseas test is that—
(a) P dies in year X,
(b) P was resident in the UK for neither of the 2 tax years preceding year X because
[i] P met the third automatic overseas test [Overseas work] for each of those years or, alternatively,
[ii] P's case falls within sub-paragraph (2), and
(c) P would meet the third automatic overseas test for year X if paragraph 14 were read with the relevant modifications.

(2) P's case falls within this sub-paragraph if—
(a) P was not resident in the UK for the tax year preceding year X because P met the third automatic overseas test for that year, and
(b) the tax year before that was a split year as respects P because the circumstances of the case fell within Case 1 (see Part 3 of this Schedule) [leaving for overseas work].

(3) The relevant modifications of paragraph 14 are—
(a) in sub-paragraph (1)(a) and (b) and sub-paragraph (3), for "year X" read "the period from the start of year X up to and including the day before the day of P's death", and
(b) in step 3 of sub-paragraph (3), for "365 (or 366 if year X includes 29 February)" read "the number of days in the period from the start of year X up to and including the day before the day of P's death".

Amended as para 16(3) directs, para 14 reads:

(1) The third automatic overseas test is that—

(a) P works sufficient hours overseas, as assessed over ~~year X~~ the period from the start of year X up to and including the day before the day of P's death,

(b) during ~~year X~~ the period from the start of year X up to and including the day before the day of P's death, there are no significant breaks from overseas work,

(c) the number of days in year X on which P does more than 3 hours' work in the UK is less than 31, and

(d) the number of days in year X falling within sub-paragraph (2) is less than 91.

(2) A day falls within this sub-paragraph if—

(a) it is a day spent by P in the UK, but

(b) it is not a day that is treated under paragraph 23(4) as a day spent by P in the UK.

(3) Take the following steps to work out whether P works "sufficient hours overseas" as assessed over ~~year X~~ the period from the start of year X up to and including the day before the day of P's death—

Step 1 [disregarded days]

Identify any days in ~~year X~~ the period from the start of year X up to and including the day before the day of P's death on which P does more than 3 hours' work in the UK, including ones on which P also does work overseas on the same day.

The days so identified are referred to as "disregarded days".

Step 2 [net overseas hours]

Add up (for all employments held and trades carried on by P) the total number of hours that P works overseas in ~~year X~~ the period from the start of year X up to and including the day before the day of P's death, but ignoring any hours that P works overseas on disregarded days.

The result is referred to as P's "net overseas hours".

Step 3 [reference-period days]

Subtract from ~~365 (or 366 if year X includes 29 February)~~ the number of days in the period from the start of year X up to and including the day before the day of P's death

(a) the total number of disregarded days, and

(b) any days that are allowed to be subtracted, in accordance with the rules in paragraph 28 of this Schedule, to take account of periods of leave and gaps between employments.

The result is referred to as the "reference period".

Step 4 [reference-period weeks]

Divide the reference period by 7. If the answer is more than 1 and is not a whole number, round down to the nearest whole number. If the answer is less than 1, round up to 1.

Step 5 [compute net overseas hours ÷ no. of reference-period weeks]

Divide P's net overseas hours by the number resulting from step 4.

If the answer is 35 or more, P is considered to work "sufficient hours overseas" as assessed over ~~year X~~ the period from the start of year X up to and including the day before the day of P's death.

4.26.4 *UK test 4: Year of death of established UK resident*

Death in a year may effectively disapply any of the UK tests. For instance, UK test 2 (UK home) will not be met if P dies before completing the necessary 91 day period.

Para 10(1) Sch 45 FA 2013 provides a UK test for the year of death:

> The fourth automatic UK test is that–
>
> (a) P dies in year X,
>
> (b) for each of the previous 3 tax years, P was resident in the UK by virtue of meeting the automatic residence test,
>
> (c) even assuming P were not resident in the UK for year X, the tax year preceding year X would not be a split year as respects P (see Part 3 of this Schedule),
>
> (d) when P died, either–
>
> (i) P's home was in the UK, or
>
> (ii) P had more than one home and at least one of them was in the UK and
>
> (e) if P had a home overseas during all or part of year X, P did not spend a sufficient amount of time there in year X..

The point of para (c) is to apply the split year rules which would otherwise require non-residence.

The point of para (e) is that the test is not intended to catch, for example, someone who is living back in their overseas home following a secondment to the UK and happens to retain a UK home. Provided the 'spending sufficient time' requirement is met in respect of an overseas home, the amendment ensures that such an individual does not automatically become UK resident by virtue of their death.

Para 10 Sch 45 FA 2013 provides:

> (2) In relation to a home of P's overseas, P "spent a sufficient amount of time" there in year X if—
>
> (a) there were at least 30 days in year X when P was present there on that day for at least some of the time (no matter how short a time), or
>
> (b) P was present there for at least some of the time (no matter how short a time) on each day of year X up to and including the day on which P died.
>
> (3) In sub-paragraph (2)—
>
> (a) the reference to 30 days is to 30 days in aggregate, whether the days were consecutive or intermittent, and

(b) the reference to P being present at the home is to P being present there at a time when it was a home of P's.

(4) If P had more than one home overseas—

(a) each of those homes must be looked at separately to see if the requirement of sub-paragraph (1)(e) is met, and

(b) that requirement is then met so long as it is met in relation to each of them.

4.26.5 *Death in year: sufficient ties test*

The sufficient ties test is amended if the individual dies during the year. Para 20(1) Sch 45 FA 2013 provides:

> If P dies in year X, paragraph 18 has effect as if the words "More than 15 but" were omitted from the first column of the Table.

The first column of the table therefore reads:

Days spent by P in the UK in year X	**Number of ties that are sufficient**
~~More than 15 but~~ fewer than 45	At least 4

Para 20 Sch 45 FA 2013 provides:

> (2) In addition to that modification, if the death occurs before 1 March in year X, paragraphs 18 and 19 have effect as if each number of days mentioned in the first column of the Table were reduced by the appropriate number.
>
> (3) The appropriate number is found by multiplying the number of days, in each case, by A ÷ 12
>
> where "A" is the number of whole months[46] in year X after the month in which P dies.
>
> (4) If, for any number of days, the appropriate number is not a whole number, the appropriate number is to be rounded up or down as follows–
>
> (a) if the first figure after the decimal point is 5 or more, round the appropriate number up to the nearest whole number,
>
> (b) otherwise, round it down to the nearest whole number.

Amended as para 20 requires, the sufficient ties test for a death before 1 March becomes:

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46 Para 145 sch 45 FA 2013 provides: "whole month" means the whole of January, the whole of February and so on, except that the period from the start of a tax year to the end of April is to count as a whole month.

Leavers

Days spent by P in UK in year X	**Number of ties that are sufficient**
~~More than 15 but~~ fewer than 46×A÷12	At least 4
More than 45×A÷12 but fewer than 91×A÷12	At least 3
More than 90×A÷12 but fewer than 121×A÷12	At least 2
More than 120×A÷12	At least 1

Arrivers

Days spent by P in UK in year X	**Number of ties that are sufficient**
More than 45×A÷12 but fewer than 91×A÷12	All 4
More than 90×A÷12 but fewer than 121×A÷12	At least 3
More than 120×A÷12	At least 2

RDR3 offers the following tables:

Table C: UK Ties needed by a deceased person who was UK resident for one or more of the three tax years before the tax year under consideration

No of ties		**Date of death**											
		6-30 Apr	May	1 Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	1 Mar to 5 Apr
		Days spent in UK in year of death											
All 4 ties	Not more than	4	7	11	15	19	22	26	30	34	37	41	45
At least 3 ties		5-7	8-15	12-22	16-30	20-37	23-45	27-52	31-60	35-67	38-75	42-82	46-90
At least 2 ties		8-10	16-20	23-30	31-40	38-50	46-60	53-70	61-80	68-90	76-100	83-110	91-120
At least 1 tie	Over	10	20	30	40	50	60	70	80	90	100	110	120

Table D: UK Ties needed by a deceased person who was UK resident for none of the three tax years before the tax year under consideration

No of ties		**Date of death**											
		6-30 Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	1 Mar to 5 Apr
		Days spent in UK in year of death											
All 4 ties		4-7	8-15	11-15	15-30	19-37	23-45	27-52	31-60	34-67	38-75	42-82	46-90
At least 3 ties		8-10	16-20	23-30	31-40	38-50	46-60	53-70	61-80	68-90	76-100	83-110	91-120
At least 2 ties	over	10	20	30	40	50	60	70	80	90	100	110	120

4.26.6 *Transitional rules for years to 2017/18*

Para 154(5) sch 45 FA 2013 deals with the transitional problem where the 3 previous tax years include pre-2013 periods, where the SRT (and in particular the automatic residence tests) did not apply:

Unless, in relation to a pre-commencement tax year, an election is made under sub-paragraph (3) as respects that year—[47]

(a) paragraph 10(b) of this Schedule has effect in relation to that year as if the words "by virtue of meeting the automatic residence test" were omitted,

(b) paragraph 16 of this Schedule has effect in relation to that year as if—

(i) in sub-paragraph (1)(b), the words "because P met the third automatic overseas test for each of those years" were omitted, and

(ii) in sub-paragraph (2)(a), the words "because P met the third automatic overseas test for that year" were omitted, and

(c) paragraph 49 of this Schedule has effect in relation to that year as if in sub-paragraph (2)(a) for the words from "because" to the end there were substituted "in circumstances where the taxpayer was working overseas full-time for the whole of that year."

4.26.7 *Transitional rules for years to 2015/06*

Para 154(5) sch 45 FA 2013 deals with the transitional problem where the 3 previous tax years include pre-2013 periods, where the SRT (and in particular the automatic residence tests) did not apply:

Unless, in relation to a pre-commencement tax year, an election is made under sub-paragraph (3) as respects that year[48]—

(a) paragraph 10(b) of this Schedule has effect in relation to that year as if the words "by virtue of meeting the automatic residence test" were omitted

4.27 Transitional issues

4.27.1 *Ascertaining pre-2013 residence for purposes of SRT*

The distinction between leavers and arrivers depends on whether a person is UK resident in the previous 3 years, so pre-2013 residence will be relevant to determine whether a person is a leaver or an arriver, and so may be relevant to post-2013 residence:

2013/14: position depended on residence in 2010/11, 2011/12, 2012/13

47 See 4.27.1 (Ascertaining pre-2013 residence for purposes of SRT).

48 See 4.27.1 (Ascertaining pre-2013 residence for purposes of SRT).

2014/15: position depends on residence in 2011/12, 2012/13
2015/16: position depends on residence in 2012/13

By **2016/17** the position will depend on residence in 2013/14 onwards, but the residence position in those years may in part depend on the old law. Thus it will take decades before pre-2013 residence is completely irrelevant to post 2013 residence, but the number of cases in which it matters will become small by 2016 and will diminish each year thereafter.

Para 154 sch 45 FA 2013 explains how one determines pre-2013 residence. One applies the pre-2013 residence law but with an election to apply the SRT:

> (1) This paragraph applies if—
>
> (a) year X or, in Part 3 of this Schedule, the relevant year is the tax year 2013-14, 2014-15, 2015-16, 2016-17 or 2017-18, and
>
> (b) it is necessary to determine under this Schedule whether an individual was resident or not resident in the UK for a tax year before the tax year 2013-14 (a "pre-commencement tax year").
>
> (2) The question under this Schedule is to be determined in accordance with the rules in force for determining an individual's residence for that pre-commencement tax year (and not in accordance with the statutory residence test).
>
> (3) But an individual may by notice in writing to HMRC elect, as respects one or more pre-commencement tax years, for the question under this Schedule to be determined instead in accordance with the statutory residence test.
>
> (4) A notice under sub-paragraph (3)—
>
> (a) must be given no later than the first anniversary of the end of year X or, in a Part 3 case, the relevant year, and
>
> (b) is irrevocable.

Probably in practice one will have regard to the SRT for pre-2013 years, even when no election is made. That would be sensible since the SRT "broadly recreates the outcome of the current residence rules".[49]

An election would seem to be appropriate in cases of doubt but it will usually have the downside of focussing HMRC attention on uncertain claims of non-residence in pre-2013 years.

An election would be appropriate where an individual is UK resident under the pre-2013 rules but non-resident under the SRT. That will be rare but it could happen if an individual spent more than 183 days in the

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49 See 4.31 (How different is the SRT from pre-2013 residence law?).

UK due to exceptional circumstances (such as illness). In that case the individual could be UK resident under the pre-2013 rule (where the 183 day test did not allow any relief for exceptional circumstances) but non-resident under the SRT.

The election does not apply for other tax purposes, such as:

(1) IHT deemed domicile rule
(2) The residence period which determines liability to pay the remittance basis charge

4.27.2 *Split years before 2013/4*

Para 155 sch 45 FA 2013 provides:

> (1) This paragraph applies if—
>
> (a) year X or, for Part 3 of this Schedule, the tax year for which an individual's liability to tax is being calculated is the tax year 2013-14 or a subsequent tax year, and
>
> (b) it is necessary to determine under a provision of this Schedule, or a provision inserted by Part 3 of this Schedule, whether a tax year before the tax year 2013-14 (a "pre-commencement tax year") was a split year as respects the individual.
>
> (2) The provision is to have effect as if—
>
> (a) the reference to a split year were to a tax year to which the relevant ESC applied, and
>
> (b) any reference to the UK part or the overseas part of such a year were to the part corresponding as far as possible, in accordance with the terms of the relevant ESC, to the UK part or the overseas part of a split year.
>
> (3) Where the provision also refers to cases involving actual or deemed departure from the UK, the reference is to be read and given effect so far as possible in accordance with the terms of the relevant ESC.
>
> (4) "The relevant ESC" means whichever of the extra-statutory concessions to which effect is given by Part 3 of this Schedule is relevant in the individual's case.

The relevant ESCs are A11, A78 and D2.

4.28 Record keeping

Careful record keeping will often be necessary, especially for individuals whose residence is governed by the sufficient ties test.

4.28.1 *Record of UK days*

Note that it is hardly possible to be present in the UK without leaving

some electronic trail behind. In *Morris v HMRC*:

> the Revenue used their powers under s 20(3) TMA to obtain copies of the taxpayers' credit card and mobile phone records. These indicated that their credit cards and phones had been used in the UK on many more days than the taxpayers claimed they had been in the country. In subsequent correspondence, the solicitors said that this was because they had been used by other family members...[50]

Perhaps it would be unwise for non-UK residents to share mobile phones and credit cards with UK residents.

4.28.2 *Record keeping: home*

RDR3 provides:

> **Home**
> 7.2 When considering whether you had a home in the UK or abroad, HMRC would look for evidence to establish your presence at a particular home and whether or not a home existed. The following information would help establish the facts.
> - General overheads - utility bills which may demonstrate that you have been present in that home, for example, telephone bills or energy bills, which demonstrate usage commensurate with living in the property.
> - TV/satellite/cable subscriptions.
> - Local parking permits.
> - Membership of clubs, for example sports, health or social clubs.
> - Mobile phone usage and bills pointing to your presence in a country.
> - Lifestyle purchases pointing to you spending time in your home – for example, purchases of food, flowers and meals out.
> - Presence of your spouse, partner or children.
> - Engagement of domestic staff or an increase in their hours.
> - Home security arrangements.
> - Increases in maintenance costs or the frequency of maintenance, for example having your house cleaned more frequently.
> - Insurance documents relating to that home.
> - SORN notification that a vehicle in the UK is "off road".
> - Re-directed mail requests.
> - The address to which you have personal post sent.
> - The address to which your driving licence is registered.
> - Bank accounts and credit cards linked to your address and

50 79 TC 184 at [6].

statements which show payments made to utility companies.
- Evidence of local municipal taxes being paid.
- Registration, at your address, with local medical practitioners.
- What private medical insurance cover you have, is it an international policy?
- Credit card and bank statements which indicate the pattern and place of your day by day expenditure.

7.3 The above list is not definitive; no one piece of evidence will demonstrate the existence of your UK or overseas home with the requisite time spent there. HMRC will consider the weight and quality of all the evidence as, taken together, a number of pieces of evidence may be sufficiently strong to demonstrate your presence in a particular home.

7.4 Where your home has changed from a holiday home to your home for the purposes of the SRT, the change in occupation could be evidenced by, amongst other things:
- utility bills which may show an increase in usage,
- changes you have notified to
  - local municipal authorities, or
  - the company providing your buildings and contents insurance.

4.28.3 *Recording keeping: work*

RDR3 provides:

Working hours and location of work done

7.5 Where your residence status is determined by the automatic tests relating to working full-time in the UK or overseas, you should keep information and records relating to:
- the split in your working life between the UK and overseas, particularly noting days where you worked (including training, being on stand-by and travelling) for more or less than three hours
- the nature and duration of your work activities - a work diary/calendar or timesheet is likely to indicate this. You may find that it would be beneficial to ensure your diary is sufficiently detailed, maybe reflecting hours worked and the nature of your work, for example reviewing and responding to emails, meetings, or filing travel claims
- breaks you had from working, for example between jobs, and why
- your periods of annual, sick or parenting leave
- time you spend visiting dependent children (those under the age of 18) when they are in the UK
- time you had to spend in the UK owing to exceptional circumstances,

  - what your circumstances were
  - what you did to mitigate them where that was possible, for example making alternative travel arrangements
- your contracts of employment, and documentation/communications which relate to these, particularly to curtailment or extension of these or other changes to them.

4.28.4 *Recording keeping: sufficient ties test*

RDR3 provides:

> 7.6 Where you have connections to the UK, such as family, accommodation, work or time spent here, you should keep information and records that will allow you to work out:
> - in which countries you have spent your days and midnights, for example
>   - your travel details
>   - booking information, or
>   - tickets, and boarding cards
> - if you left the UK to live or work abroad,
>   - the date you left the UK
>   - visa or work permit applications, etc if you had to make them
>   - contracts of employment
> - if you come to live or work in the UK
>   - the date you arrive here
>   - visa or work permit applications
>   - documentation relating to you taking up employment or ceasing your previous employment
> - when you were present at your home or homes, or other available accommodation
> - how long you owned or rented those homes, for example when you purchased, sold or leased those homes
> - the time your home was unavailable for your use, for example because it was rented out.

4.29 Contacting HMRC when arriving in or leaving the UK

RDR1 provides:

> 1.14 You should tell HMRC immediately if you come to the UK to live or work or leave the UK to live or work overseas. You should also tell HMRC if those circumstances change while you are in the UK.

There is no legal obligation to do this. But at some point arrivers are likely to have to complete a tax return, put in a remittance basis claim, or

give HMRC notice of liability to tax under s.7 TMA; it may make sense to contact HMRC in advance of the formal deadlines for those steps. The RDR Manual provides:

> **RDRM10215 - Residence: Coming to the UK: Form P86** [Jun 2011]
> Since 1 June 2010 the form P86 has been withdrawn and new arrivals to the UK will be integrated into HMRC processes by existing means
> • Form P46 or P46(Expat) for new employees
> • CWF1 for newly self employed, or
> • SA1 registration process for customers who are not self employed but who need to complete a tax return
> Please refer to BGN 044/10 for further information (also refer to EIM42890 and PAYE81750)

Form P85 is used to claim tax relief or a repayment of tax on becoming non-UK resident. For a discussion of how to answer some of the questions on this form, see Finney, "A new form of test" (24 October 2013) Taxation, p.18.

4.29.1 *Form SA109*

This form contains HMRC's standard questions on residence. The minutes of the Joint Expatriate Forum on Tax and NICs provide:

> 3.3 HMRC was aware that some agents and taxpayers felt that the SA109 asked for unnecessary or duplicate information. HMRC explained that this additional information was useful because it would allow HMRC to consider whether the claimed residence status was correct even though the basis of the claim was incorrect, e.g. an individual who failed to be automatically non-resident might not have sufficient UK ties or days of presence to be resident, and vice versa. HMRC made clear that an individual had no obligation to answer question other than those they believed to be appropriate to their circumstances.
> 3.4 HMRC acknowledged that the 2013-14 SA109 is not perfect but explained that the window of opportunity for making changes was very small. HMRC has taken on board stakeholders' comments in respect of the 2013-14 form and that they will use the information to inform the 2014-15 form and guidance notes.
> 3.5 HMRC re-iterated that ultimately individual taxpayers were responsible for entries they make on their Self Assessment returns and completing the sections of the SA109 that they believe to be appropriate to them. Any entries made can be clarified or expanded upon via an entry in the free entry white space at box 39. The following points were

addressed in discussion:

- HMRC is relaxed regarding the criteria used in making entries in boxes 6 and 7. Either split year relevant dates or dates of physical arrival and departure can be entered and the information can be qualified/ explained in Box 39 to assist a reviewer. HMRC said entry of physical dates of arrival and departure will support day-count tests. Boxes 6 and 7 will be changed in future years. HMRC confirmed that boxes 6 and 7 are not appropriate where an individual is resident in the UK under the first automatic UK test (183 days test) in consecutive years. In these circumstances as the individual has not arrived or departed and this should be explained in Box 39.
- HMRC said that it is up to the individual to decide which of the boxes are appropriate to complete and use a white space note to qualify the information provided. Returns will be risk assessed for enquiry based on the entries made on the front page of SA109 in conjunction with other entries made on the return.
- HMRC confirmed that where an individual remits prior year relevant foreign earnings but is not benefiting from overseas workdays relief in the current year Box 5 should not be ticked and Box 39 should be used to explain the situation.
- When a taxpayer is completing Box 12 for split years and there are different ties for the UK/overseas parts, the taxpayer should explain in Box 39 which tie is relevant to which part. For split years and boxes 10 and 12, HMRC is only looking for information in relation to the overseas part of the year.
- If an individual has a UK and an overseas workday on the same day, that day should be entered (twice) in each of Boxes 13 and 14. The taxpayer should explain the entries in Box 39.
- When recording split year information, all relevant cases should be disclosed in Box 39 but there is no need to identify all relevant dates where multiple cases potentially apply (subject to the statutory order of priority) – only the date the individual considers applies need be recorded.[51]

4.30 Ordinary residence

Schedule 46 FA 2013 (more or less) removed the concept of ordinary residence from tax law. The concept survives in the context of NICs, in

51 29 April 2014
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/327284/140704_Expat_Forum_Minutes_FINAL.pdf

non-tax law, and in obscure corners of tax where it could not conveniently be abolished.[52]

Para 72(1) Sch 46 provides:

> The amendments made by this Part of this Schedule [Part 2: Income tax: arising basis of taxation] have effect for the purposes of a person's liability to income tax for the tax year 2013-14 or any subsequent tax year.

Para 73 Sch 46 FA 2013 provides a transitional relief:

> (1) This paragraph applies to an individual who—
>
> (a) was resident in the United Kingdom for the tax year 2012-13, but
>
> (b) was not ordinarily resident there at the end of the tax year 2012-13.
>
> (2) The provisions listed in sub-paragraph (3) have effect, in relation to such an individual and a qualifying tax year, as if the amendments made to or with respect to those provisions by this Part of this Schedule had not been made.
>
> (3) The provisions are—
>
> (a) section 413 of ITEPA 2003 (exception for payments and benefits on termination of employment etc in certain cases involving foreign service),
>
> (b) section 414 of that Act (reduction in other cases of foreign service), and
>
> (c) Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad).
>
> (4) But, in the case of provisions within paragraph (a) or (b) of sub-paragraph (3), this paragraph applies only if service in the employment in question began before the start of the tax year 2013-14.

4.30.1 *"Qualifying tax year"*

Para 73(5) Sch 46 FA 2013 provides

> The meaning of "qualifying tax year" depends on the individual's residence status—
>
> (a) if the individual was resident in the UK for the tax year 2010-11 and the tax year 2011-12, "qualifying tax year" means the tax year 2013-14,
>
> (b) if the individual was not resident in the UK for the tax year

52 Eg, taxation of diplomats; see s.841 ITA. The concept of habitual residence, which covers similar ground, remains in the context of DTAs.

2010-11 but was resident in the UK for the tax year 2011-12, "qualifying tax year" means each of the tax year 2013-14 and the tax year 2014-15, and

(c) if the individual was not resident in the UK for the tax year 2011-12, "qualifying tax year" means each of the tax year 2013-14, the tax year 2014-15 and the tax year 2015-16.

The old law will become finally obsolete on 6 April 2016 when this transitional relief ceases to have effect.

4.30.2 *Determining ordinary residence*

Para 73(6) Sch 46 FA 2013 provides

> Where, by virtue of this paragraph, it is necessary to determine whether an individual is (or is not) ordinarily resident in the UK at a time on or after 6 April 2013, the question is to be determined as it would have been in the absence of this Schedule.

4.31 How different is the SRT from pre-2013 residence law?

The Residence Consultation Paper provides:

> 3.55 The SRT ... will broadly recreate the outcome of the current residence rules...

In short, the SRT is not generally intended to change the old law, only to clarify its vagueness. Four old cases would however be decided differently under the SRT:[53]

Rogers v IRC 1 TC 225 (the mariner's case). Rogers, a ship's captain, was not present in the UK throughout 1878-9. He was held to be UK resident, but would have been non-resident under SRT overseas test 1 (less than 16 UK days).

Cooper v Cadwalader 5 TC 101 (the American grouse shooter)
Cadwalader was an American barrister who lived and worked in New York. He spent two months each year in a shooting lodge rented in Scotland. Mr Cadwalader was an arriver in the first relevant year and so have needed 4 UK ties to make him resident. In each year his only UK tie was an accommodation tie. He was held to be resident from 1900/01 to 1903/04. Under the SRT Mr Cadwalader would not have been resident.

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53 I am grateful to Oliver Marre, Barrister, 15 Old Square, for his research in this section.

Lysaght v CIR 13 TC 511 (the non-executive director)

Lysaght was held to be resident in 1922/23 and 1923/24. He was present in the UK for approximately one week per month in each of the years of assessment, giving a UK presence of (say) 84 days p/a.

Lysaght was UK resident until sometime in 1919. If this means that he was UK tax resident in the tax year 1919/20, he would have been a "leaver" in 1922/23 and therefore have needed 3 or more UK ties to be tax resident in the UK that year. If Lysaght was not resident in 1919-20 he would have been an "arriver" in 1922/23 and so needed 4 or more UK ties.

Lysaght did not have a **family tie**.

Lysaght did not have an **accommodation tie**. His brother had a house but he did not stay there 16 nights in the year.

Lysaght did have a **work tie** in the UK. His work was the reason for his presence. Assuming he worked five of the seven days he was present in the UK, he would have worked for 60 days. 40 days constitutes a work tie.

Lysaght does not appear to have had the **90 day tie** as he does not appear to have been in the UK for more than 90 days in either of the previous two tax years.

Lysaght did not have the **country tie** as he spent more time in Ireland than in the UK.

In 1922/23 Lysaght therefore had one UK tie and would not have been resident.

In 1923/24 Lysaght would accordingly have been an "arriver" and would have needed UK ties to be resident. The same facts apply and Lysaght therefore had one UK tie.

Under the SRT Lysaght would have been non-resident.

Zorab v IRC 11 TC 289 (British subject from India)

Zorab was held not to be UK resident in 1924/25.

In that year, Zorab was present in the UK from 21 May to 18 October, making him present for 150 days.

If Zorab was an arriver, he would therefore need 2 UK ties to make him resident; and if he was a leaver, he would need 1 UK to make him resident.

In the previous three tax years, Zorab was present in the UK for 181, 182 and 173 days respectively. In the tax year 1920/21 he was present in the UK for 210 days, and therefore would have been UK resident under the 183 day test.

Accordingly in the three years prior to 1924/25 Zorab would have been

a leaver and needed just one UK tie. In each case he was present for over 90 days in the previous year and so would have been tax resident for that year.

Therefore in 1924/25 Zorab would also have been a leaver and needed just one UK tie to make him resident. He was present in the UK for over 90 days the previous year and accordingly had a **90 day tie**.

Under the SRT Zorab would have been UK resident.

Of these four cases, however, HMRC did not in practice enforce the first: they would regard Captain Rogers as non-resident.[54] The second and third were strongly (and, I think, rightly) criticised by the Canadian Supreme Court.[55] The last was a surprising decision even in its time. So the SRT has successfully identified four wrong decisions, and has provided a test of residence which is more true to the principles of the common law rules than these outlier decisions, as well as being more clear and certain.

4.32 Tax motivated non-residence

In *Reed v Clark* the taxpayer carefully organised his year abroad to reduce his tax liability but that was irrelevant to residence:

> Residence abroad for a carefully chosen limited period of work there ... is no less residence abroad for that period because the major reason for it was the avoidance of tax.[56]

The same principle will apply under the SRT.

I would regard tax-motivated migration as mitigation rather than avoidance[57] but the that classification issue is not likely to arise in this

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54 See Kessler, *Taxation of Non-residents & Foreign Domiciliaries* (11th ed., 2012), para 3.20 (Seafarers).

55 *Thomson v Minister of National Revenue*, [1946] SCR. 209 at p.221, 224: ... "*Cooper v Cadwaladar*... is the case of an American citizen living in the United States, who owned shooting rights in Scotland, where he spent a few months annually, and who was held liable in Scotland for income tax. I feel quite confident that no Canadian court, in similar circumstances, would hold that such a person... is a "resident" ... "it must, I think, be said that the language of "plain men" was stretched to the breaking point to encompass the facts that had been found by the Commissioners [in *Lysaght v IRC*] to be residence..."

56 58 TC 528 at p.556.

57 See 32.7 ("Avoidance", "mitigation", "tax reduction", "evasion": introduction). Contrast the Special Commissioner in *Shepherd v IRC* 78 TC 389 at [62]: "Although the Appellant's intention in going to Cyprus was to *mitigate* tax, I do not regard that as a relevant factor in deciding whether he was resident in the UK."

context.

As to whether becoming treaty non-resident might constitute avoidance or abuse, see 57.12 (Tax avoidance using DTAs).

4.33 Assessment of the SRT

The Residence Response Paper provides:

> 3.5 [1] The Government does not believe the test is complicated and [2] taxpayers will be able to determine their residence status with clarity if they know how many days they have spent in the UK and which of the relevant connection factors they have.

Tax complexity is a complex phenomenon[58] but no-one will take point [1] seriously. It is however true that taxpayers will for the first time be able to determine their residence status (in the large majority of cases) with reasonable certainty. That is a change for the better. The SRT is complex, voluble and repetitious, and onerous in terms of record keeping; but however much one might regret that, no-one would swap the SRT for the previous law.

Almost all the problems raised by the pre-2013 (non)definition of residence have been swept away. This carries out the reform recommended by the Consolidation Committee in 1936,[59] though the committee would have been astonished that the definition of residence required more than 50 pages of legislation and over 100 pages of HMRC guidance.

The reform benefited from the input of the professional bodies from an early stage of policy development, rather than being produced by HM Treasury/HMRC and then presented in a complete form, at a consultation stage.

4.34 The future

Given the complexity of the rules, it is likely that there will be changes in the next few years as the effect of the rules begins to be understood. It appears that Parliament expects this, as s.218(2) FA 2013 provides:

> The Treasury may by order make any incidental, supplemental, consequential, transitional or saving provision in consequence of Schedule 45.

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58 See the Introduction to this work.

59 See the 2012/13 edition of this work, para 3.15.1 (Practice prior to 1936).

The CIOT are lobbying for a review:

> The CIOT notes that the Tax Information and Impact Notes for the SRT, published on 11 December 2012, included a commitment that 'This measure will be kept under review through communication with affected taxpayer groups.' Further, in the discussion document 'Tax policy making: a new approach' issued in 2010, the Government recognised the importance, in maintaining the integrity of the tax code, of evaluating the impact and effectiveness of tax policy reforms following implementation.
>
> Accordingly, after a suitable interval, the CIOT recommends that the new SRT be formally evaluated, by an independent review, against its declared objectives in order to assess whether it is achieving those objectives.
>
> The CIOT suggests that such a review could be conducted in April 2016 ie three tax years after the SRT came into force.[60]

60 CIOT, letter to HMRC, (2013) published *http://www.tax.org.uk/Resources/CIOT/Documents/2013/12/131203%20Evaluation%20of%20the%20Statutory%20Residence%20Test%20-%20CIOT%20comments.pdf*

CHAPTER FIVE

RESIDENCE OF TRUSTEES

5.1 Trustee residence: Introduction

Trustee[1] residence (like individual residence) is fundamental to the territorial limitations of IT and CGT.

There is one main definition of trustee residence, which is the same for IT and CGT.[2] The IT and CGT provisions are differently worded, but the effect of the rules is the same. In this chapter I set out both sets of provisions.[3]

The current rules adopt proposals originally made in the Trusts Consultative Document (1991).[4] This is worth reading as it explains the background to the current rules.

Different rules apply to PRs[5] and to trustees of unit trusts.[6]

5.2 Who are the trustees?

One needs first of all to identify the trustees.

"Trustee" is not usually defined for IT and CGT purposes and the identity of trustees of a classic settlement is a matter of trust law.

What if there has been an invalid appointment of new trustees, and the

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1 Strictly, one should refer to trustee residence, not trust residence, but in practice the two expressions may be used synonymously.

2 For IHT see 5.18 (Trustee residence for IHT).

3 When introduced in the FA 2006, the wording was exactly the same (though the provisions were set out twice, once in ICTA and again in TCGA). But ITA repealed the ICTA provisions and recast them in its own plain English style. If (as the professional bodies asked at the time) the 2006 reform had been put back to 2007, this complication would have been avoided. But there it is.

4 Chapter 10, accessible *http://www.kessler.co.uk/tfd-archive*.

5 See 78.3 (Residence and domicile of PRs for CGT) and 79.4 (Residence of PRs for IT).

6 See 39.3.2 (Residence of trustees of unit trust).

trust property has been transferred to the invalidly-appointed trustees? Trust law distinguishes between:

(1) a validly appointed trustee, and

(2) a person purportedly but invalidly appointed as trustee; such a person is not the proper owner and administrator of the trust assets, but is of course subject to the duty to transfer the trust assets to the correct trustees, and if they act in trust administration, they may become a trustee *de son tort.*

What confuses matters is that the term "trustee" is sometimes (but not always) used to describe a person in category (2).[7] But it is considered that such a person is not a "trustee" in the full trust law sense, and so is not a trustee for tax purposes.[8]

For the question whether a protector may be a trustee, see 5.17 (UK protector and trustee residence). For the identity of trustees of a settlement-arrangement which is not a classic trust, see 51.2 ("Settlement" and "trustee").

5.3 Trustees treated as single and distinct person

Section 474(1) ITA provides:

> For the purposes of the Income Tax Acts (except where the context otherwise requires), the trustees of a settlement are together treated as if they were a single person (distinct from the persons who are the trustees of the settlement from time to time).[9]

EN CTA 2010 Annex 1 change 3 discusses this deeming provision:

> Section 474(1) of ITA ... substitutes a notional person for the trustees. That notional person is not a company and so cannot be an associated company [for the purposes of s.25 CTA 2010]. It follows that [the former] ESC C9 is not needed to prevent a trustee company and a company which it controls from being treated as associated. Similarly, if section 474(1) of ITA treats the trustees of two settlements as separate notional person, the concession is not needed to prevent two companies controlled by different settlements from being treated as associated [even

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7 See R.C. Nolan's learned article "Equitable Property" [2006] LQR 232.

8 For CGT this is clearer as an invalidly appointed trustee would be a nominee within s.60 TCGA, but the same would apply for IT. *Jasmine Trustees v Wells & Hind* [2007] STC 660 held that invalidly appointed trustees were "trustees" but were not "trustees of the settlement", which is another route to the same destination.

9 The CGT equivalent is s.69(1) TCGA. The CT equivalent is s.1169 CTA 2010.

if the trustees are actually the same persons].

The deeming provision applies for the taxation of the trust but not for the taxation of the trustee: trustee remuneration is income of the person who is actually the trustee, not the notional person.

5.4 Trustee residence for income tax and CGT

Section 475 ITA provides:

> (1) This section applies for income tax purposes and explains how to work out, in relation to the trustees of a settlement, whether or not the single person mentioned in section 474(1) is UK resident.
> (2) If at a time either condition A or condition B is met, then at that time the single person is UK resident.
> (3) If at a time neither condition A nor condition B is met, then at that time the single person is non-UK resident.

Similarly, s.69 TCGA provides:

> (2) The deemed person referred to in subsection (1) shall be treated for the purposes of this Act as resident in the UK at any time when a condition in subsection (2A) or (2B) is satisfied...
> (2E) If the deemed person referred to in subsection (1) is not treated for the purposes of this Act as resident in the UK, then for the purposes of this Act it is treated as being not resident in the UK.

There are therefore two circumstances in which trustees are UK resident. In the ITA they are called Condition A and Condition B. In the CGT legislation they are called Condition 1 and Condition 2. I refer to them as "**trustee residence conditions A and B**".

5.5 Trustee residence condition A: trustees all UK resident

Section 475(4) ITA provides:

> Condition A is met at a time if, at that time, all the persons who are trustees of the settlement are UK resident.

Similarly for CGT, s.69(2A) TCGA provides:

> Condition 1 is that all the trustees are resident in the UK.

One must identify the trustees' actual place of residence in their personal capacities, applying the statutory residence test to trustees who are

individuals,[10] and the corporate residence test to corporate trustees. If all the trustees are UK resident, the trust is UK resident; conversely if all the trustees are not resident in the UK, then the trust is non-resident.

5.6 Trustee residence condition B: mixed resident trustees

Condition B deals with the position of trustees of mixed residence. Section 475(5) ITA provides:

> Condition B is met at a time if at that time—
>
> (a) at least one person who is a trustee of the settlement is UK resident and at least one such person is non-UK resident, and
>
> (b) a settlor in relation to the settlement meets condition C (see section 476).

I refer to condition C as "**trustee residence condition C**".

Similarly for CGT, s.69 TCGA provides:

> (2B) Condition 2 is that:
>
> (a) at least one trustee is resident in the UK,
>
> (b) at least one is not resident in the UK, and
>
> (c) a settlor in relation to the settlement was resident or domiciled in the UK at a time which is a relevant time in relation to him.
>
> (2C) In subsection (2B)(c) 'relevant time' in relation to a settlor—
>
> (a) means where the settlement arose on the settlor's death (whether by will, intestacy or otherwise), the time immediately before his death, and
>
> (b) in any other case, a time when the settlor made the settlement (or was treated for the purposes of this Act as making the settlement).

5.7 Trustee residence condition C

Trustee residence condition C corresponds to the CGT relevant time requirement in s.69(2C) TCGA. Section 476(1) ITA provides:

> This section applies for the purpose of working out whether a settlor ("S") in relation to a settlement meets condition C at a time.

Section 476(2) ITA deals with testamentary trusts:

> If—
>
> (a) the settlement arose on S's death (whether by S's will, on S's

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10 See 4.2.1 (Residence of trustees and personal representatives).

intestacy or in any other way), and

(b) immediately before S's death, S was UK resident or domiciled in the UK,

then S meets condition C from the time of S's death until S ceases to be a settlor in relation to the settlement.

Section 476(3) ITA deals with lifetime trusts:

If—

(a) the settlement is not within subsection (2)(a), and

(b) at a time when S made the settlement (or is treated for the purposes of the Income Tax Acts as making the settlement), S was UK resident or domiciled in the UK,

then S meets condition C from that time until S ceases to be a settlor in relation to the settlement.

There is no express split year rule, so the default rule applies: condition C is met even if a trust is made during the overseas part of a split year.[11]

For the purposes of discussion it is convenient to have some terminology and I coin the following terms:

(1) A "**UK-linked settlor**" is one within Condition C, i.e. (in short) who is resident or domiciled in the UK when they made the settlement.

(2) A "**UK-linked trust**" is one where the settlor (or a settlor) was UK-linked when they made the settlement.

(3) A trust has "**mixed resident trustees**" if some trustees are UK resident and some are not.

Thus (in my terminology) a trust with mixed resident trustees is UK resident if it is a UK-linked trust; conversely it is non-resident if it is not a UK-linked trust.

5.7.1 *Identifying settlor and date of provision: tainting*

In trusts with mixed resident trustees, it is necessary to identify the settlor(s)[12] and to ascertain when the settlor(s) provide trust property.

A trust whose settlor is not UK-linked may have some UK trustees (as long as they are not the sole trustees). In that case, however, one must take care that no other UK-linked person provides even a nominal amount of funds because that will make them co-settlors and the trust UK resident.

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11 See 7.1 (Default rule: individual regarded as resident throughout tax year).

12 See 80.1 (Who is the settlor?).

This is known as "tainting" the trust.[13]

Suppose:

(1) Year 1: the settlor makes a trust when not UK resident;
(2) Year 2: the *same* settlor becomes UK resident and then adds property to the settlement.

The time that S made the settlement was year 1; S does not make a separate settlement in year 2; so at first sight it seems that the settlement is not UK-linked. But S is treated as making a settlement in year 2,[14] so it is considered that the settlement does become UK-linked.

For the position where a settlor leaves a loan outstanding after coming to the UK, see 80.19 (Interest-free or back-to-back loan).

5.7.2 *2013 ordinary residence transitional rules*

Prior to the abolition of ordinary residence in 2013, s.476 ITA provided:

> (2) If—
>
> (a) the settlement arose on S's death (whether by S's will, on S's intestacy or in any other way), and
>
> (b) immediately before S's death, S was UK resident, ordinarily UK resident or domiciled in the UK,
>
> then S meets condition C from the time of S's death until S ceases to be a settlor in relation to the settlement.
>
> (3) If—
>
> (a) the settlement is not within subsection (2)(a), and
>
> (b) at a time when S made the settlement (or is treated for the purposes of the Income Tax Acts as making the settlement), S was UK resident, ordinarily UK resident or domiciled in the UK,
>
> then S meets condition C from that time until S ceases to be a settlor in relation to the settlement.

Para 57(2)(3) sch 46 FA 2013 deleted the underlined words. But para 57 provides:

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13 See 80.3.8 (Tainting).

14 See 80.3.2 (Standard IT/CGT definition of settlor). The pre-rewrite wording was clearer. Section 110 FA 1989 referred to "the time *or, where there is more than one, each of the times* when he has provided funds ... for the purposes of the settlement." It is an interesting question to what extent the Courts will refer to pre-rewrite legislation to construe post-rewrite legislation. But that will not arise here, as the current legislation seems clear enough.

(4) The amendment made by sub-paragraph (2) does not apply if the person died before 6 April 2013.
(5) The amendment made by sub-paragraph (3) does not apply if the settlement was made before 6 April 2013.

Thus the pre-2013 rules continue to apply to govern the taxation of pre-2013 settlements. But it only makes a difference if a settlor is ordinarily resident but not UK resident, which probably never happens.[15]

5.8 Residence of individual trustee during split year

The HM Treasury residence response paper provides:

> 3.122 Under the SRT an individual is resident for the whole of a tax year or not at all. It follows that provisions that look at residence status at a particular time may not work in the same way as previously. It is recognised that this may have an unintended impact on the position of a trust in the year in which an individual trustee comes to or leaves the UK and is resident for that year.
> 3.123 Accordingly the draft legislation contains a new rule that provides that an individual trustee is not regarded as resident for the purposes of determining the residence status of the trust if the only period in the year when the individual is a trustee falls within the overseas part of a split year for that individual.[16]

Section 69(2DA) TCGA provides:

> A trustee who is resident in the UK for a tax year is to be treated for the purposes of subsections (2A) and (2B) as if he or she were not resident in the UK for that year if—
> (a) the trustee is an individual,
> (b) the individual becomes or ceases to be a trustee of the settlement during the tax year,
> (c) that year is a split year as respects the individual, and
> (d) in that year, the only period when the individual is a trustee of the settlement falls wholly within the overseas part of the year.

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15 See the 2012/13 edition of this work para 3.14 (Ordinarily resident but not resident).
16 HM Treasury, "Statutory definition of tax residence and reform of ordinary residence: summary of responses to the June 2012 consultation" (December 2012) *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/consult_responses_statutory_definitions_of_tax_residence_reform_of_ordinary_residence_responses.pdf*

This applies if an individual becomes trustee during the overseas part of a split year. It does not apply if the individual is trustee throughout the year. In such a case the trust may be resident in part of the year, and so subject to CGT for the whole year.

Section 69(2DB) TCGA provides an exception relating to the PE residence rule:[17]

> Subsection (2DA) is subject to subsection (2D) and, accordingly, an individual who is treated under subsection (2DA) as not resident is, in spite of that, to be regarded as resident whenever the individual acts as mentioned in subsection (2D).

For IT, s.475 ITA provides the same rule in slightly different words:

> (7) Subsection (8) applies if—
> (a) an individual becomes or ceases to be a trustee of the settlement during a tax year,
> (b) that year is a split year as respects the individual, and
> (c) the only period in that year when the individual is a trustee of the settlement falls wholly within the overseas part of the year.
> (8) The individual is to be treated for the purposes of subsections (4) and (5) as if he or she had been non-UK resident for the year (and hence for the period in that year when he or she was a trustee of the settlement).
> (9) But subsection (8) is subject to subsection (6) and, accordingly, an individual who is treated under subsection (8) as having been non- UK resident is, in spite of that, to be treated as UK resident whenever the individual acts as mentioned in subsection (6)

5.9 Accidental residence: a trap

A trust may become UK resident if:
(1) its sole trustee becomes UK resident; or
(2) any trustee becomes UK resident and it is a UK-linked trust.
The consequences of a trust becoming UK resident will be disastrous for CGT and (except for IIP trusts) for IT. So it is essential for an individual to resign trusteeship before becoming UK resident if (1) a sole trustee or (2) trustee of a UK-linked trust. This includes trusteeships of foreign law charitable trusts.

This state of affairs is deliberate, for the 1991 consultative document

17 See 5.12 (Permanent establishment residence rule).

discussed a relief for temporary resident trustees, but suggested, implausibly, that the problem was not significant. In practice, in cases of unfairness, I expect the problem will be overlooked or ignored by non-compliant taxpayers, and HMRC may not spot it or turn a blind eye.

5.10 Sub-funds

It is common for one trust to hold separate funds ("sub-funds") on separate terms, and it is possible (though not common) for the sub-funds to have separate trustees. Section 474(2) ITA provides:

> If different parts of the settled property in relation to a settlement are vested in different bodies[18] of trustees, subsection (1) and sections 475 and 476 apply in relation to the different bodies as if they were all one body.

Thus the trust is UK resident unless the trustees of the sub-funds jointly meet the trustee residence conditions.

Section 474(3) deals with Settled Land Act settlements:

> The cases covered by subsection (2) include cases where settled land (within the meaning of the Settled Land Act 1925) is vested in the tenant for life and investments representing capital money are vested in the trustees of the settlement.[19]

Settled Land Act settlements are obsolescent and not considered here.

The FA 2006 introduced a regime for sub-funds where there has been a sub-fund election. The regime is supposed to be a relief, but its conditions are so strict that it is almost never used. In the first year of the sub-fund regime, only *eight* sub-fund elections were made.[20] The lengthy and complex provisions are dead letter tax law. There is a special residence rule for trusts subject to a sub-fund election: see s.477 ITA. In the circumstances it is not necessary to consider this here.

5.11 Transfer between settlements

Section 476(4) ITA deals with transfers between settlements:

> (4) Further, if—

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18 The drafter has here retained the expression "body of trustees" which has elsewhere been deleted from the legislation, but it does not matter.

19 The CGT equivalent is s.69(3) TCGA.

20 Private correspondence.

(a) there is a transfer of property in relation to which section 471 applies,
(b) S is a settlor in relation to settlement 2 as a result of that section, and
(c) immediately before the disposal by the trustees of settlement 1, S meets condition C as a settlor in relation to settlement 1 as a result of subsection (2) or (3) or this subsection,

then S meets condition C as a settlor in relation to settlement 2 from the time S becomes such a settlor until S ceases to be such a settlor.
(5) "Settlement 1" and "settlement 2" are to be read in accordance with section 470(1).

For CGT, the equivalent is the last paragraph of s.69(2C) TCGA:

> and, in the case of a transfer of property from Settlement 1 to Settlement 2 in relation to which s.68B applies, "relevant time" in relation to a settlor of the transferred property in respect of Settlement 2 includes any time which, immediately before the time of the disposal by the trustees of Settlement 1, was a relevant time in relation to that settlor in respect of Settlement 1.

5.12 Permanent establishment residence rule

Section 475(6) ITA provides:[21]

> If at a time a person ("T") who is a trustee of the settlement acts as trustee in the course of a business which T carries on in the UK through a branch, agency or permanent establishment there, then for the purposes of subsections (4) and (5) assume that T is UK resident at that time.

I refer to this as the "**PE residence rule**".

The PE residence rule has four requirements:

(1) A trustee carries on a business.
(2) It carries on business in the UK.
(3) It carries on business through a branch, agency or PE in the UK.
(4) It acts as trustee in the course of that business.

HMRC has published guidance on the PE residence rule (**"HMRC Trustee Residence Guidance"**).[22]

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21 The CGT equivalent is s.69(2D) TCGA.

22 Accessible *http://www.hmrc.gov.uk/manuals/tsemmanual/attachments/tsem1461_appendix1.doc* The guidance was published July 2009 and lightly revised December 2011 (though

A very lengthy note was issued in 2010 (**"Taxguide 3/10"**).[23] This consists of (I think, excessively) detailed examples put to HMRC by the professional bodies, followed by brief statements of generalities from HMRC. This format does make it difficult to extract relevant principles, though one or two points can be found which are not made elsewhere.

See too 5.19.1 (Reason for the PE residence rule).

5.12.1 *"A business"*

The PE residence rule only applies if the trustee carries on a business. A trustee which does not charge, or only charges to recoup expenses (such as a family trustee company) does not carry on a business. This may offer a solution to the problem of the PE residence rule.

HMRC agree. HMRC Trustee Residence Guidance provides:

> By business we mean the business of providing professional trustee services for a fee.

5.12.2 *"Acting as trustee in the course of a business"*

The business must be (or include) the business of acting as trustee. For instance, a trustee may run a property business in the UK, but is not acting as trustee in the course of running that business: it is running the business in the course of acting as trustee.

HMRC agree. HMRC Trustee Residence Guidance provides:

> 8. When considering the applicability of the [PE residence rule] the following three questions are relevant:
>
> **A. Is the trustee carrying on a business in the UK?**
>
> ... This question does not relate to the business of a particular trust that might be conducted by the trustee. It enquires whether the person who is a trustee carries out business activities (as a professional or businessman, not as trustee of a particular trust) in the UK.
>
> **B. If the trustee is carrying on a business in the UK is it carrying on that business through a branch, agent, or permanent establishment**

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the website version is still dated 1 July 2009). The guidance is in appendix 1 of the TSE Manual but in the form of a downloadable word file, not online text; as a result it is not transcribed into commercial tax databases.

23 Taxguide 3/10 Trustee Residence: Guidance note agreed by HMRC issued August 2010 by ICAEW, CIOT and STEP accessible *http://www.icaew.com/~/media/archive/files/technical/tax/tax-news/taxguides/TAXGUIDE-3-10-Trustee-Residence.pdf*.

in the UK?

Again this means that the trustee is carrying on through the branch, agency or permanent establishment the sort of activities from which it substantially derives its worldwide profits - providing professional services for a fee - and not what it is doing in relation to an individual trust.

5.12.3 *Business "carried on in the UK"*

What if T carries on business partly in the UK and partly elsewhere? It is suggested that T carries on business in the UK, so if the UK part is carried on through a PE, T is deemed UK resident. If this is right, the rule lacks all proportionality. There is no *de minimis* rule. If a tiny part of T's trust business is carried on through a UK PE, the entire trust may become UK resident. As to whether a business is partly carried on in the UK, see 15.5 (Trading income of a non-resident), but if the business is carried on through a PE in the UK, there must be a business carried on in the UK.

5.12.4 *"Through a branch/agency or PE"*

In UK domestic tax law, the concept PE is used for companies[24] and "branch or agency" is used for individuals.[25] It is considered that the PE residence rule applies:

(1) If a corporate trustee is carrying on a trustee business through a PE.
(2) If an individual trustee is carrying on a trustee business through a branch/agency.

One does not ask if an individual has a PE, or if a company has a branch or agency. HMRC agree. HMRC Trustee Residence Guidance provides:

> 5. HMRC accept that for trustees the '*branch*' and '*agency*' tests apply to non-corporate trustees and the '*permanent establishment*' test to corporate trustees. Non-UK resident companies that are trustees therefore need only be concerned about being treated as UK resident if they carry on a business through a permanent establishment in the UK. This is in line with section 10B TCGA 1992 which has the effect that an overseas company is not taxed on the gains made by a UK branch or agency, but only on those made by a permanent establishment here. ...

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24 The statutory definition of PE applies only to companies: see 86.2.1 (Scope of UK law definition).

25 For discussion of these concepts, see 86.2 (Meaning(s) of "permanent establishment"); 86.14 (Meaning of "branch or agency").

In practice offshore trusts often do not have individuals as trustees, and where individuals do act, they do not usually do so "in the course of business". Accordingly, the question will normally be whether a corporate trustee has a PE: branch/agency will not normally arise. Since branch/agency is a somewhat undeveloped concept that is just as well. If, exceptionally, the issue did arise, the concept of branch/agency is more or less the same as PE and for most practical purposes is identical.

If, as advocated in this book, the concept of branch/agency was replaced altogether by PE, this complication would cease.[26]

5.12.5 *One trustee of several trusts*

What is the position if a person is trustee of several trusts and acts as trustee through a UK PE for one trust, but not the others? It is considered that only that one trust is UK resident. This view makes better sense in the context and is supported by the rule that trustees are a separate person from the person who is actually trustee. HMRC agree. HMRC Trustee Residence Guidance provides:

> 8. When considering the applicability of the [PE residence rule] the following three questions are relevant ...
> **C. If so is the trustee carrying on the activity of being a trustee of that particular trust in the course of its business through the branch, agent or permanent establishment?**
> For example, a corporate trustee could have a permanent establishment in the UK but it is only when it is acting as a trustee through that place that the deemed residence rules apply in relation to the particular trust for which the company acts as trustee. The test is on a trust by trust basis. So while a corporate trustee might be acting as a trustee in relation to one trust through a fixed place of business in the UK, other trusts must be considered separately according to their facts and circumstances.
> The same principle applies in the case of a non-corporate trustee: the test is on a trust by trust basis.

5.12.6 *Several trustees of one trust*

Suppose:

(1) a trust has two trustees, T1 and T2.

(2) T1 is deemed UK resident (because it has a UK PE) but T2 is not (e.g.

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26 See 86.16 (Commentary: let's abolish branch/agency).

T2 is an individual who does not carry on business).

This is treated as a trust with mixed resident trustees So where a trust does not have a UK-linked settlor, the appointment of a co-trustee who does not carry on trustee business would solve the difficulty posed by the PE residence rule.[27] HMRC agree. Trustee Residence Guidance example 4b provides:

> **Example 4b** (December Ltd & Mr Wednesday joint trustees of Tuesday Trust)
> As in example 4a[28] but the significance of the meetings M has in the UK with the beneficiaries of the Tuesday Trust is sufficient for D Ltd to have a permanent establishment in the UK in respect of that trust. However D Ltd has a co-trustee Mr. W who is a non-UK resident trustee.
> **HMRC view**: As there is a co-trustee who is non-UK resident and as the settlor of the T Trust was not resident or domiciled in the UK when he introduced property into the trust that means that the trustees of the T Trust as a body will not be UK resident.

5.13 When is there a UK PE?

5.13.1 *Which definition of PE?*

The term "permanent establishment" is used in different places with different definitions:

(1) "**UK-law PE**" defined in s.1141 CTA 2010.
(2) "**OECD Model PE**" defined in the OECD Model.
(3) PE as defined in any particular DTA.

The term is not defined for the purposes of trustee residence, so the applicable definition is UK-law PE.[29]

HMRC Trustee Residence Guidance in its original form (2009) assumed that the applicable definition was OECD Model PE. In December 2011, the following passage was added to the guidance:

> **Treaty Issues**
> 13. Most UK treaties contain a permanent establishment threshold (Article 5 in the OECD Model) for taxing business profits of a non-resident. This applies to both corporate and non-corporate trustees. Although permanent establishment is generally relevant to corporate

27 See 5.6 (Trustee residence condition B: mixed resident trustees).
28 See 5.15.4 (UK resident director or employee of trustee).
29 See 86.2 (Meaning(s) of "permanent establishment").

> trustees, and branch and agency to non-corporates, where trustees are residents of a treaty country (and the treaty contains a permanent establishment threshold) then effectively that is the standard that needs to be met in the case of all trustees, non-corporate as well as corporate. This means that for treaty countries broadly the same considerations for permanent establishment as set out in the guidance will apply in the case of non-corporates. This includes the independent agent exemption outlined below.
>
> 14. Thus, where a treaty exists between the UK and the country in which the trustee is resident the permanent establishment article needs to be satisfied for the trustee to be treated as UK resident for the purposes of the trustee residence rules.
>
> 15. Annex A outlines in more detail how the OECD Commentary interprets Article 5. For example, in this context for there to be a permanent establishment Article 5 usually requires the trustee to operate from a fixed place of business for more than 6 months.

There are two points here. HMRC now say:

(1) Where a corporate trustee is treaty-resident in a foreign state under a DTA with a PE article, the expression PE in the PE residence rule is understood to refer to PE as defined in the treaty.

(2) For non-corporate trustees, the same rules apply.

Point (1) is wrong, as the statutory definition applies. The definition is a taxes-act-wide definition, though it only applies in relation to companies. I suspect that the author of the guidance (both the 2009 and the 2011 versions) overlooked the statutory definition of PE. Point (2) therefore does not arise.

This is all a terrible muddle, though it would easily be resolved by straightforward tax simplification.[30] However there is probably no difference between UK-law PE and OECD model PE, and there is rarely much difference between OECD model PE and PE as defined in any particular treaty, so it will not often matter.

The more important question is what amounts to a PE, whichever definition applies. On that point HMRC Trustee Residence Guidance offers only vague and heavily qualified generalities.

There are two types of PE which I call:

(1) **"Fixed place of business PE"** and

(2) **"Agency PE"**

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30 See 86.12 (Commentary: let's have one definition of PE).

5.13.2 *Acts of the trustee in the UK: auxiliary v core activities*

HMRC Trustee Residence Guidance provides:

> **Core activities**
> 9. In connection with Question C and in line with the Commentary to the OECD Tax Model Convention, "carrying on the function of being a trustee" means in this context activities which are the core activities of a trustee and not those activities which are auxiliary or preparatory.[31] This applies equally to non-corporate trustees.

It is correct that activities which are of a preparatory or auxiliary character do not constitute a PE.[32] The use of the label "*core* activities" to describe those which are not merely preparatory or auxiliary is not entirely apt, but it is difficult to think of a better term. HMRC Trustee Residence Guidance explains "core activities":

> 10. A trustee is the person who has a legal duty to manage the assets of that trust in the best interests of the beneficiary or beneficiaries. The trustee manages, employs and disposes of the trust assets in accordance with both the terms of the trust and the duties and responsibilities which the law places upon trustees. The core activities of a trustee would therefore be regarded as including:
> 10.1 the general administration of the trusts
> 10.2 the over-arching investment strategy.
> 10.3 monitoring the performance of those investments.
> 10.4 decisions on how trust income will be dealt with and whether distributions should be made.[33]

HMRC Trustee Residence Guidance then explains "auxiliary activities":

> 11. There are other activities which trustees carry out which are not core activities central to their conduct and management of the trust, but are instead preparatory or auxiliary activities. These *generally* can include information gathering meetings, including meetings with independent agents or with beneficiaries but, as mentioned below, each case will have to be considered individually.

In fact, the rule that information gathering is auxiliary is a statutory rule.[34]

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31 See 5.12.5 (One trustee of several trusts).

32 See 86.9 (PE: preparatory and auxiliary activities).

33 The draft guidance included a further paragraph 10.5: "accounting, making tax returns and record keeping." Significantly, the final guidance has deleted this.

34 See 86.9 (PE: preparatory and auxiliary activities).

But in practice meetings tend to move seamlessly from information gathering to decision making.

> 12. In deciding whether the conduct and management of a particular trust is being carried on in the course of the corporate trustee's business through a permanent establishment, HMRC's approach will be to look at where the core activities are physically being carried out. If these core activities are being carried on in the UK through the corporate trustee's permanent establishment, the trustee would be treated as UK resident for the purposes of the particular trust. However as well as the nature or significance of the individual activities and meetings and whether they are core activities, we would also consider the issue of frequency. So where there is, in relation to a particular trust, evidence of considerable administrative work – such as meetings with investment managers or beneficiaries – being carried on in the UK through a permanent establishment, so that such meetings have become a major element of the trustee's activities in relation to that trust, and no longer preparatory or auxiliary, we would need to consider carefully whether as a matter of fact the non-UK resident corporate trustee was acting as a trustee through that permanent establishment.

Before turning to examples, the Guidance sets out the usual disclaimer:

> 13. The guidance that follows sets out examples of when a corporate trustee may or may not be regarded as UK resident. This guidance is based on the law as it stood on the day of publication. HMRC will publish amended or supplementary guidance if there is a change in the law or in the Department's interpretation of it. Whilst the guidance is intended to be as extensive and helpful as possible, it should not be assumed that it will provide a definitive answer in every case. That will depend upon the facts of each individual case. You can of course take your own advice on this issue and where HMRC's view is that there is a liability to UK tax on the basis that it regards a trust as UK resident because of how these rules apply to the trustees then the trustees can appeal to an independent tribunal.

5.13.3 *Marketing*

Marketing to prospective settlors is not carrying on trust business in the UK because no trust at that time exists. HMRC agree:

> **1. Preparatory work prior to the creation of any trust**
> 1.1 A non-UK resident trust company that is to be a trustee of a settlement may carry out a number of activities in the UK before the trust is created. This might, for example, include discussions with clients

such as potential settlors or beneficiaries over the appropriate terms of any trust. It could also include research with specialist professionals about possible trust investments and assets. These discussions may take place even before the beneficiaries are chosen.

Example 1 (February Ltd trustee of January trust)

Before the J Trust is established, F Ltd, a non-UK resident trust company holds several meetings in the UK at its Manchester office with the potential settlor Mr J. The meetings are to discuss the possible terms of the trust and suitable investments.

HMRC view: The J trust does not yet exist, so there is no need to consider the tests in section 69(2D) TCGA 1992 and section 475(6) ITA. In any case, introductory meetings and discussions of this type would generally be regarded as preparatory or auxiliary activities and not core activities.

5.14 When is there a fixed place of business PE?

5.14.1 *Occasional visits*

A place which the trustees use occasionally to meet the settlor, beneficiaries or others cannot constitute a fixed place of business PE, which requires a degree of permanency.[35] HMRC Trustee Residence Guidance provides:

2. Trustee carrying out duties for the administration of any trust

As mentioned in paragraphs 9 to 11 of the Background section of this guidance, a range of activities may be carried out by a trustee once a trust has been set up including meetings. When considering whether the corporate trustee is carrying on the administration of a particular trust in the course of their business through the permanent establishment, the frequency of the meetings will be looked at as well as their significance and quality.

Example 2 (March Ltd, trustee of April trust)

M Ltd, a non-UK resident trust company that is trustee of the A Trust, holds quarterly meetings in the UK at its London offices with investment advisers. The purpose of these meetings is for M Ltd to collect purely factual information about potential assets to inform future investment strategy for the A trust. The actual decisions about the investment strategy are taken by M Ltd at their home office outside the UK. No other activities or meetings relating to the A Trust are carried on in the UK.

35 See 86.3.2 (Degree of permanency).

> **HMRC view:** M Ltd has a permanent establishment in the UK. However, the significance of the meetings with the investment advisers is not sufficient for March Ltd to be regarded as acting as a trustee in respect of April Trust through that permanent establishment. They will not, therefore, be regarded as UK resident for the purposes of the April Trust.

The correct analysis is that the trustee does not have a PE in the UK, for two independent reasons: information collecting is an auxiliary matter, and the office is not used with sufficient regularity to constitute a PE. (One is of course looking on the matter on a trust by trust basis).

The author assumes that the trustee does have a fixed place of business PE but does not carry on business through it. Strictly a PE means a place of business through which a business is carried on, so there is no PE. However the end result is the same.

By contrast:

> **Example 2a** (May Ltd, trustee of June Trust)
> M Ltd, a non-UK resident trust company, is sole trustee of the J Trust. M Ltd carries out all the work for the trust through its UK offices, including preparatory work, general administration, meetings with investment managers, accountants, beneficiaries etc.. The investment and distribution policies are also all determined in the UK office. Formal ratification of those strategies, including signature of documents, is made by M Ltd at very brief meetings outside the UK, with little or no further discussion of the proposals before approval is given.
> **HMRC view:** Although the strategic decisions are core activities, all the administration of the J Trust has been carried out in M Ltd's UK office. The formal meetings outside the UK although prima facie core activities are in reality merely "rubber stamping" all the UK work. M Ltd has acted as a trustee in respect of the J Trust through its UK permanent establishment and so will be treated as UK resident for the purposes of the J Trust.

That seems correct. M Ltd has a fixed place of business PE.

> **Example 2b** (July Ltd, trustee of August trust)
> J Ltd, a non-UK resident trust company is trustee of the A Trust. It always carries out the core activities of the A Trust at its office overseas. The beneficiary of the trust has a single one-off meeting with J Ltd at J's

Manchester office to discuss the potential release[36] of capital from the A trust. The discussion involves the imposition of certain conditions on the beneficiary before such a release.

HMRC view: On the face of it J Ltd by discussing the release of capital and the imposition of conditions with the beneficiary has engaged in a core activity and this has taken place at what is J's permanent establishment in the UK. So prima facie J Ltd is acting as trustee of the A Trust through a permanent establishment. However the whole context has to be looked at - i.e. where the decision making on the trust is being carried on and if the meeting in the UK was a one-off. If the trustee took the information from the meetings out of the UK with them and then discussed and made the decisions outside the UK, they would not be UK resident. If there was any doubt as to where the decision making is taking place we would as part of our considerations consider the frequency of any meetings both within and outside the UK.

More analytically, the issues (which are not clearly identified or answered) are:

(1) Are the acts of the trustee in the UK merely preparatory (such as information gathering)? If so, there is no PE.

(2) Is the office used with sufficient regularity to constitute a fixed place of business PE? On the given facts, a one-off meeting is clearly not sufficient and the UK office is not a PE, so (although the HMRC example does not reach any conclusion) the answer is that the trustee is not UK resident.

5.15 When is there an agency PE?

An agency PE, which arises if (in short)

(1) An agent has and habitually exercises authority to do business on behalf of the trustee; and

(2) it is not "an agent of independent status acting in the ordinary course of the agent's business."[37]

5.15.1 *Accountancy services and tax advice*

A person who provides accountancy services or tax advice cannot be an agency PE as providing services of that kind does not constitute doing

36 The Guidance seems unfamiliar with trust terminology and practice, though nothing turns on that.

37 See 86.4 (Agency PE) and 86.6 (Independent agent).

business on behalf of the trustee: an accountant or tax adviser has no authority to do any business at all on behalf of the trustee.

If necessary, I would also say that these activities were auxiliary, not core; but it is not necessary to rely on that.

5.15.2 *Investment managers and brokers*

If the relief which I call IME PE relief applies, it is not necessary to consider further whether or not the broker/IM would otherwise be a PE.[38]

In this section I concentrate on investment managers; the position of brokers is the same.

The relief is in s.1146(1) CTA 2010 which provides:

> This section applies if an investment transaction is carried out on behalf of a non-UK resident company in the course of the company's trade by a person in the UK acting as an investment manager.

This relief can apply. The non-UK resident company (the trustee) is not carrying on the trade of dealing in securities. However the trustee is carrying on the trade of acting as trustee in the UK. The contrary view has been suggested, but this seems reasonably clear.

The question then is whether investment manager conditions A to E are met. I deal with these briefly here as they are discussed in detail elsewhere.[39] Conditions A and B are straightforward. Conditions C and E require an arm's length relationship and full remuneration (which overlap: can one envisage an arm's length relationship without remuneration?). Condition D is the 20% rule. This was not written with trustees in mind, but construed in the context (perhaps a purposive construction) it should be regarded as satisfied provided that the investment manager (and connected persons) do not have an interest in more than 20% of the trust income. That will usually be the case.

It follows that investment managers/brokers on arm's length terms will not constitute a PE. Taxguide 3/10 confirms this:

> It doesn't matter that there is a corporate relationship between the investment manager and the trustee (such as the two entities being in the same corporate group) and this will not prevent the independent agent status applying. This follows the principle in the OECD Commentary on Article 5 that a subsidiary is not automatically assumed to be a

38 See 44.2 (IME PE Relief).

39 See 44.6 (Investment manager conditions).

dependent agent of its parent.

5.15.3 *Services provided by UK companies: the guidance*

The HMRC guidance in this area bears only a tenuous connection to the law. The original HMRC guidance did have the merit of clarity:

> I can confirm that our interpretation of the rules is that the provision of services on an arms length basis would not cause non-UK trustees to have a permanent establishment and therefore would not make the non-resident trustee UK resident.
>
> More specifically, this would include where services are carried out by a subsidiary on a fully arms length basis, such as:
>
> - maintaining the financial or accounting records
> - preparation of accounts
> - preparation and submission of tax returns for any settlement by a separate entity within the organisation contracting at arms length terms.
>
> Provided the services are contracted (at arms length terms) HMRC would not consider this constitutes a permanent establishment as the UK company will be rendering a service to the trust. Therefore, these activities would not cause the non-UK trustees to have a permanent establishment in the UK and the non-UK trustee is not made resident by [the PE residence rule].[40]

The correct questions are whether the agent has and habitually exercises authority to do business on behalf of the trustee, and if so whether the IM exemption applies, and whether the agent is of independent status and acting in the ordinary course of their business. The question is not whether the agent is receiving an arm's length fee. However the HMRC arm's length fee test reflects the policy aims of the provision, would be a simpler and workable rule, and would not normally give a different result from the correct approach.

In HMRC Trustee Residence Guidance, this approach is maintained but is watered down with qualifications such as "likely" or "ordinarily":

> **3. Activities carried on for the trust other than by the non-UK resident trust company**

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40 Extract from letter dated 18 July 2007 accessible *http://old.tax.org.uk/attach.pl/5810/6458/TrusteeeResidenceTestHMRCtoEC180707.pdf*

> 3.1 Whilst a non-UK resident trust company acting as a trustee may not carry out trust business at a fixed place of business permanent establishment in the UK, it is also necessary to consider whether activities are carried out in the UK on that non-UK resident trust company's behalf by a dependent agent. If this is the case the trustee may be treated as having a permanent establishment in the UK. ...
> 3.2 The activity of providing services to a non-UK resident trustee, whether by a connected person or not, does not of itself create a dependent agency permanent establishment ... It is necessary to consider the capacity in which the person provides the services to the trust on behalf of the non-UK resident trustee. Where
> [1] the services that are provided to the trust are only those that the person is contractually obliged to provide under their agreement with the non-UK resident trustee and
> [2] are remunerated at arm's length,
> then this is *unlikely* to create a dependent agency permanent establishment.

Point [1] is hard to understand. Who would provide services without a contract? Perhaps the author has in mind a beneficiary providing services to the trust informally, but it is difficult to see how remuneration could be paid in the absence of a contract, express or implied.

> 3.3 Whether there is a dependent agency permanent establishment will depend on the facts of the case; the position is the same whether it is an unconnected third party or a UK subsidiary or other connected person that carries out the work for the trust. Where, say, a UK subsidiary of a non-UK resident trust company is providing services to a trust, then unless the powers granted to it by the non-UK resident trust company are such that it becomes a '*dependent agent with authority to do business on behalf of the non-resident trustee*' ... we will not contend that the UK subsidiary's actions cause the non-UK resident trustee company to have a permanent establishment.

This is correct.

> **Example 3** (September Ltd trustee, October Ltd investment advisers, November trust)
> S Ltd, a non-UK resident trust company contracts with O Ltd which is a UK company within the same group. The services to be provided by O Ltd are for investment advice for the N Trust. The contract between S Ltd and O Ltd is on an arm's length basis and O Ltd has no powers granted to it by September Ltd.

HMRC view: O Ltd is providing a service for S Ltd and has contracted to do so on arm's length terms. They have no authority to do business on behalf of S Ltd so are not their dependent agent. Therefore, S Ltd will not be treated as having a permanent establishment through the work carried out by O Ltd in the UK. So S Ltd will not be treated as UK resident for the purposes of the N Trust.

This is straightforward. If the investment advisor had no authority to do business on behalf of its principal, then it is not an agent at all. It cannot be an agency PE.

If the investment advisor did have power to do business on behalf of the trust, it is still not PE as long as it qualified for the IM exemption (which in practice should usually be the case).

Other examples which would be treated in the same way where there was an arm's length relationship are:

- •. Preparing trust accounts for the trustees' review and approval
- Preparing trust tax returns for the trustees' review and approval and filing the return on their behalf with HMRC
- Obtaining quotes for necessary repair work on trust property
- Having contact with workmen to ensure that those repairs are carried out
- Day to day management of let property (such as dealing with tenants etc)
- Signing small cheques such as paying for minor repairs

Example 3a (September Ltd trustee, October Ltd investment advisers) As above but O Ltd also has authority to buy and sell commodities with a view to realising profits for the trust subject to trading limits set by S Ltd. It receives an arm's length fee for this activity.

HMRC view: The investment manager is appointed by the trustee, and so is its agent. If it receives an arm's length fee for the investment management services, it will not *ordinarily* constitute a dependent agent of the non-UK resident trustee.

If, however O Ltd was providing investment management services to the trustees other than on arm's length terms i.e. was acting as their dependent agent, rather than simply providing a service to them, in that case the trustees would be *likely* to have a dependent agent permanent establishment.

(This is in line with the Investment Manager Exemption provisions – in particular that the provision of services at less than a customary rate can indicate that the investment manager is not an independent agent of the non-UK resident trustee.)

5.15.4 *UK resident director or employee of trustee*

The question may arise whether a UK resident director/employee can be an agency PE, though I wonder how often a non-resident trustee company has a UK resident director/employee.

HMRC Trustee Residence Guidance provides:

> **4. UK resident directors or other employees of a non-UK resident trust company.**
> 4.1 First, it is necessary to consider the role of the UK resident director or employee of the non-UK resident trustee.
> 4.2 If the UK resident employee is not carrying out activities that would be regarded as core trustee activities in relation to a particular trust then the presence in the UK of an employee of a non-UK resident trust company could not by itself cause a non-UK resident trustee to have a permanent establishment in the UK.

This is consistent with the point made at 5.13.2 (Acts of the trustee in the UK).

> 4.3 Where in relation to a particular trust the UK resident employee does carry out [core] trustee activities in the UK then it is likely that the non-UK resident trustee will have a permanent establishment in the UK. This will be the case if
> [1] the employee operates from a fixed base, or
> [2] does not have a fixed base but habitually acts on behalf of the non-UK resident trustee for the particular trust, i.e. is a dependent agent permanent establishment of the non-UK resident trustee.
>
> The crucial point in relation to a dependent agent permanent establishment is whether the non-UK resident trustee company has in the UK-resident employee a dependent agent with authority to conduct business on behalf of the non-UK resident trustee. If this UK resident employee of a non-UK resident trustee does have the authority to make decisions then s/he is likely to constitute a dependent agent permanent establishment of the non-UK resident trust company.

The first example is a simple variant of example 1 (marketing):

> **Example 4 (December Ltd trustee; Mr Monday employee)**
> D Ltd, a non-UK resident trustee has a director or other employee M who is resident in the UK. (This individual may also be an employee or director of UK resident group members.)
> The group provides office accommodation in the UK to M. His role is to market the business of the non-UK resident trust company in the UK which includes meeting with prospective settlors and other business

contacts for this purpose.

HMRC view: In this case, M's role is only meeting with prospective settlors and other business contacts for the purpose of marketing the business of D Ltd. Although these activities are carried out at the same place, they are not activities as a trustee that are carried out at a fixed place of business. They would generally be preparatory or auxiliary activities. This would not cause D Ltd to be treated as carrying on trustee business through a permanent establishment in the UK.

In the next example, the director/employee does more than marketing:

Example 4a

As in example 4, but M's role also extends to meeting beneficiaries of existing trusts.

HMRC view: In this case, the importance of the subject matters discussed and the decisions taken at those meetings, and the frequency of the meetings held, will need to be analysed in relation to each trust in order to reach a conclusion as to whether D Ltd is carrying on a business through a permanent establishment in the UK for that trust through M.

If no office accommodation is at his disposal M could still constitute a dependent agent permanent establishment of the non-UK resident trustee if he has authority to enter into contracts or otherwise do business on behalf of the trustee of the trusts i.e. more than simply meeting the beneficiaries and he habitually exercises that authority on behalf of his employer for the trust.

HMRC do not answer the question in the example, but the general approach to the answer is correct.

5.16 Conclusion: Some guidelines on the PE residence rule

It is considered that the following guidelines will avoid difficulties under the PE residence rule. It is assumed that the trust has only a corporate trustee, or if it has individual trustees, they are not carrying on a business (so it is necessary to consider PE issues but not branch/agency issues).

Use of professional UK investment managers and brokers on arm's length terms is safe.

Use of professional UK advisors to prepare tax returns or give tax advice is safe.

Use of UK agents to manage UK property investments is safe, providing they are acting in the ordinary course of their business, which in practice

they should be.

The trustees may meet beneficiaries (or others) in the UK in any of the following circumstances:

(1) If the meeting is at the offices of the beneficiaries (or others) or hotels; not in the trustees own offices, or in offices provided by a company in the same group as the trustees.

(2) If the meeting is occasional. Once a year or less would safely be "occasional" for this purpose.

(3) If the meeting is purely for information gathering purposes. (The minutes of the meeting should make that clear.) However it may be difficult to restrict meetings to information gathering topics.

The trustees should not appoint a beneficiary to act for the trustee (unless, exceptionally, the beneficiary is carrying on a business and acting in the course of that business).

Where the trustees own a house which is occupied by the beneficiary, I see no difficulty in the trustees authorising the beneficiary to maintain the house, as that does not constitute carrying on business in the UK.

Marketing and meetings with prospective settlors are safe.

In cases where the settlor was not UK resident or domiciled when the settlement was made, all difficulty under the PE residence rule can be avoided by the appointment of an individual co-trustee who is not UK resident and not carrying on a business.

5.17 UK protector and trustee residence

5.17.1 *Protectors*

It is common practice to appoint a "protector" who (typically) has power:

(1) to consent to certain key matters of trust administration; and

(2) to appoint and dismiss trustees.

The protector may be a UK resident. A protector could not be regarded as a trustee[41] and so their actual residence is irrelevant in ascertaining the

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41 *Re Marshall* [1945] Ch 21 held that trustees for the purpose of the obsolescent Settled Land Act 1925 are "trustees" for the purpose of the Judicial Trustee Act 1896. Although trust land is not vested in SLA trustees, capital money and investments other than land are vested in them, and *for this reason* they were held to be trustees.

In *Manoogian v Sonsino* a settlement provided:

"... the Bank shall make such investments as may from time to time be particularly and specifically directed to be made of it in writing from time to time by the Armenian Patriarchate of Jerusalem."

actual residence of the trustees in their personal capacities.

A protector has functions imposed by the trust deed, and is not an agent of the trustees. So a protector cannot constitute an agency PE, and does not affect trustee residence under the PE residence rule.

5.17.2 *Reserved powers*

The same points arise for reserved power trusts. Taxguide 3/10 provides:

> If the settlor has reserved the investment function to himself do HMRC consider the settlor to be an agency PE of the trustees if he habitually

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The Patriarch was not a trustee for the purposes of the Charities Act:

> "His power to direct investments is not an obligation to do so. His position is analogous to powers of a life tenant under a conventional strict settlement. The life tenant is often given powers to possess land, direct investments and so on, but none of those things make him a trustee of the settlement."

[2002] EWHC 1304 (Ch); [2002] WTLR 989; 5 ITELR 125 at [41].

In *Bridge Trustees v Noel Penny (Turbines)* [2008] EWHC 2054 (Ch) an employer had power to distribute the surplus assets of a pension scheme. The employer was not "a trustee properly so called, that is to say, a person in whom property is vested as trustee"; see at [23].

This view is generally accepted: See Hubbard *Protectors of Trusts* (2013) para 2.24 (Distinction between a Protector and a Trustee), 8.70 ('Not a trustee' provision; Underhill and Hayton, *Law of Trusts and Trustees* (18th ed, 2010), p.1.78: "Because the protector merely has powers vested in him and not trust property he is not a trustee".

It might be a different matter if the protector's powers extend beyond those traditionally given to a protector. One could imagine a trust deed under which:

(1) persons named "trustees" held legal title to property; and
(2) a person (mis)named "protector" held all the administrative and dispositive powers normally given to trustees.

This case (depending on the drafting) might be equivalent to the common situation where trust property is vested in nominees. In such a case no one suggests that the nominees are "trustees" for the purposes of the trust residence rule. Although the legal title may not be vested in the trustees, the trustees have the right to call for it.

Alternatively (depending on the drafting) the case may be equivalent to the situation where custodian trustees hold the trust fund on behalf of managing trustees under s.4 Public Trustee Act 1906. In such a situation, the (so-called) protector would be a trustee. This is hypothetical – I have never seen it in practice – but worth mentioning as warning of the problems which might arise if the powers of a UK resident protector were extremely extended.

Many offshore Trust Laws state expressly that a protector is not a trustee; but (i) that only states what would in principle be the position, and (ii) that could not be determinative of the meaning of "trustee" in a UK statute.

exercises the investment function while present in the UK? Our view is that this is NOT the case. The settlor cannot be a PE of the trustees' business because the investment function is not part of the trustees' business. The trustees' primary and overriding responsibility is to comply with the terms of the trust deed and the trust deed does not give the trustees the investment function in the first place.

HMRC answers

If settlor has investment function under trust deed then it cannot be acting as agent of trustee.

5.18 Trustee residence for IHT

Trustee residence is not very important for IHT but the concept is used on a few occasions. IHT definitions of trustee residence are different from the IT/CGT definition.

For the (somewhat academic) relief for foreign currency bank accounts,[42] s.157(4) IHTA provides:

> For the purposes of this section—
>
> (a) the question whether a person is resident in the UK shall, subject to paragraph (b) below, be determined as for the purposes of income tax; but
>
> (b) the trustees of a settlement shall be regarded as not resident in the UK unless the general administration of the settlement is ordinarily carried on in the UK and the trustees or a majority of them (and, where there is more than one class of trustees, a majority of each class) are resident there.

For the duty to disclose the creation of non-resident trusts,[43] s.218(3) IHTA provides:

> For the purposes of this section trustees of a settlement shall be regarded as not resident in the UK unless the general administration of the settlement is ordinarily carried on in the UK and the trustees or a majority of them (and, where there is more than one class of trustees, a majority of each class) are for the time being resident in the UK.

For the purposes of s.201(1)(d) IHTA (collection of non-resident trust's tax from settlor), s.201(5) IHTA makes an identical provision.[44]

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42 See 62.20 (Non-residents foreign currency bank accounts).

43 See 87.11 (IHT reporting requirement on creation of settlement).

44 For completeness, the same definition is set out yet again in the IHT (Delivery of Accounts) (Excepted Settlements) Regulations 2008.

For the question of where the administration of a settlement is carried on, see the 5th edition of this work, para 5.6. There are various interesting points that could in theory arise under these definitions, but I doubt if they will ever arise in practice.

5.18.1 *Trustee residence for IHT: Commentary*

IHT trustee residence is a mess: essentially the same definition is repeated four times.

There is no need to have a separate definition of trustee residence for IHT at all, and if we need to keep the concept of trustee residence, it would be best to switch to the IT/CGT definition. Failing that, a single standard definition applying for all IHT purposes would be a small improvement.

5.19 Trust residence: commentary

Various policy considerations simmer below the surface of this topic.

One factor is the desirability of attracting the business of trust administration to the UK. The work will not come to the UK if that is going to incur additional tax liabilities.

Another factor is to avoid a loss of tax, measured from the benchmark of the present system.

More fundamentally, trustee residence needs to be discussed in the context of the very broad set of questions of how to tax trusts generally on (1) trust gains, and (2) trust income.[45]

Residence of *individuals* is a sensible connecting factor for UK taxation: everyone accepts that an individual who is UK resident should to some extent at least be subject to UK tax. It is not self-evident that it should be the main connecting factor, or a connecting factor at all, for the taxation of *trusts*. The move from individual residence to trust residence is problematic in two respects:

(1) Residence of trustees is a matter which is chosen by the appointment of trustees.

(2) Trustees are taxed as representing the beneficiaries, who may or may not be UK resident. Unfortunately the solution of taxing beneficiaries

45 In this paragraph I use the term "trust income" to mean income of trustees other than a life tenant's income. The taxation of life tenant's income is easy: one should tax the life tenant. I assume that settlor-interested trust rules are not in point.

on trust income or gains on an arising basis is not available.

There are three broad categories of solution. None are wholly satisfactory.

The first solution is the present system with or without minor variants.

The second solution is a system of residence by election:

> Why not let all trustees elect that they and their beneficiaries and settlors should be taxed as if they were non-UK resident. All the trust business which now goes offshore could come back to the UK. The economy, and therefore the Revenue, wold benefit, while beneficiaries would be less exposed to some of the practical problems to which offshore trusts are prone. Drug enforcement officers would then know that the reason that Mr X had set up a trust in some Caribbean jurisdiction would have nothing to do with UK taxation. [46]

Venables concludes: "No doubt the suggestion will be dismissed out of hand. Yet is it so absurd?" Discuss.

A third and more radical solution abandons the concept of trust residence. Trusts pay tax on trust income and gains regardless of the residence of the trustees: the connecting factor should be that property is provided by a UK domiciled or resident settlor. Conversely, trusts should be exempt from CGT and IT (like non-residents) in relation to property provided (or wholly provided) by foreign domiciled non-resident settlors. This is (I think) the basis of taxation of trust income and gains in Canada, New Zealand and, I suspect, most other common law jurisdictions. It is also the basis of IHT trust tax. Of course, domicile and residence of the settlor are not perfect connecting factors. Such a thing does not exist. International families can sometimes break the link by tax planning. But the rickety anti-avoidance structure of ss.86 to 98 TCGA, bolstered (supposedly) by Schs 4A to 5, can be replaced with one based on the TAA rules. The reform, like any, would bring winners and losers but the overall result could — if properly drafted — be a system which was fairer, simpler and much more effective.

5.19.1 *Reason for the PE residence rule*

It appears that the PE residence rule is based in part on loss of tax considerations and in part (somewhat implausibly) on a desire to support UK professional trustees.

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46 Venables, *Comments on the Inland Revenue Consultative Document on Trusts* (1991) p.60.

The Trusts Consultative Document (1991) explains:

> 10.21 The income tax test might need to be modified for certain foreign corporate trustees. A trust company, resident outside the UK, could be the sole trustee of a trust which was dealt with in this country by the company's UK branch. It would not be appropriate if such a trust were treated as non-resident, because it would then be taxed more favourably than a similar trust dealt with by a branch of a UK corporate trustee, or by some other UK professional. That could both lead to a loss of tax and put UK professionals at a competitive disadvantage. It is therefore suggested that the UK branch of a foreign trustee should be treated as a trustee resident in the UK for the purpose of the common residence test.[47]

5.19.2 *Relief for professional trustees*

The law before 2007/08 provided that a UK professional trustee of a trust with a non-resident, non-domiciled settlor was regarded as non-resident. This sensible provision allowed UK professional trustees to act without attempting to tax them. The object was to allow the UK to compete on equal tax terms with foreign trustees. The reason given for its abolition was that the Department of Trade and Industry had advised the rule breached EU restrictions on State Aid.[48]

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47 accessible *http://www.kessler.co.uk/tfd-archive.*

48 There are strong arguments against that view of EU law, and indeed the former UK rule still applies in Ireland. However HMRC refused to disclose the DTI advice which makes it impossible to assess the advice which HMRC said they received. One might speculate as to whether this was a true reason or an excuse. Following an application under the Freedom of Information Act, the Information Tribunal "urged" HMRC to disclose their reasons (which were "bald and substantially unexplained.") Unfortunately the Tribunal did not order HMRC to do so and HMRC disregarded the urging of the Information Tribunal as non-binding. So it remains a matter of speculation. For the freedom of information aspects, see *http://www.kessler.co.uk/FoI.*

CHAPTER SIX

TREATY-RESIDENCE

6.1 Three concepts of residence

The starting point is to note that there are (at least) three distinct concepts of residence. We need terms to describe them, and I coin the following terminology.

(1) **"UK-law residence"** means residence as defined in UK tax law.
   (a) A person who is resident in the UK within the UK tax law definition is **"UK-law UK resident"**
   (b) A person who is not resident in the UK within the UK tax law definition is **"UK-law non-UK resident"**.

(2) **"Treaty-residence"** means residence as defined in a DTA.
   (a) A person who is a resident of the UK within a DTA definition is **"treaty-resident in the UK"**.
   (b) A person who is resident in the foreign state within a DTA definition is **"treaty-resident in the foreign state"**. One could use the term "treaty-resident outside the UK." Statute sometimes calls this *"treaty non-resident"* but I think my term is clearer.

"Foreign-law residence" means residence as defined in some foreign tax law.

"Domestic law" means the law of the UK, or of a foreign state, as opposed to treaty law or international law.

This chapter discusses treaty-residence. The discussion is mainly on the OECD model treaty, though I refer at points to the US and other treaties. In any particular case it will be necessary to review the terms of the actual treaty concerned.

DTAs refer to a resident *of* a treaty state and UK tax law refers to a person who is resident *in* the UK; but nothing turns on the choice of preposition. I guess that the DTA wording was influenced by the French wording *résident d'un État contractant.* In this book I use *in* or *of* as

grammar dictates, whichever the context.

6.1.1 *"State"*

DTAs refer to "contracting state" but I abbreviate this to **"treaty state"** or just **"state"** and where that state is not the UK, I refer to it as **"the foreign state"**.

Article 4 OECD Model Convention provides that "contracting state"

> also includes that State and any political subdivision or local authority thereof.

For this reason, UK legislation generally uses the word "territory" rather than "state".

6.1.2 *Cross references*

The following matters are considered elsewhere:
57.1 (Introduction to DTAs).
84.25 (US S-Corps and LLCs).
For further reading, see Avery Jones et al, "Dual Residence of Individuals: The Meaning of the Expressions in the OECD Model Convention", [1981] BTR 15 & 104; Maisto (ed.) *Residence of Individuals under Tax Treaties and EC Law* (2010); Venables "The interpretation of double taxation conventions: Residence of dual resident and temporarily non-UK resident individuals" (1999) 8 OTR 189.

6.2 Relationship between treaty-residence and UK-law residence

A person cannot be treaty-resident in two treaty states: the tie-breaker test requires treaty-residence to be in one state alone.

However a person who is UK-law UK resident may be resident in another state under the UK law, or foreign law, or DTA definitions of residence. That is, UK-law UK residence does not preclude residence elsewhere.

In particular, a person may be UK-law UK resident while treaty-resident in a foreign state. Treaty-residence in a foreign state does not preclude UK-law UK residence (except for companies).

The INT Manual provides:

> **154020. Dual residents** [December 2011]
> ... Although the agreement overrides some of the normal consequences of being a UK resident, it does not, in the case of an individual, override the fact of UK residence itself for purely domestic law purposes. Even

> though an individual may be resident for agreement purposes elsewhere, he (as a resident of the UK for UK tax purposes) still has to complete returns and fulfil any similar obligations imposed by the Taxes Management Act. He will also remain entitled to any personal allowances which may be due on account of his UK residence status.

Sometimes this rule works in favour of the taxpayer; for instance, it preserves the right to personal allowances (which are conferred on UK-law UK residents but not generally available to non-residents).[1] Often however the rule works in favour of HMRC. For instance, a year in which an individual is UK-law UK resident counts for the purposes of:

(1) the long-term residence test for the remittance basis claim charge;[2]
(2) deemed domicile for IHT (the 17 year residence rule);

even though the individual is treaty-resident in a foreign state throughout the year.

In the Canadian case *Black v. The Queen*[3] the taxpayer was Canadian-law resident in Canada but treaty-resident in the UK under the tie-breaker. He argued that (contrary to the view taken here) treaty-residence outside Canada precluded his being Canada-law resident. I do not see how this was properly arguable: under the treaty, treaty-residence was defined only *for the purposes of this Convention.* The court agreed, even if it took 20 pages to set out the arguments behind that conclusion.

6.3 Residence under art. 4.1

Article 4 OECD Model Convention provides:

> 1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature....

I describe a person who is within this paragraph as **"resident in a state under article 4.1"**.

For the purposes of discussion it is convenient to abbreviate the phrase "domicile, residence, place of management or any other criterion of a similar nature" to "UK-law residence"; in a UK context this is a

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1 See 47.7 (Personal allowances under DTAs: non-residents).

2 See 10.11.11 (Individual treaty non-resident).

3 2014 TCC 12 accessible *https://www.canlii.org*. The case is going on appeal, but it seems safe to predict that the decision of the lower court will be upheld.

permissible shorthand since it is UK-law residence (not the other criteria mentioned) which determines whether a person is liable to UK tax.

There are then four requirements to be a resident of a state under article 4.1:

(1) There must be a "person".
(2) The person must be liable to tax in the state.
(3) The person must be domestic-law resident in that state.
(4) Domestic-law residence must be the reason for liability to tax.

A person may be a resident of one treaty state alone under article 4.1 , in which case they are treaty-resident in that state. A person may be a resident of both treaty states under article 4.1, in which case the tie-breaker tests discussed below are applied to identify the state of treaty-residence.

So far as the UK is concerned, a person who is UK-law UK resident is in general a resident of the UK under article 4.1.

6.3.1 *Certificate of residence*

HMRC helpsheet 302 (Dual Residents - 2012/13) provides:

> If you:
> - are resident in the UK under domestic law, and
> - are also resident in another country under that country's rules, and
> - want to claim that you are a resident of the other country for the purposes of the DTA between the UK and that other country
>
> then you need to obtain a certificate from the overseas tax authority confirming that it regards you as resident there under its domestic law for the period in question, which must be stated on the certificate.
> You should attach the certificate to your completed claim on pages 8 to 11 of this helpsheet and sent with your tax return.

A certificate is not needed for a USA treaty-resident who seeks relief under the USA/UK treaty: see 6.19 (USA/UK DTA).

A UK treaty-resident who seeks foreign tax relief under a DTA may need a certificate of UK residence for the foreign tax authorities. One can now apply online for a certificate of UK residence.[4]

6.4 "Person"

The first requirement of treaty-residence is that there must be a "person" and one must identify:

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4 *http://www.hmrc.gov.uk/news/cert-of-residence.htm*.

(1) who that person is; and
(2) whether that person is an individual or a person other than an individual (because different tie-breaker tests apply).

The term "person" is defined (after a fashion). Article 3.1(a) OECD Model provides:

> 1. For the purposes of this Convention, unless the context otherwise requires:
>
> a) the term "person" includes an individual, a company[5] and any other body of persons;

For individuals (who are "natural persons") and companies (which are "legal persons") this is straightforward, but partnerships, trusts and some other entities are more problematic. See:

6.14 (Treaty-residence: Trusts)
6.15 (Treaty-residence: Partnerships)
84.9.3 (Is a stichting a person for treaty purposes?)

6.5 "Liable to tax"

"Tax" is usually defined to mean IT or CGT.

A remittance basis taxpayer is "liable to tax" (and so resident in the UK under article 4.1) because (among other reasons) the remittance basis is a form of tax liability.

The Canada Revenue Authority take this view:

> The Department takes the view that individuals who are subject to tax on a remittance basis are liable to tax on a world income basis. Accordingly, persons who are liable to tax in a contracting state on a remittance basis, would not in our view, be precluded from being resident there for the purposes of paragraph 1 of the residence article of a convention.[6]

That is clearly right, and the OECD commentary also assumes that it is the case.[7] The issue is normally one for foreign tax authorities rather than HMRC. It would matter for UK tax only if the foreign state operated a

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5 Article 3.1(b) OECD Model defines company: "the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes".

6 Canada Revenue Authority, "Income Tax -- Technical News No. 16", (March 1999) *http://www.cra-arc.gc.ca/E/pub/tp/itnews-16/itnews-16-e.html*. The position is even clearer now the remittance basis is a matter of a claim, not compulsory (as was formerly the case)..

7 See 57.15 (Interaction of DT reliefs and the remittance basis).

remittance basis; the only examples of which I am aware are Ireland and Japan.

For whether partnerships are liable to tax, see 6.15.2 (Is a partnership "liable to tax"?).

6.6 Change of residence during tax year

6.6.1 *Change of residence of individual during tax year*

An individual cannot cease to be resident during a tax year.

If the split year rules are met, the individual is still resident in the UK during the overseas part of a split year. During that part the individual is still "liable to tax", since the reliefs for the overseas part of a split year cover most types of income but not all, so the individual is a resident of the UK under article 4.1 even during the overseas part of a split year.

Para 42 sch 45 FA 2013 confirms the point:

> The existence of special charging rules for cases involving split years is not intended to affect any question as to whether an individual would fall to be regarded under double taxation arrangements as a resident of the UK.

This is clear on first principles, but if authority is needed, see *Smallwood v HMRC*.

Some DTAs expressly address the question of migration during the year. For instance, article 14(6) France/UK DTA qualifies the OECD model CG article:

> The provisions of paragraph 5 [CGT relief] shall not affect the right of a Contracting State to levy according to its law a tax chargeable in respect of gains from the alienation of any property
> [a] on a person who is, and has been at any time during the previous six fiscal years, a resident of that Contracting State or
> [b] on a person who is a resident of that Contracting State at any time during the fiscal year in which the property is alienated.

6.6.2 *Change of residence of trustee during tax year*

In *Smallwood v HMRC*[8] a trust had three different trustees, resident in different states, in the course of one tax year:

Apr - Dec: Jersey resident trustees ("the Jersey period")

8 *Smallwood v HMRC* [2010] STC 2045.

Dec - Mar: Mauritius resident trustees ("the Mauritian period")
Mar onwards: UK resident trustees ("the UK period")

Gains accrued during the Mauritian period. During this period the trustees were residents of Mauritius under article 4.1 as they were liable to Mauritian tax[9] by reason of their residence in Mauritius. The question was whether they were also residents of the UK under article 4.1.[10]

One might have thought that they were not. The Mauritian trustees were liable to tax in the UK during the Mauritian period, but not by reason of *their* residence: they were so liable by reason of *someone else's* residence (namely, the residence of their successor trustees during the UK period). However the Court of Appeal held that for treaty purposes trustees should be regarded as a continuing body of persons distinct from the actual trustees.[11] The trustee-body were residents of the UK under article 4.1 during the Jersey and Mauritian periods since:

(1) they were liable to UK tax[12] during that period; and
(2) they were so liable by reason of "their" UK residence in the subsequent UK period.

During the Jersey and Mauritian periods (April - March) the trustees could not know that they were residents of the UK under article 4.1, as the facts which made them residents of the UK occurred later. That did not matter: "The issue of liability has to be looked at retrospectively".[13] That is not surprising, as during a tax year a non-resident trustee never knows whether they are subject to UK CGT, since they will be subject to tax if they become UK resident later in the tax year.

Although the trustees were residents of the UK under article 4.1, they

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9 In fact the trustees were not liable to CGT in Mauritius, because Mauritius did not tax capital gains but only to income tax; but that made no difference because the trustees were liable to "tax" as defined.

10 A further question arose concerning POEM; see 6.18.4 (Short term period in foreign state).

11 The Court relied on s.69 TCGA. The wording of the section has changed, but the changes are not significant. The current wording reads: "*For the purposes of this Act* the trustees of a settlement shall, unless the context otherwise requires, together be treated as if they were a single person (distinct from the persons who are trustees of the settlement from time to time)." It might have been argued that s.69 is irrelevant to DTAs. However art.3.1 would justify treating trustees as a continue body of persons, and the decision on this point seems right.

12 In fact it could have been argued that the trustees were *not* liable to tax in the UK, because of s.77 TCGA and s.624 ITTOIA; but the taxpayer did not take that point.

13 *Smallwood v HMRC* [2010] STC 2045 at [42].

were also residents of Mauritius under article 4.1, so treaty-residence was decided under the tie breaker.

Smallwood is in part somewhat muddled and its reasoning is not quite that set out above. But however one reaches that result, the law should be regarded as settled.

In *Smallwood* the law decided by the CA favoured HMRC. However the rule will sometimes favour the taxpayer because income/gains arising at a time when a person does not meet the requirements to be a resident of a treaty state under article 4.1 may later meet those requirements, and retrospectively qualify for relief. Suppose:

(1) A company within s.13 TCGA is resident in Jersey during part of a tax year ("the Jersey resident period").
(2) The company becomes resident in state A under the law of state A during part of the tax year ("the state A resident period").
(3) Under the tax law of state A the company is liable to tax throughout both periods. That is, state A has a rule similar to that which applies to individuals and trusts in the UK.
(4) The company is at no time UK-law UK resident.

A gain arising in the Jersey resident period will retrospectively qualify for relief under a treaty between the UK and state A, which would benefit a UK participator within the scope of s.13. (Before the Court of Appeal's decision in *Smallwood*, an advisor might have thought that the company had to be able to say at the time the gain accrued. that it was resident under article 4.1 at that time, in order for treaty relief to apply. But now we know the position is looked at retrospectively.)

6.6.3 *HMRC view*

The International Manual provides:

> **154040. Individuals** [December 2011]
> Different countries have different fiscal years, for example, the United States tax year ends on 31 December. An individual who wishes to make a treaty claim as a resident of the United States in respect of the UK tax year 2010/11 will need to demonstrate that he is a resident of the United States during both of the United States tax years 2010 and 2011. If an individual was resident in the United States during the tax year 2010 but ceased to be so resident after 31 December 2010, then he may make a claim as a United States resident for any 2010/11 income which arose during 2010 but no claim is possible in respect of income arising in 2011. If income arises partly during a period of residence in the other country

> and partly during a period of residence in the UK, the income may be apportioned between the periods on a time basis, unless it is clear that the income arose unevenly over the two periods, for example a bonus payable for duties performed in one of the periods.

6.7 Exception where source tax only

Article 4(1) OECD Model Convention continues:

> This term, ["resident of a Contracting State"] however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

This only applies in the unusual case where:

(1) A person is liable to tax in a state by reason of his domicile, residence, place of management or any other criterion of a similar nature; but
(2) the person is only liable on income from a source in that state, or on gains on property in that state.

One example is diplomats. A UK resident diplomat is exempt from tax on foreign source income and gains and so not treaty-resident in the UK. The US Department of the Treasury Technical Explanation of the Convention provides:

> Thus, a consular official of the UK who is posted in the United States, who may be subject to U.S. tax on U.S. source investment income, but is not taxable in the United States on non-U.S. source income, would not be considered a resident of the United States for purposes of the Convention. (See Code section 7701(b)(5)(B))....[14]

Another example is a person who holds as nominee for a non-resident beneficiary. A UK resident nominee for a non-resident beneficiary is not subject to tax on foreign income, and so not treaty-resident in the UK.

6.8 Tie-breaker tests for individuals

It is of course possible for a person to be:

(1) a resident of state A under art. 4.1 during the whole of a tax year and
(2) a resident of state B under art. 4.1 during the whole of the same period.

This may arise for various reasons:

(1) Two states may have different domestic-law definitions of residence.

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14 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*. While this is directed at the US DTA, the relevant wording is (more or less) the same: See 6.19 (USA/UK DTA).

(2) Residence (however defined) is distinct from presence: a person may be UK-law UK resident throughout a year while only present in the UK during part of the year; such a person may be regarded by the foreign state as a resident of the foreign state.
(3) Split residence years: see above.

In such cases the tie-breaker tests are needed. For individuals, there are a series of tie-breaker tests, in order of priority:
(1) permanent home
(2) centre of vital interests
(3) habitual abode
(4) nationality
(5) mutual agreement.

6.9 Permanent home

Article 4 OECD Model Convention provides:

> 2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
>
> a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him;

For clarity of exposition it is helpful to consider separately the concepts of:
(1) "home"
(2) "permanent"
(3) "available"

But this neat analysis is not practical: the three terms interact, for a property which is not "available" or "permanent" is less likely to be a "home".

6.9.1 *"Home"*

"Home" matters for several tax purposes:
(1) Treaty-residence
(2) Residence[15]
(3) Child's domicile if parents living apart.[16]

See 4.14 ("Home").

15 See 4.14 ("Home").
16 See 3.14 (Child's domicile of dependency).

6.9.2 *"Permanent"*

The concept of "permanent" is as vague as the concept of "home". The OECD commentary is untrammelled by the restraint of precision:

> 11 The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, eg where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.
> 12 Subparagraph (a) means, therefore, that in the application of the Convention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.
> 13. ... But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc).

Para 11 of the commentary looks at the situation where "the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State". The commentary is not making a contrast between:

(1) permanent, and
(2) a stay of some length.

The point correctly being made is that the existence of one (undoubtedly) permanent home impacts on whether one regards *another* place as a permanent home.

Paras 12 and 13 contrast:

(1) permanent use, and
(2) a stay of short duration; exemplified as "travel for pleasure, business travel, educational travel, attending a course at a school, etc".

This suggests that a stay of more than short duration qualifies as permanent. Thus in *Hankinson v HMRC* 81 TC 424, an apartment held under an 18 month lease, where the taxpayer lived for some 130 nights between 6 April 1998 and 2 January 1999, was found to be a permanent

home.

A similar view is taken in Australia on the phrase "permanent place of abode".[17] The court said:

> "permanent" is used in the sense of something which is to be contrasted with that which is temporary or transitory. It does not mean everlasting. The question is thus one of fact and degree.[18]

6.9.3 *"Available"*

HMRC helpsheet 302 (Dual Residents - 2012/13) provides:

> A permanent home is any form of accommodation which is continuously available to you for your personal use. It does not necessarily have to be owned by you.

6.10 Centre of vital interests

Article 4(2)(a) OECD Model Convention provides:

> if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

The test is multifactorial, no single factor is decisive. The OECD commentary provides:

> 15 If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can,

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17 Section 6(1) of the (Australian) Income Tax Assessment 1936 provides: "resident or resident of Australia ... includes a person ... whose domicile is in Australia, unless ... his permanent place of abode is outside Australia".

18 *Applegate v Federal Commissioner of Taxation* [1978] 1 NSWLR 126 at p.134, affirmed on appeal [1979] FCA 37; (1979) 38 FLR 1.

> together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

This is only relevant where the tie-breaker is not decided by the question of a permanent home.

A similar expression "centre of a debtor's main interests" is used in Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings; case law on that may also be helpful in relation to the expression centre of vital interests.

Yates v HMRC [2012] UKFTT 568 (TC) and *Hankinson v HMRC* 81 TC 424 offer illustrations but are otherwise of no particular importance.

The Australian Revenue offer another illustration:

> **Facts**
>
> The taxpayer and his spouse and children initially lived in the UK.
>
> The taxpayer accepted employment in Australia for a period of 18 months, which is the period in question.
>
> The taxpayer and his spouse and children moved to Australia for that period.
>
> The taxpayer and his spouse own family homes both in Australia and in the UK, and each home is maintained so that it can be used by the taxpayer or his family at any time.
>
> Prior to, and during, the period in question, the taxpayer had business interests in both the UK and Australia.
>
> While the taxpayer lived in Australia, he managed both his Australian and UK business interests from Australia, but he made occasional short trips to the UK when it was necessary.
>
> The taxpayer is a member of several clubs in the UK. When he was living in the UK or visiting the UK he would regularly socialise with friends and with members of his extended family.
>
> While he was living in Australia the taxpayer did not join any clubs, and he did not socialise as regularly, as he did not have many friends or any extended family members in Australia.
>
> The taxpayer's hobby is attending cooking classes, and he attended cooking classes as often as he could, both in Australia and in the UK.
>
> During the 18 months that the taxpayer lived in Australia, he remained on the electoral roll in the UK but he was not on the Australian electoral roll.
>
> The taxpayer's children have a cat, which remained in the UK with friends while the taxpayer was living in Australia.
>
> At the end of the 18 months, the taxpayer and his spouse and children returned to the UK to live.

Reasons for Decision

Paragraph 10 of the OECD Commentary on Article 4 states that the facts to which the special rules in Article 4(2) of the OECD Model will apply are those existing during the period when the residence of the taxpayer affects tax liability. In this case the relevant period is the 18 months that the taxpayer lived in Australia.

[The Australian Revenue cite para 15 of the OECD commentary and continue:] This means that the taxpayer's relations with Australia must be weighed against the taxpayer's relations with the UK, with more weight being given to the taxpayer's personal acts.

Klaus Vogel on Double Taxation Conventions, Third Edition, Kluwer Law International 1997, is consistent with paragraph 15 of the OECD Commentary on Article 4(2)(a) and states that 'personal relations encompass a taxpayer's entire way of life' (emphasis added). This includes family and social, political and cultural relations. At paragraphs 74 and 74a of page 249, Vogel suggests that factors that are part of a person's personal relations include intention to spend their old age at a certain place; possession of an identity card; enlistment on the electoral roll; and relations to a thing or to an impersonal entity such as a private collection or membership in a club or the exercise of a hobby.

As the taxpayer pursued his hobby in both Australia and the UK, the hobby is not significant in deciding the centre of vital interests.

The registration on the electoral roll; the club memberships; the presence of friends and extended family members and the family's cat; and the active social life when he visits the UK, are factors which point to the UK as the taxpayer's centre of vital interests during the 18 months that he is living in Australia.

However, at page 249, paragraph 74a, Vogel states that the most significant factor in establishing to which state a taxpayer's personal relations are closer is where the taxpayer regularly lives with his family. Where a taxpayer lives alone, the location of any family members will be relevant if the taxpayer maintains relations with them.

The taxpayer lived with his family in Australia during the 18 months in question. Even though he had strong ties with the UK during that time, the presence of his spouse and children in Australia carries greater weight.

Regarding economic relations, the OECD Commentary on Article 4 at paragraph 15 refers to 'the place from which he administers his property, etc'.

Consistent with this, Vogel at page 249, paragraph 74b, states:

> **Economic relations will primarily exist with activities** linked with a locality or with sources of income. ... A permanent home mainly

> serving the realization or maintenance of economic relations, would be a manifestation of special ties with a place to live. This, will as a rule, be **that home from where the individual proceeds to perform his everyday work and from where he manages and controls his capital or income** (emphasis added).

In this case, during the 18 months in question the taxpayer was employed in Australia so the home from where he proceeded to perform his everyday work was in Australia. In addition, although he made some trips to the UK when his business interests made it necessary, he generally managed his business interests from Australia during the time he lived in Australia.

For the 18 months in question the taxpayer lived with his spouse and children in Australia, and generally managed his business interests from Australia. Consequently, even though he also had ties with the UK, the taxpayer's personal and economic relations, during the 18 months in question, were closer with Australia than with the UK.[19]

6.11 Habitual abode

Article 4(2) OECD Model Convention provides:

> b) if
>
> [i] the State in which he has his centre of vital interests cannot be determined, or
>
> [ii] if he has not a permanent home available to him in either State,
>
> he shall be deemed to be a resident only of the State in which he has an habitual abode;

The OECD commentary provides:

> 16 Subparagraph (b) establishes a secondary criterion for two quite distinct and different situations:
>
> (a) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;
>
> (b) the case where the individual has a permanent home available to him in neither Contracting State.
>
> Preference is given to the Contracting State where the individual has an habitual abode.
>
> 17 In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual

19 ATO ID 2011/53.

> abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.
> 18 The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.
> 19 In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has an habitual abode, subparagraph (b) does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

HMRC helpsheet 302 (Dual Residents - 2012/13) provides:

> You will be a resident of the State in which you have a 'habitual abode'. This test which is applied to each State is whether you live in that State regularly, normally or customarily. The number of visits as well as the duration of the visits are taken into account and this test is applied over a sufficient period as is necessary depending on the facts of each case. If you cannot be said to have a habitual abode in either of the two countries or you have a habitual abode in both of them, you should move on to the next test.

In *Hankinson v HMRC* 81 TC 424, the tribunal said:

> In a case in the Tax Court of Canada ... *Lingle v R* 12 ILTR 55, Campbell J makes the point that the French equivalent to an habitual abode is *où elle séjourne d'une façon habituelle* which means "where one stays[20] in an habitual way." He was dealing with the US-Canada treaty the official languages of which are English and French whereas we are dealing with

20 [Footnote original] We also point out that *séjourne* is also translated as "is present" in article 15(2)(c) of the Model: *le bénéficiaire séjourne dans l'autre État pendant une période ou des périodes n'excédant pas au total 183 jours durant toute période de douze mois*….("the recipient is present in the other state for a period or periods not exceeding in aggregate 183 days in any twelve month period…").

the Treaty, which is in English and Dutch but as the French is the same in the French official version of the OECD Model we consider that it is permissible to look at it to confirm the meaning of the expression in English which is an odd use of the English language. In the overlap period [the appellant] did not stay in either state because he was in Barbados. We find that he did not have an habitual abode in either state during the overlap period. If it is possible to look at a longer period as required by paragraph 19 of the Commentary, such as the UK tax year 1998-99, he stayed in an habitual way in both countries (some 130 nights in the Netherlands and 82 nights in the UK, including non-working days) and the intervals were fairly evenly spaced. We regard both of these as habitual. We do not read this test as purely a matter of counting days in spite of the Commentary's reference to "tips the balance towards the State where he stays more frequently" unless one is far larger than the other because the Treaty deals with the possibility of habitual abode being in both or neither state, which would virtually never arise with counting days. We would therefore decide if it were relevant that the Appellant had an habitual abode in neither state if only the overlap period were taken or that he had an habitual abode in both states if the tax year 1998-99 were taken.[21]

6.12 Nationality and mutual agreement procedure

Article 4(2)(c)(d) OECD Model Convention provides:

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

6.13 Period for enquiry into individuals tie-breaker tests

In *Hankinson v HMRC* 81 TC 424 the Tribunal said:

> It seems therefore that while one applies the tie-breaker at the time of alienation in a case concerning capital gains, this does not mean that one cannot look at a longer period in applying the elements of the tie-breaker when appropriate, which it may not be for permanent home, but it is necessarily for habitual abode.

21 The Court of Appeal stated this on p.497 at [69].

While one needs to determine whether a person is treaty-resident at a particular moment, one looks over an appropriate period of time to determine whether they are treaty-resident at that moment; see 6.18.3 (Period for enquiry into POEM).

6.14 Treaty-residence: Trusts

The first step is to identify who is the "person" for treaty purposes.[22]

6.14.1 *The trust law background*

The following propositions are well established.

(1) A trust is not a person (ie does not have legal personality, which in short means the ability to hold property and be subject to liabilities). This is the case in English law, Scots law[23] or, as far as I know, any other trust law.[24]

(2) A trustee is a person. It is often convenient to distinguish:
(a) a person acting in their capacity as trustee and
(b) that person acting in their private capacity.
However trust law does not recognise the concept of separate personality, that is, there is only one person: the person acting in one capacity is not a different person from the person acting in another capacity. For instance, a person (as trustee) cannot enter into a contract with himself (as individual) because of the rule that a contract must be made between two persons.[25]

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22 See 6.4 ("Person").

23 The Scottish Law Commission discussed but rejected a proposal to give trusts legal personality: *Discussion Paper on the Nature and the Constitution of Trusts* (October 2006) para 2.29-2.45.

24 Though a trust is close to being a person. Gretton, "Trusts Without Equity" (2000) 49 Int'l & Comp. LQ 599:
"In ordinary language the noun 'trust' is a person word. Idiom treats it like 'company'. 'This land is owned by a trust.' 'These shares are held by a trust'. ... 'The trust is liable for this debt.' Ordinary language is right."
So one should not rule out the possibility that context may show that the word "person" is used (loosely rather than strictly) to mean or include a trust.

25 Discussion of the topic demands reference to *The Mikado:*
Ko-Ko. Pooh-Bah, it seems that the festivities in connection with my approaching marriage must last a week. I should like to do it handsomely, and I want to consult you as to the amount I ought to spend upon them.
Pooh-Bah. Certainly. In which of my capacities? As First Lord of the Treasury, Lord Chamberlain, Attorney General, Chancellor of the Exchequer, Privy Purse, or Private

It seems to me that the source of difficulty is not rule (1) that a trust is not a person: it is rule (2) that a trustee does not have a separate personality. Despite that rule, references in legislation to "individuals" have always been understood to exclude trustees (and references to "trustees" exclude individuals) and that usage takes us towards some concept of separate personality. Further, for UK IT and CGT purposes, a trustee is deemed to be a distinct, notional person.[26] So in a tax context, at least, rule (2) does not apply: the person acting as trustee *is* generally regarded as a separate person from the same person acting in their private capacity.

6.14.2 *Position of trustees under OECD Model treaty*

One would expect:

(1) Trustees (if more than one) to be treated as one person ("a trustee-person"). That avoids the difficulty which otherwise arises if a trust

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Secretary?

Ko-Ko. Suppose we say as Private Secretary.

Pooh-Bah. Speaking as your Private Secretary, I should say that, as the city will have to pay for it, don't stint yourself, do it well.

Ko-Ko. Exactly — as the city will have to pay for it. That is your advice.

Pooh-Bah. As Private Secretary. Of course you will understand that, as Chancellor of the Exchequer, I am bound to see that due economy is observed.

Ko-Ko. Oh! But you said just now "Don't stint yourself, do it well".

Pooh-Bah. As Private Secretary.

Ko-Ko. And now you say that due economy must be observed.

Pooh-Bah. As Chancellor of the Exchequer.

Ko-Ko. I see. Come over here, where the Chancellor can't hear us. Now, as my Solicitor, how do you advise me to deal with this difficulty?

Pooh-Bah. Oh, as your Solicitor, I should have no hesitation in saying "Chance it —"

Ko-Ko. Thank you. I will.

Pooh-Bah. If it were not that, as Lord Chief Justice, I am bound to see that the law isn't violated.

Ko-Ko. I see. Come over here where the Chief Justice can't hear us. Now, then, as First Lord of the Treasury?

Pooh-Bah. Of course, as First Lord of the Treasury, I could propose a special vote that would cover all expenses, if it were not that, as Leader of the Opposition, it would be my duty to resist it, tooth and nail. Or, as Paymaster General, I could so cook the accounts that, as Lord High Auditor, I should never discover the fraud. But then, as Archbishop of Titipu, it would be my duty to denounce my dishonesty and give myself into my own custody as first Commissioner of Police.

Ko-Ko. That's extremely awkward."

26 See 5.4 (Trustee residence for income tax and CGT).

had trustees who are resident in different places in their private capacities.

(2) Whether there is a single trustee, that person is to be treated as a person (again, one may use the expression "trustee-person") who is distinct from the individual or company who is the trustee, acting in their private capacity. That allows for the possibility that the person may be treaty-resident in one state in their private capacity and treaty-resident in another state in their trustee capacity.

Is there any difficulty in reading the model treaty to reach this result? Where there is more than one trustee, there is no difficulty at all: the trustees should be regarded as a body of persons (and so constitute one person) for treaty purposes. That trustee-person is necessarily distinct from the persons who act as trustees.

Where there is a sole trustee, it should still be regarded as a person distinct from the person who is actually the trustee in their private capacity. It would be odd to have one rule for a sole trustee and another where there is more than one trustee. One way to reach this result is to say that even a sole trustee is a "body of persons" it may seem odd to say that a single person constitutes a body of persons but the institution of a "corporation sole" is an example. Another way to reach this result is to say that "person" is to be understood by reference to domestic tax law, domestic tax law treats the trustee as a separate person, despite the trust law rule to the contrary; and so the same rule applies for a treaty.

The trustee-person is not an individual, so its treaty-residence is decided by the POEM rule, not the rule for individuals (which would obviously not be appropriate).

Another possible analysis would be that the *trust* is a person for OECD model purposes. There are two difficulties with that:

(1) A trust is not a "person" in English law.

(2) Even if the trust were a person, it is only treaty-resident in a treaty state under article 4.1 if it is a person "liable to tax." Whether a person is liable to tax is a matter of domestic law. In UK law, it is the trustees rather than trust which is liable to tax.

These arguments are not insuperable: since treaties can be loosely construed, there are no words from which there is no escape. One could say that a trust is a person (in the treaty sense) even though not a person in English law; and that the trust is "liable to tax" (in the treaty sense) since the trust fund will bear the tax. But there is no need to take this high-handed course, as to regard the trustee or trustees as a distinct trustee-

person is the simpler and more satisfactory solution.[27]

While it is possible that a foreign law might look at the matter differently, it would be desirable if possible for all countries to adopt the same approach, and in practice this seems to be the case.

HMRC agree. INT Manual provides:

> **162120. Certificates of Residence: for trusts** [January 2014]
> Trusts are not themselves liable to tax in the UK, but the trustees may be liable to tax in the UK. A trust therefore cannot be a resident of the UK for the purposes of most UK Double Taxation Agreements (DTAs). Accordingly a Certificate of Residence (CoR) cannot normally be issued in respect of a trust. However, some trusts are included within the definition of 'resident of a Contracting State' in specific DTAs. In those limited circumstances a certificate of residence can be issued in respect of a trust. It is therefore essential that the relevant DTA is checked on receipt of all applications.
> Trustees as a body (rather than the trust) are regarded as a single person. Where the trustees as a body are regarded as resident in the UK they will be entitled to the benefits of a DTA as they are liable to tax in the UK in respect of the income of the trust. Subject to the comments in the next paragraph a CoR can be issued in respect of a UK resident body of trustees.

The International Manual also provides:

> **353600. Claims by trustees in Ireland** [January 2010]
> Article 4(3) (Fiscal Residence) of the convention makes reference to 'a person other than an individual'. Trustees act as a body of persons and so are persons other than an individual for the purposes of the article, and we therefore refer to the criteria in Article 4(3) to determine whether trustees of an Irish trust are resident in the Ireland for the purposes of the convention.

This is commenting on the Ireland/UK treaty but the same would apply generally as that follows the OECD model.

The same would apply to the estate of a deceased person.

On this topic, see Prebble, "Trusts and Double Taxation Agreements"

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27 It has been suggested that the question whether the person for the purposes of the OECD Model is the trustees (as a body) or the trust is purely theoretical and makes no difference in practice. I have some sympathy with that view. But (1) it is always good to know what one is talking about; (2) HMRC need to know what name(s) to put on a residence certificate: the trust or the trustee(s).

ejournal of Tax Research (2004) vol 2 no 2 p192, accessible *http://www.atax.unsw.edu.au/ejtr/content/issues/previous/paper3_v2n2.pdf*.

6.15 Treaty-residence: Partnerships

6.15.1 *Is a partnership a "person" for treaty purposes?*

This section considers whether a partnership is a treaty-resident of a state. For other DT issues see 41.10 (DT relief for partnership).

The first question is whether a partnership is a "person" for treaty purposes.[28] Before turning to the definition, one might expect a partnership to be a person, since:

(1) It avoids difficulty which would arise if a partnership had partners who were resident in different places in their private capacity.
(2) It avoids an undesirable distinction between English partnerships (which are not legal persons) and Scottish partnerships (which are).
(3) "It is highly improbable that so common a vehicle for commercial activity as a partnership should have been intended to be excluded " from a DTA...[29]

Article 3.1(a) OECD Model provides:

> 1. For the purposes of this Convention, unless the context otherwise requires:
>
> a) the term "person" includes an individual, a company[30] and any other body of persons;

There are three bases for arguing that a partnership is a person within this definition:

(1) A partnership is a body of persons, and so within the definition (the "body of persons" argument).
(2) A partnership is a person in the ordinary sense of the expression (the "ordinary person" argument.) If so it does not matter whether a partnership is a body of persons.
(3) Partners (being individuals or companies) are persons (in their private capacities) and a partnership is a person because the singular includes the plural (the singular/plural argument).

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28 See 6.4 ("Person").

29 *Padmore v IRC* 62 TC 352 at p.377.

30 Article 3.1(b) defines company: "the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes".

Discussion is made more difficult because of the variety of wording in different treaties.

The body of persons argument succeeded in *Padmore v IRC*, where the issue was whether a partnership was a person for the purposes of the Jersey/UK DTA. This is an old colonial model DTA, and the definition of "person" is not quite OECD model form. Para 2(1)(d) of the Jersey/UK DTA provides:

> The term "person" includes any body of persons, *corporate or not corporate*;

The Court held that a partnership is a body of persons in the ordinary sense of that term.[31] Accordingly it constitutes a person within the Jersey/UK treaty definition.

The Revenue's argument was a subtle one. They referred to the general principle that undefined treaty terms have domestic law meanings[32] and argued:

> "Body of persons", it is contended by the Crown, is a term of art in UK tax law and is defined in [what is now s.989 ITA] as follows:
>
> > " 'Body of persons' means any body politic, corporate or collegiate, and any company, fraternity, fellowship and society of persons whether corporate or not corporate".[33]
>
> The Jersey Law has a provision in the same terms ....[34]

That is, the Revenue argued that (1) a partnership (although a body of persons in the general sense) was not a body of persons in the UK tax law sense and (2) the UK tax law sense applied in the treaty. The Court's reason for rejecting the argument at point (2) was equally subtle:

> If that [UK tax law] definition [of body of persons] is applicable, a partnership is (I will assume) not within it; because a partnership cannot be brought within any of the groups specified in the definition. ... however ... the [UK tax law] definition is not applicable. The draftsman of the Arrangement in para 2(1)(d) was giving a comprehensive

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31 See 6.15.1 (Is a partnership a "person" for treaty purposes?).

32 Article 2(3) of the Jersey/UK DTA, which is broadly similar to the OECD model form, see 57.11 (Undefined terms have domestic law meanings).

33 Section 989 ITA copies the earlier provision verbatim. These terms are now of historical interest and it is a pity that the tax law rewrite failed to modernise and simplify this. Perhaps the Office of Tax Simplification could do so.

34 *Padmore v IRC* 62 TC 352 at p.377.

> definition of the word "person". If he was assuming that the statutory definition of "body of persons" would apply, I see no reason why he should have added the words "corporate or not corporate". They form part of the Article 2(1)(d) definition itself, and their inclusion had no purpose if the statutory definition applied. I do not think that they can be dismissed as mere tautology. On the face of the Arrangement they are a specific part of what is intended to be a self-contained definition for the purposes of the Arrangement. They are not, it seems to me, consistent with an intention on the part of the draftsman to utilise the statutory definition. They indicate a contrary intention. A partnership is, as a matter of the ordinary use of English, plainly a body of persons, and the language used by the draftsman does not, in my opinion, indicate that he was intending any different meaning.

Unfortunately that reasoning does not apply to the OECD model form, since that lacks the words "corporate or not corporate." See Article 3.1(a) OECD Model set out above. It is however considered that "body of persons" in the OECD model should be given its ordinary meaning rather than its UK tax meaning. It is relevant to note that the term does not have a UK tax meaning, only an income tax meaning. There is no similar definition for CGT. Thus a partnership is a body of persons (within the meaning of the Model convention) and so a person within the OECD definition.

Avery Jones agrees:[35]

> ...it is hardly likely that the other State, if it had troubled to ask in the course of negotiations what body of persons meant in UK tax law, would wish to have an 18th century list of bodies govern the interpretation of the treaty. It is therefore not difficult to say that the context otherwise requires, and one should include partnerships either within the ordinary meaning of body of persons, or merely by reading the singular as the plural.[36] On the basis a partnership may be included in those cases

35 Avery Jones, "Bodies of Persons" [1991] BTR 453 at p.464.

36 [Footnote original] This was mentioned as a possibility in *Padmore* [1989] STC 493, 498g but Fox L.J. stated that this was not sufficient for the taxpayer to succeed, as those persons were not all resident in Jersey. It is not clear why persons in partnerships should not be given a single residence under TA 1988, s.112, which the court held to be applicable for the purpose of interpreting the treaty. The statutory definition of residence of trustees in FA 1989, s.110 does not give them a residence as a body but deems the resident trustees to be non-residence and vice versa.

> where wording similar to the 1977 Model is used.[37]

Alternatively one could fall back on the ordinary person or the singular/plural arguments. The difficulty with that is that some treaties provide:

> the term "person" *comprises* an individual, a company and any other body of persons;

Others provide:

> the term "person" *means* an individual, a company and any other body of persons;

Avery Jones comments:

> Normally in modern UK treaties the definition of person is that it *comprises* an individual, a company and any other body of persons, which was the wording of the 1963 model; at first sight this might prevent the ordinary meaning of *person* from being used.[38] The official French version of the Model, however, uses the same word *comprend* in both the 1963 and the 1977 versions. There may therefore be no difference between it and the 1977 Model, which makes it difficult to see why the UK persists in using the 1963 wording. In eight treaties the word *means* is used instead of the Model's *includes*, in which case the ordinary meaning, in addition to the defined meaning, of person cannot be used. But certainly where *includes* and probably in the light of the French version where *comprises*, is used, the argument that the context includes partnerships under the ordinary meaning of body of persons is still available, as these words are not intended to be comprehensive. It is considered that partnerships are so included under that wording, on the basis that they cannot have been intended to be excluded.[39]

It is considered that any of these arguments will suffice, so a partnership is a "person" for DTA purposes in all cases, though the precise arguments which arise vary from one wording to another. The commentary to the

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37 [Footnote original] See art. 1 Comm. Paras. 2-6 of the application of the OECD Model to partnerships. The UK gives a residence to a partnership: TA 1988, s.112(1).

38 [Footnote original] The OECD Commentary (Art.3 Comm. Para.2), however, stated that the provision was not worded as an exhaustive definition and should be read as indicating that the term person is used in a very wide sense.

39 Avery Jones, "Bodies of Persons" [1991] BTR 453 at p.464.

OECD model convention supports this view. The commentary to article 3 provides:

> Partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons.

6.15.2 *Is a partnership "liable to tax"?*

But even though a partnership is a person, it is only a resident of a treaty state within the OECD definition if it is a person liable to tax. Whether a person is liable to tax is a matter of domestic law.

In UK law, it is the partners rather than the partnership which is liable to tax. Partners are of course "persons" in their private capacity. They can be treaty-resident in the UK. It seems that a partnership (though a "person") cannot be treaty-resident in the UK. A partnership could (depending on the foreign domestic law) be treaty-resident in a foreign state.

INT Manual provides:

> **162033. Certificates of Residence and partnerships** [January 2013]
> UK partnerships (including Scottish partnerships and UK LLPs) cannot be resident in the UK for the purposes of any of the UK's Double Taxation Conventions (DTCs) because they are not themselves liable to tax in the UK. Therefore they cannot claim the benefits of any DTC. However, UK resident partners making up the partnership are entitled to such benefits as they are taxed in the UK on their share of the partnership worldwide profits.

This is correct for OECD Model treaty-residence. Para 5 of the OECD Commentary to article 1 similarly provides:

> Where... a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for the purposes of the Convention.

The same (more or less) applies to LLPs. BI Manual provides:

> **82145 Limited Liability Partnership (LLP): International aspects** [December 2013]
> ... A UK LLP is not itself liable to tax in the UK as the LLP tax provisions identify other persons (i.e. the members) as the persons who are to be taxed. Accordingly for the purposes of the Double Taxation

> Agreements (DTAs) the LLP is not regarded as being resident in the UK and cannot itself therefore claim relief from foreign taxes under such agreements. As is now the case with ordinary and limited partnerships the members must make the claim.
> ...In the very narrow circumstances where the LLP is not treated as transparent, but instead as a body corporate for tax purposes (such as when the LLP is in liquidation or being wound up in circumstances where transparency cannot be retained), we take the view that the LLP can itself claim relief for foreign taxes, including if appropriate underlying tax.

However HMRC do not always apply this view in practice.[40]

6.15.3 *HMRC practice*

For US partnerships this practice is not followed and HMRC allow claims from partnerships.[41] There is no reason why American partnerships should be treated better than other partnerships, and other partnerships could therefore seek to obtain similar treatment, even though there would be no legal remedy if HMRC insist on applying the strict law. In practice HMRC accept such claims. INT Manual provides:

> **335510. Background** [December 2011]
> ***How Double Taxation Agreements treat partnerships***
> Double Taxation Agreements (DTAs) do not normally give a tax-transparent concern such as a partnership the right to claim treaty relief. Instead, in those cases where the income of the partnership is taxable in the hands of the partners (rather than at the level of the partnership) each partner should in strictness make a separate claim to treaty relief...
> ***HMRC's approach to Partnerships***
> We recognise that applying the provisions of the DTA in such a literal way would be unwelcome and could possibly hamper the business interests of both countries.
> Accordingly, HMRC may accept a single claim from a partnership on behalf of its partners. Where a partnership wishes to take advantage of this departure from the strict position and to claim treaty benefits on

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40 See 59.16.3 (US partnerships and LLCs).
This view was rejected in India: *Linklaters LLP v Income Tax Officer* [2010] ITELR 245. However in India (unlike the UK) a partnership is treated as a person for income tax purposes: s.2 [India] Income Tax Act 1961.

41 See 59.16.3 (US partnerships and LLCs).

behalf of its partners, the general or managing partner should sign the declaration on the claim form. In addition to the normal information that is required by the claim form, a list of the names and addresses (residential addresses for individuals and registered addresses where the partners are companies) of the partners should be supplied. These lists should also normally show for each partner their respective percentage shares of the income that is the subject of the claim. In those cases where all of the partners are resident for tax purposes in the same country as the one in which the partnership is established (the country with which the DTA applies) it is not necessary to insist upon this information being provided.

Where any of the partners are resident for tax purposes in a country other than that in which the partnership is established, they should make separate claims to relief from UK tax under the terms of any relevant DTA.

In cases where such a partner is resident in a country which (unusually) does not regard the partnership as fiscally transparent - which would mean that it regards the partnership rather than the UK payer as the source of the payments its resident receives - then that partner may have difficulty in getting a claim form certified as relevant to a DT treaty with the UK. In such rare cases, you should consider accepting an uncertified claim form. If you decide to invite a claim in these circumstances you should ask for the claim form to be supported by additional evidence (for example copies of recent tax returns) to show that the partner is resident for tax purposes in the country concerned. Any such case should be referred to Specialist Personal Tax, PT International Advisory at an early stage.

335520. Examination of claims [December 2011]

What Personal Tax International will do

Where you are able to conclude that all of the beneficial owners of the income for which relief is being claimed are "qualifying persons" within the meaning of a DTA, then you should process the claim in the normal way without further enquiry. This includes asking the tax office for the UK payer of the income to complete a report on forms in the 4450 series as appropriate.

If the supplementary information that is supplied with the claim form does not allow you to conclude that each of the partners is resident for tax purposes in the same country as that in which the partnership is established, you will have to ask for further information to be supplied.

If any of the partners that are identified are themselves (at face value) transparent for tax purposes (for instance Limited Partnerships and Limited Liability Companies, as well as Trusts and some types of

investment funds) you should ask for similar information to be supplied about these 2nd and 3rd level partners. Your aim should be to reach a reasonable level of assurance that all of the underlying participators in these concerns are themselves "persons" who would be able to claim double taxation relief if they were receiving the money directly rather than through the partnership.
(This text has been withheld because of exemptions in the Freedom of Information Act 2000)
Where the partnership is unable to provide sufficient information about the identity of its partners to allow you to be satisfied that each person is entitled to relief from UK tax, the amount of relief to be allowed must be restricted to the percentage share of the income that is attributable to the partners who you accept as being entitled to treaty benefits in their own right.

6.16 Partnerships under non-OECD model DTAs

Some DTAs do not follow the OECD model. The former International Tax Handbook provided:

1656. Later DT Agreements
The significance of 1987 for partnerships and Double Taxation Agreements is that in 1986 the High Court gave its decision on the Padmore case which upset our view that a treaty did not apply to partnerships unless they were specifically mentioned. We look at the Padmore case and its consequences in the next paragraphs. Later treaties will normally have something about partnerships, either specifically excluding some or all of them from the treaty or preserving our right to tax the UK resident partners. The precise provisions may depend on the status of partnerships in the country of the treaty partner. Examples of later treaties where partnerships are mentioned are Italy and Bulgaria.

6.16.1 *Partnerships under UK/Switzerland DTA*

Article 4.1 of the UK/Switzerland DTA provides, unusually:

> In the case of Switzerland, the term [resident of a Contracting State] includes a partnership created or organised under Swiss law.

The former International Tax Handbook provided:

1655. Older DT Agreements
... the Swiss Agreement which includes as a resident of Switzerland a partnership created or organised under Swiss law. If this were the only provision it could mean that we would not have the right to tax under

> Case V a UK-resident partner in a Swiss partnership which had no permanent establishment in the UK. But our right to tax our resident partners is specifically protected by a separate provision.

The DTR Manual now provides:

> **DT18104 - Switzerland: Partnerships** [September 2011]
> The agreement makes it clear that, if a partnership is a resident of Switzerland and is entitled, in accordance with the provisions of the agreement, to exemption from UK tax on any income, the UK nevertheless has the right to tax a UK resident partner on his share of the partnership income. Such income is deemed to be income from a source in Switzerland (Article 27(2)).
> The agreement provides in Article 4 (1) that, in the case of Switzerland, the term 'resident of a Contracting State' includes a partnership created or organised under Swiss law. This provision should not be understood to override the general requirement that a resident must be liable to taxation in the relevant Contracting State. Where a claim is received in respect of the income of a Swiss partnership it should be ascertained that the income is actually taxed in Switzerland. Any claim that income of a Swiss partnership which has not been taxed in Switzerland should be relieved from taxation in the UK should be referred to Business Profits, International.

6.17 RICs, REITs and REMICs

The US Department of the Treasury Technical Explanation of the Convention[42] provides:

> Certain entities that are nominally subject to tax but that in practice are rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, RICs, REITs and REMICs are all residents of the United States for purposes of the treaty. Although the income earned by these entities normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore may be regarded as "liable to tax." They also must satisfy a number of requirements under the Code in order to be entitled to special tax treatment.

While this is directed at the US DTA, the wording in point ("liable to tax") is the same generally and the same argument should apply to REITs in other states.

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42 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf.*

6.18 Place of effective management ("POEM")

Article 4.3 OECD Model Convention provides:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

This is the tie-breaker for trusts, companies and PRs. The OECD commentary provides:

> 24. ... The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

This has often been cited and adopted in UK cases, as one would expect. The UN commentary provides:

> [The term "place of effective management"] is used in several provisions of the OECD Model Convention, as is the term "place of management". Neither term is defined explicitly in the Convention itself or in the commentary thereon, nor is it made clear whether the two terms are to be construed as having the same meaning or two different meanings. It is, however, understood that when establishing the place of effective management, circumstances which may, inter alia, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view, and the place where the most important accounting books are kept.[43]

The International Manual provides:

> **353600. Claims by trustees in Ireland** [January 2010]
> ***... When you need to determine the place of effective management of an***

43 United Nations Manual for the Negotiation of Bilateral Tax Treaties between developed and Developing Countries 2003.

Irish trust

... So if you have a claim from a trust under the treaty with Ireland and find that the trustees are resident in more than one country, you will need to establish the trust's place of effective management.

You should ask Technical Advice Group to confirm any judgement you make on the residence of a group of individual trustees.

Criteria for determining the place of effective management of an Irish trust

You need to find out who generally controls and supervises the work of administering the trust. By administering the trust we mean: keeping accounts, conducting correspondence, arranging the trustees' meetings and putting the trustees' decisions into effect.

If the trustees are all individuals

You will need to find out which of the trustees is responsible for the tasks outlined above, and the dates and locations of all trustees' meetings held during the period of the claim.

If a professional body acts as a trustee

You can accept that the place of business of the professional body is the place of effective management of the trust.

For this purpose the professional body is appointed by the testator or settlor of the trust, and does not include:

- An individual who is a solicitor or an accountant
- An agent or an attorney administrator appointed by the trustees

Residence of a professional body

If a professional body acting as a trustee is a branch in Ireland of a UK bank or similar institution, it is considered to be in Ireland for the purposes of Article 4(3). A UK branch of an Irish bank would however not be considered to be in Ireland.

6.18.1 *"Effective" management*

In *Smallwood v HMRC* [2008] STC (SCD) 209 the Special Commissioners said at [112]:

> We believe 'effective' should be understood in the sense of the French 'effective' (siège de direction effective) which connotes real, French being the other official version of the [OECD] model, though not of the [Mauritius/UK] treaty.

This does not take matters much further. The word "real" never does.

6.18.2 *Comparison with "central management and control"*

In *Smallwood v HMRC* (CA) at [58] Patten LJ says:

> [In] *Wood v Holden* 78 TC 1 ... Chadwick LJ expressed the view that it was difficult to draw any meaningful distinction between the two tests [POEM, and central management and control] but that even if they did in fact differ in substance, they were unlikely to lead to different results.

The difference between the two expressions is only one of nuance, as both stress "top level" or "key supervision" and neither are concerned with day to day matters.

In *Smallwood v HMRC* [2008] STC (SCD) 209 the Special Commissioners discussed POEM:

> 111. There was thus some debate about whether, or to what extent, POEM differed from CMC [central management and control]. We consider that this misses the point; the two concepts serve entirely different purposes. CMC determines whether a company is resident in the UK or not; POEM is a tie-breaker the purpose of which is to resolve cases of dual residence by determining in which of two states it is to be found. CMC is essentially a one-country test; the purpose is not to decide where residence is situated, but whether or not it is situated in the UK…
> 112. POEM, on the other hand, must be concerned with what happens in both states since its purpose is to resolve residence under domestic law in both states, caused for whatever reason, which could include incorporation in one state and management in the other, or different meanings of management applied in each state, or different interpretations of the same meaning of management applied in each state, or divided management. One must necessarily weigh up what happens in both states and according to the ordinary meaning to be given to the terms of the treaty in their context (to quote art 31 of the Vienna Convention on the Law of Treaties) decide in which state the place of effective management is found.[44]

The Australian Revenue have given guidance on "central management and control"of a superannuation fund (which is a trust) and it is considered this is also helpful to the concept of effective management:[45]

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44 That is in the context of a trust, but the same passage was applied in the context of a company: *Laerstate BV v HMRC* [2009] UKFTT 209 at [48]. See Avery Jones, "The Definition of Company Residence in Early UK Tax Treaties" [2008] BTR 556.

45 Taxation Ruling TR 2008/9, "Income tax: meaning of 'Australian superannuation fund' in subsection 295-95(2) of the Income Tax Assessment Act 1997" *http://law.ato.gov.au/atolaw/view.htm?locid=%27PAC/19970038/295-95%282%29%27&PiT=99991231235958#295-95%282%29*

Meaning of 'central management and control' in the context of a superannuation fund

108. The phrase 'central management and control' is not defined in the ITAA 1997. Therefore, the term takes its meaning from the context in which it appears. In this case, the operations of a superannuation fund form part of that context, using the word 'context' in its widest sense.[46]

109. The term 'central management and control' was developed by the courts as the common law rule for determining the residence of a company. As Lord Loreburn LC stated in De Beers Consolidated Mines v Howe[47] (De Beers):

> In applying the concept of residence to a company, we ought, I think, to proceed as nearly as we can upon an analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business...a company resides for purposes of income tax where its real business is carried on. I regard that as the true rule, and the real business is carried on where the central management and control actually abides.

110. Since the House of Lords decision in De Beers, there have been a number of cases, both in the UK and Australia, which have discussed the application of the CM&C test in relation to companies. In *Koitaki Para Rubber Estates v FCT*[48] (Koitaki), Williams J stated that in relation to determining the residence of a company:[49]

> the crucial test is to ascertain where the real business of the company is carried on, not in the sense of where it trades but in the sense of from where its operations are controlled and directed. It is the place of personal control over and not of the physical operations of the business which counts.[50] (emphasis added)

111. There is currently no case law which has discussed the meaning of CM&C in the context of superannuation funds. In the absence of such guidance, the question arises as to whether the CM&C test that is applied to companies can also be applied to determine the meaning of CM&C as it relates to superannuation funds.[51]

112. Williams J in Koitaki stated that the important element in determining the location of CM&C is the place of personal control over, and not the physical operations of, the business. Although this statement was made in the context of a company that carried on an operational business (for example, manufacturing or major trading activities), the CM&C test applied in Koitaki has been applied to companies that have as their main activity management of investment assets.[52]

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46 *CIC Insurance v Bankstown Football Club* (1997) 187 CLR 384.

47 [1906] AC 455 at 458.

48 (1941) 64 CLR 241; (1941) 6 ATD 82.

49 (1941) 64 CLR 241 at 248; (1941) 6 ATD 82 at 89.

50 [Footnote original] Williams J referred to his comments in Koitaki in *Waterloo Pastoral Company Limited v Federal Commissioner of Taxation* (1946) 72 CLR 262 at 266.

51 [Footnote original] For guidance on how the CM&C test is applied to companies refer to Taxation Ruling TR 2004/15: Income tax: residence of companies not incorporated in Australia - carrying on business in Australia and central management and control.

52 [Footnote original] See for example *Egyptian Delta Land and Investment Company Limited v Todd* [1929] AC 1 and *Esquire Nominees v FCT* (1973) 129 CLR 177; 72 ATC 4076; (1972) 3 ATR 105.

113. In the context of the activities of a superannuation fund, its income earning outcomes are largely dependent on the investment decisions made in respect of its assets rather than any productive or operational activities. Hence, despite differences between the kinds of activities a company may undertake and those of a superannuation fund, we consider that an analogy can be drawn between the business activities of a company and the activities of a superannuation fund in that the activities of a superannuation fund, like the business activities of a company, require personal control and direction. Accordingly, we consider that the principles established in cases dealing with the operation of the CM&C test in relation to companies are capable of application to determine the meaning of CM&C as it relates to superannuation funds.[53]

114. The cases which have considered the application of the CM&C test in relation to companies have held that the CM&C of a company comprises the high level management and control and strategic decision making.[54] Such an analysis focuses on who makes those high level and strategic decisions and when and where those decisions are made.

115. Like companies, determining the CM&C of a superannuation fund involves a focus on the who, when and where of the strategic and high level decision making of the fund.

116. In the context of the operations of a superannuation fund, the strategic and high level decision making of the fund includes the performance of the following duties and activities:

- formulating the investment strategy for the fund;[55]
- reviewing and updating or altering the investment strategy of the fund as well as monitoring and reviewing the performance of the fund's investments;
- if the fund has reserves[56] - the formulation of a strategy for their prudential management;[57] and
- determining how the assets of the fund are used to fund member benefits, for example the decision to segregate certain fund assets to support superannuation income stream benefits.

117. The other principal areas of operation of a superannuation fund that form part of the day-to-day or operational side of the fund's activities will not constitute CM&C. These activities do not form part of the CM&C of the fund because they are not of a strategic or high level nature. Rather, these activities are of a more formalistic or administrative

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53 [Footnote original] There is nothing in the legislative or historical context of the definition of 'Australian superannuation fund' to indicate that the legislature intended that the term CM&C in the context of superannuation funds was to have a different meaning than that in the context of companies.

54 *Koitaki Para Rubber Estates v FCT* (1941) 64 CLR 241 at 244; (1941) 6 ATD 82 at 83-84.

55 [Footnote original] An investment strategy is a plan or policy adopted by the fund for investing the fund's assets to achieve the fund's investment objectives. A fund can have more than one investment strategy. The duty to formulate an investment strategy is contained in paragraph 52(2)(f) of the SISA.

56 [Footnote original] Where permitted by the trust deed, reserves may be maintained by a fund for the purpose of smoothing investment returns to members.

57 [Footnote original] The requirement to formulate a reserving strategy where a fund maintains reserves is set out in paragraph 52(2)(g) of the SISA.

nature. Examples of such activities include the acceptance of contributions that are made on a regular basis, the actual investment of the fund's assets, the fulfilment of administrative duties[58] and the preservation, payment and portability of benefits.

118. Furthermore, in accepting such contributions, paying benefits and in the fulfilment of administrative obligations, the prudential requirements in SISA, the governing rules of the fund and other legislative requirements are merely being complied with. As emphasised by the courts in the context of companies, compliance with statutory requirements is not, of itself, sufficient to constitute CM&C but rather is a matter to be taken into account in determining where the CM&C is located. In *Egyptian Delta Land and Investment Company v Todd*,[59] the House of Lords held that a company, which was incorporated in England and did nothing in that country beyond fulfilling its statutory requirements, was not a resident of England as its CM&C was in Egypt.

Who exercises the CM&C of the fund?

119. As mentioned above, the majority of superannuation funds operate under a trust structure. According to the general law of trusts, a trust is not a legal person but rather is a collection of rights, duties and powers arising from the relationship to property held by the trustee for the benefit of beneficiaries.[60] Therefore, the trustee is the legal person to that relationship.[61] Since the legal responsibility for operating and managing the fund, including the responsibility for performing the high level duties and actions mentioned in paragraph 116 of this Ruling rests solely with the trustee, it is the trustee of the fund who has the legal obligation for exercising the CM&C of a fund.

120. In the context of companies, the courts have held that the 'bare possession' of the legal right or power to exercise CM&C is not equivalent to taking part in the CM&C of the company.[62] Rather, the focus has been on whether that right or power has been exercised in practice. This is a question of fact. This point was emphasised by Lord Loreburn LC in De Beers:[63]

> This is a pure question of fact, to be determined, not according to the construction of this or that regulation or bye-law, but upon a scrutiny of the course of business or trading.

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58 [Footnote original] Such as lodging the regulatory and income tax return for the fund, the preparation of financial statements, the audit of the fund and record-keeping.

59 [1929] AC 1.

60 [Footnote original] Trusts and superannuation funds are given statutory status as entities in themselves under subsection 960-100(1) of the ITAA 1997. See also the definition of 'superannuation entity' in section 10 of the SISA.

61 [Footnote original] To be a regulated superannuation fund within the meaning of the SISA, a superannuation fund must have a trustee - subsection 19(2) of the SISA. The trustee of the fund can be an individual, a group of individuals or a corporate trustee. A 'trustee' for the purposes of the SISA is defined in section 10 of that Act.

62 [Footnote original] *Mitchell v Egyptian Hotels* [1915] AC 1022 at 1041, per Lord Sumner. See also *Egyptian Delta Land and Investment Company v Todd* [1929] AC 1 where it was considered that the mere existence of the capacity for ultimate control was not sufficient to constitute CM&C where the control was not exercised in practice.

63 [1906] AC 455 at 458.

121. In *Unit Construction Co v Bullock*[64] (Unit Construction), the House of Lords held that the CM&C of three African subsidiaries of a UK parent company was not exercised by the subsidiary companies' boards even though the boards possessed the legal power to exercise CM&C under each company's constitution. Rather, the court concluded that it was in fact the board of directors of the parent company in London that had exercised the real management and control of the African subsidiaries.[65] In reaching this conclusion, the House of Lords followed the approach laid down in De Beers. In the context of the facts in Unit Construction, Viscount Simonds stated:[66]

> Nothing can be more factual and concrete than the acts of management which enable a court to find as a fact that central management and control is exercised in one country or another. It does not in any way alter their character that, in greater or less degree, they are irregular or unauthorised or unlawful. The business is not the less managed in London because it ought to be managed in Kenya. Its residence is determined by the solid facts, not by the terms of its constitution however imperative.

122. In the context of superannuation funds, this same principle applies in that the trustee's duty or responsibility to carry out or perform those activities that constitute CM&C does not, of itself, amount to CM&C. It is only by performing those high level duties and activities that the trustee will be exercising the CM&C in practice.[67] There also may be situations where a person other than the trustee is exercising the CM&C of the fund.

Delegation of trustee's duties and powers

123. Where permitted by the trust deed of the fund or in the circumstances prescribed in the trustee legislation of the relevant State or Territory, and consistent with the provisions of the SISA, the individual trustee or trustees of a superannuation fund may delegate all or any of their duties and powers.[68] For example, in all jurisdictions, the trustee legislation permits a trustee to delegate the execution of the trust where he or she is absent from the jurisdiction or about to depart from it. In accordance with the Corporations Act 2001, the directors of a corporate trustee may also delegate their duties and powers.[69]

124. Where the trustee of a fund delegates their duties to another person, the delegate will be exercising the CM&C of the fund if they independently and without influence from the trustee, perform those duties and activities that constitute CM&C of the superannuation fund.

125. However, if the trustee continues to participate in the strategic and high level decision making and activities of the fund then it cannot be said that the delegate is exercising the CM&C of the fund. The trustee may continue to participate in such

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64 [1959] 3 All ER 831.

65 [Footnote original] In that case, the directors of the African subsidiaries 'stood aside' from their directorial duties and never purported to function as a board of management.

66 [1959] 3 All ER 831 at 834.

67 [Footnote original] Since duties are imperative, that is, they compel or prohibit a trustee from acting in a certain way, the failure to fulfil a duty prima facie renders the trustee liable for breach of trust.

68 [Footnote setting out relevant provisions of the trustee legislation omitted].

69 [Footnote setting out provisions of the Corporations Act 2001 omitted].

activities by reviewing or considering the decisions and actions of the delegate before deciding whether any further action is required. The decision in *BW Noble v Mitchell*[70] (BW Noble) illustrates this principle.

126. In BW Noble, full management and control of the business of the company registered in England was vested in the board of directors in London by the company's articles of association, with powers of delegation. The board of directors exercised that power by executing a power of attorney granting one of the directors of the board full power to carry on the company's business in France. The French attorney sent some reports on the progress of the business to the directors in London, and on one or two occasions received the agreement of the board to his proposals. It was held that the CM&C of the company remained with the board of directors in London and had not been shifted to France under the power of attorney. Relevantly, Rowlatt J stated:[71]

> ...in my judgment that power of attorney did not and could not, consistently with the Articles, and did not by its tenor, divest the Board in London of their authority; it did not make an independent plenipotentiary who could do what he liked until the power of attorney was determined. It seems to me that although he held the power of attorney, the Directors at any moment could have said to him: 'Well, we do not think under your power you ought to do this; we decide that it shall not be done, although you might have done it under your power of attorney if we had not told you to the contrary'.

127. Similarly, despite the intention to delegate the trustee's duties, the trustee may continue to make the high level decisions in respect of the fund and instruct the delegate to implement those decisions. Or alternatively, the trustee may continue to make those decisions and perform those duties and activities that constitute CM&C themselves. In these situations, the CM&C of the fund would remain with the trustee and would be located where the trustee makes those decisions.

Delegation of the investment management function

128. The trustee of a superannuation fund will often appoint an investment manager to invest the assets of the fund, consistent with the investment strategy of the fund, on behalf of the trustee. Importantly, the investment manager is subject to a prudential requirement under SISA to periodically provide information to the trustee of the fund regarding the making of, and return on those investments and to provide such information as is necessary to enable the trustee to assess the capability of the investment manager to manage the investments of the fund.[72]

129. The delegation of the investment management function to an investment manager does not mean however that the investment manager is exercising the CM&C of the fund in any sense. This is because the trustee is still controlling the operations of the fund by ensuring that the investments of the fund are consistent with the investment strategy of the fund and by monitoring and evaluating the performance of the investment manager. Further, the actions of the investment manager in investing the assets of the fund in accordance with the fund's investment strategy comprise part of the day-to-day or 'operational' side of the operations of the fund rather than the strategic or high level decision making activities of the fund.

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70 11 TC 372.

71 11 TC 372 at p.410.

72 [Footnote original] Section 102 of the SISA.

130. This view is consistent with the decision of Dixon J at first instance in Koitaki.[73] The company in Koitaki, which was incorporated in Sydney, owned rubber plantations in Papua. The plantations were managed by an officer of the company who acted under a power of attorney by which the company authorised him to manage, carry on and conduct the company's property, affairs and business. The officer sent weekly reports of the working of the plantations to the chairman of directors in Sydney which is where the directors of the company resided and met. He also periodically sent to the manager of the company in Sydney for presentation to the directors, reports concerning the running of the plantations and the yield of rubber.

131. Dixon J's decision, which was affirmed by the Full High Court on appeal,[74] was that the company was not a resident of Papua as the company's central management and control was not there exercised, despite the responsibilities of the attorney. His Honour stated that the responsibility of the attorney was confined to the production and shipment of rubber and did not extend to the control of the general or corporate affairs of the company or to matters of policy and finance.[75] The matters of policy and finance were matters which in fact formed part of the CM&C of the company as distinct from the day to day management of the production and shipment of rubber. The fact that the performance of the attorney was being monitored from Sydney was also an important consideration in the decision of Dixon J.

Trustee acting on external advice

132. The trustee of a fund may seek external advice relating to the performance of their high level duties and activities in relation to the fund. Provided that the trustee makes the actual decisions for the fund, the circumstance that the trustee acts on or is influenced by such advice does not affect the fact that the trustee is exercising the CM&C of the fund. This view is supported by the decision of Gibbs J at first instance in *Esquire Nominees v FC of T* (Esquire Nominees).[76]

133. In Esquire Nominees, his Honour stated that even if it was accepted that the decision makers of the appellant company did what the company's advisers told them to do, it did not necessarily follow that the control and management of the company's affairs lay with the advisers. He acknowledged the possibility that the advisers in Esquire Nominees exerted strong influence on the company directors but found that even though the advisers had power to exert influence on the company directors, that power of itself did not amount to the advisers exercising control and management of the company. He also considered that had the advisers instructed the company's directors to 'do something which they considered improper or inadvisable' that he did not believe that the directors would have acted on the instruction. He decided, on the facts of Esquire Nominees, that the company directors were the high level decision makers.[77]

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73 *Koitaki Parra Rubber Estates v FCT* (1940) CLR 15; (1940) 6 ATD 42.

74 *Koitaki Parra Rubber Estates v FCT* (1941) 64 CLR 241; (1941) 6 ATD 82.

75 (1940) CLR 15 at 18; (1940) 6 ATD 42 at 45.

76 (1973) 129 CLR 177; 72 ATC 4076; (1972) 3 ATR 105.

77 [Footnote original] In the context of companies, there are a number of other cases which have stated the principle that influence is not the same thing as control and that a board of directors may act under the influence of another person or persons but that does not necessarily mean that the directors have ceased to exercise central

Location of the CM&C of the fund

134. The place where the CM&C of the fund is exercised is a question of fact[78] to be determined in light of all the relevant facts and circumstances. The location of the CM&C of the fund is intertwined with identifying who it is that is exercising the CM&C of the fund. This is because the place where the person(s) exercise the CM&C of the fund determines the location of the CM&C of the fund. Hence, in the case of a fund with an individual trustee who exercises the CM&C of the fund, the place where the trustee performs the high level duties and activities that constitute CM&C will determine the location of the CM&C of the fund.

135. Equally, in the case of a fund with a group of individual trustees or a corporate trustee, the place where the trustees (or directors of the corporate trustee) meet will determine where the CM&C of the fund is located, provided that the CM&C of the fund is exercised at those meetings.[79] If the CM&C of the fund is not exercised at the meeting of trustees, it will be located where the strategic and high level decisions and activities are in fact made and carried out.

136. If the CM&C of the fund is being exercised by a person or persons other than the trustee, the place where the person(s) performs the strategic and high level duties and activities in relation to the fund will determine the location of the CM&C of the fund (subject to the principles set out in paragraphs 125 to 127 of this Ruling).

137. Where individual trustees or directors of a corporate trustee participate in the CM&C of the fund via electronic facilities[80] (rather than physical attendance), the focus is on where the participants contributing to the high level decisions and activities are located rather than where the electronic facilities are based. This view applies in situations where the trustees or directors conduct a meeting via electronic facilities and in situations where the strategic and high level decisions are facilitated through electronic facilities without the need for an actual meeting (for example, decisions made via email).

138. In these situations, the fact that a majority of the individual trustees or directors of a corporate trustee regularly participate in the CM&C of the fund from a jurisdiction other than Australia would support a conclusion that the CM&C of the fund is not located in Australia (and vice versa where the majority of trustees/directors are located in Australia).

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management and control. For example, see *Re Little Olympian Each Ways* [1995] 1 WLR 560; *New Zealand Forest Products Finance NV v Commissioner of Inland Revenue* [1995] 2 NZLR 357; *Untelrab v McGregor* [1996] STC (SCD) 1; *Wood and another v Holden (Inspector of Taxes)* [2006] 1 WLR 1393.

78 *Unit Construction Co (Inspector of Taxes) v Bullock* [1959] 3 All ER 831 at 839, per Lord Radcliffe.

79 [Footnote original] In determining where the CM&C of a company is located, the common law places significant weight on the place where the board of directors meet. For example, De Beers and Koitaki. However, the courts have also held that the place where the board meets is not necessarily conclusive of the location of CM&C: Lord Radcliffe in Unit Construction.

80 [Footnote original] For example, by teleconference or video conference.

139. The residency status of those who exercise the CM&C of the fund is not relevant in determining the location of the CM&C of the fund.[81]

6.18.3 *Period for enquiry into POEM*

While one needs to determine whether a person is treaty-resident at a particular moment, one looks over an appropriate period of time to determine the POEM: see eg *Smallwood v HMRC* (CA) at [47]. Contrast 6.13 (Period for enquiry into individuals tie-breaker tests).

6.18.4 *Short term period in foreign state*

In *Smallwood v HMRC*, a trust had different trustees resident in different states, all in one tax year:

Apr - Dec: Jersey resident trustees
Dec - Mar: Mauritius resident trustees ("the Mauritian period")
Mar onwards: UK resident trustees ("the UK period")

It was necessary to apply the tie-breaker test.[82] Everything was done which could reasonably be done to ensure that the Mauritian trustees carried out effective management, but POEM was nevertheless in the UK throughout:

> The scheme was devised in the UK by Mr Smallwood on the advice of KPMG Bristol. The steps taken in the scheme were carefully orchestrated throughout from the UK, both by KPMG and by Quilter. And it was integral to the scheme that the trust should be exported to Mauritius for a brief temporary period only and then be returned, within the fiscal year, to the UK, which occurred. Mr Smallwood remained throughout in the UK. There was a scheme of management of this trust which went above and beyond the day to day management exercised by the trustees for the time being, and the control of it was located in the UK.[83]

The dissenting decision of Patten LJ seems more convincing to me, and the majority dealt with the point in two short paragraphs, as if a fuller exposition of their reasons would be an embarrassment. However the conclusion must be that tax avoidance schemes requiring short term residence in a treaty state are likely to fail on factual POEM grounds.

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81 *John Hood and Company v Magee* (1918) 7 TC 327. See also comments of Dixon J in *North Australian Pastoral Co v Federal Commissioner of Taxation* (1946) 71 CLR 623 at 628.

82 See 6.6.2 (Change of residence of trustee during tax year).

83 *Smallwood v HMRC* at [70].

6.19 USA/UK DTA

This section considers the definition of treaty-residence in the USA/UK DTA.

Article 4(1) of the US/ UK DTA provides:

> [a] Except as provided in paragraphs 2 and 3 of this Article, the term "resident of a Contracting State" means, for the purposes of this Convention, any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, *citizenship,* place of management, *place of incorporation,* or any other criterion of a similar nature.

This is standard OECD model form except for the addition of the italicised words, which reflect the US rule that citizens and US incorporated companies are liable to tax regardless of residence and other such criteria.

Article 4(1) of the US/ UK DTA continues:

> [b] This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State.

This is close to standard OECD model form[84] and the differences do not seem material.

6.19.1 *US citizens/green card holders*

Article 4(2) of the US/ UK DTA provides:

> An individual who is a United States citizen or an alien admitted to the United States for permanent residence (a "green card" holder) is a resident of the United States only if
> [a] the individual has a substantial presence, permanent home or habitual abode in the United States and
> [b] if that individual is not a resident of a State other than the UK for the purposes of a double taxation convention between that State and the UK.

The US Department of the Treasury Technical Explanation of the Convention[85] provides:

> Paragraph 2 contains an exception to the general rule of paragraph 1 that

84 See 6.7 (Exception where source tax only).

85 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

residence under internal law also determines residence under the Convention. The exception applies with respect to a U.S. citizen or alien lawfully admitted for permanent residence (i.e., a "green card" holder). Under paragraph 1, a person is considered a resident of a Contracting State for purposes of the Convention if he is liable to tax in that Contracting State by reason of citizenship. Although this rule applies to both Contracting States, only the United States taxes its non-resident citizens in the same manner as its residents. In addition, aliens admitted to the United States for permanent residence ("green card" holders) qualify as U.S. residents under the first sentence of paragraph 1 because they are taxed by the United States as residents, regardless of where they physically reside.

Under the exception of paragraph 2, a U.S. citizen or green card holder will be treated as a resident of the United States for purposes of the Convention, and, thereby entitled to treaty benefits, only if he meets two conditions. First, he must have a substantial presence (see section 7701(b)(3)), permanent home or habitual abode in the United States. This rule requires that the U.S. citizen or green card holder have a reasonably strong economic nexus with the United States. Second, he must not be treated as a resident of a state other than the UK under any treaty between the UK and a third state. This rule prevents a U.S. citizen or green card holder who is a resident of a country other than the United States or the UK from choosing the benefits of the Convention over those provided by the treaty between the UK and his country of residence. If the U.S. citizen or green card holder's country of residence does not have a treaty with the UK, however, then he will be treated as a resident of the United States as long as he meets the first requirement of an economic nexus. If such a person is a resident of both the United States and the UK, whether or not he is to be treated as a resident of the United States for purposes of the Convention is determined by the tie-breaker rules of paragraph 4.

The text goes on to give some examples:

Thus, for example, an individual resident of Mexico who is a U.S. citizen by birth, or who is a Mexican citizen and holds a U.S. green card, but who, in either case, has never lived in the United States, would not be entitled to benefits under the Convention. However, a U.S. citizen who is transferred to Mexico for two years would be entitled to benefits under the Convention if he maintains a permanent home or habitual abode in the United States and is not a resident of Mexico for purposes of the U.K.-Mexico tax treaty. If he were treated as a resident of Mexico under the U.K.-Mexico tax treaty, he could claim only the benefits of that treaty, even if the Convention would provide greater benefits.

The fact that a U.S. citizen who does not have close ties to the United States may not be treated as a U.S. resident under the Convention does not alter the application of the saving clause of paragraph 4 of Article 1 (General Scope) to that citizen. For example, a U.S. citizen who pursuant to the "citizen/green card holder" rule is not considered to be a resident of the United States still is taxable on his worldwide income under the generally applicable rules of the Code.

HMRC helpsheet 302 (Dual Residents - 2012/13) provides:

Special rules apply where the other country is the United States of America (US), if you are claiming to be a resident of the US for the purposes of the UK/US Double Taxation Convention (DTC). Statements concerning residence should not normally be sought from the US Internal Revenue Service. This is because the US operates a special system whereby it taxes its 'citizens' on their worldwide income, wherever they may be resident. US citizens are not, however, necessarily 'residents' of the US for the purposes of the DTC.

Article 4(2) of the DTC provides that a citizen or green card holder will be treated as a resident of the US for purposes of the DTC, and thereby entitled to treaty benefits, only if two conditions are met:

- first, you must have a substantial presence (see below), permanent home or habitual abode in the US
- second, you must not be treated as a resident of a State other than the UK under any treaty between the UK and a third State.

6.19.2 *Substantial presence*

It appears that "substantial presence" is a technical term in US tax law (whose meaning applies in the treaty). HMRC helpsheet 302 (Dual Residents - 2012/13) provides:

Substantial presence test

You will have a substantial presence if:

- you were present in the US on at least 31 days in the calendar year under test, and
- the sum total of days on which you were present in the US in the year under test, and in the two preceding years, adds up to at least 183 days.

For the purposes of this calculation a day spent in the US in the year preceding the year under test counts as 1 /3, and a day in the year before that counts as 1 /6. Part days of presence in the US should be treated as if they were whole days for this purpose.

Example 1
If you spent 48 days in the US in 2013, 250 days in 2012 and 365 days in 2011, the calculation would be as follows:
Year of test – 2013 (more than 31 days spent in the US)

2013	48 days × 1/1 =	48
2012	250 days × 1/3 =	84
2011	365 days × 1/6 =	61
		193

Both conditions of the substantial presence test are passed and you will be regarded as resident in the US under that country's domestic law.

6.19.3 *Miscellaneous bodies*

The USA/UK DTA continues:

> (3) The term "resident of a Contracting State" includes—
> (a) a pension scheme;
> (b) a plan, scheme, fund, trust, company or other arrangement established in a Contracting State that is operated exclusively to administer or provide employee benefits and that, by reason of its nature as such, is generally exempt from income taxation in that State;
> (c) an organisation that is established exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes and that is a resident of a Contracting State according to its laws, notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that State; and
> (d) a qualified governmental entity that is, is a part of, or is established in, that State.

The US Department of the Treasury Technical Explanation of the Convention[86] provides:

> Paragraph 3 provides that certain tax-exempt entities such as pension funds and charitable organizations will be regarded as residents of a Contracting State regardless of whether they are generally liable for income tax in the State where they are established. The inclusion of this provision is intended to clarify the generally accepted practice of treating an entity that would be liable for tax as a resident under the internal law of a State but for a specific exemption from tax (either complete or partial) as a resident of that state for purposes of paragraph 1.
> Subparagraph (a) of paragraph 3 applies to pension schemes, as defined

86 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf.*

in subparagraph (o) of paragraph 1 of Article 3 (General Definitions). Subparagraph (b) applies to any plan, scheme, fund, trust, company or other arrangement established in a Contracting State that is generally exempt from taxation in that State because it is operated exclusively to administer or provide employee benefits. The reference to a general exemption is intended to reflect the fact that under U.S. law, certain organizations that generally are considered to be tax-exempt entities may be subject to certain excise taxes or to income tax on their unrelated business income. Subparagraph (c) applies to an organization that is established exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes and that is a resident of a Contracting State. Thus, an exempt section 501(c) organization (such as a U.S. charity) that is generally exempt from tax under U.S. law is a resident of the United States for all purposes of the Convention. Subparagraph (d) applies to a qualified governmental entity, as defined in subparagraph (k) of paragraph 1 of Article 3, if it is the Contracting State itself, is established in a Contracting State or is a part of that State.

6.19.4 *Tie breaker*

For individuals, art.1(4) provides standard OECD model wording.

Art 1(5) USA/UK DTA provides:

> Where by reason of the provisions of paragraph 1 of this Article a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the mode of application of this Convention to that person. If the competent authorities do not reach such an agreement, that person shall not be entitled to claim any benefit provided by this Convention, except those provided by paragraph 4 of Article 24 (Relief from Double Taxation), Article 25 (Non-discrimination) and Article 26 (Mutual agreement procedure).

The US Department of the Treasury Technical Explanation of the Convention[87] provides:

> Dual residents other than individuals (e.g., companies, trusts, and estates) are addressed by paragraph 5. If such a person is, under the rules of paragraph 1, resident in both Contracting States, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention. For example, a company is treated as resident in the United States if it is created or organized under

87 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf.*

the laws of the United States or a political subdivision. Under U.K. law, a company is treated as a resident of the UK if it is either established there or managed and controlled there. Dual residence, therefore, can arise if a U.S. company is managed and controlled in the UK. Paragraph 5 provides that the competent authorities will try to determine a single State of residence for such a company.

If the competent authorities do not reach an agreement on the single State of residence, that person may not claim any benefit provided by the Convention, except those provided by paragraph 4 of Article 24 (Relief from Double Taxation), Article 25 (Non-Discrimination), and Article 26 (Mutual Agreement Procedure). Thus, for example, a State cannot discriminate against a dual resident company, and such a company can bring issues to the competent authorities.

Dual resident companies also may be treated as resident for purposes other than that of obtaining benefits under the Convention. For example, if a dual resident company pays a dividend to a resident of the UK, the U.S. paying agent would withhold on that dividend at the appropriate treaty rate because reduced withholding is a benefit enjoyed by the resident of the UK, not by the dual resident. The dual resident company that paid the dividend would, for this purpose, be treated as a resident of the United States under the Convention. In addition, information relating to dual resident companies can be exchanged under the Convention because, by its terms, Article 27 (Exchange of Information and Administrative Assistance) is not limited to residents of the Contracting States.

CHAPTER SEVEN

YEAR OF ARRIVAL AND DEPARTURE

7.1 Default rule: individual regarded as resident throughout tax year

The starting point, under the SRT, is that an individual is resident (or not) in the UK during the whole of a tax year. Para 3, 4, Sch 45 FA 2013 provides:

> 3 An individual ("P") is resident in the UK for a tax year ("year X") if—
> (a) the automatic residence test is met for that year, or
> (b) the sufficient ties test is met for that year.
> 4 If neither of those tests is met for that year, P is not resident in the UK for that year.

Para 2(3) Sch 45 FA 2013 explains the significance of being resident "for" a year:

> An individual who, in accordance with the statutory residence test, is resident (or not resident) in the UK "for" a tax year is taken for the purposes of any enactment relating to relevant tax[1] to be resident (or not resident) there at all times in that tax year.

This general rule is subject to two exceptions of such breadth that the principle only rarely applies:
(1) The statutory split year rules
(2) Relief may be available under DTAs[2]

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1 Defined Para 1(4) Sch 45 FA 2013: "Relevant tax" means-
(a) income tax,
(b) capital gains tax, and
(c) (so far as the residence status of individuals is relevant to them) inheritance tax and corporation tax.

2 See 6.6 (Change of residence during tax year).

This chapter considers the definition of "split year". The treatment of income or gains arising during a split year is discussed in the chapters considering that type of income or gains.

In the absence of an applicable statutory split year provision, the default rule remains that a year is not split. It is not possible to give a full list of cases where the default rule applies, but they include:

(1) Some remittance basis rules:
  (a) Sub-£2k remittance basis taxpayers[3]
  (b) Non-taxpayers remittance basis[4]
  (c) Remittance basis claim charge[5]
(2) ToA income: s.720 income[6] and 731 income[7]
(3) Non-residents income tax relief[8]
(4) Year counting for:
  (a) Remittance basis claim charge[9]
  (b) IHT deemed domicile[10]

7.1.1 *Cross references*

The following topics are considered elsewhere:

4.29 (Contacting HMRC when arriving in or leaving the UK).
8.1 (Exit taxes).

The topic of companies becoming or ceasing to be UK resident is not discussed.

7.2 Split year of trustees and PRs

Para 2 sch 45 FA 2013 provides that *individuals* are resident during whole tax years. The SRT split year rules do not apply to trustees or PRs. Para 41 sch 45 FA 2013 provides:

> This Part [Part 3: Split Year Treatment]—
> (a) does not apply in determining the residence status of personal

3 See 10.8.1 (Interaction of £2k limit with split-year rules).
4 See 10.9 (Non-taxpayers: s.809E).
5 See 10.11.12 (Remittance basis claim charge in year of arrival and departure).
6 See 29.9.3 (Split year) and 29.14.1 (Remittance during overseas part of split years).
7 See 29.9.3 (Split year); 30.35.4 (Split years).
8 See 42.2.1 (split years).
9 See 10.11.2 (7 and 12-year residence tests).
10 See 61.2.5 (Meaning of "residence" for 17-year residence rule).

representatives, and

(b) applies to only a limited extent in determining the residence status of the trustees of a settlement (see section 475 of ITA 2007 and section 69 of TCGA 1992, as amended by this Part).

For para (b) see 5.8 (Residence of individual trustee during split year).

If a trust changes residence, the HMRC view is that the tax year is split into UK and non-UK resident periods for income tax purposes.[11] HMRC Residency: Non-resident Trusts (published 1 April 2008) provides:

> **Change in residence status of body of trustees**
> A change in the residence status of a body of trustees is usually caused by a change in the trustees who make up the body. It can also happen where the trustees remain the same but one of them changes their residence status.
> For income tax purposes if the residence status of a body of trustees changes during the tax year then the trustees are potentially liable for income tax on all their worldwide income for the period they were actually resident. They are only liable for income tax on their UK source income for the period they were actually non-resident.[12]

This view was probably formulated before the introduction in 2006 of the rule that trustees are a single and distinct person for IT;[13] but HMRC do not argue that that has altered the position.

7.3 Definition of a "split year"

Para 43 Sch 45 FA 2013 provides:

(1) As respects an individual, a tax year is a "split year" if-
  (a) the individual is resident in the UK for that year, and
  (b) the circumstances of the case fall within–
    (i) Case 1, Case 2 or Case 3 (cases involving actual or deemed departure from the UK), or
    (ii) Case 4, Case 5, Case 6, Case 7 or Case 8 (cases involving actual or deemed arrival in the UK).

I refer to **"split-year cases 1-8"**. The split year cases can be summarised as follows:

---

11 The rule is different for CGT: see 49.1.4 (Gains accruing to trustees in split year).

12 See *http://www.hmrc.gov.uk/cnr/nr_trusts.htm*.

13 See 5.3 (Trustees treated as single and distinct person).

Leaving UK		
Case	*Para*	*Outline*
1	44	Starting full-time work overseas
2	45	Partner starting full-time work overseas
3	46	Ceasing to have a home in the UK
Coming to UK		
4	47	Starting to have only home in the UK
5	48	Starting full-time work in the UK
6	49	Ceasing full-time work overseas
7	50	Partner ceasing full-time work overseas
8	51	Starting to have a home in the UK

7.4 Split-year case 1: Starting full-time work overseas

Para 44(1) Sch 45 FA 2013 provides:

> The circumstances of a case fall within Case 1 if they are as described in sub-paragraphs (2) to (4).

7.4.1 *UK resident in previous year*

Para 44(2) Sch 45 FA 2013 provides:

> The taxpayer was resident in the UK for the previous tax year (whether or not it was a split year).

This is a requirement in each of split year cases 1-3, which apply to leavers.

7.4.2 *Overseas work*

Para 44(3) Sch 45 FA 2013 provides:

> There is at least one period (consisting of one or more days) that—
> (a) begins with a day that—
> (i) falls within the relevant year, and
> (ii) is a day on which the taxpayer does more than 3 hours' work overseas,
> (b) ends with the last day of the relevant year, and
> (c) satisfies the overseas work criteria.

7.4.3 *"Overseas work criteria"*

"Overseas work criteria" is a label for 4 sets of conditions. Para 44(5) Sch 45 FA 2013 provides:

> A period "satisfies the overseas work criteria" if—

(a) the taxpayer works sufficient hours overseas, as assessed over that period,

See 7.4.4 ("Sufficient hours overseas").

(b) during that period, there are no significant breaks from overseas work,
(c) the number of days in that period on which the taxpayer does more than 3 hours' work in the UK does not exceed the permitted limit, and

I refer to days within (c) as **"3-hour UK work days"**.

(d) the number of days in that period falling within sub-paragraph (6) does not exceed the permitted limit.

I refer to days within (d) as **"UK days"**; see 7.4.6 ("The permitted limit").

7.4.4 *"Sufficient hours overseas"*

Para 44(5) Sch 45 FA 2013 provides:

A period "satisfies the overseas work criteria" if—
(a) the taxpayer works sufficient hours overseas, as assessed over that period...

Para 44(7) Sch 45 FA 2013 provides:

To work out whether the taxpayer works "sufficient hours overseas" as assessed over a given period, apply paragraph 14(3) but with the following modifications—
(a) for "P" read "the taxpayer",
(b) for "year X" read "the period under consideration",
(c) for "365 (or 366 if year X includes 29 February)" read "the number of days in the period under consideration", and
(d) in paragraph 28(9)(b), as it applies for the purposes of step 3, for "30" read "the permitted limit".

Amended as para 44(7) requires, para 14(3) provides:

(3) Take the following steps to work out whether [the taxpayer] works "sufficient hours overseas" as assessed over [the period under consideration]—
Step 1 [disregarded days]
Identify any days in [the period under consideration] on which [the taxpayer] does more than 3 hours' work in the UK, including ones on which [the taxpayer] also does work overseas on the same day.

The days so identified are referred to as "disregarded days".

Step 2 [net overseas hours]

Add up (for all employments held and trades carried on by [the taxpayer]) the total number of hours that [the taxpayer] works overseas in [the period under consideration], but ignoring any hours that [the taxpayer] works overseas on disregarded days.

The result is referred to as [the taxpayer]'s "net overseas hours".

Step 3 [reference-period days]

Subtract from the number of days in [the period under consideration]—

(a) the total number of disregarded days, and

(b) any days that are allowed to be subtracted, in accordance with the rules in paragraph 28 of this Schedule, to take account of periods of leave and gaps between employments.[14]

The result is referred to as the "reference period".

Armed with the figures from steps 2 and 3, we proceed to the computation. This is set out in the remaining two steps:

Step 4: *[compute reference period ÷ 7]*

Divide the reference period by 7. If the answer is more than 1 and is not a whole number, round down to the nearest whole number. If the answer is less than 1, round up to 1.

Step 5 [compute net overseas hours ÷ reference-period weeks]

Divide [the taxpayer]'s net overseas hours by the number resulting from step 4.

If the answer is 35 or more, [the taxpayer] is considered to work "sufficient hours overseas" as assessed over [the period under consideration].

See 4.7.2 (Overseas work condition (a): "Sufficient hours overseas").

RDR3 provides:

5.13 Table E sets out the permitted limits for Case 1 – the appropriate portions of the full-year permitted limits

Table E

	Overseas part of year starts on												
	6 -30 Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	1-5 Apr
X	30	27	25	22	20	17	15	12	10	7	5	2	0
Y	90	82	75	67	60	52	45	37	30	22	15	7	0

14 See 4.16 (Reference period: deduction of non-work days).

Key

X – permitted limit on days where you can work more than 3 hours and maximum number of days that can be subtracted for gaps between employments

Y – permitted limit on days spent in the UK

RDR3 provides some examples:

Example 33 (Richard)

R has lived and worked in London for the last ten years and is UK resident for tax purposes. He is seconded abroad by his employer for a three year period. His overseas contract starts on 3 November 2014 when he takes up duty at his new office in Madrid. This example assumes he fails the third automatic overseas test for 2014-15 but meets it for 2015-16.

On 2 December 2014 he returns to the UK office to finish off a project he was involved in before his secondment. His work in the UK is completed on 16 December 2014 (11 UK workdays and four non-working days). He then takes leave until 28 December (12 days) flying back to Madrid and resuming work on 29 December. On his return to Madrid he works only at the Madrid office until 5 April.

R calculates that he meets the criteria for Case 1 split year treatment from 3 November, this being the first date on which he works for more than three hours overseas. Using table E he calculates that between 3 November 2013 and 5 April 2015 he can spend 37 days in the UK and work for more than three hours in the UK for up to 12 days.

R determines that:

- he was UK resident for the previous tax year (2013-14)
- he is resident in the UK for the current year (2014-15) and that he does not meet the third automatic overseas test
- he was non-UK resident for 2015-16
- he calculates that he meets the sufficient hours overseas test for the period 3 November 2014 to 5 April 2015
- he did not exceed the limits of 12 UK work days and 37 days spent in the UK between 3 November 2014 and 5 April 2015, and
- he had no significant break from overseas work during the period.

To determine that he worked full time overseas during a relevant period, R did the calculations below.

His reference period

Days in the period 3 November 2014 to 5 April 2015 = 155

Less

- Disregarded days 11

(Days spent working more than three hours in the UK)

- Annual, sick and parental leave 8

(leave on 17, 18, 19, 22, 23, 24, 27 and 28 December)

- Embedded non-working days (20 &21 December)	2	
- Gaps between employments	Nil	
Total		21
Reference Period =		134 days
Sufficient Hours Test		
All hours worked overseas from 3 November		670
Less: Hours worked overseas on disregarded days		Nil
Net overseas Hours		670

Divide Reference Period by 7 (134÷7) = 19.14 (rounded down) = 19
Divide net overseas hours by 19 (670÷19) = 35.26
R meets the sufficient hours overseas test because his average over the reference period (3 November 2014 to 5 April 2015) is more than 35.
For R, the UK part of the tax year ends on the 2 November 2014 and the overseas part starts on 3 November 2014 (the earliest date from which he meets all the conditions of the sufficient hours overseas test.

Example 34 (Amanda)
A has been living in the UK since she was born and is UK resident for tax purposes. She has worked in the media industry for five years and gets a job as a reporter on a three-year contract based in India. She moves there on 10 November 2013 and lives in an apartment provided by her new employer. She meets the overseas work criteria from 10 November 2013.
She returns to visit her family over the Christmas period for two weeks, and does not work while she is there.
A remains working in India throughout the tax year 2014-15, again only returning for a two-week period over Christmas.
A will receive split year treatment for tax year 2013-14 because:
- she was UK resident for 2012-13 and 2013-14
- she is non-UK resident for 2014-15 and meets the third automatic overseas test for that year

From 10 November 2013 until 5 April 2014 she:
- does not work at all in the UK
- spends 14 days in the UK, which is less, by reference to Table E above than the permitted limit of 37 days.

For Amanda, the UK part of the tax year will end on 9 November 2013, and the overseas part of the tax year will start on 10 November 2013.

7.4.5 *UK days within permitted limit*

Para 44 Sch 45 FA 2013 provides:

(5) A period "satisfies the overseas work criteria" if ...

(d) the number of days in that period falling within sub-paragraph (6) does not exceed the permitted limit.

(6) A day falls within this sub-paragraph if—

(a) it is a day spent by the taxpayer in the UK, but

(b) it is not a day that is treated under paragraph 23(4)[15] as a day spent by the taxpayer in the UK.

I refer to days within (6) as **"UK days"**.

7.4.6 *"The permitted limit"*

The expression "permitted limit" is used in split-year cases 1, 2 and 6. It is defined each time, but the cases 1 and 6 definitions are identical.

For case 1, the "permitted limit" matters for three purposes:

(1) 3-hour UK work days must not exceed the permitted limit: para 44(5))(c).

(2) UK days must not exceed the permitted limit: para 44(5)(d).

(3) For the purposes of ascertaining the reference period: para 44(7)(d).

Case 1 has two definitions of "permitted limit". It would have been simpler to have two terms, but there it is. Para 44(8) Sch 45 FA 2013 provides:

> The permitted limit is—
>
> (a) for sub-paragraphs (5)(c) [3-hour UK work days] and (7)(d), the number found by reducing 30 by the appropriate number, and
>
> (b) for sub-paragraph (5)(d) [days spent in UK] , the number found by reducing 90 by the appropriate number.

7.4.7 *"The appropriate number"*

The drafter of the SRT was fond of the expression "appropriate number" which is used in almost every one of the split year cases, with a different definition every time, or sometimes (as in split-year case 1) with two definitions. Para 44(9) Sch 45 FA 2013 provides:

> The appropriate number is the result of—
>
> A × (B÷12)
>
> where—
>
> "A" is—
>
> (a) 30, for sub-paragraphs (5)(c) and (7)(d), or
>
> (b) 90, for sub-paragraph (5)(d), and

---

15 See 4.13.5 (The deeming rule).

> "B" is the number of whole months in the part of the relevant year before the day mentioned in sub-paragraph (3)(a).

For rounding, see 7.12.4 (Rounding).

7.4.8 *Overseas work in following year*

Para 44(4) Sch 45 FA 2013 provides:

> The taxpayer is not resident in the UK for the next tax year because the taxpayer meets the third automatic overseas test for that year (see paragraph 14).

In short, the individual must continue working overseas in the following year. See 4.7 (Automatic overseas test 3: Overseas work).

7.5 Split-year case 2: Partner of someone starting full-time work overseas

Para 45(1) Sch 45 FA 2013 provides:

> The circumstances of a case fall within Case 2 if they are as described in subparagraphs (2) to (6).

7.5.1 *UK resident in previous year*

Para 45(2) Sch 45 FA 2013 provides:

> The taxpayer was resident in the UK for the previous tax year (whether or not it was a split year).

This is a requirement in each of split year cases 1-3, which apply to leavers.

7.5.2 *Partner working overseas*

Para 45(3) Sch 45 FA 2013 provides:

> The taxpayer has a partner[16] whose circumstances fall within Case 1 for–
> (a) the relevant year, or
> (b) the previous tax year.

7.5.3 *Living with partner*

Para 45(4) Sch 45 FA 2013 provides:

---

16 See 7.12.3 ("Partner").

On a day in the relevant year, the taxpayer moves overseas so the taxpayer and the partner can continue to live together while the partner is working overseas.

7.5.4 *No (principal) UK home*

Para 45(5) Sch 45 FA 2013 provides:

> In the part of the relevant year beginning with the deemed departure day-
>
> (a) the taxpayer
>
> [i] has no home in the UK at any time, or
>
> [ii] has homes in both the UK and overseas but spends the greater part of the time living in the overseas home, and
>
> (b) the number of days that the taxpayer spends in the UK does not exceed the permitted limit.

There are two possible deemed departure days. Para 45 Sch 45 FA 2013 provides:

> (7) If sub-paragraph (3)(a) applies, [partner's split year is the same year] the "deemed departure day" is the later of—
>
> (a) the day mentioned in sub-paragraph (4), and
>
> (b) the first day of what is, for the partner, the overseas part of the relevant year as defined for Case 1 (see paragraph 53).
>
> (8) If sub-paragraph (3)(b) applies, [partner's split year is the previous year] the "deemed departure day" is the day mentioned in sub-paragraph (4).

Para 45 Sch 45 FA 2013 defines the permitted limit in two stages:

> (9) The permitted limit is the number found by reducing 90 by the appropriate number.
>
> (10) The appropriate number is the result of—
>
> A × (B÷12)
>
> where—
>
> "A" is 90, and
>
> "B" is the number of whole months in the part of the relevant year before the deemed departure day.

For rounding, see 7.12.4 (Rounding).

It would have been easier to say that the permitted limit is 90 – (A×B÷12) but the author of the SRT is somewhat algebra-phobic (or else thought that the reader would be).

7.5.5 *Non-resident in next year*

Para 45(6) Sch 45 FA 2013 provides:

> The taxpayer is not resident in the UK for the next tax year.

7.5.6 *HMRC examples*

RDR3 provides:

> **Example 35 (Peter)**
> P is A's husband (see Example 34). He too had lived in the UK for all his life and was resident in the UK for tax purposes. He travels with A on 8 January 2014 to live with her in India, having given up his job. A and P have let their flat in the UK for a three-year period, commencing on 9 January 2014.
> Once in India, P spends his time following his lifelong hobby as a lepidopterist, cataloguing Indian butterflies. He spends all his time there, except for the Christmas trips to the UK with A.
> P will receive split year treatment for tax year 2013-14 as he meets the Case 2 conditions:
> - he has no home in the UK after 8 January 2014
> - he was UK resident for 2012-13
> - he is non-UK resident for 2014-15
>
> From 8 January 2014 until 5 April 2014 he spends less than the permitted limit of 22 days in the UK (Table E).
> For P the UK part of the tax year will end on 7 January 2014 and the overseas part of the tax year will start on 8 January 2014, the day he joined A to live together in India.

7.6 Split-year case 3: Ceasing to have a home in the UK

Para 46(1) Sch 45 FA 2013 provides:

> The circumstances of a case fall within Case 3 if they are as described in subparagraphs (2) to (6).

7.6.1 *UK resident in previous year*

Para 46(2) Sch 45 FA 2013 provides:

> The taxpayer was resident in the UK for the previous tax year (whether or not it was a split year).

This is a requirement in each of split year cases 1-3, which apply to leavers.

7.6.2 *No UK home*

Para 46(3) Sch 45 FA 2013 provides:

> At the start of the relevant year the taxpayer had one or more homes in the UK but-
>
> (a) there comes a day in the relevant year when P ceases to have any home in the UK, and
>
> (b) from then on, P has no home in the UK for the rest of that year.

7.6.3 *Less than 16 UK days*

Para 46(4) Sch 45 FA 2013 provides:

> In the part of the relevant year beginning with the day mentioned in subparagraph (3)(a) [day when ceasing to have UK home], the taxpayer spends fewer than 16 days in the UK.

7.6.4 *Non-resident in next year*

Para 46(5) Sch 45 FA 2013 provides:

> The taxpayer is not resident in the UK for the next tax year.

7.6.5 *Sufficient overseas link*

Para 46 Sch 45 FA 2013 provides:

> (6) At the end of the period of 6 months beginning with the day mentioned in sub-paragraph (3)(a), the taxpayer has a sufficient link with a country overseas.
>
> (7) The taxpayer has a "sufficient link" with a country overseas if and only if-
>
> (a) the taxpayer is considered for tax purposes to be a resident of that country in accordance with its domestic laws, or
>
> (b) the taxpayer has been present in that country (in person) at the end of each day of the 6-month period mentioned in sub-paragraph (6), or
>
> (c) the taxpayer's only home is in that country or, if the taxpayer has more than one home, they are all in that country.

7.6.6 *HMRC examples*

RDR3 provides:

> **Example 36 (Maureen)**
>
> M has been based in the UK for most of her working life, and has been

resident here for tax purposes. On holiday in Bali in the summer of 2013 she meets Maurice, who lives and works in the United Arab Emirates. Some twelve months later, they marry. M resigns from her job and moves out of her home on 24 September 2014. She spends the nights of 24 and 25 September in a hotel and flies out to the UAE to live with Maurice on 26 September 2014. She has no close family in the UK and does not return to the UK in the remainder of the tax year. She does not take up any employment in the UAE. Maurice and M plan to live in the UAE for at least another five years.

M will receive split year treatment for 2014-15 as she meets the Case 3 conditions.

- She was UK resident for 2013-14
- She is non-UK resident for 2015-16
- From 24 September 2014 until 5 April 2015 she has no home in the UK and spends fewer than 16 days in the UK
- She had established her only home is in UAE within six months.

For M, the overseas part of the tax year will start on 24 September 2014, the day she no longer had a home in the UK.

7.7 Split-year case 4: Starting to have a home in the UK only

Para 47(1) Sch 45 FA 2013 provides:

> The circumstances of a case fall within Case 4 if they are as described in subparagraphs (2) to (4).

7.7.1 *Non-resident in previous year*

Para 47(2) Sch 45 FA 2013 provides:

> The taxpayer was not resident in the UK for the previous tax year.

This is the requirement of each of split year cases 4 - 8, which apply to arrivers.

7.7.2 *Acquiring UK home*

Para 47(3) Sch 45 FA 2013 provides:

> [a] At the start of the relevant year, the taxpayer did not meet the only home test, but
> [b] there comes a day in the relevant year when that ceases to be the case and
> [c] the taxpayer then continues to meet the only home test for the rest of that year.

Para 47(5) Sch 45 FA 2013 defines the only home test:

> The "only home test" is met if-
> (a) the taxpayer has only one home and that home is in the UK, or
> (b) the taxpayer has more than one home and all of them are in the UK.

7.7.3 *Insufficient UK ties in previous period*

Para 47(4) Sch 45 FA 2013 provides:

> For the part of the relevant year before that day [day of acquiring UK home], the taxpayer does not have sufficient UK ties.

"Sufficient ties" occurs in split-year cases 4, 5 and 8. The expression is defined separately, three times in all, but the definitions are almost identical. It has the usual SRT meaning, with minor adjustments. For split-year case 4, para 47 Sch 45 FA 2013 provides:

> (6) Paragraphs 17 to 20 (and Part 2 of this Schedule so far as it relates to those paragraphs) apply for the purposes of sub-paragraph (4) with the following adjustments-
> (a) references in those paragraphs and that Part to year X are to be read as references to the part of the relevant year mentioned in subparagraph (4), and
> (b) each number of days mentioned in the first column of the Table in paragraphs 18 and 19 is to be reduced by the appropriate number.
> (7) The appropriate number is found by multiplying the number of days, in each case, by-
> A ÷ 12
> where "A" is the number of whole months in the relevant year beginning with the day mentioned in sub-paragraph (3).
> (8) Sub-paragraph (6)(a) does not apply to the references to year X in paragraphs 32(1)(b) and 33 of this Schedule (which relate to the residence status of family members) so those references must continue to be read as references to year X.

RDR3 provides:

> 5.26... When you are considering whether you have sufficient UK ties in this part of the year, you should reduce the day count limits in the sufficient UK ties tables by substituting the values from the table below.

Table F

Day before satisfying only home or having a UK home tests is

	6 to 30 Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	1 Mar to 5 Apr
For 15 substitute	1	2	4	5	6	7	9	10	11	12	14	15
For 45 substitute	4	7	11	15	19	22	26	30	34	37	41	45
For 90 substitute	7	15	22	30	37	45	52	60	67	75	82	90
For 120 substitute	10	20	30	40	50	60	70	80	90	100	110	120

7.7.4 *HMRC example*

RDR3 provides:

> **Example 37 (Olan)**
> O has been working for his employer in Germany for the last five years. He had no UK ties and was not resident in the UK. On 1 June 2013 O moves to the UK to look for work here. He rents out his flat in Germany on a two year lease, from 27 May 2013
> He arrives in the UK and stays in temporary accommodation while he finds a flat to rent. He signs a 12 month lease on a flat in London on 1 July 2013.
> He starts UK employment on 22 July 2013 and remains in the UK for a further two years.
> O receives split year treatment for 2013-14 as he meets the Case 4 conditions:
> - he is non-UK resident for 2012-13
> - he started to have his only home in the UK during the tax year and that continued until at least the end of the tax year.
> - he had no UK ties from 6 April 2013 to 1July 2013.
>
> For O the overseas part of the tax year will end on 30 June 2013, and the UK part of the tax year will start on 1 July 2013, the day he started to have his only home in the UK.
> Note: O might also meet the criteria for Case 5 or Case 8 split years, but priority is given to the case where the overseas part is the shortest.

7.8 Split-year case 5: Starting full-time work in the UK

Para 48(1) Sch 45 FA 2013 provides:

> The circumstances of a case fall within Case 5 if they are as described in subparagraphs (2) and (3).

7.8.1 *Non-resident in previous year*

Para 48(2) Sch 45 FA 2013 provides:

> The taxpayer was not resident in the UK for the previous tax year.

This is the requirement of each of split year cases 4 - 8, which apply to arrivers.

7.8.2 *UK work*

Para 48(3) Sch 45 FA 2013 provides a set of 5 conditions:

> There is at least one period of 365 days in respect of which the following conditions are met—
>
> (a) the period begins with a day that—
>
> (i) falls within the relevant year, and
>
> (ii) is a day on which the taxpayer does more than 3 hours' work in the UK,
>
> (b) in the part of the relevant year before the period begins, the taxpayer does not have sufficient UK ties,
>
> (c) the taxpayer works sufficient hours in the UK, as assessed over the period,
>
> (d) during the period, there are no significant breaks from UK work, and
>
> (e) at least 75% of the total number of days in the period on which the taxpayer does more than 3 hours' work are days on which the taxpayer does more than 3 hours' work in the UK.

7.8.3 *"Sufficient hours in the UK"*

Para 48(4) Sch 45 FA 2013 provides:

> To work out whether the taxpayer works "sufficient hours in the UK" as assessed over a given period, apply paragraph 9(2) but for "P" read "the taxpayer".

7.8.4 *Sufficient UK ties*

Para 48(3) Sch 45 FA 2013 provides:

> There is at least one period of 365 days in respect of which the following conditions are met ...
>
> (b) in the part of the relevant year before the period begins, the taxpayer does not have sufficient UK ties,

"Sufficient ties" has the usual SRT meaning, with minor adjustments.

Para 48 Sch 45 FA 2013 provides:

> (5) Paragraphs 17 to 20 (and Part 2 of this Schedule so far as it relates to those paragraphs) apply for the purposes of sub-paragraph (3)(b) with the following adjustments—
>
> (a) references in those paragraphs and that Part to year X are to be read as references to the part of the relevant year mentioned in subparagraph (3)(b), and
>
> (b) each number of days mentioned in the first column of the Table in paragraphs 18 and 19 is to be reduced by the appropriate number.
>
> (6) The appropriate number is found by multiplying the number of days, in each case, by—
>
> $A \div 12$
>
> where "A" is the number of whole months in the part of the relevant year beginning with the day on which the 365-day period in question begins.
>
> (7) Sub-paragraph (5)(a) does not apply to the references to year X in paragraphs 32(1)(b) and 33 of this Schedule (which relate to the residence status of family members) so those references must continue to be read as references to year X.

This is almost the same as in 7.11.3 (Insufficient UK ties in previous period) but with a slightly different definition of "A".

7.8.5 *HMRC example*

RDR3 provides:

> **Example 38 (Andrea)**
>
> A arrived in the UK on 20 May 2013 from Poland for a two week visit. She stays with her sister who is working in the UK. This is her first trip to the UK and she has never previously been UK resident for tax purposes. Just before A is about to return to Poland, she is offered a part-time job at a hotel. This will be her first ever job. She starts work on 10 June 2013. For the first eight weeks of her employment she works 20 hours a week (five hours a day) but from 5 August 2013 she is offered full-time hours of 40 hours a week. She takes 20 days leave during the tax year; there are no non-working days embedded within any of her periods of leave.
>
> Although for the first eight weeks of her employment she only works 20 hours per week, she works out that she meets the third automatic UK test from 10 June 2013 as follows:
>
> **Step 1:** In a 365-day period there are 0 disregarded days when she did

more than three hours of work overseas.
Step 2: Total number of UK hours worked during the 365 period (8 weeks x 20 hours & 40 weeks x 40 hours) = 1760 hours
Step 3: Subtract 0 disregarded days and 20 other days that can be deducted from 365 = which leaves a reference period of 345 days.
Step 4: Divide the reference period by 7: 345÷7 = 49.29, which is rounded down to 49
Step 5: Divide A's net UK hours by 49 (the result of Step 4):
1760÷49 = 35.91 hours
A's hours average out at over 35 over the 365-day period from 10 June 2013 (which is a day on which she worked more than three hours in the UK); she meets the third automatic UK test from that date.
A meets the criteria for Case 5 split year on the basis that:

- she was non-UK resident in the previous year
- she meets the third automatic UK test for the 365-day period commencing 10 June 2013 (which is a day on which she worked more than three hours in the UK).
- in the part of the tax year from 6 April until 10 June 2013 she did not have sufficient UK ties. See Table F.

The minutes of the Joint Forum on Expatriate Tax and NICs provide:

Sufficient hours – non alignment of Case 5 and FTWUK
These tests diverge insofar as, for Case 5, the period starts with a day on which the individual works for three or more hours in the UK, but this is not a requirement for the third automatic UK test. You could therefore find that an individual is resident under the third automatic UK test in the tax year following re turn to the UK, but does not meet the Case 5 condition to split the arrival year, which would be seen as odd. Could this be addressed?
HMRC reply: HMRC agrees these dates can differ and th is is because the two tests are testing different things. If an individual meets the FTWUK test for a year they will be resident here. Case 5 then determines if they are entitled to split year tax treatment in that tax year. The Case 5 3hr requirement is there to ensure that the UK part of a split year does not start before the individual has done any UK work – which would otherwise be possible under the 35hr averaging requirement. Not setting it as a requirement does not seem to make sense for a split on the basis of FTWUK. The Government believes that for the majority of people the 365 day period they identify for FTWUK is likely to start with a day on which they worked more than 3 hours in the UK even though

it is not a requirement for the 3rd automatic UK test.[17]

7.9 Case 6: Ceasing full-time work overseas

Split-year case 1 is for individuals who start work overseas during a year. Case 6 is for individuals who have been working abroad and stop during the year. Accordingly there are concepts and definitions in common, though the legislation repeats them in each place.

Para 49(1) Sch 45 FA 2013 provides:

> The circumstances of a case fall within Case 6 if they are as described in subparagraphs (2) to (4).

7.9.1 *Non-resident in previous year*

Para 49(2) Sch 45 FA 2013 provides:

> The taxpayer—
>
> (a) was not resident in the UK for the previous tax year because the taxpayer met the third automatic overseas test for that year (see paragraph 14), but
>
> (b) was resident in the UK for one or more of the 4 tax years immediately preceding that year.

Para (a) is the requirement of each of split year cases 4 - 8, which apply to arrivers, but in this case non-residence must be specifically due to meeting the 3rd overseas test. See 4.7 (Automatic overseas test 3: (Full-time overseas work)).

7.9.2 *Full-time overseas work*

Para 49(3) Sch 45 FA 2013 provides:

> There is at least one period (consisting of one or more days) that—
>
> (a) begins with the first day of the relevant year,
>
> (b) ends with a day that—
>
> (i) falls within the relevant year, and
>
> (ii) is a day on which the taxpayer does more than 3 hours' work overseas, and
>
> (c) satisfies the overseas work criteria.

---

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https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf

7.9.3 *"Overseas work criteria"*

Para 49 Sch 45 FA 2013 provides:

> (5) A period "satisfies the overseas work criteria" if—
>
> (a) the taxpayer works sufficient hours overseas, as assessed over that period,
>
> (b) during that period, there are no significant breaks from overseas work,
>
> (c) the number of days in that period on which the taxpayer does more than 3 hours' work in the UK does not exceed the permitted limit, and
>
> (d) the number of days in that period falling within sub-paragraph (6) does not exceed the permitted limit.
>
> (6) A day falls within this sub-paragraph if—
>
> (a) it is a day spent by the taxpayer in the UK, but
>
> (b) it is not a day that is treated under paragraph 23(4)[18] as a day spent by the taxpayer in the UK.

This is identical to the "overseas work criteria" in split-year case 1: see 7.4.3 ("Overseas work criteria").

7.9.4 *"Sufficient hours overseas"*

Para 49(7) Sch 45 FA 2013 provides:

> To work out whether the taxpayer works "sufficient hours overseas" as assessed over a given period, apply paragraph 14(3) but with the following modifications—
>
> (a) for "P" read "the taxpayer",
>
> (b) for "year X" read "the period under consideration",
>
> (c) for "365 (or 366 if year X includes 29 February)" read "the number of days in the period under consideration", and
>
> (d) in paragraph 28(9)(b), as it applies for the purposes of step 3, for "30" read "the permitted limit".

This is identical to "sufficient hours overseas" in split-year case 1: see 7.4.4 ("Sufficient hours overseas").

Para 49 Sch 45 FA 2013 provides:

> (8) The permitted limit is—
>
> (a) for sub-paragraphs (5)(c) and (7)(d), the number found by

18 See 5.8 (The deeming rule).

reducing 30 by the appropriate number, and

(b) for sub-paragraph (5)(d), the number found by reducing 90 by the appropriate number.

(9) The appropriate number is the result of A × (B÷12) where—

"A" is—

(a) 30, for sub-paragraphs (5)(c) and (7)(d), or

(b) 90, for sub-paragraph (5)(d), and

"B" is the number of whole months in the part of the relevant year after the 365-day period in question ends.

RDR3 provides:

5.37 Table G sets out the permitted limits for Case 6 – the appropriate portions of the full-year permitted limits.

Table G

	UK part of year starts on											
	6 -30 Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	1 Mar to 5 Apr
X	2	5	7	10	12	15	17	20	22	25	27	30
Y	7	15	22	30	37	45	52	60	67	75	82	90

Key

X – permitted limit on days where you can work more than 3 hours in overseas part of the year or maximum number of days which may be subtracted from the reference period on account of gaps between employment.

Y – permitted limit on days spent in the UK in overseas part of year

7.9.5 *HMRC example*

RDR3 provides:

Example 39 (Edward)

E left the UK on 1 November 2010 to work full-time for a company based in Switzerland. Prior to this date he had always lived, worked and been resident in the UK. He has kept an apartment in the UK throughout his time in Switzerland so he had a place to stay whenever visiting family in the UK.

E retires from his employment, his last overseas workday being 31 October 2014. He returns permanently to the UK on 3 November 2014 and takes up residence in his apartment. E also has an apartment in Switzerland which is up for sale, but until a buyer is found he continues to use it when he visits Switzerland.

Provided E did not exceed the limits for days spent working more than three hours in the UK or days spent in the UK before the UK part of the tax year commenced (see Table G), he will receive split year treatment under Case 6 for 2014-15 as follows:

- he is not resident in the UK for 2013-14 tax year because he met the

test for full-time work overseas for that tax year
- from 6 April 2014 until 31 October 2014 he worked full-time overseas
- he is UK resident for the tax year following his return to the UK, 2015-16 tax year (he has retired permanently to the UK).

E does not meet Case 4, Case 5 or Case 8 criteria for split year treatment. The overseas part of the tax year ends on 31 October 2014 which is the day that E finished his spell of working full-time overseas and the UK part of the tax year starts on 1 November 2014.

7.9.6 *UK resident in following year*

Para 49(4) Sch 45 FA 2013 provides:

> The taxpayer is resident in the UK for the next tax year (whether or not it is a split year).

7.10 Split-year case 7: Partner of someone ceasing full-time work overseas

Case 2 applies if an individual accompanies their partner who works overseas. Case 7 applies if the individual accompanies their partner who works in the UK. The two cases share some common drafting.

Para 50(1) Sch 45 FA 2013 provides:

> The circumstances of a case fall within Case 7 if they are as described in subparagraphs (2) to (6).

7.10.1 *Non-resident in previous year*

Para 50(2) Sch 45 FA 2013 provides:

> The taxpayer was not resident in the UK for the previous tax year.

This is the requirement of each of split year cases 4 - 8, which apply to arrivers.

7.10.2 *Living with partner*

Para 50 Sch 45 FA 2013 provides:

> (3) The taxpayer has a partner[19] whose circumstances fall within Case 6 for—
>
> (a) the relevant year, or

19 See 7.12.3 ("Partner").

(b) the previous tax year.

(4) On a day in the relevant year, the taxpayer moves to the UK so the taxpayer and the partner can continue to live together on the partner's return or relocation to the UK.

The wording is the same as case 2: see 7.5.3 (Living with partner).

7.10.3 *No previous UK home*

Para 50 Sch 45 FA 2013 provides:

(5) In the part of the relevant year before the deemed arrival day—

(a) the taxpayer

[i] has no home in the UK at any time, or

[ii] has homes in both the UK and overseas but spends the greater part of the time living in the overseas home, and

(b) the number of days that the taxpayer spends in the UK does not exceed the permitted limit.

(7) If sub-paragraph (3)(a) applies, the "deemed arrival day" is the later of—

(a) the day mentioned in sub-paragraph (4), and

(b) the first day of what is, for the partner, the UK part of the relevant year as defined for Case 6 (see paragraph 54).

(8) If sub-paragraph (3)(b) applies, the "deemed arrival day" is the day mentioned in sub-paragraph (4).

(9) The permitted limit is the number found by reducing 90 by the appropriate number.

(10) The appropriate number is the result of—

$$A \times (B \div 12)$$

where—

"A" is 90, and

"B" is the number of whole months in the part of the relevant year beginning with the deemed arrival day.

7.10.4 *Resident in following year*

Para 50(6) Sch 45 FA 2013 provides:

The taxpayer is resident in the UK for the next tax year (whether or not it is a split year).

7.10.5 *HMRC example*

RDR3 provides:

Example 40 (Joan)
J is E's wife (see Example 39). J lived with E in Switzerland for the duration of his employment. She also retires from work and returns to live in the UK with E. However she does not return on 3 November with her husband; she arrives in the UK on 8 November 2014 having worked her notice at her part-time job (20 hours a week) in Switzerland.
Provided J did not exceed the limits for days spent in the UK before the UK part of the tax year commenced, she meets the criteria for Case 7 for 2014-2015 as follows:

- she was not UK resident for the 2013-14 tax year
- she does not qualify for Case 6 as she did not meet the criteria for the third automatic overseas test. Nor does she qualify for Cases 4, 5 or 8
- her husband will receive Case 6 split year treatment
- she is resident in the UK for the tax year following her return to the UK, 2015-16
- she has come to the UK to continue to live with her husband.

The UK part of the tax year 2014-15 starts on 8 November 2014 when J moves to the UK.

7.10.6 *Transitional rul for 2013/14*

Para 156 Sch 45 FA 2013 provides:

> (1) Sub-paragraph (2) applies in determining whether the test in paragraph 50(3) is met where the relevant year is the tax year 2013-14.
> (2) The circumstances of a partner of the taxpayer are to be treated as falling within Case 6 for the previous tax year if the partner was eligible for split year treatment in relation to that tax year under the relevant ESC on the grounds that he or she returned to the United Kingdom after a period working overseas full-time.
> (3) Where the circumstances of a partner are treated as falling within Case 6 under sub-paragraph (2), the reference in paragraph 50(7)(b) to the UK part of the relevant year as defined for Case 6 is a reference to the part corresponding, so far as possible, in accordance with the terms of the relevant ESC, to the UK part of that year.
> (4) "The relevant ESC" means whichever of the extra-statutory concessions to which effect is given by Part 3 of this Schedule is relevant in the partner's case.

7.11 Split-year case 8: Starting to have a home in the UK

Para 51(1) Sch 45 FA 2013 provides:

The circumstances of a case fall within Case 8 if they are as described in subparagraphs (2) to (5).

7.11.1 *Non-resident in previous year*

Para 51(2) Sch 45 FA 2013 provides:

> The taxpayer was not resident in the UK for the previous tax year.

This is the requirement of each of split year cases 4 - 8, which apply to arrivers.

7.11.2 *Acquiring UK home*

Para 51(3) Sch 45 FA 2013 provides:

> At the start of the relevant year, the taxpayer had no home in the UK but—
>
> (a) there comes a day when, for the first time in that year, the taxpayer does have a home in the UK, and
>
> (b) from then on, the taxpayer continues to have a home in the UK for the rest of that year and for the whole of the next tax year.

7.11.3 *Insufficient UK ties in previous period*

Para 51(4) Sch 45 FA 2013 provides:

> For the part of the relevant year before the day mentioned in sub-paragraph (3)(a), the taxpayer does not have sufficient UK ties.

"Sufficient ties" has the usual SRT meaning, with minor adjustments. Para 51 Sch 45 FA 2013 provides:

> (6) Paragraphs 17 to 20 (and Part 2 of this Schedule so far as it relates to those paragraphs) apply for the purposes of sub-paragraph (4) with the following adjustments—
>
> (a) references in those paragraphs and that Part to year X are to be read as references to the part of the relevant year mentioned in subparagraph (4), and
>
> (b) each number of days mentioned in the first column of the Table in paragraphs 18 and 19 is to be reduced by the appropriate number.
>
> (7) The appropriate number is found by multiplying the number of days, in each case, by—
>
> A ÷ 12

where "A" is the number of whole months in the part of the relevant year beginning with the day mentioned in sub-paragraph (3)(a).
(8) Sub-paragraph (6)(a) does not apply to the references to year X in paragraphs 32(1)(b) and 33 of this Schedule (which relate to the residence status of family members) so those references must continue to be read as references to year X.

7.11.4 *Resident in following year*

Para 51(5) Sch 45 FA 2013 provides:

> The taxpayer is resident in the UK for the next tax year and that tax year is not a split year as respects the taxpayer.

7.11.5 *HMRC example*

RDR3 provides:

> **Example 41 (Nicola)**
> N is retired. She is non-resident in the UK for tax purposes having lived in Cyprus for a number of years. She has a home in Cyprus and she also has a property in the UK which has been let out on a commercial basis for the last few years. She has recently become a grandmother and decides that she will now split her time between Cyprus and the UK so that she can see more of her grandson who lives in the UK.
> She comes back to the UK and moves into the UK property when the rental agreement with her tenant expires on 4 August 2014. She now has two homes, one in each country.
> Between 6 April 2014 and 4 August 2014 when she started to have a UK home, N only spent four days in the UK, visiting her daughter, and therefore did not exceed the limit for days spent in the UK in the overseas period before she started to have the UK home.
> N meets the criteria for Case 8 for 2014-15 on the basis that:
> - she was not UK resident for 2013-14
> - she is UK resident for 2015-16 (N is possibly dual resident in UK and Cyprus)
> - she continues to have a home in the UK for the rest of 2014-15 and the following tax year
> - she did not have sufficient UK ties to make her resident from 6 April 2014 until 4 August 2014
>
> N does not meet the criteria for Case 4, 5, 6 or 7 split year treatments.
> The UK part of the split year starts on 4 August 2014 which is when N starts to have a home in the UK.

7.12 Definitions for split year rules

7.12.1 *"Relevant year"*

Para 43 Sch 45 FA 2013 provides:

> (2) The 8 Cases are described in paragraphs 44 to 51.
> (3) In those paragraphs, the individual is referred to as "the taxpayer" and the tax year as "the relevant year".
> (4) In applying Part 2 of this Schedule to those paragraphs, for "P" read "the taxpayer".

I refer to a **"split year"** rather than the less helpful term "relevant year".

7.12.2 *"Previous tax year" "next tax year"*

Para 52 Sch 45 FA 2013 provides commonsense definitions:

> (1) This paragraph applies for the purposes of paragraphs 44 to 51.
> (2) A reference to "the previous tax year" is to the tax year preceding the relevant year.
> (3) A reference to "the next tax year" is to the tax year following the relevant year.

7.12.3 *"Partner"*

Para 52(4) Sch 45 FA 2013 provides:

> "Partner", in relation to the taxpayer, means—
> (a) a husband or wife or civil partner,
> (b) if the taxpayer and another person are living together as husband and wife, that other person, or
> (c) if the taxpayer and another person of the same sex are living together as if they were civil partners, that other person.

In non-legal English the word "partner" has long had this sense. In legal English (or at least, in tax legislation) the word has only been used to describe a partner within the meaning of the Partnership Acts; so this is something of a legal English innovation. But no confusion is likely to arise.

7.12.4 *Rounding*

Para 52(5) Sch 45 FA 2013 provides:

If calculation of the appropriate number results in a number of days that is not a whole number, the appropriate number is to be rounded up or down as follows—

(a) if the first figure after the decimal point is 5 or more, round the appropriate number up to the nearest whole number,

(b) otherwise, round it down to the nearest whole number.

7.12.5 *"The overseas part"*

Para 53 Sch 45 FA 2013 provides:

(1) "The overseas part" of a split year is the part of that year defined below—

(a) for the Case in question, or

(b) if the taxpayer's circumstances fall within more than one Case, for the Case which has priority (see paragraphs 54 and 55).

(2) For Case 1, the overseas part is—

(a) if there is only one period falling within paragraph 44(3) [overseas work period], the part beginning with the first day of that period, and

(b) if there is more than one such period, the part beginning with the first day of the longest of those periods.

(3) For Case 2, the overseas part is the part beginning with the deemed departure day as defined in paragraph 45(7) and (8).

(4) For Case 3, the overseas part is the part beginning with the day mentioned in paragraph 46(3)(a) [day ceasing to have UK home].

(5) For Case 4, the overseas part is the part before the day mentioned in paragraph 47(3) [day acquiring UK home].

(6) For Case 5, the overseas part is—

(a) if there is only one period falling within paragraph 48(3) [roughly, day starting UK work], the part before that period begins, and

(b) if there is more than one such period, the part before the first of those periods begins.

(7) For Case 6, the overseas part is—

(a) if there is only one period falling within paragraph 49(3), the part ending with the last day of that period, and

(b) if there is more than one such period, the part ending with the last day of the longest of those periods.

(8) For Case 7, the overseas part is the part before the deemed arrival day as defined in paragraph 50(7) and (8).

(9) For Case 8, the overseas part is the part before the day mentioned in paragraph 51(3)(a) [day acquiring UK home].

7.12.6 *Priority between cases*

Para 54 sch 45 FA 2013 deals with priority between split-year cases 1 to 3:

> (1) This paragraph applies to determine which Case has priority where the taxpayer's circumstances for the relevant year fall within two or all of the following—
> Case 1 (starting full-time work overseas);
> Case 2 (the partner of someone starting full-time work overseas);
> Case 3 (ceasing to have a home in the UK).
> (2) Case 1 has priority over Case 2 and Case 3.
> (3) Case 2 has priority over Case 3.

Para 55 deals with priority between split-year cases 4-8:

> (1) This paragraph applies to determine which Case has priority where the taxpayer's circumstances for the relevant year fall within two or more of the following—
> Case 4 (starting to have a home in the UK only);
> Case 5 (starting full-time work in the UK);
> Case 6 (ceasing full-time work overseas);
> Case 7 (the partner of someone ceasing full-time work overseas);
> Case 8 (starting to have a home in the UK).
> (2) In this paragraph "the split year date" in relation to a Case means the final day of the part of the relevant year defined in paragraph 53(5) to (9) for that Case.
> (3) If Case 6 applies—
> (a) if Case 5 also applies and the split year date in relation to Case 5 is earlier than the split year date in relation to Case 6, Case 5 has priority;
> (b) otherwise, Case 6 has priority.
> (4) If Case 7 (but not Case 6) applies—
> (a) if Case 5 also applies and the split year date in relation to Case 5 is earlier than the split year date in relation to Case 7, Case 5 has priority;
> (b) otherwise, Case 7 has priority
> (5) If two or all of Cases 4, 5 and 8 apply (but neither Case 6 nor Case 7), the Case which has priority is the one with the earliest split year date.
> (6) But if, in a case to which sub-paragraph (5) applies, two or all of the Cases which apply share the same split year date and that date is the only, or earlier, split year date of the Cases which apply, the Cases with that split year date are to be treated as having priority.

7.12.7 *"The UK part"*

Para 56 Sch 45 FA 2013 provides:

> "The UK part" of a split year is the part of that year that is not the overseas part.

CHAPTER EIGHT

EXIT TAXES

8.1 Exit taxes: Introduction

This chapter considers exit taxes, that is, taxes imposed on emigration from the UK by individuals or trustees. They are as follows:
(1) Clawbacks of hold-over and EIS relief on emigration of individual.
(2) Charges on emigration of a trust.
(3) Charges on emigration of persons carrying on a trade.
I hope in a future edition to discuss restrictions on CGT share exchange relief which are akin to an exit charge.[1] Exit taxes on companies are not considered.

I use the term **"emigration"** to refer to a person becoming UK law non-UK resident (ie non-resident as defined in UK tax law), and **"treaty-emigration"** to refer to a person becoming treaty-resident in a foreign state (ie resident as defined in a DTA.)

8.1.1 *Cross references*

This chapter only considers exit taxes. For taxation of income and gains arising during the year, see (Year of arrival and departure).

The emigration of a trust may lose the benefit of transitional reliefs for s.86 TCGA.[2]

8.2 Clawback of hold-over relief on emigration of individual

Section 168(1) TCGA provides a clawback of hold-over relief on emigration of individuals.

If—

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1 See *Coll v HMRC* [2010] STC 1849.

2 See 50.5 (Pre-1998 protected trusts); 50.7 (Pre-1991 protected trusts).

> (a) relief is given under section 165 in respect of a disposal to an individual or under section 260 in respect of a disposal to an individual ("the relevant disposal"); and
> (b) at a time when he has not disposed of the asset in question, the transferee ceases to be resident in the UK,
>
> then, subject to the following provisions of this section, a chargeable gain shall be deemed to have accrued to the transferee immediately before that time, and its amount shall be equal to the held-over gain (within the meaning of section 165 or 260) on the relevant disposal.

There is no charge if the individual becomes treaty non-resident but remains UK-law UK resident.

The gain accruing to the individual may qualify for DT relief.

An individual ceases to be resident in the UK at the end of a tax year, even if the year is a split year.[3]

These rules give some scope for tax planning. But given the EU issues discussed below, and the CGT temporary non-residence rules, this may not matter much.

8.2.1 *Disposal prior to emigration*

The clawback charge does not apply if the individual disposes of the asset before emigration. Section 168(2) TCGA deals with part disposals:

> For the purposes of subsection (1) above the transferee shall be taken to have disposed of an asset before the time there referred to only if he has made a disposal or disposals in connection with which the whole of the held-over gain on the relevant disposal was represented by reductions made in accordance with section 165(4)(b) or 260(3)(b) and where he has made a disposal in connection with which part of that gain was so represented, the amount of the chargeable gain deemed by virtue of this section to accrue to him shall be correspondingly reduced.

Section 168(3) TCGA provides that inter-spouse disposals are disregarded:

> The disposals by the transferee that are to be taken into account under subsection (2) above shall not include any disposal to which section 58 applies; but where any such disposal is made by the transferee, disposals by his spouse or civil partner shall be taken into account under subsection (2) above as if they had been made by him.

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3 See 7.1 (Default rule: individual regarded as resident throughout tax year).

This is obviously right.

8.2.2 *Time limit*

Section 168(4) TCGA contains a time limit:

> Subsection (1) above shall not apply by reason of a person ceasing to be resident more than 6 years after the end of the year of assessment in which the relevant disposal was made.

8.2.3 *Relief for short term postings abroad*

Section 168(5) TCGA contains a relief for short term postings abroad:

> Subsection (1) above shall not apply in relation to a disposal made to an individual if—
>
> (a) the reason for his ceasing to be resident in the UK is that he works in an employment or office all the duties of which are performed outside the UK, and
>
> (b) he again becomes resident in the UK within the period of 3 years from the time when he ceases to be so, without having meanwhile disposed of the asset in question;
>
> and accordingly no assessment shall be made by virtue of subsection (1) above before the end of that period in any case where the condition in para (a) above is, and the condition in para (b) above may be, satisfied.

Section 168(6) TCGA deals with part disposals and inter-spouse disposals by the short term non-resident. The wording is based on s.168(2)(3) but its effect is different:

> For the purposes of subsection (5) above a person shall be taken to have disposed of an asset if he has made a disposal in connection with which the whole or part of the held-over gain on the relevant disposal would, had he been resident in the UK, have been represented by a reduction made in accordance with section 165(4)(b) or 260(3)(b) ...

This is a strict rule, since even a part disposal loses the benefit of the relief for the entire asset. The subsection continues:

> and subsection (3) above shall have effect for the purposes of this subsection as it has effect for the purposes of subsection (2) above.

Thus there is no exit charge on an asset if T goes non-resident, and gives the asset to the spouse, provided that T becomes UK resident again within 3 years and the spouse does not dispose of the asset during that period. It

is irrelevant whether the spouse becomes UK resident.

8.2.4 *Collection of clawback charge from donor or trustee*

The tax may be collected from:
(1) the donor who gave the asset to the individual; or
(2) the trustee who transferred the asset to the individual.
This is not usually important for an individual donor because they will generally be prepared to take a view about the future actions of their donee. It is important for trustees who transfer assets to beneficiaries and claim hold-over relief to avoid a charge under s.71 TCGA.

Section 168(7) TCGA provides:

> Where an amount of tax assessed on a transferee by virtue of subsection (1) above is not paid within the period of 12 months beginning with the date when the tax becomes payable then, subject to subsection (8) below, the transferor may be assessed and charged (in the name of the transferee) to all or any part of that tax.

Section 168(8) TCGA sets out a time limit:

> No assessment shall be made under subsection (7) above more than 6 years after the end of the year of assessment in which the relevant disposal was made.

Thus a donor who makes a claim for hold-over relief is at risk of a clawback if the donee emigrates within (approximately) 4 years of the gift.
Suppose:
(1) In 2001/02 D makes a gift to E.
(2) E emigrates in 2005/06.
The exit charge is payable on 31 January 2007.
E cannot be assessed until 12 months later, 31 January 2008. That is just within "6 years after the end of the year of assessment in which the relevant disposal was made". But if E had made the gift in 2000/01 it would have been too late for HMRC to collect the tax from E.

Section 168(9) TCGA provides an indemnity (for what it may be worth):

> Where the transferor pays an amount of tax in pursuance of subsection (7) above, he shall be entitled to recover a corresponding sum from the transferee.

8.2.5 *Prevention of double charge*

Section 168(10) TCGA provides:

> Gains on disposals made after a chargeable gain has under this section been deemed to accrue by reference to a held-over gain shall be computed without any reduction under section 165(4)(b) or 260(3)(b) in respect of that held-over gain.

This prevents double UK taxation (if the individual later makes a disposal within the charge to CGT, eg if they return to the UK). It does not prevent double taxation if the individual pays foreign tax on the same gain. The EU have noted the issue and recommend member states to act, but the UK has not done anything and show no sign of taking any notice..

8.3 Clawback of EIS relief

There is a similar clawback of EIS relief if (in short) an individual becomes non-resident within three years of acquiring EIS shares: para 3 Sch 5B TCGA.

8.4 Charge on emigration of trust

Section 80 TCGA provides an exit charge for trusts:

> (1) This section applies if the trustees of a settlement become at any time ("the relevant time") not resident in the UK.
> (2) The trustees shall be deemed for all purposes of this Act—
> (a) to have disposed of the defined assets immediately before the relevant time, and
> (b) immediately to have reacquired them,
> at their market value at that time.

Unlike the exit charge for individuals, this applies to all gains, not just held-over gains.

8.4.1 *Defined assets*

"Defined assets" is a label which brings in a number of rules which limit the scope of the charge. Section 80(3) TCGA provides:

> Subject to subsections (4) and (5) below, the defined assets are all assets constituting settled property of the settlement immediately before the relevant time.

8.4.2 *Assets of UK trade*

Section 80(4) TCGA brings in an exception for UK trades:

> If immediately after the relevant time—

(a) the trustees carry on a trade in the UK through a branch or agency, and
(b) any assets are situated in the UK and either used in or for the purposes of the trade or used or held for the purposes of the branch or agency,

the assets falling within para (b) above shall not be defined assets.

No charge is needed as these assets remain within the charge to CGT.

8.4.3 *DTA exemption*

Section 80(5) TCGA brings in an exception for assets protected by DTAs:

Assets shall not be defined assets if—
(a) they are of a description specified in any double taxation relief arrangements, and
(b) were the trustees to dispose of them immediately before the relevant time, the trustees would fall to be regarded for the purposes of the arrangements as not liable in the UK to tax on gains accruing to them on the disposal.

No charge is needed as these assets never were within the charge to CGT.

8.4.4 *Restriction of roll-over relief*

Section 80 TCGA provides:

(6) Section 152 shall not apply where the trustees—
(a) have disposed of the old assets, or their interest in them, before the relevant time, and
(b) acquire the new assets, or their interest in them, after that time, unless the new assets are excepted from this subsection by subsection (7) below.
(7) If at the time when the new assets are acquired—
(a) the trustees carry on a trade in the UK through a branch or agency, and
(b) any new assets are situated in the UK and either used in or for the purposes of the trade or used or held for the purposes of the branch or agency,

the assets falling within para (b) above shall be excepted from subsection (6) above.
(8) In this section "the old assets" and "the new assets" have the same meanings as in section 152.

The CG Manual explains:

38215. Roll-over Relief [November 2012]
Section 80(6) prevents roll-over relief under TCGA 1992, s.152 from applying so as to avoid the new exit charge where trustees dispose of assets before, then acquire new assets after becoming non-resident where the new assets are outside the UK tax charge.

8.4.5 *Accidental emigration on death of trustee*

Section 81 TCGA provides:

> (1) Subsection (2) below applies where—
> (a) section 80 applies as a result of the death of a trustee of the settlement, and
> (b) within the period of 6 months beginning with the death, the trustees of the settlement become resident in the UK.

This could apply if for instance a trust has a UK and a foreign trustee, and the UK trustee dies.

> (2) That section shall apply as if the defined assets were restricted to such assets (if any) as—
> (a) would be defined assets apart from this section, and
> (b) fall within subsection (3) or (4) below.

That is, there is no charge apart from the exceptional cases of (3) and (4). Section 81(3) TCGA provides:

> Assets fall within this subsection if they were disposed of by the trustees in the period which—
> (a) begins with the death, and
> (b) ends when the trustees become resident in the UK.

Since the trust will be UK resident in the year and subject to CGT on its gains, it is difficult to see the point of this. Section 81(4) TCGA provides:

> Assets fall within this subsection if—
> (a) they are of a description specified in any double taxation relief arrangements,
> (b) they constitute settled property of the settlement at the time immediately after the trustees become resident in the UK, and
> (c) were the trustees to dispose of them at that time, the trustees would fall to be regarded for the purposes of the arrangements as not liable in the UK to tax on gains accruing to them on the disposal.

8.4.6 *Accidental immigration on death of trustee*

Section 81 goes on to give a relief where there has been an accidental immigration to the UK followed by emigration:

> (5) Subsection (6) below applies where—
>
> (a) at any time the trustees of a settlement become resident in the UK as a result of the death of a trustee of the settlement, and
>
> (b) section 80 applies as regards the trustees of the settlement in circumstances where the relevant time (within the meaning of that section) falls within the period of 6 months beginning with the death.
>
> (6) That section shall apply as if the defined assets were restricted to such assets (if any) as—
>
> (a) would be defined assets apart from this section, and
>
> (b) fall within subsection (7) below.

There is only one exceptional case:

> (7) Assets fall within this subsection if—
>
> (a) the trustees acquired them in the period beginning with the death and ending with the relevant time, and
>
> (b) they acquired them as a result of a disposal in respect of which relief is given under section 165 or in relation to which section 260(3) applies.

This is only a limited relief, since it does not avoid the CGT charge on actual disposals of assets by the trustees in a year when accidentally UK resident.

8.5 **Liability of trustees for exit charge**

There are special rules. The usual rule for liability of trustees for CGT is in s.65(1) TCGA:

> Subject to subsection (3) below, capital gains tax chargeable in respect of chargeable gains accruing to the trustees of a settlement or capital gains tax due from the personal representatives of a deceased person may be assessed and charged on and in the name of any one or more of the relevant trustees ....[4]

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4 Defined in s.65(4): "In this section ...
"the relevant trustees", in relation to any chargeable gains, means the trustees in the year of assessment in which the chargeable gains accrue and any subsequent trustees of the settlement..."

Section 65(3) has an exemption for trustees who retired before an emigration without knowing of a proposed emigration:

> Where section 80 applies as regards the trustees of a settlement ("the migrating trustees"), nothing in subsection (1) above shall enable any person—
>
> (a) who ceased to be a trustee of the settlement before the end of the relevant period,[5] and
>
> (b) who shows that, when he ceased to be a trustee of the settlement, there was no proposal that the trustees might cease to be resident in the UK,
>
> to be assessed and charged to any capital gains tax which is payable by the migrating trustees by virtue of section 80(2).

Section 82 TCGA provides:

> (1) This section applies where—
>
> (a) section 80 applies as regards the trustees of a settlement ("the migrating trustees"), and
>
> (b) any capital gains tax which is payable by the migrating trustees by virtue of section 80(2) is not paid within 6 months from the time when it became payable.
>
> (2) The Board may, at any time before the end of the period of 3 years beginning with the time when the amount of the tax is finally determined, serve on any person to whom subsection (3) below applies a notice—
>
> (a) stating particulars of the tax payable, the amount remaining unpaid and the date when it became payable;
>
> (b) stating particulars of any interest payable on the tax, any amount remaining unpaid and the date when it became payable;
>
> (c) requiring that person to pay the amount of the unpaid tax, or the aggregate amount of the unpaid tax and the unpaid interest, within 30 days of the service of the notice.
>
> (3) This subsection applies to any person who, at any time within the relevant period,[6] was a trustee of the settlement, except that it does not apply to any such person if—
>
> (a) he ceased to be a trustee of the settlement before the end of the relevant period, and
>
> (b) he shows that, when he ceased to be a trustee of the settlement,

---

5 Defined by reference in s.65(4): In this section—
"the relevant period" has the same meaning as in section 82;..."

6 Defined in s.82(6) as (in effect) one year.

there was no proposal that the trustees might cease to be resident in the UK.

(4) Any amount which a person is required to pay by a notice under this section may be recovered from him as if it were tax due and duly demanded of him; and he may recover any such amount paid by him from the migrating trustees.

(5) A payment in pursuance of a notice under this section shall not be allowed as a deduction in computing any income, profits or losses for any tax purposes.

SP 5/82 sets out HMRC practice:

5 Payment can only be sought from former trustees where the Revenue is unable to obtain payment from current trustees. In the first instance, payment will generally be sought from those persons who resigned as trustees immediately before the trust migrated and then from earlier trustees. Each case will, however, need to be considered in the light of the relevant facts.

SP 5/82 correctly states:

6 An amount recovered from present trustees by a former trustee in respect of capital gains tax under TCGA 1992 s 82 is not regarded as a capital payment under s 97. Further, such amounts do not fall within the provisions of [what is now s.720, 727 or 731 ITA] nor are there any inheritance tax implications.

8.5.1 *The relevant period*

This term is defined in s.82(6) TCGA:

For the purposes of this section—

(a) [this is a spent transitional rule for an emigration in 1991-2];

(b) in any other case, the relevant period is the period of 12 months ending with the relevant time.

8.5.2 *Commentary*

In short, a trustee at the time of the emigration is liable, and a trustee who retired up to a year before is liable if aware of the proposal to migrate the trust. This may help HMRC (because they can go back to trustees in an earlier year) and it may help the trustees (if they can say that they were not aware of a migration). But it is not likely to make any difference either way. There is no good reason for special rules and s.82 and s.65(3) TCGA should be repealed, resulting in a small but worthwhile tax simplification.

8.6 Charge on treaty-emigration of trust

Section 83 TCGA provides:

> (1) This section applies if the trustees of a settlement, while continuing to be resident in the UK, become at any time ("the time concerned") trustees who fall to be regarded for the purposes of any double taxation relief arrangements[7] —
>
> (a) as resident in a territory outside the UK, and
>
> (b) as not liable in the UK to tax on gains accruing on disposals of assets ("relevant assets") which constitute settled property of the settlement and fall within descriptions specified in the arrangements.
>
> (2) The trustees shall be deemed for all purposes of this Act—
>
> (a) to have disposed of their relevant assets immediately before the time concerned, and
>
> (b) immediately to have reacquired them,
>
> at their market value at that time.

This charge does not contain any of the exceptions applicable to the s.80 exit charge and has no special rules for trustee liability.

8.6.1 *Restriction of roll-over relief*

Section 84 TCGA provides:

> (1) Section 152 shall not apply where—
>
> (a) the new assets[8] are, or the interest in them is, acquired by the trustees of a settlement,
>
> (b) at the time of the acquisition the trustees are resident in the UK and fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK,
>
> (c) the assets are of a description specified in the arrangements, and
>
> (d) were the trustees to dispose of the assets immediately after the acquisition, the trustees would fall to be regarded for the purposes of the arrangements as not liable in the UK to tax on gains accruing to them on the disposal.

This is the equivalent of s.80(6): see 8.4.4 (Restriction of roll-over relief).

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7 See 9A.3.3 ("DTR arrangements": CGT).

8 Defined by reference in s.84(2): "In this section "the new assets" has the same meaning as in section 152."

8.7 Disclosure of emigration or treaty-emigration of trust

Para 5 Sch 5A TCGA provides:

(1) This paragraph applies if—

(a) the trustees of a settlement cease at any time (the relevant time) on or after the commencement day[9] to be resident in the UK, or

(b) the trustees of a settlement, while continuing to be resident in the UK, become at any time (the relevant time) on or after the commencement day trustees who fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK.

(2) Any person who was a trustee of the settlement immediately before the relevant time shall, before the expiry of the period of twelve months beginning with the relevant day, deliver to the Board a return specifying—

(a) the day on which the settlement was created,

(b) the name and address of each person who is a settlor in relation to the settlement immediately before the delivery of the return, and

(c) the names and addresses of the persons who are the trustees immediately before the delivery of the return.

(3) For the purposes of sub-paragraph (2) above the relevant day is the day when the relevant time falls.

There are minor exceptions in para 6 sch 5A TCGA:

(1) Nothing in paragraph 2, 3, 4 or 5 above shall require information to be contained in the return concerned to the extent that—

(a) before the expiry of the period concerned the information has been provided to the Board by any person in pursuance of the paragraph concerned or of any other provision, or

(b) after the expiry of the period concerned the information falls to be provided to the Board by any person in pursuance of any provision other than the paragraph concerned.

(2) Nothing in paragraph 2, 3, 4 or 5 above shall require a return to be delivered if—

(a) before the expiry of the period concerned all the information concerned has been provided to the Board by any person in pursuance of the paragraph concerned or of any other provision,

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9 Defined para 1 sch 5A TCGA: "In this Schedule "the commencement day" means the day on which the Finance Act 1994 was passed."

or

(b) after the expiry of the period concerned all the information concerned falls to be provided to the Board by any person in pursuance of any provision other than the paragraph concerned.

8.8 Emigration of individual trader[10]

Section 17 ITTOIA provides:

(1) This section applies if—

(a) an individual carries on a trade otherwise than in partnership, and

(b) there is a change of residence.

(1A) For the purposes of this section there is a "change of residence" if—

(a) the individual becomes or ceases to be UK resident, or

(b) a tax year is, as respects the individual, a split year.

(1B) The change of residence occurs—

(a) in a case falling within subsection (1A)(a), at the start of the tax year for which the individual becomes or ceases to be UK resident, and

(b) in a case falling within subsection (1A)(b), at the start of whichever of the UK part or the overseas part of the tax year is the later part.

(2) If this section applies and the individual does not actually cease permanently to carry on the trade immediately before the change of residence occurs, the individual is treated for income tax purposes—

(a) as permanently ceasing to carry on the trade at the time of the change of residence, and

(b) so far as the individual continues to carry on the trade, as starting to carry on a new trade immediately afterwards....

8.8.1 *Emigration of partner in trading partnership*

For the equivalent rules for partnerships, see s.852 ITTOIA:

(6) If there is a change of residence, the partner is treated as permanently ceasing to carry on one notional trade when that change of residence occurs and starting to carry on another immediately afterwards...

(8) Subsections (1A) and (1B) of section 17 apply for the purposes of subsection (6).

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10 References in this paragraph to a trade include a profession or vocation, since there is no difference between them.

8.9 EU restriction on exit taxes

8.9.1 *Exit charge on emigration of individual to EU state*

An EC communication on exit taxes[11] provides:

> **2. EXIT TAXES: LEGAL FRAMEWORK**
>
> **2.1. The decision of the ECJ in *de Lasteyrie*[12] and its implications for individuals**
>
> On 11 March 2004, the ECJ gave an important interpretation of the freedom of establishment in the context of French legislation taxing unrealised increases in value of securities where individual taxpayers move their tax residence outside France. When Mr. de Lasteyrie du Saillant in 1998 moved from France to Belgium, he was subject to immediate taxation on the unrealised increase in value of the shares which he held in a French company.
>
> The ECJ held that the French provision in question was likely to restrict the exercise of the freedom of establishment, having at the very least a dissuasive effect on taxpayers wishing to establish themselves in another MS, because they were subjected in the exit country, by the mere fact of transferring their tax residence outside France, to tax on a form of income that had not yet been realised, and thus to disadvantageous treatment by comparison with a person maintaining his residence in France.
>
> Although the ruling in *de Lasteyrie* relates to the facts and circumstances of the case at issue, the ECJ's interpretation of EC Law implies conclusions as regards exit taxes in general.
>
> Taxing residents on a realisation basis and departing residents on an accruals basis is a difference in treatment which constitutes an obstacle to free movement. Where a MS decides to assert a right to tax gains accrued during a taxpayer's residence within its territory, it cannot take measures which present a restriction to free movement.
>
> This rules out the possibility of immediate collection of the tax due on the unrealised gains when taxpayers move their tax residence to another MS.

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11 "Exit taxation and the need for co-ordination of Member States' tax policies" 19.12.2006 COM(2006) 825 final, accessible *ec.europa.eu/taxation_customs/resources/documents/taxation/COM(2006)825_en.pdf*

12 *de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie,* [2005] STC 1722.

This view has since been reaffirmed in *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond / kantoor Rotterdam*.[13]

The communication then considers permitted forms of charges on departing residents (not applicable in the UK)[14] and concludes:

> Most MSs which had exit tax rules on individual shareholders similar to those at issue in *de Lasteyrie* have since abolished or amended them in line with the ruling. This has enabled the Commission to suspend infringement proceedings against a number of MSs on this particular aspect. The Commission will, however, continue to monitor MSs' rules in this area with a view to ensuring their EC law compatibility.

The UK has three exit charges on individuals, the hold-over clawback, the EIS clawback, and the charge on migrating traders. So far they seem to have escaped direct EU attention. If the migration is to a member state, these can hardly be described as compliant with EU freedom of establishment[15] and freedom to reside.[16]

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13 [2012] STC 114.

14 "The ECJ ruled in *de Lasteyrie* and in *N* [*N v Inspecteur van de Belastingsdienst Oost/kantoor Almelo*, [2008] STC 436] that the possible suspension of payment made subject, for example, to conditions that guarantees must be provided, constitutes a restrictive effect in that the taxpayer is deprived of enjoyment of the assets given as a guarantee. Similarly, it is clear from *de Lasteyrie* that suspension of payment cannot be made subject to the condition of designating a representative in the MS of origin. In general, any means of preserving the tax claim must be strictly proportional to that aim and must not entail disproportionate costs for the taxpayer.
As the ECJ confirmed in *N*, when a resident of a MS transfers his/her residence to another MS, the MS from which he/she departs is not prevented by EU law from assessing the amount of income on which it wishes to preserve its tax jurisdiction, provided this does not give rise to an immediate charge to tax and that there are no further conditions attached to the deferral. Such a practice is in line with the principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises. A requirement, that the taxpayer submits a tax declaration at the time of the transfer of residence, necessary for the purpose of assessing the income, can be considered proportionate having regard to the legitimate objective of allocating the taxing powers, in particular so as to eliminate double taxation, between the MSs."

15 See 60.4 (Freedom of establishment).

16 Art. 21 TFEU provides:
"Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in the Treaties and by the measures adopted to give them effect."

8.9.2 *Exit charge on emigration of trust to EU state*

What about the exit charge for trusts? The EC communication does not discuss trusts, but it does discuss companies:

> **3.1. Implications of *de Lasteyrie* for companies**
> The Commission is of the opinion that the interpretation of the freedom of establishment given by the ECJ in *de Lasteyrie* in respect of exit tax rules on individuals also has direct implications for MSs' exit tax rules on companies.

This is obviously correct since freedom of establishment applies to companies as well as individuals.[17] The same will apply to a trust either on the grounds that it is an "undertaking" within the meaning of the freedom of establishment rule[18] or on the grounds of the freedom of movement or of establishment of the trustee in its personal capacity.

8.9.3 *Exit charge on emigration to EEA state*[19]

The EC communication continues:

> **4.1. Freedoms applicable to EEA-states**
> The European Economic Area (EEA) Agreement provides for the same four basic freedoms as the EC Treaty (goods, persons, services and capital). It also includes horizontal provisions relevant to the four freedoms. Secondary Community legislation in the area of taxation, however, has not been incorporated in the EEA Agreement. The Mutual Assistance Directive and the Recovery Directive therefore do not apply to these states
> **4.2. Emigration of individuals/transfer of seat of companies – free movement of workers/freedom of establishment**
> Taxes levied in case of the emigration of individuals or the transfer of seat of companies would primarily appear to involve the free movement of workers (Article 39 EC/28 EEA Agreement) and the freedom of establishment (Article 43 EC/31 EEA Agreement) respectively. The exit taxes at issue in *de Lasteyrie* and *N* which applied to individuals with substantial shareholdings were found to contravene the freedom of establishment. As the same basic freedoms apply to EEA states, the rulings in *de Lasteyrie* and *N* are of direct relevance to them. The

17 See 60.4 (Freedom of establishment).

18 See 60.10 (Section 86 TCGA).

19 The states within the EEA (European Economic Area) are Norway, Iceland and Liechtenstein.

question is whether there are significant differences in situation which could justify such restrictions in the case of EEA states. The Commission is of the opinion that an immediate collection of tax may be justified in certain circumstances by overriding reasons in the general interest, in particular the need to ensure the effectiveness of fiscal supervision and to prevent tax evasion.
EEA states are not obliged to implement secondary Community legislation in the area of taxation, such as the Mutual Assistance Directive and the Recovery Directive. As a consequence, MSs do not necessarily have the same guarantees that deferred tax claims can be discharged at a later stage as they would have within the Community. In many cases, MSs have, however, concluded bilateral or multilateral tax conventions with EEA states which include information exchange obligations that provide for an equivalent level of mutual assistance. The Commission believes that in situations where a lack of administrative cooperation prevents MSs from safeguarding their tax claims they should be entitled to take appropriate measures at the moment of emigration or transfer.

Council Directive 2010/24/EU[20] applies to MSs but not to EEA states. However, all the EEA states have a DTA with an information exchange article which should suffice.

8.9.4 *Exit charge on emigration to other countries*

The EC communication continues:

5. EXIT TAXES IN RESPECT OF THIRD COUNTRIES
Of the four basic freedoms, only the free movement of capital and payments applies to third countries.
In respect of the emigration or transfer of seat to other third countries as such, the provisions on the free movement of persons do not apply and MSs remain free to assess and collect their taxes at the moment of departure. However, the emigration of an individual or the transfer of seat of a company may involve transactions which are covered by the provisions on the free movement of capital. The transfer of assets to a PE in a third country may also fall to be examined from the perspective of the free movement of capital.
Since the result of the application of the different freedoms should be the same, it would appear that an immediate collection of tax at the

20 16 March 2010, concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.

> moment of transfer of such assets constitutes a restriction on the free movement of capital. However, as noted above, the Commission believes that a lack of administrative co-operation may justify a restriction in these circumstances. The Commission would encourage MSs, where appropriate, to enhance administrative co-operation with their non-EU partners, as this is the best means of ensuring tax compliance and preventing tax evasion.[21]

The European Parliament supports this view.[22]

In the case of an emigration to a third country (not a MS or EEA state), it would be necessary to review the treaties between the UK and that state in order to ascertain the position.

8.9.5 *EU proceedings against UK*

The EC say:

> The European Commission has formally requested the UK to amend its legislation providing for exit taxes on companies.
>
> The UK legislation at stake results in immediate taxation of unrealised capital gains in respect of certain assets when the seat or place of effective management of a company is transferred to another EU/EEA State. However, a similar transfer within the UK would not generate any such immediate taxation and the relevant capital gains would only be taxed once they have been realised.
>
> The Commission considers that the UK has failed to fulfil its obligations under EU rules by maintaining these restrictive provisions. Exit taxes may breach the freedom of establishment as they make it more expensive to transfer a company seat or place of effective management to another Member State than to another location in the UK.
>
> The Commission's request takes the form of a reasoned opinion (second step of EU infringement proceedings). In the absence of a satisfactory response within two months, the Commission may refer the UK to the Court of Justice of the European Union.[23]

In the area of company migration (outside the scope of this work) the CIOT have been lobbying the EU for action.[24]

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21 In EU terminology, "tax evasion" includes tax avoidance.

22 European Parliament resolution of 24 October 2007 on the contribution of taxation and customs policies to the Lisbon Strategy.

23 IP/12/285, 22/03/2012.

24 Letter dated 20 March 2007 accessible *http://www.tax.org.uk* (search for *Heydt*).

The UK response was Sch 49 FA 2013, though whether this achieves EU law compliance has been questioned.[25] However, no changes have been made to the exit charges for trusts and individuals.

8.10 Council Resolution on coordinating exit taxation

The Council of the European Union (the Council of Ministers) adopted a resolution on 2 December 2008 which invites Member States to adopt the following guiding principles:

> A. "Transfer of economic activities" means any operation whereby a taxpayer subject to corporation tax or a natural person engaged in a business:
> 1) ceases to be subject to corporate or personal income tax in a Member State (the exit State) while at the same time becoming subject to corporate or personal income tax in another Member State (the host State); or
> 2) transfers a combination of assets and liabilities from a head office or a permanent establishment in the exit State to a permanent establishment or a head office in the host State.
>
> B. When, in connection with a transfer of economic activities, the exit State reserves the option to exercise its taxing rights on the reserves made (profits realised but not yet taken into account for tax purposes) and to take back, in full or in part, the provisions made (expenditure not yet incurred but already taken into account for tax purposes), the host State may provide for the creation of reserves or provisions of identical or different amounts, in accordance with the rules governing the tax base in that State, and allow deduction from taxable results for the year in which they were established.
>
> C. When, in connection with a transfer of economic activities, the exit State reserves the option to exercise its taxing rights on the unrealised gains corresponding to the assets held by the taxpayer, calculated as the difference between the market value of these assets on the transfer date and their book value, the host State takes the market value on the transfer date when calculating the subsequent added value in the event of disposal.
>
> D. In case of disagreement between the host State and the exit State regarding the market value of the assets on the transfer date, the two

25 See CIOT Letter to HMRC re FB13 exit charges (May 2013) accessible *http://www.tax.org.uk/tax-policy/public-submissions/2013/exit_charges*

States settle their dispute using the appropriate procedure.

E. The host State can require the taxpayer engaged in a transfer of economic activities to provide evidence that the exit State has exercised or will exercise its rights under the conditions set out above, as well as evidence of the market value applied by the exit State.

F. The provisions laid down at Community level in relation to Mutual Assistance provide the framework for the host State to assist the exit State, in particular for the purposes of determining the disposal date.

This does not seem to have much impact yet, at least in the UK, but the law is not stable.

CHAPTER NINE

TEMPORARY NON-RESIDENCE POST-2013 DEPARTURES

9.1 Temporary non-residence: Introduction

This chapter discusses the temporary non-residence rules (**"TNR rules"**). Para 153(3) Sch 45 FA 2013 provides:

> Part 4 of this Schedule has effect if the year of departure (as defined in that Part) is the tax year 2013-14 or a subsequent tax year.

It is therefore necessary to distinguish:

(1) **"The post-2013 TNR rules"** which apply where an individual's year of departure is 2013/14 or later.

(2) **"The pre-2013 TNR rules"** which continue to apply where an individual's year of departure is before 2013/14.

This does make the legislation twice as complicated as necessary. The two sets of rules are best regarded as separate topics, though occasionally the same wording is used, and often the end result is the same. At the cost of some repetition - those who read tax statutes must become enured to repetition - I address the new rules in this chapter and the old rules in the next chapter.

The rules were introduced in 1998 and constantly amended, producing a fine tangle. Perhaps the authors of the FA 2013 realised that the legislation was a mess, because it was almost completely rewritten (as well as extended) by part 4 Sch 45 FA 2013. Unfortunately some of the problems under the pre-2013 rules are preserved in the post-2013 rules.

The decision to keep all the old legislation for pre-2013 leavers, even the parts which are gibberish, does seem rather odd. But there it is.

The rules apply if an individual's temporary period of non-residence is 5 years or less, so the pre-2013 rules will finally become obsolete on 6 April 2018, when those who left the UK in 2012/13 clock up five years non-residence, after which they can no longer be caught by the TNR rules.

9.1.1 *Residence terminology*

In this book I use the following terminology:

(1) **"UK-law residence"** means residence as defined in UK tax law.
   (a) A person who is resident in the UK within the UK tax law definition is **"UK-law UK resident"**
   (b) A person who is not resident in the UK within the UK tax law definition is**"UK-law non-UK resident"**.

(2) **"Treaty-residence"** means residence as defined in a DTA.
   (a) A person who is a resident of the UK within a DTA definition is **"treaty-resident in the UK"**.
   (b) A person who is resident in the foreign state within a DTA definition is **"treaty-resident in the foreign state"**. One could use the term "treaty-resident outside the UK." Statute calls this *"treaty non-resident"*[1] but I think my term is clearer.

Since UK-law residence and treaty-residence are distinct concepts,[2] a person who is UK-law UK resident may be:

(1) treaty non-UK resident (under the tie-breaker test);[3] or
(2) not treaty non-UK resident: described as having **"sole UK residence"**.[4]

These are somewhat clumsy terms but it is difficult to think of better.

9.1.2 *Cross references*

For the interaction with sch 4C TCGA, see 52.22.2 (Trust within s.87).

9.2 Purpose of the temporary non-residence rules

It is helpful to outline the three sets of problems which the TNR rules are intended to address.

9.2.1 *Gains accruing during temporary period of non-residence*

In the absence of the TNR rules, gains of temporary non-residents are not

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1 See 9.3.2 ("Treaty non-resident").

2 See 6.2 (Relationship between treaty-residence and UK-law residence).

3 It would be useful to have a short term to describe someone who is UK-law UK resident but treaty-resident outside the UK (= treaty non-UK resident). But *dual resident* and *semi-resident* do not encapsulate the concept; *treaty tie-breaker non-UK resident*" does encapsulate the concept but it is so long-winded it seems better just to use the full expression when it is needed.

4 See 9.3.3 ("Sole UK residence").

in general subject to tax.

So a possible method of CGT planning for a UK resident would be as follows. An individual could become UK-law non-UK resident and realise gains (typically by disposing of assets) during a year of non-residence; in the following tax year they could become UK resident again. Thus relatively brief periods of UK-law non-residence offered the opportunity of CGT-free disposals.

A variant of this planning is: an individual could remain UK-law UK resident but become treaty non-UK resident (ie treaty-resident in a state with a DTA conferring CGT relief under the tie-breaker); the individual realises gains while treaty non-UK resident; following the disposal the individual could cease to be treaty non-resident. Thus relatively brief periods of treaty non-UK residence offered some opportunity of CGT-free disposals (so far as CGT treaty relief could be available).

The TNR rules bring gains into charge on the return of the temporary non-resident to the UK.

9.2.2 *Income arising during temporary period of non-residence*

In the absence of the TNR rules, some income of temporary non-residents is not subject to UK tax. So a similar method of IT planning for a UK resident would be to arrange for income to arise to an individual when UK-law non-UK resident, or when treaty non-UK resident. Relatively brief periods of UK-law or treaty non-residence offered the opportunity of receiving income free of IT.

The TNR rules bring some of this income ("TNR income") into charge on the return of the temporary non-resident to the UK. The rules are aimed at types of income which could be arranged to accrue during the non-resident period. The categories of income caught by the TNR rules are as follows:

(1) Close companies in which the individual has a material interest
(2) OIGs
(3) Gains from life policies and bonds
(4) Specific employment income (not discussed here):
    (a) Pension schemes charges: s.394A, 576A, s.572A, 579CA ITEPA
    (b) Disguised remuneration: s.554Z4A, 554Z11A ITEPA
    (c) Employer-financed retirement benefits: s.394A ITEPA

Other types of income accruing to temporary non-residents remain exempt on return to the UK.

HMRC summarise the position as follows:

> 3.47 Ceasing to be UK resident means that an individual is no longer liable to UK tax on income from non-UK sources. In many instances there can also be a reduced tax liability on income from UK sources. This can result in people finding it advantageous to become not resident for a short period of time if they expect substantial amounts of income to arise which otherwise would be liable to tax in the UK. This leads to a cost to the Exchequer.
> 3.48 A similar position used to arise for CGT. It was possible for individuals to leave the UK temporarily and realise capital gains in the period of non-residence and therefore be exempt from liability to UK tax on those gains. Legislation was enacted in Finance Act 1998 to counter such avoidance of CGT.
> 3.49 Introducing a statutory definition will make it clearer when a person is tax resident or not resident in the UK. This could enable those who want to avoid liability on substantial amounts of income to plan short periods of temporary non-residence with more certainty.
> 3.50 The SRT rules will therefore need to counteract the risk of individuals creating artificial short periods of non-residence, during which they receive a large amount of income (which accrued during periods of UK residence) free of UK tax and then bring the income back into the UK tax-free. This activity would undermine the effectiveness of an SRT (?) and present an unacceptable risk to the Exchequer.[5]

9.2.3 *Remittance by temporary non-resident*

In the absence of the TNR rules, a possible method of remitting RFI tax free would be as follows. Suppose an individual had RFI taxable on remittance (in this chapter called "**pre-departure income**").

The individual could become UK-law non-UK resident and remit the pre-departure income during a year of non-residence; in the following tax year they could become UK resident again. Thus relatively brief periods of UK-law non-residence offered the opportunity of tax-free remittances of pre-departure income.

The same applies for pre-departure gains but not for foreign earnings.[6]

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5 HM Treasury/HMRC, "Statutory Definition of Tax Residence" (June 2011) *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81588/consult_condoc_statutory_residence.pdf*

6 See 22.24 (Remittance when non-resident).

9.3 Statutory terminology

The TNR provisions share a common terminology. These are not taxes-act-wide definitions so they have to be repeated or incorporated by reference where used in other statutes in a TNR context.

9.3.1 *"Residence period"*

This term is devised to deal with full tax years and split years. Para 109 Sch 45 FA 2013 provides:

> In relation to an individual, a "residence period" is—
> (a) a tax year that, as respects the individual, is not a split year, or
> (b) the overseas part or the UK part of a tax year that, as respects the individual, is a split year.

9.3.2 *"Treaty non-resident"*

Para 112(3) Sch 45 FA 2013 provides:

> An individual is "Treaty[7] non-resident" at any time if at the time the individual falls to be regarded as resident in a country outside the UK for the purposes of double taxation arrangements[8] having effect at the time.

It might be clearer to say "treaty-resident in the foreign state" or "treaty non-UK resident".

9.3.3 *"Sole UK residence"*

Para 112 Sch 45 FA 2013 provides a commonsense definition:

> (1) An individual has "sole UK residence" for a residence period consisting of an entire tax year if—
> (a) the individual is resident in the UK for that year, and
> (b) there is no time in that year when the individual is Treaty non-resident.
> (2) An individual has "sole UK residence" for a residence period consisting of part of a split year if—
> (a) the residence period is the UK part of that year, and

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7 The legislation, I think rather oddly, uses a capital *T* in this expression.

8 Para 145 Sch 45 FA 2013 provides the standard definition:
"In this Schedule ... "double taxation arrangements" means arrangements that have effect under section 2(1) of TIOPA 2010".

(b) there is no time in that part of the year when the individual is Treaty non-resident.

Taxation gives this example:

> M leaves the UK 9 August 2015 to work in Ruritania.
> 2014/15 is a split year.
> The Ruritania tax year runs 1 Jan - 31 Dec. Under Ruritania tax law, M is resident in the calendar year 2015.
> Using the OECD model tie-breaker test, M is treaty-resident in Ruritania in the calendar year 2015.

The *Taxation* analysis is:

> Although the 2015/16 tax year is a split year, the period from 6 April 2015 to 8 August 2015 is not a period of sole UK residence because under the treaty he is resident in Ruritania during that period (Sch 1, para 101(2)(b)).
> M was also treaty non-resident in the UK from 1 January to 5 April 2015, which is part of the 2014/15 tax year. As a result, he does not have sole UK residence during that tax year either.

Is that right?

9.3.4 *"Period A"*

Para 110 Sch 45 FA 2013 provides:

> (1) An individual is to be regarded as "temporarily non-resident" if—
> (a) the individual has sole UK residence for a residence period,
> (b) immediately following that period (referred to as "period A"), one or more residence periods occur for which the individual does not have sole UK residence ...

"Period A" is the last pre-departure UK period. The label is not ideal, but I adopt it as it is easiest to follow the statutory terminology.

9.3.5 *"Temporary period of non-residence"*

Para 113 Sch 45 FA 2013 provides a commonsense definition:

> In relation to an individual, "the temporary period of non-residence" is the period between—
> (a) the end of period A, and
> (b) the start of the next residence period after period A for which the individual has sole UK residence.

9.3.6 *"Year of departure"*

Para 114 Sch 45 FA 2013 provides:

> "The year of departure" is the tax year consisting of or including period A.

9.3.7 *"Period of return" and "year of return"*

Para 115 Sch 45 FA 2013 provides:

> "The period of return" is the first residence period after period A for which the individual has sole UK residence.

Section 10A(11) TCGA provides:

> In this section ... "the year of return" means the tax year that consists of or includes the period of return.

9.4 "Temporarily non-resident"

"Temporarily non-resident" is a key term. The definition is slightly different from the pre-2013 TNR rules.

9.4.1 *Residence followed by non-residence*

Para 110 Sch 45 FA 2013 provides:

> (1) An individual is to be regarded as "temporarily non-resident" if—
> (a) the individual has sole UK residence for a residence period,
> (b) immediately following that period (referred to as "period A"), one or more residence periods occur for which the individual does not have sole UK residence ...

This sets the scene for what are essentially two conditions.

9.4.2 *4/7 UK resident years before departure*

Para 110 Sch 45 FA 2013 provides:

> (1) An individual is to be regarded as "temporarily non-resident" if...
> (c) at least 4 out of the 7 tax years immediately preceding the year of departure were either—
> (i) a tax year for which the individual had sole UK residence, or
> (ii) a split year that included a residence period for which the individual had sole UK residence,

I refer to this as **"the 4/7 UK years test"**.

9.4.3 *Temporary period of non-residence not above 5 years*

Para 110 Sch 45 FA 2013 provides:

> (1) An individual is to be regarded as "temporarily non-resident" if...
> (d) the temporary period of non-residence is 5 years or less.

RDR3 provides:

> 6.2... Note that, for the special rules to not apply, your period of temporary non-residence has to be for more than five years; it does not have to be for five complete tax years.

9.4.4 *Residence in years before 2013/14*

An individual whose year of departure is 2013/14 or later, and so who falls within the post-2013 TNR rules, may need to look at some pre-2013/14 years in order to apply the 4/7 UK years test, thus:

Year of Departure	Years for 4/7 year test	No. pre-2013/14 years
2013/14	2006/07 - 2012/13	7
2014/15	2007/08 - 2013/14	6
2015/16	2008/09 - 2014/15	5
2016/17	2009/10 - 2015/16	4
2017/18	2010/11 - 2016/17	3
2018/19	2011/12 - 2017/18	2
2019/20	2012/13 - 2018/19	1

Para 157 Sch 45 FA 2013 provides:

> (1) This paragraph applies in determining whether the test in paragraph 110(1)(c) is met in relation to a tax year before the tax year 2013-14 (a "pre-commencement tax year").

Two rules then follow:

> (2) Paragraph 110(1) is to have effect as if for paragraph (c) there were substituted—
> "(c) at least 4 out of the 7 tax years immediately preceding the year of departure was a tax year meeting the following conditions—
> (i) the individual was resident in the UK for that year, and
> (ii) there was no time in that year when the individual was Treaty non-resident (see paragraph 112(3)).".

This incorporates the pre-2013 TNR definition of temporarily non-resident. It is needed as the statutory split year concept did not apply

before 2013.

> (3) Whether an individual was resident in the UK for a pre-commencement tax year is to be determined in accordance with the rules in force for determining an individual's residence for that pre-commencement tax year (and not in accordance with the statutory residence test).

This applies the pre-2013 residence rules. One cannot elect to apply the SRT rules.

This transitional provision will at last become obsolete on 6 April 2020.

9.5 HMRC examples

RDR3 provides:

Example 42 (Max)
Max has had sole residence in the UK for the previous ten years. On 22 February 2015 Max moves to Poland and is considered resident there from this point, as well as retaining his UK residence up to the end of the tax year. From 22 February to 5 April 2015 he is treaty non-resident.
For the purpose of this example, Max does not satisfy the conditions for split year treatment in tax year 2014-15.
Max is not solely UK resident from 22 February 2015 but he will remain UK resident for the tax year. As this is not a split year, Period A will end at the end of the tax year 2013-14, because that is the end of the last tax year in which Max was solely UK resident. His year of departure for the purpose of applying the temporary non-resident provisions is therefore 2013-14, even though he actually physically left the UK on 22 February 2015. The next residence period begins on 6 April 2014 and Max will begin to be regarded as temporarily non-resident from this point.
Max returns on 26 May 2018 and split year treatment applies.
Max has sole UK residence from 26 May 2018. He is treaty resident for the UK part of the year. His temporary non-residence ends on 25 May 2018. The period of temporary non-residence is 6 April 2014 to 25 May 2018 inclusive, which is less than five years and so Max is within the scope of the temporary non-residence provisions.

Example 43 (Louis)
Louis moves to the UK on 9 January 2014, becoming resident here for 2013-14. He satisfies the conditions for split year treatment for 2013-14 and is treaty resident in the UK from arrival.
On 4 January 2017, Louis moves to the USA. He becomes a US tax resident and is not treaty resident in the UK from that point onwards. He satisfies the

conditions for split year treatment and his overseas part of the split year starts on 4 January 2017.
Louis returns to the UK on 9 March 2022 and split year treatment applies. He is treaty resident in the UK from the date of his return.
Louis meets the 'four out of seven' test for tax years immediately preceding his departure.

- 2013-14 was a split year which included a residence period for which Louis had sole UK residence
- 2014-15 and 2015-16 were full tax years for which he had sole UK residence
- 2016-17 was a tax year that included a residence period for which he had sole UK residence (6 April 2016 – 3 January 2017). This last period is period A.

Louis has more than one residence period immediately following period A in which he does not have sole UK residence. The first such period is 4 January 2017 – 5 April 2017 (the overseas part of the split year in the year of his departure).
By the time Louis returns he has been non-resident for more than five years (4 January 2017 to 8 March 2022), therefore he is not temporarily non-resident for the purposes of the statutory residence test. He does not need to be non-resident for five complete tax years in order to be outside the scope of the temporary non-residence provisions.

9.6 Gains and losses accruing in temporary period of non-residence

Section 10A TCGA provides:

> (1) This section applies if an individual ("the taxpayer") is temporarily non-resident.
> (2) The taxpayer is chargeable to capital gains tax as if gains and losses within subsection (3) were chargeable gains or, as the case may be, losses accruing to the taxpayer in the period of return.

I refer to gains within (3) as **"TNR gains"**.

9.6.1 *Ordinary gains/losses*

Section 10A TCGA provides:

> (3) The gains and losses within this subsection are—
> (a) chargeable gains and losses that accrued to the taxpayer in the temporary period of non-residence,

Section 10A(3)(a) works because gains are in principle chargeable gains even if they accrue to a non-resident.

Section 87 gains are TNR gains, within 10A(3)(a) TCGA as they are chargeable gains, treated as accruing to the beneficiary under s.87, even if the beneficiary is non-resident.

However, s.10A(3)(a) does not catch s.86 or s.13 gains, as gains under these sections do *not* accrue to a non-resident. The sections only apply to a settlor or participator who is UK resident. Hence the drafter extends s.10A(3) to catch these gains. It was not necessary to do this for s.87.

For the interaction with sch 4C TCGA, see 52.22.2 (Trust within s.87).

9.6.2 *Section 13 gains*

In the absence of express provision, s.13 gains would not be TNR gains. Section 10A TCGA provides:

> (3) The gains and losses within this subsection are ...
>
> (b) chargeable gains that would be treated under section 13 as having accrued to the taxpayer in that period if the residence assumption were made...
>
> (4) The residence assumption is—
>
> (a) that the taxpayer had been resident in the UK for the tax year in which the gain or loss accrued to the company, or
>
> (b) if that tax year was a split year as respects the taxpayer, that the gain or loss had accrued to the company in the UK part of it.

9.6.3 *Section 13 losses*

In the absence of express provision, s.13 losses of a temporary non-resident would not be within the TNR rules, and would not be allowable. Section 10A TCGA provides:

> (3) The gains and losses within this subsection are ...
>
> (c) losses that would be allowable in the taxpayer's case under section 13(8) in that period if that assumption [the residence assumption] were made ...

Section 10A(3)(c) is needed because s.13 losses do not accrue to participators or settlors who are non-resident.

Section 10A TCGA provides:

> (7) To determine the losses mentioned in subsection (3)(c)—
>
> (a) calculate separately, for each tax year falling wholly or partly in the temporary period of non-residence, the portion of sum A that does not exceed sum B, and
>
> (b) add up all those portions.

(8) For the purposes of subsection (7)—
"sum A" is the aggregate of the losses that were not available in accordance with section 13(8) for reducing gains accruing to the taxpayer by virtue of section 13 in the relevant tax year, but would have been available if the residence assumption had been made, and "sum B" is the amount of the gains that did not accrue to the taxpayer by virtue of section 13 in that tax year but would have so accrued if that assumption had been made.

Section 13 losses are limited to s.13 gains. This is consistent with the usual rule for s.13 losses: see 53.26 (Loss accruing to non-resident company).

Careful timing of disposals is necessary to ensure that s.13 losses are not wasted.

9.6.4 *Section 86 gains*

In the absence of express provision, s.86 gains would not be TNR gains. Section 10A TCGA provides:

(3) The gains and losses within this subsection are ...
(d) chargeable gains that would be treated under section 86 as having accrued to the taxpayer in a tax year falling wholly in that period if the taxpayer had been resident in the United Kingdom for that year.

9.6.5 *TNR gains remitted during period of temporary non-residence*

Section 10A TCGA provides:

(9) If section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the taxpayer for the year of return, any foreign chargeable gains[9] falling within subsection (3) by virtue of paragraph (a) of that subsection that were remitted to the UK at any time in the temporary period of non-residence are to be treated as remitted to the UK in the period of return.

What about s.13 gains within s.10A(3)(b)?

A foreign domiciled settlor is not within s.86, so no particular exemption is needed for s.86 TNR gains, which fall within s.10A(3)(d).

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9 Section 10A(11) incorporates the standard definition by reference: "In this section "foreign chargeable gains" has the meaning given by section 12(4)".

9.6.6 *Time limit for assessment*

Section 10AA TCGA provides:

> (5) Nothing in any enactment imposing any limit on the time within which an assessment to capital gains tax may be made prevents any assessment for the year of departure from being made in the taxpayer's case at any time before the end of the second anniversary of the 31 January next following the year of return (as defined in section 10A).

This copies the wording of the pre-2013 s.10A(7) TCGA, which was intended to deal with problems relating to the former ESC D2.[10] I do not think it is now needed, though it does no harm.

9.7 Gains subject to CGT on an arising basis

Section 10A TCGA provides:

> (5) But—
>
> (a) a gain is not within subsection (3) if, ignoring this section, the taxpayer is
>
> [i] chargeable to capital gains tax in respect of it
>
> [ii] (and could not cease to be so chargeable by making a claim under section 6 of TIOPA 2010), and
>
> (b) a loss is not within subsection (3) if the test in paragraph (a) would be met if it were a gain.

Para [i] sensibly disapplies the TNR rules where the temporarily non-resident individual is already subject to CGT. That may be:

(1) If the individual is UK-law UK resident and treaty non-UK resident but:
   (a) the treaty does not have a CG article.
   (b) the treaty CG article does not apply to the gain (eg UK land)
(2) If the individual is UK-law non-UK resident but carrying on a trade in the UK through a branch or agency. [11]

9.8 Post-departure acquisitions

Section 10AA(1) TCGA provides:

> (1) Section 10A(2) does not apply to a gain or loss accruing on the disposal by the taxpayer of an asset if—

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10 See 9A.10 (Time limit for assessment).

11 See 49.8 (Non-resident trader with UK branch).

Four conditions must be satisfied.

9.8.1 *Acquisition post-departure*

The first condition is:

> (a) the asset was acquired by the taxpayer in the temporary period of non-residence,

9.8.2 *Exclusion following no gain/no loss transfers*

The next condition is:

> (b) it was so acquired otherwise than by means of a relevant disposal that by virtue of section 58, 73 or 258(4) is treated as having been a disposal on which neither a gain nor a loss accrued,

The sections referred to are:
Section 58 TCGA (transfers between spouses),
Section 73 TCGA (death of life tenant),
Section 258(4) TCGA (works of art).
In practice the first of these is the most important.
Section 10AA(2) TCGA defines "relevant disposal":

> "Relevant disposal" means a disposal of an asset acquired by the person making the disposal at a time when that person was resident in the UK and was not Treaty non-resident.

The drafter not used the term "Sole non-residence"; I assume only because the term is defined in Sch 45 FA 2013 and incorporating a definition by reference was more trouble than it was worth.

The test focuses on when the asset was originally acquired. There is still scope for planning for assets acquired when non-resident. Eg:
(1) H acquires an asset when non-resident.
(2) H returns to the UK.
(3) H and W become temporarily non-resident.
If H disposes of the asset, the gain is a TNR gain and taxed on H's return to the UK. But if H gives it to W, the gain on the disposal by W qualifies for post-departure acquisition relief.

9.8.3 *Exclusion for settled property*

The next condition is:

(c) the asset is not an interest created by or arising under a settlement

This prevents an avoidance scheme under which T might acquire an interest under a settlement with relevant income or trust gains, and then sell the interest tax free.

9.8.4 *Exclusion following roll-over transfers*

The next condition is:

(d) the amount or value of the consideration for the acquisition of the asset by the taxpayer does not fall, by reference to any relevant disposal, to be treated as reduced under section 23(4)(b) or (5)(b), 152(1)(b), 153(1)(b), 162(3)(b) or 247(2)(b) or (3)(b).

The sections referred to are:
Section 23 TCGA (compensation and insurance)
Sections 152 and 153 TCGA (business assets roll-over relief),
Section 162 TCGA (transfer of business to a company)
Section 247 TCGA (compulsory acquisition).

9.8.5 *Exclusion following reorganisation, etc*

Section 10AA, TCGA provides:

(3) Subsection (1) does not apply if—
(a) the gain is one that (ignoring section 10A) would fall to be treated by virtue of section 116(10) or (11), 134 or 154(2) or (4) as accruing on the disposal of the whole or part of another asset, and
(b) that other asset meets the requirements of paragraphs (a) to (d) of subsection (1), but the asset in respect of which the gain actually accrued or would actually accrue does not.

The sections referred to are:
Section 116 TCGA (new asset is a qualifying corporate bond)
Section 134 TCGA (compensation stock)
Section 154 TCGA (depreciating assets)

9.8.6 *Interaction with share pooling rules*

The CIOT raise an interesting question:

Suppose an individual were to own 100 shares in a limited company. The individual becomes non-resident and, whilst non-resident,

> purchases in the market a further 200 shares (of the same class) in the same company.
> Whilst non-resident, the individual then disposes of the entire shareholding at a gain.
> Under TCGA 1992 section 10A, assets owned at the date of departure which are then disposed of whilst non-resident are treated as disposed of in the year of return if the individual is away for fewer than five tax years. Section 10A therefore catches the disposal of the 100 shares. The policy behind section 10A would not therefore seek to charge tax on any gain arising in respect of the 200 shares acquired, held and disposed of whilst the individual was non-resident. This would ordinarily be provided for by section 10A(3)(a). However, section 104 provides that shares (and other fungible assets) are treated as a single asset 'growing or diminishing' as the case may be. Therefore, it would appear that section 104 TCGA treats the 200 shares as if they were part of the same asset which previously consisted of only 100 shares. That asset is one that was held prior to the individual's departure (and therefore falls outside the exception for post-departure acquisitions.[12]

9.9 DTA override

Most DTAs with a capital gains article broadly adopt the OECD Model form:

> Gains from the alienation of any property, other than [specified exceptions] shall be taxable only in the Contracting State of which the alienator is a resident.

Gains accruing to an individual when treaty-resident in a foreign state (in the statutory terminology, treaty non-resident) would in principle qualify for this relief even if within the scope of s.10A. Section 10AA(4) TCGA provides a treaty override:

> Nothing in any double taxation relief arrangements is to be read as preventing the taxpayer from being chargeable to capital gains tax in respect of any chargeable gains treated under section 10A as accruing to the taxpayer in the period of return (or as preventing a charge to that tax from arising as a result).[13]

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12 *http://www.tax.org.uk/Resources/CIOT/Documents/2012/10/121011_s10A_CIOT.pdf*

13 I would be grateful to any reader who could explain why the words in brackets are needed.

This constitutes a breach of treaties in OECD Model form.[14] However the intention of Parliament is clear and that prevails over the treaty.[15]

9.9.1 *Foreign tax credit relief*

For the pre-2013 TNR rules, EN FB 2005 provided:

> The application of section 10A in relation to an individual does not prevent the individual obtaining relief for foreign tax paid in respect of chargeable gains which are treated as arising to him or her in the year of return.

The same should apply to the post-2013 rules.

9.10 Interaction of TNR rules and deadline for entrepreneurs' relief claim

The CGT liaison group (HMRC and the tax professional bodies) has issued a guidance note which provides:[16]

> **Technical tax analysis put forward for HMRC comment**
> 49 Under s.10A TCGA 1992 the gain will be treated as accruing to a taxpayer in the year of return. The view taken is that the original disposal date applies for ER purposes. As s.169M TCGA requires an election for ER to be made before the first anniversary of 31 January following the tax year in which the disposal takes place, it is likely that the individual will be out of time in making an ER claim if he waits until he has resumed UK residence. The advice is therefore to make a protective claim...
> **HMRC response ...**
> 51 ER is only available on the making of a claim and such claim must be made within the statutory time limit which is set by reference to the date of the qualifying disposal (see s.169M(3) TCGA 1992). It is for the taxpayer to consider whether to submit a protective claim for ER within this time period.

9.11 Interaction of s.86 TNR charge and s.87

In the absence of relief, gains accruing to the trustees during the settlor's

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14 This is recognised in some treaties, which have an additional provision specifically to authorise a s.10A charge (and any foreign state's equivalent). See 9.24 (Recent departure non-residence rules).

15 *Padmore (No 2) v IRC* 73 TC 470.

16 *http://www.tax.org.uk/Resources/CIOT/Documents/2012/02/120213%20ER%20Technical%20Questions%20and%20HMRC%20response.pdf*

period of temporary non-residence may be:

(1) s.86 gains of the settlor in the year of return, and

(2) s.2(2) amounts (trust gains) which may effectively be charged on beneficiaries of the settlement who receive capital payments.

Section 86A TCGA provides relief against double taxation

Section 86A TCGA provides:

> (1) Subsection (3) applies if—
>
> (a) chargeable gains of an amount equal to the amount referred to in section 86(1)(e) for a tax year ("year A") are treated under section 10A as accruing to a settlor under section 86 in the period of return,

"Year A" is one of the temporary non-resident years. The label is not ideal, but I adopt it as it is easiest to follow the statutory terminology.

> (b) there are amounts on which beneficiaries of the settlement are charged to tax under section 87 or 89(2) for one or more tax years, each of which is earlier than the year of return, and
>
> (c) those amounts are in respect of matched capital payments received by the beneficiaries.

It is considered that non-resident beneficiaries are not "charged to tax" unless they are temporary non-resident beneficiaries who have returned to the UK before the settlor's year of return. Remittance basis beneficiaries are "charged to tax" even if nothing is remitted.

> (2) A "matched" capital payment is a capital payment, all or part of which is matched under section 87A with the section 2(2) amount for year A.

9.11.1 *The reliefs*

There are three reliefs. Firstly, s.86A(3)(4) TCGA provides s.87 gains charged to tax are deducted from the settlor's s.86 gains:

> (3) The amount of the chargeable gains mentioned in subsection (1)(a) for year A that are treated under section 10A as accruing to the settlor under section 86 in the period of return is to be reduced by the appropriate amount.
>
> (4) The appropriate amount is—
>
> (a) the sum of the amounts mentioned in subsection (1)(c) to the extent that the matched capital payments are matched under section 87A with the section 2(2) amount for year A, or

(b) if the property comprised in the settlement has at any time included property not originating from the settlor, so much (if any) of that sum as, on a just and reasonable apportionment, is properly referable to the settlor.

Section 86 gains which are brought into charge are deducted from s.2(2) amounts. That follows the usual rule in s.87(4)(b) TCGA.[17] The legislation has separate rules for the year of return and for earlier years (why?). Section 86A(5) deals with the year of return:

(5) If a reduction falls to be made under subsection (3) for the year of return, the deduction to be made in accordance with section 87(4)(b) for the settlement for that year must not be made until—

(a) all the reductions to be made under subsection (3) for that year for each settlor have been made, and

(b) those reductions are to be made starting with the year immediately preceding the year of return and working backwards.

Lastly, s.86A(6)(7) deals with the earlier years:

(6) Subsection (7) applies if, with respect to year A, an amount remains to be treated under section 10A as accruing to any of the settlors in the period of return after having made the reductions under subsection (3) with respect to year A.

(7) The aggregate of the amounts remaining to be so treated (for all of the settlors) is to be applied in reducing so much of the section 2(2) amount for year A as has not already been matched with a capital payment under section 87A for any year prior to the year of return (but not so as to reduce the section 2(2) amount below zero).

Section 86A(8) TCGA provides definitions needed for a trust with multiple settlors:

(8) In this section—

(a) "the settlement" means the settlement in relation to which the settlor mentioned in subsection (1)(a) is a settlor,

(b) a reference to "the settlors" or "each settlor" is to the settlors or each settlor in relation to the settlement,

(c) "period of return" and "year of return" have the same meanings as in section 10A, and

17 See 51.5.2 (Section 86 gains deducted from s.2(2) amount).

(d) paragraph 8 of Schedule 5 applies in construing the reference to property originating from the settlor.

9.12 TNR dividend provisions: introduction

The position can be summarised in a table:

Section	Income type: Relief affected	TNR term
UK dividends		
401C ITTOIA	dividend/distribution: DT relief	Relevant distribution
413A ITTOIA	stock dividend- *not discussed here*	Relevant stock dividend income
420 ITTOIA	debt write-off- *not discussed here*	
812A ITA	div/distrib'n: s.811 non-residents IT relief	TNR income (my terminology)
Foreign dividends		
408A ITTOIA	Foreign dividend	TNR income (my terminology)
689A ITTOIA	Foreign distribution	TNR income (my terminology)

I refer to the provisions together as the **"TNR dividend provisions**"

9.13 TNR dividend provisions: terminology

Some common terminology is used throughout the TNR dividend provisions.

9.13.1 *"Participator" and "associate"*

These terms have their standard meanings: s.401C(12) ITTOIA provides:

> In this section ...
> "associate" and "participator" have the same meanings as in Part 10 of CTA 2010 (see sections 448 and 454);

This definition only applies for s.401C but the same definition is repeated throughout the TNR dividend provision: see s.408A(4)(a), 689A(4)(a) ITTOIA

For discussion, see 85.5 (Associates); 85.17 (Definition of "Participator").

9.13.2 *"Material" participator*

Section 401C(12) ITTOIA provides:

> In this section ...
> "material participator" means a participator who has a material interest in the company, as defined in section 457 of CTA 2010;

That definition only applies for s.401C but the same definition is repeated throughout the TNR dividend provisions: see s.408A(4)(b), 689A(4)(b)

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Our journey takes us to s.457 CTA 2010, which provides:

> (1) A person has a material interest in a company for the purposes of section 456 if condition A or B is met.
> (2) Condition A is that the person (with or without one or more associates) or any associate of that person (with or without one or more other such associates) is—
> (a) the beneficial owner of, or
> (b) directly or indirectly able to control,
> more than 5% of the ordinary share capital of the company.
> (3) Condition B is that, in the case of a close company, the person (with or without one or more associates) or any associate of that person (with or without one or more other such associates) possesses or is entitled to acquire such rights as would—
> (a) in the event of the winding up of the company, or
> (b) in any other circumstances,
> give an entitlement to receive more than 5% of the assets which would then be available for distribution among the participators.

The net is cast wider than is necessary to deal with TNR avoidance. Contrast s.13 TCGA, which started with a 5% de minimis limit, later increased to 10% and now set at an appropriate 25%.

9.13.3 *"Relevant time"*

Section 401C(12) ITTOIA provides:

> In this section ...
> "relevant time" means—
> (a) any time in the year of departure or, if the year of departure is a split year as respects the individual, the UK part of that year, or
> (b) any time in one or more of the 3 tax years preceding that year;

That definition only applies for s.401C but the same definition is repeated throughout the TNR dividend provisions: see s.408A(4)(c), 689A(4)(c)

9.14 UK distributions: UK-law UK res./treaty non-res. (treaty users)

9.14.1 *"Relevant distribution" (TNR income)*

This is the key term. Section 401C(6) ITTOIA provides:

> For the purposes of this section, a dividend or other distribution is a "relevant distribution" if—

(a) it is a dividend or other distribution of a close company, and
(b) it is made or treated as made to the individual because the individual was at a relevant time—
    (i) a material participator in the company,...

9.14.2 *The causation test*

There are two requirements to satisfy condition (b)(i):

(1) The individual was a material participator in the company at a relevant time. That is relatively straightforward. If an individual only purchases shares after departure, the distribution on the shares is not a relevant distribution.
(2) The dividend was made to the individual *because* the individual was a material participator at the relevant time.

Requirement (2) is a causation test, and causation is not straightforward. Bramwell says:

> Take the most obvious case: a shareholder in a close company departs from the UK in Year 1 ("the year of departure") for a period of temporary non-residence.
> In Year 2 (a year of non-residence) a dividend is declared and paid on the shares he owned in the year of departure and which he continues to own.
> The issue is whether the income arises to him because he was a material participator in the company at "a relevant time" namely, at a time in the year of departure. In fact the income arises to him because he owns the shares when the dividend is declared in Year 2.[18]

It is correct that the income arises to the shareholder because they own shares in year 2 when the dividend is declared. But the reason they own shares in that year is that they held the shares in year 1 (the year of departure) and have retained them. The causation test ought to be applied in the context of the purpose of the provisions.[19] So in the context it is suggested that the causation condition in (6)(b)(i) is satisfied.

Similarly, if T holds shares before departure, and by a reorganisation becomes entitled to other shares, then a distribution on the other shares is

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18 Bramwell on Corporation Tax para E2.3.7A.

19 On causation, a large topic, the starting point is Hart and Honoré Causation in the Law, and Hoffmann's judgements in *Fairchild v Glenhaven* [2003] 1 AC 32 and *Chester v Afshar* [2005] 1 AC 134. In short: causation tests ought to be applied flexibly and in a manner sensitive to the context or purpose of the provisions.

in principle a relevant distribution.

What if T holds shares in the relevant period and:

(1) T sells those shares when non-resident and T repurchases shares in the same company; or

(2) T sells the shares to his spouse?

It is suggested that the causation condition is met if the arrangement is designed to avoid the rules.

One might have expected definition of relevant distribution to provide:

> A distribution is a relevant distribution if it arises in respect of shares held by the same person (or by a connected person) at any time in the relevant period.

That would be too wide: it would catch all cases where the individual had bought and sold and later bought the same shares in a four year period. the work involved in keeping track could be considerable. At the cost of some uncertainty, the causation wording allows some innocent arrangements to escape, and catches some arrangements designed to avoid the rules.

9.14.3 *Settlor-interested trusts*

The settlor of a settlor-interested trust is taxed on trust income but would not be caught by s.401C(6)(b)(i) as the settlor is not a participator. This is caught by s.401C(6)(b)(ii); it is necessary to read this in the context of the whole of subsection (6):

> (6) For the purposes of this section, a dividend or other distribution is a "relevant distribution" if—
>
> (a) it is a dividend or other distribution of a close company, and
>
> (b) it is made or treated as made to the individual because the individual was at a relevant time ...
>
> (ii) an associate of a material participator in the company.

This could apply to the settlor of a settlor-interested trust where the trustees are the material participator. The settlor is an associate of the trustees; it may in principle be said that the dividend is treated as made to the settlor because he was an associate so the causation condition in (6)(b)(ii) may be satisfied.

9.14.4 *The rule*

In the absence of a specific rule, a relevant distribution would qualify for

DT relief in the hands of a treaty user. Treaty relief is in art.10 OECD Model.[20] It is easier to follow if rewritten to specify which states is which, in the present context:

> 1. Dividends paid by a company which is a resident of a Contracting State [the UK] to a resident of the other [the foreign] Contracting State [may be taxed in that other [the foreign] State.
> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident [in the UK] and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other [the foreign] Contracting State, the tax so charged shall not exceed:
> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
> b) 15 per cent of the gross amount of the dividends in all other cases.

Equipped with the definition of relevant distribution, and with this DT relief in mind, we can at last turn to the TNR rule itself. Section 401C ITTOIA provides:

> (1) This section applies if—
> (a) an individual is temporarily non-resident,
> (b) a relevant distribution is made or treated as made to the individual in the temporary period of non-residence,
> (c) the tax year in which it is made or treated as made ("the distribution year") is a tax year for which the individual is UK resident, and
> (d) the amount of income tax charged on the distribution under this Chapter is less than it would have been if the existence of double taxation relief arrangements were disregarded.

The rules distinguish between the year of return and earlier temporary non-resident years. For the earlier non-resident years, s.401C ITTOIA provides:

> (2) Subsections (3) and (4) have effect in cases where the distribution year is not the year of return.
> (3) The total income (see Step 1 of the calculation in section 23 of ITA 2007) on which the individual is charged to income tax for the year of

20 See 20.7 (DT relief for dividend income).

return is to be increased by an amount equal to the amount on which tax would be charged under this Chapter in respect of the distribution disregarding any double taxation relief arrangements.
(4) But the notional UK tax[21] on that distribution is to be allowed as a credit against the individual's liability to income tax for the year of return under Step 6 of the calculation in section 23.

Does this work?

For the year of return, s.401C(5) ITTOIA provides:

> If the distribution year is the year of return, the tax charged under this Chapter in respect of the relevant distribution is to be charged and assessed without regard to the existence of double taxation relief arrangements.

Why is there a separate rule for the year of return?

9.15 Relief for post-departure trade profits

Section 401C(7) ITTOIA provides:

> But a dividend or other distribution within subsection (6) in the form of a cash dividend is not a "relevant distribution" to the extent that the dividend is paid in respect of post-departure trade profits.

The relief applies only to a cash dividend. It is difficult to see why, but perhaps it will not often matter.

9.15.1 *"Post-departure trade profits"*

Section 401C ITTOIA provides:

> (8) "Post-departure trade profits" are—
> (a) trade profits[22] of the close company arising in an accounting period that begins after the start of the temporary period of non-residence, and
> (b) so much of any trade profits of the close company arising in an accounting period that straddles the start of that temporary

21 Section 401C(10) ITTOIA provides: "The "notional UK tax" on the relevant distribution is so much of the income tax paid by the individual for the distribution year as is attributable on a just and reasonable basis to the relevant distribution." The tax is not "notional", it is payable.

22 Section 401C(12) ITTOIA provides: "In this section... "trade profits of the close company" means the profits of any trade carried on by the close company, as calculated in accordance with Part 3 of CTA 2009 (trading income)."

period as is attributable (on a just and reasonable basis) to a time after the start of that temporary period.

(9) The extent to which a dividend is paid in respect of post-departure trade profits is to be determined on a just and reasonable basis.

9.16 Foreign dividends received by temporary non-resident

Section 408A ITTOIA provides:

(1) This section applies if an individual is temporarily non-resident.

(2) Dividends within subsection (3) are to be treated for the purposes of this Chapter as if they were received by the individual, or as if the individual became entitled to them, in the period of return.

I refer to dividends within (3) as **"TNR dividends"**.

9.16.1 *TNR dividends*

Section 408A(3) ITTOIA provides:

A dividend is within this subsection if—

(a) the individual receives or becomes entitled to it in the temporary period of non-residence,

(b) it is a dividend of a company that would be a close company if the company were UK resident,

(c) the individual receives or becomes entitled to it by virtue of[23] being at a relevant time—

(i) a material participator in the company, or

(ii) an associate of a material participator in the company, and

(d) ignoring this section, the individual—

(i) is not liable for tax under this Chapter in respect of the dividend, but

(ii) would have been so liable if the individual had received the dividend, or become entitled to it, in the period of return.

Section 408A(4) ITTOIA provides:

For the purposes of subsection (3) ...

(d) paragraph (d)(i) includes a case where the individual could be relieved of liability on the making of a claim under section 6 of TIOPA 2010 (double taxation relief), even if no claim is in fact

23 The drafter has used "by virtue of" where s.401C used "because". I guess that the drafter started with the traditional legal language, and someone later remembered the plain legal English aspect, but did not reword the provisions consistently.

made.

9.16.2 *Foreign dividends remitted in period of temporary non-residence*

Section 408A(5) ITTOIA provides:

> If section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for the year of return, any dividend within subsection (3) that was remitted to the UK in the temporary period of non-residence is to be treated as remitted to the UK in the period of return.

This is the standard formula.

9.16.3 *Relief for post-departure trade profits*

Section 408A ITTOIA provides:

> (6) This section does not apply to a dividend within subsection (3) to the extent that it is paid in respect of post-departure trade profits.
> (7) "Post-departure trade profits" are—
> (a) trade profits of the company arising in an accounting period that begins after the start of the temporary period of non-residence, and
> (b) so much of any trade profits of the company arising in an accounting period that straddles the start of that temporary period as is attributable (on a just and reasonable basis) to a time after the start of that temporary period.
> (8) The extent to which a dividend is paid in respect of post-departure trade profits is to be determined on a just and reasonable basis.

This is the standard formula. Section 408A ITTOIA provides:

> (9) [This deals with interaction with SIP regime; not discussed here].
> (10) In this section—
> "remitted to the UK" has the meaning given in Chapter A1 of Part 14 of ITA 2007;
> "trade profits of the company" means the profits of any trade carried on by the company, as they would be calculated in accordance with Part 3 of CTA 2009 (trading income) if the company were UK resident."

9.17 Foreign distributions received by temporary non-resident

Section 689A ITTOIA provides:

> (1) This section applies if an individual is temporarily non-resident.
> (2) Distributions within subsection (3) are to be treated for the purposes of this Chapter as if they had been received by the individual, or as if the

individual had become entitled to them, in the period of return.

I refer to distributions within (3) as **"TNR distributions"**.

9.17.1 *TNR distributions*

Section 689A(3) ITTOIA provides:

> A distribution is within this subsection if—
> (a) the individual receives or becomes entitled to it in the temporary period of non-residence,
> (b) it is a distribution of a company
> [i] that is a close company or
> [ii] that would be a close company if the company were UK resident,
> (c) the individual receives or becomes entitled to the distribution by virtue of being at a relevant time—
> (i) a material participator in the company, or
> (ii) an associate of a material participator in the company, and
> (d) ignoring this section the individual-
> (i) is not liable for tax under this Chapter in respect of the distribution, but
> (ii) would have been so liable if the individual had received the distribution, or become entitled to it, in the period of return.

At first sight the reference in (b)[i] to a distribution of a *close* company is odd. The individual will always be liable to tax in respect of the distribution,[24] so the condition in (d)(i) will never be satisfied. The answer is in s.689A(4) ITTOIA provides:

> For the purposes of subsection ...
> (d) paragraph (d)(i) includes a case where the individual could be relieved of liability on the making of a claim under section 6 of TIOPA 2010 (double taxation relief), even if no claim is in fact made.

Treaty relief in OECD model form does not

9.17.2 *Distributions remitted during temporary period of non-residence*

Section 689A(5) ITTOIA provides:

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24 See 20.2 (Income from UK resident company).

If section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for the year of return, any distribution within subsection (3) that is relevant foreign income and is remitted to the UK in the temporary period of non-residence is to be treated as remitted to the UK in the period of return.

This is the standard formula: see 9.16.2 (Foreign dividends remitted during period of temporary non-residence).

9.18 Section 811 non-residents income tax relief

Section 812A ITA provides:

(1) This section applies if—
- (a) an individual is temporarily non-resident,
- (b) the individual's liability to income tax for a tax year is limited under section 811,
- (c) that tax year ("the non-resident year") falls within the temporary period of non-residence, and
- (d) the individual's income for that tax year includes relevant investment income.

(2) The total income (see Step 1 of the calculation in section 23) on which the individual is charged to income tax for the year of return is to be increased by an amount equal to the amount of that relevant investment income.

(3) But the notional UK tax on that relevant investment income is to be allowed as a credit against the individual's liability to income tax for the year of return under Step 6 of the calculation in section 23.

9.18.1 *"Relevant investment income"*

Section 812A ITA provides:

(4) Income is "relevant investment income" if—
- (a) it is chargeable under Chapter 3 or 5 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies and stock dividends from UK resident companies),
- (b) the distributing company is a close company, and
- (c) the income arises or is treated as arising to the individual because the individual was at a relevant time—
  - (i) a material participator in that company, or
  - (ii) an associate of a material participator in the company.

9.18.2 *Relief for post-departure trade profits*

Section 812A ITA provides:

(5) But income within subsection (4) in the form of a cash or stock dividend is not "relevant investment income" to the extent that the dividend is paid, or the share capital is issued, in respect of post-departure trade profits.

(6) "Post-departure trade profits" are—

(a) trade profits of the distributing company arising in an accounting period that begins after the start of the temporary period of non-residence, and

(b) so much of any trade profits of the distributing company arising in an accounting period that straddles the start of that temporary period as is attributable (on a just and reasonable basis) to a time after the start of that temporary period.

(7) The "notional UK tax" on relevant investment income is—

(a) the total of any sums in respect of that income that were included within amount A in determining the limit under section 811, less

(b) any credit for foreign tax paid in respect of that income that was allowed under Chapter 2 of Part 2 of TIOPA 2010 against the individual's liability to income tax for the non-resident year.

(8) The following matters are to be determined on a just and reasonable basis—

(a) the extent to which a dividend is paid, or share capital is issued, in respect of post-departure trade profits, and

(b) the extent to which a sum included within amount A is a sum in respect of relevant investment income.

(9) Nothing in any double taxation arrangements is to be read as preventing the individual from being chargeable to income tax by virtue of this section (or as preventing a charge to that tax from arising as a result)...

9.19 Gains from policies and contracts

Section 465B ITTOIA provides:

(1) This section applies if an individual is temporarily non-resident.

(2) The individual is liable for tax under this Chapter for the year of return in respect of any gain that meets the conditions in subsection (3).

(3) The conditions are—

(a) the gain arose in the temporary period of non-residence,

(b) it arose from a policy issued in respect of an insurance made, or from a contract made, before the start of that period,

(c) the chargeable event giving rise to it was neither a death nor a chargeable event treated as occurring under section 525(2),

(d) no-one is liable under section 466 or 467 in respect of the gain,
(e) no-one is liable by virtue of section 468 for either the year of return or an earlier tax year as a result of the gain, and
(f) the individual would have been liable under section 465 in respect of the gain, applying the assumptions in subsection (4).

(4) The assumptions are—
(a) the individual was UK resident for the tax year in which the gain arose, and
(b) that tax year was not a split year as respects the individual.

(5) If the individual is liable by virtue of subsection (2) in respect of a gain—
(a) the amount of the gain in respect of which he or she is liable is the amount on which tax would have been charged under this Chapter applying the assumptions in subsection (4), but
(b) in determining that amount, section 528 must be applied ignoring those assumptions.

(6) That amount is treated as income of the individual for the year of return.

(7) If the gain arises from a policy or contract treated under section 473A as a single policy or contract, the date, for the purposes of subsection (3)(b), on which the insurance or contract is made is the date on which the first insurance is made in respect of which the connected policies were issued or, as the case may be, the date on which the first of the connected contracts is made.

(8) This section does not apply to a gain if—
(a) in relation to the policy or contract from which the gain arises, a terminal event occurs in the temporary period of non-residence or in the period of return,
(b) the chargeable event giving rise to the gain occurred before that terminal event,
(c) the chargeable event giving rise to the gain is one that is treated as occurring under section 509(1) as a result of the application of section 498(1)(a),
(d) section 498(1)(a) applies other than by virtue of section 500, and
(e) a person (whether or not the individual) is liable for tax under this Chapter (including by virtue of this section) in respect of any gain resulting from the terminal event.

9.19.1 *DT relief overridden*

Section 465B ITTOIA provides:

(9) Nothing in any double taxation relief arrangements is to be read as

preventing the individual from being liable for tax under this Chapter in respect of any gain in respect of which the individual is liable for tax by virtue of subsection (2) (or as preventing a charge to tax on that gain from arising under this Chapter).
(11) In this section—
"terminal event" means an event mentioned in section 499(3);...

9.20 Offshore funds

The regulations were rewritten by the Temporary Non-Residence (Miscellaneous Amendments) Regulations 2013.

Regulation 2 of these regulations provides:

2. The amendments made...
(b) by regulation 4 have effect for the purposes of income tax for the tax year 2013-14 or any subsequent tax year.

This is unlike the FA 2013 commencement rule, which only applies if the *year of departure* is 2013/14 or later.[25] The new offshore fund rules apply to OIGs from 2013/14 regardless of the year of departure.

Regulation 23 OFTR provides:

(1) This regulation applies where an individual ("the taxpayer") is temporarily non-resident.
(2) The taxpayer is chargeable to income tax as if offshore income gains within paragraph (3) were offshore income gains arising to the taxpayer in the period of return.

I refer to OIGs within (3) as **"TNR OIGs"**.

9.20.1 *TNR OIGs*

Regulation 23 OFTR provides:

(3) The offshore income gains within this paragraph are those that—
(a) arise to the taxpayer in the temporary period of non-residence, and
(b) would be treated under section 13 of TCGA 1992 (attribution of gains to members of non-resident companies) as it applies to offshore income gains by virtue of regulation 24 as having arisen to the taxpayer in that period if the residence assumption were made.
(4) The residence assumption is—

25 See 9.1 (Temporary non-residence – Introduction).

(a) that the taxpayer had been resident in the UK for the tax year in which the offshore income gain arose to the company, or
(b) if that tax year was a split year as respects the taxpayer, that offshore income gain had arisen to the company in the UK part of it.

This is the same as s.10A TCGA, except (consistently with the OIG regime) there is no relief for losses and no provision dealing with s.86.

9.20.2 *OIGs of non-residents subject to CGT on an arising basis*

Regulation 23 OFTR provides:

> (5) But a gain is not within paragraph (3) if, ignoring this regulation, the taxpayer is chargeable to income tax in respect of it (and could not cease to be so chargeable by making a claim under section 6 of the Taxation (International and Other Provisions) Act 2010).

This sensibly disapplies the TNR rules where the temporarily non-resident individual is already subject to IT on the OIG. That may be:
(1) If the individual is UK-law UK resident and treaty-resident in a state whose treaty does not have an article giving relief from OIGs.
(2) If the individual is UK-law non-UK resident but carrying on a trade in the UK through a branch or agency. [26]

9.20.3 *TNR OIGs remitted during period of temporary non-residence*

Regulation 23 OFTR provides:

> (7) If section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the taxpayer for the year of return, any offshore income gains to which regulation 19(2) applies falling within paragraph (3) of this regulation by virtue of sub-paragraph (a) of that paragraph that were remitted to the UK at any time in the temporary period of non-residence are to be treated as remitted to the UK in the period of return.

What about gains within reg 23(3)(b)?

9.20.4 *Post-departure acquisitions*

Regulation 23A(1) OFTR deals with post-departure acquisitions:

> (1) Regulation 23(2) does not apply to an offshore income gain accruing

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26 This is only theoretical: see 35.9 (OIG non-residence defence).

on the disposal by the taxpayer of an asset if –

(a) the asset was acquired by the taxpayer in the temporary period of non-residence,

(b) it was so acquired otherwise than by means of a relevant disposal[27] that by virtue of section 58, 73 or 258(4) TCGA 1992 is treated as having been a disposal on which neither a gain nor a loss accrued, and

(c) the asset is not an interest created by or arising under a settlement.

See 9.8 (Post-departure acquisitions).

9.20.5 *DTA override*

Regulation 23A(2) OFTR provides the DTA override:

> (2) Nothing in any double taxation relief arrangements is to be read as preventing the taxpayer from being chargeable to income tax in respect of any offshore income gains treated under regulation 23 as accruing to the taxpayer in the period of return (or as preventing a charge to that tax from arising as a result).

See 9.9 (DTA override).

9.20.6 *Time limit for assessment*

Regulation 23A(3) provides the (unnecessary) time extension for assessment:

> (3) Nothing in any enactment imposing any limit on the time within which an assessment to income tax may be made prevents any assessment for the year of departure from being made in the taxpayer's case at any time before the end of the second anniversary of the 31 January next following the year of return.

See 9.6.6 (Time limit for assessment).

9.21 Income not caught by TNR rules

The following types of income arising during the temporary period of non-residence are not caught by TNR rules

(1) Income of discretionary trusts (annual payments)

(2) Section 720 income (transferors)

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27 Defined by reference in reg 23A(4) "In this regulation (a) "relevant disposal" has the meaning given in section 10AA(2) of TCGA 1992".

(3) discretionary trust income

In the case of a settlor-interested trust, UK source dividend income would be caught, but other types of income would not be.

It would be bold to plan on this continuing to be the position in the future.

9.22 Pre-departure income

Section 832A ITTOIA provides:

> (1) This section applies if an individual is temporarily non-resident.
> (2) Treat any of the individual's relevant foreign income within subsection (3) that is remitted to the UK in the temporary period of non-residence as remitted to the United Kingdom in the period of return.

I refer to income within (3) as **"pre-departure RFI"**.

9.22.1 *Pre-departure RFI*

Section 832A ITTOIA provides:

> (3) Relevant foreign income is within this subsection if—
> (a) it is relevant foreign income for the UK part of the year of departure or an earlier tax year, and
> (b) section 832 applies to it.

So we need to refer back to s.832(1) ITTOIA:

> This section applies to an individual's relevant foreign income for a tax year ("the relevant foreign income") if section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year.

This is intended to apply to a temporary non-resident who is UK-law non-UK resident and remits pre-departure RFI[28] during the temporary period of non-residence.

It is not needed where a temporary non-resident is UK resident and domestic law non-resident and remits pre-departure RFI during the temporary period of non-residence, as treaties do not provide relief in this

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28 That is, RFI which:
(1) is taxed on a remittance basis, ie accruing to a remittance basis taxpayer while the individual was UK resident; and
(2) which was not remitted prior to departure (so was not subject to tax before departure).

situation, so tax planning of this kind was not possible. Nevertheless s.832A does apply in this case.

The drafter may perhaps have thought that this planning was possible, or may have introduced the rule unintentionally by copying across in s.832A the s.10A TCGA rules which were designed for a different situation.

Income arising after the year of departure is not caught by this section. What about pre-ITTOIA income to which s.832 does not apply?

9.22.2 *Just and reasonable apportionment*

Section 832A ITTOIA provides:

> (4) Any apportionment required for the purposes of subsection (3)(a) is to be done on a just and reasonable basis.

9.22.3 *DTA override*

Section 832A ITTOIA provides:

> (5) Nothing in any double taxation relief arrangements is to be read as preventing the individual from being chargeable to income tax in respect of any relevant foreign income treated by virtue of this section as remitted to the UK in the period of return (or as preventing a charge to that tax from arising as a result).

This is based on a misconception that DT relief may apply in this case.

9.22.4 *HMRC examples*

RDR3 gives a straightforward example:

Example 46 (Marie)
Marie returned to the UK during the tax year 2018–19 after a period of residence abroad.
She originally left the UK to become resident abroad on 2 September 2013 (end of period A) and so her year of departure was 2013–14. She had been resident in the UK for the seven years before her departure and claimed the remittance basis in those years.
While Marie was resident abroad she remitted to the UK the following relevant foreign income (RFI):
- £15,000 RFI from 2009–10 remitted in 2014–15
- £18,000 RFI from 2010–11 remitted in 2014–15
- £18,000 RFI from 2011–12 remitted in 2015–16
- £20,000 RFI from 2012–13 remitted in 2016–17

Total £71,000

As she was not resident in the UK, this income was not taxed when remitted here.

On her return to the UK on 1 June 2018 (the beginning of the UK part of split year 2018-19), Marie is within the special rules because her period of temporary non-residence was less than five years. She will be liable to UK tax on these earlier remittances which took place when she was temporarily non-resident. They will be chargeable to UK tax in 2018-19, the tax year of her return.

9.23 Pre-departure gains

What is the position if a temporary non-resident remits pre-departure gains to the UK (ie gains which accrued when solely UK resident)? Section 12 TCGA provides:

> (1) This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if—
>
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
>
> (b) the individual is not domiciled in the United Kingdom in that year.
>
> (2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the United Kingdom.

The gains are deemed to accrue when remitted. This deeming then brings into effect s.10A TCGA:

> (1) This section applies if an individual ("the taxpayer") is temporarily non-resident.
>
> (2) The taxpayer is chargeable to capital gains tax as if gains and losses within subsection (3) were chargeable gains ... accruing to the taxpayer in the period of return.
>
> (3) The gains and losses within this subsection are—
>
> (a) chargeable gains ... that accrued to the taxpayer in the temporary period of non-residence,

The pre-departure gains did not accrue to the taxpayer in the temporary period of non-residence, but they are deemed to have done so, so they are further deemed to accrue in the year of return.

9.24 Recent departure non-resident rules

Some DTAs impose a short-term non-residence rule in their CGT article.

This is not in the OECD model treaty, but about one third of UK treaties have a restriction of this kind.

Treaties are easier to follow if one notes in the text which contracting state is which. A variety of wordings are used and Italy will serve as an example. We are considering a claim for UK CGT relief by a person treaty resident in Italy. Article 13 of the UK/Italy DTA provides:

> (4) Gains from the alienation of any property other than that referred to in the preceding paragraphs of this Article shall be taxable only in the Contracting State of which the alienator is a resident [Italy]

This is (more or less) the OECD model form; the restriction then follows:

> (5) The provisions of paragraph (4) of this Article shall not affect the right of a Contracting State [UK] to levy according to its law a tax on gains from the alienation of any property derived by an individual who:
>
> (a) is a resident of the other Contracting State [Italy]; and
>
> (b) has been a resident of the first-mentioned Contracting State [UK] at any time during the five years immediately preceding the alienation of the property; and
>
> (c) is not subject to tax on those gains in the other Contracting State [Italy]

This is not strictly a *temporary* non-residence rule as it applies to those who do not return to the UK, but the idea is similar.

The IHT s.267 deemed domicile rule can be considered in part a similar short term non-residence rule, since its effect is that a person who ceases to be UK resident (or domiciled) continues for a 3 or 4 year period to be regarded as UK domiciled for IHT purposes and so within the scope of IHT.

9.25 Planning

There is scope for planning for types of income not caught by the TNR rules. For instance, payments of up front interest may be possible.

Remittance basis taxpayers must take care not to mix foreign income/gains of the non-resident period with other sums which can be remitted tax free.

Careful timing is needed for gifts to charity: normally avoid gifts during the period of temporary non-residence, and defer them to the year of return. Likewise for other IT reliefs.

The conditions allow (indeed invite) tax planning by arranging that the period of non-residence is more than five years.

9.26 TNR rules: commentary

The TNR rules are aimed at taxpayers who deliberately accrue or remit income or gains in years of temporary non-residence.[29] But the rules apply regardless of whether the individual intended to reduce UK tax.

The TNR rules work unfairly in that they bunch income and gains of up to four years into the year of return, so:

(1) Lower rate taxpayers may fall into the higher or additional rates of tax.

(2) Personal allowances and annual exemptions of non-resident years are lost.

Before 2013, this was unfair but perhaps not grievously so, as the amounts involved were not so significant, and bunching is always a possible downside of the remittance basis. Following the extension of the TNR rules in 2013, the unfairness has increased considerably. A motive test would be difficult to operate and an averaging rule would be impractical. However the unfairness is not difficult to resolve. The TNR rules should not apply to TNR income/gains if the rate of foreign tax is, say, at least 50% of the UK rate. If that exclusion does not apply, there should be a *de minimis* exclusion, say, twice the IT personal allowance/ CGT annual exemption for each year of non-residence. That would target the rules at those at whom they are aimed.

9.26.1 *EU law compliance*

The rules can give rise to an exit charge and where the charge arises on ceasing to reside in an EU member state, it is an interesting question whether the charge is EU law compliant.

29 See 9.2 (Purpose of the temporary non-residence rules).

CHAPTER 9A

TEMPORARY NON-RESIDENCE: PRE-2013 DEPARTURES

9A.1 Temporary non-residence: Introduction

This chapter discusses the pre-2013 TNR rules, which apply where an individual's year of departure was before 2013/14. For an introduction to the topic, and residence terminology, see 9.1 (Temporary non-residence – Introduction).

Para 158 sch 45 FA 2013 provides:

> (1) The existing temporary non-resident provisions, as in force immediately before the day on which this Act is passed, continue to have effect on and after that day in any case where the year of departure (as defined in Part 4 of this Schedule) is a tax year before the tax year 2013-14...
>
> (3) The existing temporary non-resident provisions are—
>
> (a) section 10A of TCGA 1992 (chargeable gains),
>
> (b) section 576A of ITEPA 2003 (income withdrawals under certain foreign pensions),
>
> (c) section 579CA of that Act (Income withdrawals under registered pension schemes), and
>
> (d) section 832A of ITTOIA (relevant foreign income charged on remittance basis).

9A.1.1 *Residence in years before 2013/14*

A person whose year of departure is 2013/14 or later, and so who falls within the rules discussed in this chapter, may still need to look at some pre 2013/14 years in order to apply the 4/7 years part of the test. Para 158 sch 45 FA 2013 provides:

> (2) Where those provisions continue to have effect by virtue of sub-paragraph (1)—
>
> (a) the question of whether a person is or is not resident in the UK

for the tax year 2013-14 or a subsequent tax year is to be determined for the purposes of those provisions in accordance with Part 1 of this Schedule, but

(b) the effect of Part 3 is to be ignored.

This is the same as the post-2013 TNR rule: see 9.4.4 (Residence in years before 2013/14).

9A.2 Temporary non-resident conditions

Section 10A TCGA sets out four conditions which must all be satisfied if the section is to take effect. I refer to these as the "**TNR conditions**". Section 10A(1) TCGA provides:

> This section applies in the case of any individual ("the taxpayer") if—
>
> (a) he satisfies the residence requirements for any year of assessment ("the year of return");
>
> (b) [i] he did not satisfy those requirements for one or more years of assessment immediately preceding the year of return but
>
> [ii] there are years of assessment before that year for which he did satisfy those requirements;[1]
>
> (c) there are fewer than five years of assessment falling between the year of departure and the year of return; and
>
> (d) four out of the seven years of assessment immediately preceding the year of departure are also years of assessment for each of which he satisfied those requirements.

Section 832A(1) ITTOIA is the same for IT.[2]

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1 Limb [ii] appears to be otiose, given para (d); but it does not matter.

2 Section 832A(1) ITTOIA provides:

"This section applies if—

(a) an individual satisfies the residence requirements for any tax year ("the year of return"),

(b) the individual did not satisfy those requirements for one or more tax years immediately before the year of return but did satisfy those requirements for an earlier tax year,

(c) there are fewer than 5 tax years between—

(i) the last tax year before the year of return for which the individual satisfied those requirements ('the year of departure'), and

(ii) the year of return, and

(d) the individual satisfied those requirements for at least 4 out of the 7 tax years immediately before the year of departure."

The legislation uses three defined terms with commonsense definitions:
(1) Year of departure.[3]
(2) Intervening year.[4]
(3) Year of return.[5]

9A.3 "Residence requirements"

"Residence requirements" is defined in s.10A(9) TCGA:

> For the purposes of this section an individual satisfies the residence requirements for a year of assessment—
>
> (a) if, during any part of that year of assessment, he is resident in the UK and not Treaty non-resident, or
>
> (b) if he is ordinarily resident in the UK during that year of assessment, unless he is Treaty non-resident during that year of assessment.

Section 832A(4) ITTOIA is the same for IT.[6]

One has to read s.10A(9) more than once, to assimilate the double negatives (s.832A(4) is better drafted), but the matter can be set out in a table:

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3 Section 10A(8) TCGA provides:
"'the year of departure' means the last year of assessment before the year of return for which the taxpayer satisfied the residence requirements."

4 Section 10A(8) TCGA provides:
"'intervening year' means any year of assessment which, in a case where the conditions in paras (a) to (d) of subsection (1) above are satisfied, falls between the year of departure and the year of return."
That is, an intervening year is one in which the temporary non-resident conditions are satisfied.

5 Defined in s.10A(1)(a) TCGA as the year in which the temporary non-resident again satisfies the residence requirements.

6 Section 832A(4) ITTOIA provides:
"For the purposes of subsection (1) an individual 'satisfies the residence requirements' for a tax year if—
(a) at any time in that year, the individual is UK resident and not Treaty non-resident, or
(b) the individual is ordinarily UK resident, and is not Treaty non-resident, for that year."

Resident	Ord Resident	Treaty non-res.	Resident Reqs met
Y	Non relevant	N	Y
Y	Non relevant	Y	N
Not relevant	Y	N	Y
Not relevant	Y	Y	N
N	N	Not relevant	N

Section 10A(9)(b) only applies to the theoretical case of a person who is non-resident but ordinarily resident.

9A.3.1 "*Treaty non-resident*"

"Treaty non-resident" is defined for CGT in s.288(7B) TCGA:

> For the purposes of this Act, a person is Treaty non-resident at any time if, at that time, he falls to be regarded as resident in a territory outside the UK for the purposes of double taxation relief arrangements having effect at that time.

Section 832A(5) is the same for IT.[7]

The key term is "double taxation relief arrangements" (here called "DTR arrangements").

9A.3.2 *"DTR arrangements": IT*

Section 832A(6) ITTOIA defines DTR arrangements for the purposes of the IT provision:

> In subsection (5) "double taxation relief arrangements" means arrangements which have effect under section 2(1) of TIOPA 2010.

9A.3.3 *"DTR arrangements": CGT*

Section 288(1) TCGA defines DTR arrangements for the purpose of CGT:

> "double taxation relief arrangements"—
>
> (a) in relation to a company[8] means arrangements that have effect under section 2(1) of TIOPA 2010 except so far as they have effect in relation to petroleum revenue tax, and

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7 Section 832A(5) ITTOIA provides:
"For the purposes of subsection (4) an individual is 'Treaty non-resident' at any time if, at that time, he is regarded as resident in a territory outside the UK for the purposes of double taxation relief arrangements having effect at that time."

8 Companies are not relevant to this chapter but one needs to read para (a) in order to follow para (b).

(b) in relation to any other person means arrangements that have effect under section 2(1) of TIOPA 2010 but only so far as they have effect in relation to capital gains tax;

This is different from the IT definition because the treaty needs to contain a CGT provision. For instance, the Jersey DTA counts as "DTR arrangements" for IT but not for CGT because it applies for IT but not for CGT.

9A.4 Gains and losses accruing in intervening years

Section 10A(2) TCGA sets out the consequence if the TNR conditions are met:

> Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if—
>
> (a) all the chargeable gains and losses which (apart from this subsection) would have accrued to him in an intervening year,
>
> (b) all the chargeable gains which under section 13 or 86 would be treated as having accrued to him in an intervening year if he had been resident in the UK throughout that intervening year ...[9]
>
> were gains or, as the case may be, losses accruing to the taxpayer in the year of return.

Para (a) works because gains accruing on disposals of assets by individuals are in principle chargeable gains even if the individual is non-resident. This needs to be supplemented by para (b) because s.13 gains and s.86 gains do not accrue to participators or settlors who are non-resident.

Section 10A(2) is a deeming provision. Gains which actually accrued in an intervening year are deemed to have accrued in the year of return. I refer to this as "**the s.10A(2) fiction**". Applying the s.10A(2) fiction the intervening year gains are in principle taxable in the year of return.

Losses can be carried back, ie losses accruing in a later intervening year can be set against gains accruing in an earlier intervening year.

9A.5 Interaction with remittance basis

For a remittance basis taxpayer there could be a conflict between two deeming rules:

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9 S.10A(2)(c) TCGA deals with losses of non-resident companies: see 9A.9.1 (Losses of non-resident company within s.13 TCGA).

(1) Section 12 TCGA (the CGT remittance basis) provides that gains are treated as accruing when remitted.
(2) The s.10A(2) fiction which provides that gains are treated as accruing in the year of return.

Section 10A(9ZA) TCGA provides:

> If—
>
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the taxpayer for the year of return, and
> (b) the taxpayer is not domiciled in the UK in that year,
>
> any foreign chargeable gains[10] falling within subsection (2)(a) which were remitted in an intervening year are treated as remitted in the year of return.

9A.5.1 *"Subsection (2)(a) gains"*

Section 10A(9ZA) only applies to gains "falling within subsection (2)(a)" that is:

> chargeable gains ... which (apart from subsection 2(a)) would have accrued to him in an intervening year,

That is, gains accruing in an intervening year and remitted in an intervening year: they are treated as accruing in the year of return, not when remitted. I refer to those as **"subsection (2)(a) gains"**. It is an interesting question how to treat gains accruing in an intervening year and not remitted until after the year of return.

I had previously considered that s.10A(9ZA) applied to pre-departure gains (foreign gains accruing while the individual was UK resident, ie gains before departure) which were remitted during an intervening year. However on reflection that does not appear to be the case because these are not subsection 2(a) gains.

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10 Section 10A(9ZA) adds: "For this purpose 'foreign chargeable gains' has the meaning given by section 12(4)." If there were a TCGA-wide definition this would not be necessary.

Suppose (1) an individual has a UK foreign currency account (2) the individual disposes of the account when temporarily resident abroad. The account is non-UK situate for CGT purposes; the gain is a foreign chargeable gain and is charged under the temporary non resident rules when the individual returns to the UK, but qualifies for the remittance basis.

9A.5.2 *Treaty users*

Section 10A(9B) TCGA provides:

> Where this section applies in the case of any individual in circumstances in which one or more intervening years would, but for his being Treaty non-resident during some or all of that year or those years, not be an intervening year, ...

That is a case of an individual who is UK-law UK resident but treaty non-resident (**"treaty-users"**).[11] The position of treaty users is different from individuals who are UK-law non-UK resident, since treaty-users are subject to CGT unless treaty relief applies.

Where no CGT treaty relief applies, there is no need for the TNR provisions, and the TNR rules should simply have been disapplied. Instead the rules are disapplied in part, in a complex manner, and the problems have not been fully thought through.

Section 10A(9B) makes four modifications to s.10A:

> this section shall have effect in the taxpayer's case—
>
> (a) as if subsection (2)(a) above did not apply in the case of any amount treated by virtue of section 87 or 89(2) as an amount of chargeable gains accruing to the taxpayer in any such intervening year,

Section 10A(9B)(a) disapplies the TNR rules for s.87 gains: such gains accrue in the year that the s.87 code provides (under the s.87 matching rules and s.87 remittance basis) and not in the year of return. This is sensible on the view (taken in this book) that such gains do not qualify for DT exemption.

Secondly:

> this section shall have effect in the taxpayer's case ...
>
> (b) as if any such intervening year were not an intervening year for the purposes of subsections (2)(b) and (c) and (6) above.

There are three amendments here. They are best considered separately.

To follow the first we need to refer back to s.10A(2)(b):

> Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if—
>
> (b) all the chargeable gains which under section 13 or 86 would

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11 See row 2 of the table in 9A.3 ("Residence requirements").

> be treated as having accrued to him in an intervening year if he had been resident in the UK throughout that intervening year ...
>
> were gains ...accruing to the taxpayer in the year of return.

Section 10A(9B)(b) disapplies the TNR rules for s.13 gains: such gains accrue in the year that the s.13 code provides (the year of accrual, subject to the s.13 remittance basis) and not in the year of return. Similarly, the subsection disapplies the TNR rules for s.86 deemed gains: such gains accrue in the year that s.86 provides (the year of accrual) and not in the year of return. This would be sensible on the view that s.13 gains and s.86 deemed gains do not qualify for DT exemption but in some cases they do.

The other amendments made by s.10A(9B)(b) concern s.10A(2)(c) and s.10A(6): these are consequential amendments relating to losses.[12]

What about gains of an individual who is UK-law UK resident, treaty non-resident, but which do not qualify for treaty relief (eg gains on a disposal of UK land)? They fall within the TNR rules, so the gain accrues in the year of disposal (and tax is paid) but it accrues instead in the year of return (and the former computation is revised, and tax paid or repaid accordingly).

9A.6 Pre-departure income

The drafting of s.832A was based on the existing s.10A which was designed for a different situation, resulting in anomalies.

The reader may wonder if the following planning was possible: suppose an individual remained UK-law UK resident but became treaty-resident in a state with a DTA conferring the necessary relief (ie "treaty non-resident"); the individual remitted the pre-departure income/gains while treaty non-resident. However treaties do not provide relief in this situation so planning of this kind was not possible. Nevertheless s.832A does apply in this case. The drafter may perhaps have thought that this planning was possible, or they may have introduced the rule unintentionally by copying across in s.832A the s.10A(2) rules which were designed for a different situation.

Section 832A(3) ITTOIA provides:

> Relevant foreign income is within this subsection if—

12 See 9A.9.1(Losses of non-resident company within s.13 TCGA).

(a) it is for the year of departure or any earlier tax year,[13] and
(b) section 832 applies to it.

In the following discussion I refer to such income as **"pre-departure income"**; in other words, that means RFI which:

(1) is taxed on a remittance basis, ie accruing to a remittance basis taxpayer while the individual was UK resident; and
(2) which was not remitted prior to departure (so was not subject to tax before departure).

Section 832A(2) ITTOIA sets out the taxation of pre-departure income if the TNR conditions are met:

> Treat any of the individual's relevant foreign income within subsection (3) which is remitted to the UK after the year of departure and before the year of return as remitted to the UK in the year of return.

Pre-departure income which is remitted during an intervening year is treated as remitted in the year of return. This makes sense for an individual who is UK-law non-UK resident during the intervening year. It makes no sense for someone who is UK-law UK resident but treaty non-resident, unless one takes the view that treaty relief is available on remitted income during the intervening year, which would not seem to be the case.

Income arising after the year of departure is not caught.

The RDR Manual provides a straightforward example. Omitting irrelevant detail (and rewriting slightly to enhance clarity) this provides:[14]

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13 "Any earlier year" would include a year in which a person was non-resident, but income of such a year is not relevant foreign income: see 10.3.1 (Relevant foreign income).

14 The example including its irrelevant detail in full is as follows:

32520 Temporary Non Residents: qualifying conditions [June 2010] *Example (Travis)*

T, a long-term UK resident has been a remittance basis user since 2000-01. He leaves the UK for a work secondment in January 2009 (2008-09) and is not resident in 2009-10 and 2010-11.

T returns to the UK in August 2011 and meets the residence requirements in s832A in 2011-12.

He has £6,000 of relevant foreign income from 2007-08, a year in which he had claimed the remittance basis under ITA07/s831. He also has £8,000 of relevant foreign income from 2008-09, a year in which he claimed the remittance basis under the new rules at ITA07/s809B.

In 2009-10 and 2010-11 he remits all of this relevant foreign income to the UK to

> T is UK resident in 2007-08 and 2008-09 and a remittance basis taxpayer in both years.
> T is non-resident in 2009-10 and 2010-11.
> T is UK resident again in 2011-12 and the temporary non residence conditions of s.832A ITTOIA are satisfied.
> He had £6,000 of unremitted relevant foreign income from 2007-08, and £8,000 of relevant foreign income from 2008-09.
> In 2009-10 and 2010-11 he remits all of this relevant foreign income to the UK.
> T will be taxed on £14,000 in 2011-12 (the 'year of return') in respect of his remittances of his relevant foreign income in the years of 'temporary non-residence'.

9A.6.1 *2008 transitional rules*

Para 83(4) Sch 7 FA 2008 provides:

> Nothing in section 832A of that Act applies in relation to anything remitted to the UK in the tax year 2007-08 or any earlier tax year.

Thus pre-2008 income is caught by the new rule if remitted after 2008/09. This retrospective rule is intentional. The RDR Manual provides a straightforward example of a case where transitional relief is available. Omitting irrelevant detail (and slightly rewriting for enhanced clarity) this provides:[15]

> J is non-resident in 2007-08 but meets the temporary non-residence

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meet certain ongoing UK financial commitments.
T will be taxed on £14,000 in 2011-12 (the 'year of return') in respect of his remittances of his relevant foreign income in the years of 'temporary non-residence'.

15 The example including its irrelevant detail in full is as follows:
31440 Relevant foreign income and the temporary non-residents rule [July 2010]
Example (Johan)
J is not-resident in 2007-08 but meets the residence requirements in s832A when he returns to the UK in 2008-09.
He has £6,000 of relevant foreign income from 2006-07, a year in which he was resident and had claimed the remittance basis under ITA07/s831.
In 2007-08 he remits all of this relevant foreign income to the UK to meet certain ongoing UK financial commitments.
This transitional provision means that J will not be taxed in 2008-09 (the 'year of return') in respect of this remittance of the £6,000 relevant foreign income from 2006-07, although all of the 'temporary non-resident' conditions at ITTOIA05/s832A are otherwise met.

conditions of s.832A when he returns to the UK in 2008-09.
He has unremitted relevant foreign income from 2006-07, a year in which he was resident and had claimed the remittance basis.
In 2007-08 he remits this relevant foreign income to the UK.
This transitional provision means that J will not be taxed in 2008-09 (the "year of return") in respect of this remittance of the RFI from 2006-07, although all of the 'temporary non-resident' conditions at s.832A ITTOIA are otherwise met.

9A.7 Interaction with double taxation relief

9A.7.1 *DT exemption*

Section 10A(9C) TCGA provides:

> Nothing in any double taxation relief arrangements shall be read as preventing the taxpayer from being chargeable to capital gains tax in respect of any of the chargeable gains treated by virtue of subsection (2)(a) above as accruing to the taxpayer in the year of return (or as preventing a charge to that tax from arising as a result).

The wording is the same in the post-2013 TNR rules: for a discussion see 9.7 (Interaction with DTAs).

9A.7.2 *Foreign tax credit relief*

EN FB 2005 provides:

> The application of section 10A in relation to an individual does not prevent the individual obtaining relief for foreign tax paid in respect of chargeable gains which are treated as arising to him or her in the year of return.

9A.8 Post-departure acquisitions

Section 10A(3) TCGA provides:

> Subject to subsection (4) below, the gains and losses which by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return shall not include any gain or loss accruing on the disposal by the taxpayer of any asset if—
>
> (a) that asset was acquired by the taxpayer at a time in the year of departure or any intervening year when—
>
> (i) he was neither resident nor ordinarily resident in the UK, or
>
> (ii) he was resident or ordinarily resident in the UK but was Treaty non-resident; ...

The CG Manual provides:

26230. Temporary non-residence: Gains or losses excluded from scope of s.10A [August 2011]

An individual may acquire assets after leaving the UK in a period of temporary residence abroad. If such assets are disposed of during the period of temporary non-residence, during an intervening year (see CG26155) any gains or losses on such assets are, in general, excluded from the scope of Section 10A, but see CG26240 which tells you about the exceptions to this general rule.

TCGA92/S10A(3)(a)

Section 10A(3)(a) provides that a gain or loss on an asset that was acquired after departure from the UK in either the tax year of departure or any of the intervening tax years when the taxpayer was not resident or not ordinarily resident* shall not be treated as chargeable in the tax year of return.

If the asset was acquired at a time when the taxpayer was resident or ordinarily resident* in the UK but was Treaty non-resident, any gain on that asset may fall within the scope of S10A. (This is only likely to apply to acquisitions after the date of departure up to the next 5 April).

You should note that the general exclusion of gains on assets acquired and disposed of during temporary non residence applies only to gains and losses which would otherwise be chargeable or allowable by virtue of TCGA92/S10A. Such gains or losses can only accrue in an intervening year.

Where assets are acquired after the date of departure and disposed of in the year of departure or year of return while the individual is not resident and not ordinarily resident the gains will be chargeable under TCGA92/S2 unless the concessionary treatment under ESCD2 is available to the individual, see CG26300+.

* For 2013-14 and later years ordinary residence does not need to be considered.

Example 1 (Mr Smith)

S who has lived all his life in the UK, leaves the UK on 10 July 2008 for a four year contract of employment abroad.

He resumes tax residence in the UK on 15 August 2012.

On 8 May 2009 S buys 20,000 shares in a UK Company. He sells all of the shares on 10 January 2011, realising a gain of £12,000.

S fulfils all of the conditions for Section 10A to apply, see CG26156, but because the shares were acquired after his departure from the UK the gain is not treated as chargeable in the year of return.

9A.8.1 *Exceptions to relief*

The CG Manual provides:

26240 Temporary non-residence: Exceptions to the exclusion from section 10A [April 2010]

Sometimes the exclusion from the scope of s.10A TCGA 1992 afforded to gains accruing during intervening years on assets acquired after departure from the UK is not appropriate. Some assets acquired by an

individual after departure in either the tax year of departure or any of the intervening tax years when the taxpayer was not resident or not ordinarily resident have a connection with the earlier period of residence. These exceptional assets fall under three headings (see below). Where they apply, any gains or losses on the disposal of the assets during intervening years are treated as chargeable in the tax year of return, that is to say they are within the scope of section 10A.

There are three categories of exceptions. Section 10A(3)(b) TCGA requires:

> (b) that asset was so acquired otherwise than by means of a relevant disposal which by virtue of section 58, 73 or 258(4) is treated as having been a disposal on which neither a gain nor a loss accrued;

The sections referred to are:
Section 58 TCGA (transfers between husband and wife or between civil partners),
Section 73 TCGA (death of life tenant),
Section 258(4) TCGA (works of art).

Section 10A(3)(c) TCGA requires:

> (c) that asset is not an interest created by or arising under a settlement;

This prevents an avoidance scheme under which T might acquire an interest under a settlement with relevant income or trust gains, and then sell the interest tax free.

Lastly, s.10A(3)(d) requires:

> (d) the amount or value of the consideration for the acquisition of that asset by the taxpayer does not fall, by reference to any relevant disposal, to be treated as reduced under section 23(4)(b) or (5)(b), 152(1)(b), 153(1)(b), 162(3)(b) or 247(2)(b) or (3)(b).

The sections referred to are:
Section 23(4)(b) and (5)(b) TCGA (compensation and insurance)
Section 152(1)(b) and s.153(1)(b) TCGA (business assets roll-over relief),
Section 162(3)(b) TCGA (transfer of business to a company)
Section 247(2)(b) and (3)(b) TCGA (compulsory acquisition).

The asset must be acquired "by the taxpayer". The CG Manual provides:

> **26231. Assets acquired by an offshore trust** [October 2013]
> The exclusion from charge, see CG26230, for assets acquired after the taxpayer's departure does not apply to assets acquired within an offshore trust, TCGA 1992, s.86 or TCGA 1992, s.87 or by a non-resident closely controlled

company, TCGA 1992, s.13.

26243. Arrival in and departure from UK: temporary non-residence: exceptions to the exclusion from section 10A: example – year of departure 2012-13 or earlier [October 2013]

Example (Mr and Mrs Brown)

Mr and Mrs B, who have lived in the UK all of their lives, leave the UK on 15 November 2009 for Mr B to take up a three year contract of employment abroad. They resume tax residence in the UK on 1 December 2012.

Mr B had acquired a property in the UK on 4 March 2002. On 12 June 2010, he gave the property to Mrs B. Mrs B sold the property on 10 March 2011 realising a gain of £100,000.

TCGA92/S58 applies to the gift by Mr B, so that for Capital Gains Tax purposes at the time of transfer neither gain nor loss arises. On the sale by Mrs B, the gain is treated as accruing in the year of return as she fulfils all of the conditions for TCGA92/S10A to apply, and the asset is not excluded from the scope of TCGA92/S10A (subsection (3)(b)).

Section 10A(4) TCGA provides:

Where—

(a) any chargeable gain that has accrued or would have accrued on the disposal of any asset ("the first asset") is a gain falling (apart from this section) to be treated by virtue of section 116(10) or (11), 134 or 154(2) or (4) as accruing on the disposal of the whole or any part of another asset, and

(b) the other asset is an asset falling within paras (a) to (d) of subsection (3) above but the first asset is not,

subsection (3) above shall not exclude that gain from the gains which by virtue of subsection (2) above are to be treated as accruing to the taxpayer in the year of return.

The CG Manual provides:

26250 Arrival in and departure from UK: temporary non-residence: held-over gains - year of departure 2012-13 or earlier [October 2013]

Sometimes a gain on disposal of an asset (the first asset) is 'held over' and not charged until another asset is disposed of. Where this happens under one of the provisions listed below then the gains which eventually accrue when the other asset is disposed of are not excluded from the scope of s.10A TCGA 1992 by subsection (3) of that section, where subsection (3) would otherwise apply because the other asset was within its scope (see CG26230 and CG26240). Note that for subsection (3) to be disapplied in this way, the first asset must not be within its scope.

Where s.10A(4) TCGA 1992 applies, a held-over gain which accrues on

a disposal in an intervening year when a taxpayer is not UK resident will be treated as accruing in the year of return to the UK, even if the asset which is disposed of was acquired after the taxpayer became non-resident, see CG26111.

The Capital Gains Tax 'hold-over' provisions to which this subsection refers are:

- s.116(10) TCGA 1992 or s.116(11) TCGA 1992 (where the new asset is a qualifying corporate bond), see CG53845+.
- s.134 TCGA 1992 (compensation stock), see CG55045+.
- s.154(2) TCGA 1992 or (4) (depreciating assets), see CG60370+.

Example (Mr Priestley)

Mr P goes to live in France for political reasons. As a result, he is not resident in the UK for the next three full years of assessment. During the first of those years he sells his shares in P Chemicals Ltd and receives qualifying corporate bonds issued by the purchaser, Davy Plc. In the following year he redeems the qualifying corporate bonds and receives cash.

Although he has actually disposed of his shares, s.116(10) TCGA 1992 applies and so he is treated for the purposes of TCGA 1992 as if he had not done so. Instead, a gain is computed as if he had disposed of the shares and that gain is 'held over' or 'frozen' until he disposes of the qualifying corporate bonds. Without the special provision at s.10A(4) TCGA 1992 the gain which accrued when the qualifying corporate bonds were disposed of would not be within the scope of section 10A because they are assets both acquired and disposed of whilst Mr P was not UK resident. Note that the first asset, the shares, is not within the scope of subsection (3) because it was acquired before Mr P left the UK: it is appropriate to bring the gain latent in those shares within the potential scope of s.10A even though the gain did not arise until some other asset was disposed of.

9A.9 Section 10A and non-resident trusts/companies

9A.9.1 *Losses of non-resident company within s.13 TCGA*

Section 10A provides:

> (2) Subject to the following provisions of this section and section 86A, the taxpayer shall be chargeable to CGT as if— ...
>
> (c) any losses which by virtue of section 13(8) would have been allowable in his case in any intervening year if he had been resident in the UK throughout that intervening year,
>
> were ... losses accruing to the taxpayer in the year of return. ...
>
> (6) The reference in subsection (2)(c) above to losses allowable in an

individual's case in an intervening year is a reference to only so much of the aggregate of the losses that would have been available in accordance with subsection (8) of section 13 for reducing gains accruing by virtue of that section to that individual in that year as does not exceed the amount of the gains that would have accrued to him in that year if it had been a year throughout which he was resident in the UK.

The CG Manual explains:

26201 Losses attributed to participators in non-resident companies [October 2013]
Losses on the disposal of an asset by a non-resident company are only attributed to a participator under s.13 TCGA 1992 in certain circumstances, s.13(8) TCGA 1992. A loss is attributed only if it will be set off against a gain attributed to the same person from the same company in the same year of assessment or against a gain made by another non-resident company which has been attributed to the taxpayer in the same year of assessment, see CG57250+, in particular, CG57295-CG57299.
Section 10A TCGA 1992 can apply to losses which are attributed to a UK resident participator under s.13 just as it applies to attributed gains, so that the losses are treated as accruing in the year the individual returns to the UK. However, the restriction to the attribution contained in s.13(8) TCGA 1992 has a parallel at s.10A(6) TCGA 1992, which restricts the amount of losses within the scope of s.10A to the amount which would be available under s.13, subsection (8) to set against attributed gains. Losses of a year in excess of the gains attributed in that year are not within the scope of section 10A.
26203. Temporary non-residence [April 2010]
Example (Mrs Adams)[16]

16 The example including all its irrelevant detail in full is as follows:
26203. – Losses [October 2013]
Example
Mrs. Adams, who has lived in the UK all of her life, leaves the UK on 1 September 2008 to take up a four year contract of employment abroad.
She resumes tax residence in the UK on 31 August 2012.
Mrs Adams has owned all of the shares in a company resident in Jersey for many years. The company owns a portfolio of shares and a number of properties. During Mrs Adams' period of non-residence the company makes a number of disposals. Gains and losses accrue as follows:
3 May 2009 gain £20,000 (year of assessment 2009-10)
23 October 2009 loss £ 5,000 (year of assessment 2009-10)
14 July 2010 loss £10,000 (year of assessment 2010-11)

The CG Manual provides an example where the facts (stripping out irrelevancies) are as follows:

> A is non-UK resident in 1999/00 - 2001/02 inclusive.
> A has owned all of the shares in a non-resident company. During A's period of non-residence gains and losses accrue to the company as follows:
> 1999/00 gain £20,000; loss £5,000
> 2000/01 loss £10,000
> 2001/02 gain £20,000
> The TNR conditions apply to A. Under Section 10A(2)(b) all the gains which would have been treated as accruing to A in the intervening years if she had been resident in those years are treated as accruing to her in the year of return. Losses are allowable to be set against gains of the same year of actual accrual.
> A is therefore chargeable in the year of return, 2002-2003 as follows
> - net gains of £15,000 (gain £20,000 less loss £5000) for 1999-2000
> - a gain of £20,000 for 2001-2002.
>
> The total gains chargeable are therefore £35,000.
> The loss arising in 2000-2001 is not allowable.

9A.9.2 *Temporarily non-resident beneficiaries: s.87 charge*

Section 10A TCGA does not mention s.87 TCGA. So at first sight it might seem that s.87 gains are not caught; but this is not the case. Section 10A(2)(a) TCGA applies to gains accruing to the individual on actual disposals. If a non-resident individual disposes of assets, chargeable gains do accrue to then (even though under s.2 TCGA they are outside the charge to CGT). Subsection (a) likewise applies if an individual receives

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> 4 September 2011 gain £20,000 (year of assessment 2011-12)
> Mrs Adams fulfils all of the conditions for Section 10A to apply, see CG26156. Under Section 10A(2)(b) all the gains which would have been treated as accruing to Mrs Adams in the intervening years if she had been resident in those years are treated as accruing to her in the year of return. Losses are attributed to her, and section 10A applies to them, to the extent that they may be set against gains attributed in the same year.
> Mrs Adams is therefore chargeable in the year of return, 2012-13 as follows
> * net gains of £15,000 (gain £20,000 less loss £5000) from 2009-10
> * a gain of £20,000 for 2011-12.
>
> The total gains chargeable are therefore £35,000.
> The loss arising in 2010-2011 is not allowable because no gains from that year were attributed to her.

a capital payment, as trust gains are treated as accruing to the beneficiary under s.87, even if they are non-resident. However, subsection (a) would not catch s.86 or s.13 gains, as gains under these sections do *not* accrue to a non-resident. The sections only apply to a UK resident settlor or participator. Hence the drafter correctly extends s.10A(2) by subsection (b), which applies ss.13 and 86 by deeming the taxpayer to be UK resident. It was not necessary to do this for s.87.

For the interaction with sch 4C TCGA, see 52.22.2 (Trust within s.87).

9A.9.3 *Temporarily non-resident settlor: s.86 charge*

CG Manual provides:

> **26220 – Attribution of gains to settlor** [February 2014]
> TCGA92/S86 provides that in certain cases a UK resident settlor of a non-resident settlement is assessed on the chargeable gains of the trustees, see CG38200+. Following the enactment of TCGA92/S10A a settlor who is temporarily resident outside the UK may also be assessed under Section 86 on gains realised by the trustees during his/her period of non-residence.
> However, all or part of the gains realised by the trustees during the settlor's period of temporary non-residence may already have been charged, under TCGA92/S87, to beneficiaries of the settlement who have received capital payments, see CG38210. TCGA92/S86A provides relief in this situation by excluding the gains charged to beneficiaries under Section 87 from the extended charge on the settlor under Section 86.
> Any case involving Section 86 or Section 86A is to be reported to Specialist PT Trusts and Estates in accordance with CG38200.

The last sentence tacitly acknowledges that s.86A is a difficult section. The amendments in 2008 have created a fine mess. I do not attempt to consider the transitional rules.

Section 86A(1) TCGA provides:

> (1) Subsection (2) below applies in the case of a person who is a settlor in relation to any settlement ("the relevant settlement") where—
> (a) by virtue of section 10A, amounts falling within section 86(1)(e) for any intervening year or years would (apart from this section) be treated as accruing to the settlor in the year of return; and
> (b) there is an excess of the relevant chargeable amounts for the non-residence period over the amount of the section 87 pool at the end of the year of departure.

"Relevant chargeable amounts" is defined in s.86A(3) TCGA:

> In subsection (1) above, the reference to the relevant chargeable amounts for the non-residence period is (subject to subsection (5) below) a reference to the aggregate of the amounts on which beneficiaries of the relevant settlement are charged to tax under section 87 or 89(2) for the intervening year or years in respect of any capital payments received by them.

"Section 87 pool" is defined in s.86A(4) TCGA:

> In subsection (1) above, the reference to the section 87 pool at the end of the year of departure is (subject to subsection (5) below) a reference to the amount (if any) which, *in accordance with subsection (2) of that section*, fell in relation to the relevant settlement to be carried forward from the year of departure to be included in the amount of the *trust gains* for the year of assessment immediately following the year of departure.

The definition of "s.87 pool" refers back to s.87(2) TCGA. That worked by reference to the original s.87(2) TCGA. Unfortunately s.87 was redrafted in 2008 and by reference to the current s.87(2) the italicised words make no sense. This can be seen by comparing the two provisions:

Original s.87(2):
(2) There shall be computed in respect of every year of assessment for which this section applies the amount on which the trustees would have been chargeable to tax under section 2(2) if they had been resident and ordinarily resident in the UK in the year; and that amount, together with the corresponding amount in respect of any earlier such year so far as not already treated under subsection (4) below or section 89(2) as chargeable gains accruing to beneficiaries under the settlement, is in this section and sections 89 and 90 referred to as the trust gains for the year.

Current s.87(2):
(2) Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement who has received a capital payment from the trustees in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under section 87A as it applies for the relevant tax year) with the section 2(2) amount for the relevant tax year or any earlier tax year.

The drafter in 2008 failed to notice that consequential amendments were needed here. Taken literally, therefore, the definition of "section 87 pool"

is nonsense and the amount of the s.87 pool should be zero. If one could adopt a position of sufficient indifference to statutory words, one might rewrite the section to say what Parliament would presumably have said, had the point been noticed, in which case the "section 87 pool" means s.2(2) amounts; though this really amounts to legislation and not construction.

Section 86A(5) deals with settlements with more than one settlor.[17]

Section 86A(6)(7) was intended to deal with the computation of trust gains, now s.2(2) amounts:

> Where any reduction falls to be made by virtue of subsection (2) above in any amount to be attributed in accordance with section 10A to any settlor for any year of assessment, the reduction to be treated as made for that year *in accordance with section 87(3)* in the case of the settlement in question shall not be made until—
>
> (a) the reduction (if any) falling to be made by virtue of that subsection has been made in the case of every settlor to whom any amount is so attributed; and
>
> (b) effect has been given to any reduction required to be made under subsection (7) below.

This provision refers to s.87(3) TCGA. That worked by reference to the original s.87(3) TCGA. Unfortunately s.87 was redrafted in 2008 and by reference to the current s.87(3) the italicised words again make no sense. The same problem affects s.86A(7)(8):

> Where in the case of any settlement there is (after the making of any reduction or reductions in accordance with subsection (2) above) any amount or amounts falling in accordance with section 10A to be attributed for any year of assessment to settlors of the settlement, the amount (or aggregate amount) falling in accordance with that section to be so attributed shall be applied in reducing the amount carried forward to that year in accordance with section 87(2).
>
> (8) Where an amount has been applied, in accordance with subsection (7)) above, in reducing the amount which in the case of any settlement is carried forward to any year in accordance with section 87(2), that

17 "Where the property comprised in the relevant settlement has at any time included property not originating from the settlor, only so much (if any) of any capital payment or amount carried forward in accordance with section 87(2) as, on a just and reasonable apportionment, is properly referable to property originating from the settlor shall be taken into account for the purposes of subsections (3) and (4) above."

> amount (or, as the case may be, so much of it as does not exceed the amount which it is applied in reducing) shall be deducted from the amount used for that year for making the reduction under section 87(3) in the case of that settlement.

Lastly, for completeness, s.86A(9) provides some referential definitions.[18]

For the interaction with sch 4B TCGA, see 52.22.1 (Trust within s.86 TCGA).

9A.10 Time limit for assessment

Section 10A(7) TCGA provides:

> Where this section applies in the case of any individual, nothing in any enactment imposing any limit on the time within which an assessment to capital gains tax may be made shall prevent any such assessment for the year of departure from being made in the taxpayer's case at any time before the end of two years after the 31st January next following the year of return.

The CG Manual provides:

> **26270. Assessment time limits** [October 2013]
> The normal assessment time limits apply where gains accruing in the intervening years are treated by virtue of TCGA92/S10A as assessable in the tax year of return to UK residence.
> Where, however, a gain accrues in the tax year of departure from the UK after the date of the departure, this gain should be assessed by virtue of TCGA92/S2 in the year of departure. ESC D2 will not apply in cases where TCGA92/S10A would apply to any gains accruing in intervening years, see CG26300. In these circumstances, to ensure there is sufficient time in which to assess such a gain, the time limit has been specifically extended where the individual satisfies the conditions of Section 10A TCGA 1992 (whether or not gains accrue which are chargeable under that section). (TCGA92/S10A(7)).
> The extended time limit permits gains accruing in the tax year of departure from the UK to be assessed at any time up to two years after 31 January next following the year of return to the UK notwithstanding any other time limit for the making of an assessment.

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18 "Expressions used in this section and section 10A have the same meanings in this section as in that section; and paragraph 8 of Schedule 5 shall apply for the construction of the references in subsection (5) above to property originating from the settlor as it applies for the purposes of that Schedule."

If the conditions of Section 10A TCGA 1992 are not satisfied then the normal assessment time limits will apply.

9A.11 Offshore funds

This topic (by an unintended accident of drafting) is dealt with by the post-2013 TNR rules, even if the year of departure was before 2013/14. See 9.20 (Offshore funds).

CHAPTER TEN

THE REMITTANCE BASIS

10.1 Remittance basis: Introduction

Income tax and CGT employ two types or bases of assessment:

(1) An **"arising basis"** under which tax is charged on the amount of income/gains which arise.

(2) A **"remittance basis"** under which tax is charged on the amount of income/gains which are received in the UK.

A remittance basis applies (in short) when a foreign domiciliary receives:

(1) Foreign income/gains

(2) Deemed income/gains under the settlement provisions, the ToA provisions and s.87 TCGA.

I use the following self-explanatory terminology:

(1) **"The ITA remittance basis"** (which applies from 2008/09 for all tax purposes).

(2) **"The pre-2008 remittance basis"** (which applied until 2008/2009); there were different rules for different taxes, so one might specifically refer to **"the pre-2008 RFI/employment income/CGT remittance bases"**.

10.1.1 *Cross references*

I deal with the subject in four chapters:

(1) This chapter considers who qualifies for the remittance basis, and the remittance basis claim charge

(2) Chapter 11: what counts as a remittance

(3) Chapter 12: remittance reliefs

(4) Chapter 13: the mixed funds rule.

The remittance basis as it applies to particular anti-avoidance rules is discussed in the chapter on those rules. Thus I refer to "the s.624 remittance basis"; "the s.720 remittance basis"; the s.87 remittance basis;

etc.

The following points are considered elsewhere:

26.2.3 (Life tenant remittance basis taxpayer).

46.3.2 (Rates of tax on interest under remittance basis)

46.4.3 (Rates of tax on foreign dividend income under remittance basis)

10.2 HMRC guidance

Most of the HMRC guidance is to be found in the vast RDR Manual.

The RDR Manual frequently makes its point by examples. In some cases the examples are straightforward and might have been better omitted for the sake of brevity.[1] In almost all cases the examples are padded out with irrelevant facts. (No doubt in the spirit of *The Mikado*, "intended to give artistic verisimilitude to an otherwise bald narrative".) This is about as unhelpful a method of explaining statutory provisions as could be devised. The consequence is to make it quite unnecessarily difficult to identify the important points from the examples. I try to deal with this by editing or rewriting the example so the reader can more easily see the relevant point; I set the original text of the Manual in a footnote, so that the reader can see what I have done.

The RDR Manual was published online in 2010, and updated from time to time since, but no guidance can ever be up to date as long as tax reform continues at its present frenetic pace.

Earlier guidance was in the form of Q&As.[2] Most of the Q&As are now superceded by the RDR Manual but they are still sometimes relevant. Guidance published before then, under the name of FAQs, is now of historic interest only.

10.3 "Foreign income and gains"

Section 809Z7(1) ITA provides:

> This section applies for the purposes of this Chapter.

These are chapter-wide definitions. In accordance with the principles of Plain English drafting, the legislation contains occasional (somewhat

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1 But for the sake of completeness, and just in case some readers should find them helpful, I sometimes set them out in footnotes.

2 I refer to these as "**December 2008 Q&As**"; "**January 2009 Q&As**"; and "**March 2009 Q&As**". HMRC have removed the Q&As from their website but they are accessible on *http://www.kessler.co.uk/tfd-archive*.

unnecessary) pointers to the definitions.[3]

Section 809Z7(2) ITA provides:

> An individual's "foreign income and gains" for a tax year are—
> (a) the individual's relevant foreign earnings for that year,
> (b) the individual's foreign specific employment income for that year,
> (c) the individual's relevant foreign income for that year, and
> (d) the individual's foreign chargeable gains for that year.

10.3.1 "*Relevant foreign income*"

The expression RFI is used so often in tax that it is not possible to provide a complete list. The most important significance of RFI is that it qualifies for the remittance basis. In addition:

(1) There are special deductions and reliefs for RFI: chapter 2 part 8 ITTOIA.

(2) There is a relief for RFI of consular officials: s.771 ITTOIA.

Section 830(1) ITTOIA provides the definition of "RFI":

> In this Act "relevant foreign income" means income which
> (a) arises from a source outside the UK, and
> (b) is chargeable under any of the provisions specified in subs.(2) (or would be so chargeable if s.832 [remittance basis] did not apply to it).

Section 830(2) ITTOIA sets out 15 categories of RFI:

> The provisions are—
> (a) Chapter 2 of Part 2 (trade profits),
> (b) Chapter 17 of Part 2 (adjustment income),
> (c) Chapter 3 of Part 3 (profits of property business),
> (e) Chapter 2 of Part 4 (interest),
> (f) Chapter 4 of Part 4 (dividends from non-UK resident companies),
> (g) Chapter 7 of Part 4 (purchased life annuity payments),
> (h) Chapter 8 of Part 4 (profits from deeply discounted securities),
> (i) Chapter 13 of Part 4 (sales of foreign dividend coupons),
> (j) Section 579 (royalties and other income from intellectual property),
> (k) Chapter 3 of Part 5 (films and sound recordings: non-trading

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3 Eg s.809C(6) ITA: "See s.809Z7 for the meaning of an individual's foreign income and gains for a tax year".

businesses),
(l) Chapter 4 of Part 5 (certain telecommunication rights: non-trading income),
(m) section 649 (estate income),
(n) Chapter 7 of Part 5 (annual payments not otherwise charged), and
(o) Chapter 8 of Part 5 (income not otherwise charged).

Section 830(3) ITTOIA concerns the very specialist case of a clawback of relief for unremittable income (exchange control income).[4]

Section 830(4) ITTOIA flags up another 9 cases where income is treated as RFI:

> For the treatment of other income as relevant foreign income, see—
> (a) section 857(3) (a partner's share of a firm's trading income),
> (aa) regulation 19 of the Offshore Funds (Tax) Regulations 2009,
> (b) paragraph 6(3) of Schedule 3 to the Commonwealth Development Corporation Act 1999 (distributions by the Commonwealth Development Corporation),
> (c) section 575(3) of ITEPA 2003 (taxable pension income: foreign pensions),
> (d) section 613(4) of that Act (taxable pension income: foreign annuities),
> (e) section 631(3) of that Act (pre–1973 pensions paid under the Overseas Pensions Act 1973),
> (f) section 635(4) of that Act (taxable pension income: foreign voluntary annual payments),
> (g) section 679(2) of that Act (taxable social security income: foreign benefits),
> (h) section 670A of ITA 2007 (accrued income profits), and
> (i) sections 726, 730 and 735 of that Act (transfer of assets abroad: foreign deemed income).

As far as I can see, it makes no difference whether income is in the s.830(2) list (defined as RFI) or the s.830(4) list (treated as RFI).

Thus there are 24 categories of RFI altogether. The 24 categories includes almost all foreign income (other than earnings); in particular, they include trading income, property income, interest and dividends. This is income formerly taxed under Schedule D Cases IV and V.

"Relevant foreign income" is a narrower concept than "foreign income"

4 See 56.4 (Withdrawal of unremittable income relief).

in two respects:

(1) Some types of foreign income (formerly charged under schedule D case VI) are not "relevant foreign income."

(2) Foreign source income of a non-resident is not RFI as it is not "chargeable" and does not meet the condition in s.830(1)(b).[5]

There is therefore a distinction between (1) income arising from a source outside the UK (foreign source income) and (2) RFI. All RFI is foreign source income; but foreign source income is not RFI if (a) it is not within the 24 categories of RFI; or (b) it is received by a non-resident.

Relevant foreign income is not a helpful label but no short label could do justice to the complexities.

Sometimes the drafter overlooks s.830(1)(b) in the statutory definition, ie the term is understood to include foreign income of a non-resident.[6]

The s.830 ITTOIA definition only applies for ITTOIA, but s.989 ITA provides:

> The following definitions apply for the purposes of the Income Tax Acts—
> "relevant foreign income"
> [a] has the meaning given by section 830(1) to (3) of ITTOIA 2005
> [b] but also includes, for any purpose mentioned in any provision listed in section 830(4) of that Act, income treated as relevant foreign income for that purpose by that provision

10.3.2 *Let's simplify the definition of RFI*

It is suggested that the law should be simplified in two ways.

First, "RFI" should be extended to include all income arising outside the UK (except employment income). There is no reason why any foreign source income should not qualify for the reliefs currently given to RFI. The amount of tax involved is small because properly advised remittance basis taxpayers will not invest in foreign source income which is taxed on an arising basis. The law simply laying traps.

If, contrary to that view, there must continue to be special cases of foreign income which does not qualify for the remittance basis, they should be specified as express exemptions from the definition of RFI. We should not specify the 24 categories of RFI: RFI should be all foreign

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5 Unless the temporary non-residence rules apply.

6 See 27.4 (Section 624 remittance basis); 18.16.1 (Foreign source interest).

source income with specified exceptions.

Something also needs to be done about the rule in s.830(1)(b) that only income of a UK resident is RFI. Its role in ITTOIA to avoid a charge if a UK resident remits foreign income arising in a period of non-residence. But the rule makes no sense (and has sometimes been overlooked) when the concept of RFI is used elsewhere. The rule should not be in the definition of RFI: it should be moved to the charge on remitted income in s.832 ITTOIA. Then RFI would mean foreign source income (other than earnings and, perhaps, other specified categories): that is the meaning that it is often (incorrectly) ascribed to it at present.

The term RFI could be relabelled "foreign investment income" but the choice of a label is a secondary issue.

10.3.3 *Relevant foreign earnings ("RFE")*

Section 809Z7(3) ITA provides the definition of RFE:

> An individual's "relevant foreign earnings" for a tax year are—
>
> (a) if the individual does not meet the requirement of section 26A of ITEPA 2003 [Overseas Workday Relief] for that year, the individual's chargeable overseas earnings[7] for that year, and
>
> (b) otherwise, the individual's general earnings within s.26(1) of ITEPA 2003 for that year (non-UK earnings).

10.3.4 *Foreign specific employment income*

Section 809Z7 ITA incorporates the definitions from ITEPA:

> (4) An individual's "foreign specific employment income" for a tax year ("the relevant tax year") consists of the income (if any) within subsections (4A) and (4B).
>
> (4A) The income within this subsection is the individual's specific employment income for the relevant tax year so far as it consists of foreign securities income for the purposes of section 41A of ITEPA 2003.
>
> (4B) The income within this subsection is any income, or any part of any income, of the individual—
>
> (a) to which section 554Z9(2) or 554Z10(2) of ITEPA 2003 applies, and

---

7 Section 809Z7(6) provides: "In subs.(3)(a) 'chargeable overseas earnings' has the same meaning as in s.22 of ITEPA 2003 (see s.23 of that Act)." See 22.12 (Chargeable overseas earnings).

(b) which consists of the value of a relevant step, or a part of the value of a relevant step, which is "for" the relevant tax year as determined under section 554Z4 of ITEPA 2003.

Specific employment income raises a set of specialist topics not discussed in this book, though I hope to cover them in a future edition.

10.3.5 *Foreign chargeable gains*

Section 12(4) TCGA provides a commonsense definition:

> In this section "foreign chargeable gains" means chargeable gains accruing from the disposal of an asset which is situated outside the UK.

This is only a section-wide definition, so it has to be repeated or incorporated when the expression is used elsewhere.

Section 809Z7(5) ITA incorporates this definition:

> An individual's "foreign chargeable gains" for a tax year are the individual's foreign chargeable gains (within the meaning of s.12(4) of TCGA 1992) accruing to the individual in that year.

10.3.6 *Income/capital terminology in remittance basis context*

One might start off by thinking that a remittance of income is subject to income tax and a remittance of capital is not. It is not that simple. The terminology of "capital" and "income" in the context of the remittance basis is potentially confusing.

A sum received in the UK may not be taxable under the remittance basis because it is derived not from income but from some fund easily identified as capital in the hands of the taxpayer, such as a gift or inheritance, or borrowing. In cases in this category it makes sense to say that the remittance is tax free because it is one of capital.

A sum received in the UK may not be taxable under the remittance basis because:

(1) the donor was non-resident when the remitted sum accrued; or
(2) the remitted sum has already been subject to income tax.

Such sums might be said to be "income" in the normal sense of the word. These examples show that a remittance of a sum which is income in nature may nevertheless be remittance free of tax under the remittance basis.

(3) Conversely, suppose a remittance basis taxpayer accumulates income offshore for many years; the accumulated fund might be said to be

their "capital" in the normal sense of the word. Yet for the purposes of the remittance basis, it is in principle taxable if remitted.[8] Perhaps it is better described as "income".

It is best not to use the terminology of income/capital in any of cases (1) to (3): it is unnecessary to do so.

10.4 History of the remittance basis

It is not necessary for a practitioner to know the history of the remittance basis but it makes an interesting story and is helpful to understand the background to the older cases.[9]

Until 1914 all foreign income was taxed on a remittance basis: s.100 Income Tax Act 1842. Since then the remittance basis has been withdrawn, in stages, except for foreign domiciliaries. In 1914 income from "securities, stocks, shares, or rents in any place out of the UK" was brought onto an arising basis: s.5 FA 1914. This did not apply to foreign domiciliaries and non-ordinarily resident British subjects. Even those who were domiciled and ordinarily resident in the UK retained the remittance basis for foreign source income other than income from securities and rents. Hence the need for cases to decide whether trust income was to be regarded as income arising from securities or from the trust.[10]

In 1940 the general remittance basis was further restricted, to (a) income from offshore trades, professions or vocations, and (b) income from offshore offices, employments or pensions: s.19 FA 1940. The exception was intended, perhaps, to encourage foreign trade. However, it did enable tax planning by splitting a single mixed UK and foreign based trade into

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8 See (if authority is needed) *Walsh v Randall* 23 TC 55:
"... the accumulated income which he had derived from the drawings of the firm of which he was a sleeping partner. I have no doubt that he had come to regard this sum of money as capital. It was invested savings and it was in that sense capital, unless it can be said that, for instance, a professional man's invested savings never are and never become capital. I should have thought it was quite a harmless thing to use the word 'capital' in relation to a professional man, or indeed to any other private person. I think that word may very definitely have a meaning with regard to ordinary private persons and may be correctly used to describe some part of their property. That, however, is not, for Income Tax purposes, the test. To the Crown the [unremitted] income of a person residing in the UK is, as I gather, always income until it is taxed."

9 See John Avery Jones, "Taxing Foreign Income from Pitt to the Tax Law Rewrite—The Decline of the Remittance Basis", *Studies in the History of Tax Law* (Vol 1 2004), accessible *http://www.kessler.co.uk/tfd-archive*.

10 See 26.3 (Taxation of life tenant).

separate UK and foreign source trades, the latter qualifying for the remittance basis. An arrangement of this kind was held to be successful in *Newstead v Frost* 53 TC 525. So in 1974 this was abolished: ss.22, 23 FA 1974.

The same rules applied to companies as to individuals, until the introduction of corporation tax in 1965, which put UK resident companies onto an arising basis.

In 2008 the remittance basis was recast, and restricted by the remittance basis claim charge.

10.5 Who qualifies for the remittance basis?

After the traditional overview, in accordance with the principles of plain English drafting,[11] s.809B, 809D and 809E ITA set out three categories of individuals to whom the remittance basis applies:

(1) Section 809B is the main category, those who make a claim for the remittance basis. I refer to these as "**remittance basis claimants**".

The other two categories are classes of *de minimis* taxpayers, defined with complex and pernickety detail.

(2) Section 809D applies to individuals whose unremitted foreign income and gains are less than £2,000. I refer to these as "**sub-£2k taxpayers**".

(3) Section 809E applies to those with no (or virtually no) taxable (UK source) income and gains who do not remit any foreign income or gains. I refer to these as "**non-taxpayers**".

The advantages of being in one of the two de minimis categories are as follows:

(1) No claim is needed, so the taxpayer may not need to submit a tax return.

(2) The remittance basis claim charge does not apply, personal allowances remain available,[12] and the individual is not forced to make a CGT loss election.[13]

I refer to the three groups together as "**remittance basis taxpayers**". HMRC use the term "remittance basis user" (HMRC do not like to use the

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11 Section 809A ITA provides: "This Chapter provides for an alternative basis for charge in the case of individuals who are not domiciled in the UK".

12 See 47.5 (Withdrawal of personal allowances & CGT annual exemption for remittance basis claimants).

13 See 54.9 (Loss accruing to remittance basis taxpayer).

word "taxpayer"[14]) and in 2012 that usage was adopted into statute.[15]

10.6 Remittance basis claimants: s.809B

10.6.1 *Entitlement to claim remittance basis*

Section 809B ITA provides:

> (1) This section applies to an individual for a tax year if the individual-
> (a) is UK resident in that year,
> (b) is not domiciled in the UK for that year, and
> (c) makes a claim under this section for that year.

I refer to the claim as a **"remittance basis claim"**.

10.6.2 *Is a claim worthwhile?*

A claim gives the advantages of the remittance basis but has the following drawbacks:

(1) Loss of personal allowances:[16]
  (a) CGT annual exemption.
  (b) IT personal allowance (only a concern for those with taxable income up to about £100k as otherwise there is no personal allowance to lose[17])
(2) The need to make a CGT loss election
(3) Remitted dividends are taxed at a higher rate than dividends taxed on an arising basis
(4) Loss of 10% deduction for foreign pension[18]
(5) For long-term residents: the remittance basis claim charge

The effect of the remittance basis claim charge is to withdraw the remittance basis from long-term residents except the most wealthy, since a claim is not likely to be worthwhile for individuals whose income is much less than £150,000 in the year in question, though the position varies a great deal from one case to another.

For short-term residents, a claim is likely to be worthwhile as long as

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14 See 1.2.5 ("Customers" of HMRC).

15 See s.809Z10 ITA.

16 See 10.6.2 (Is a claim worthwhile?).

17 See 47.4 (Withdrawal of allowances for high earners). For completeness: in rare cases the allowance may be saved by a DTT: see 47.7.2 (Personal allowances under DTAs: remittance basis claimants).

18 See 24.3 (Foreign pension).

they expect to have foreign income in excess of the personal allowance (if available).

10.6.3 *Is a remittance basis claim worthwhile: US taxpayers*

Bober states:

> Generally, the ability to claim double tax relief will mean that an adult US citizen (or green- card holder) who is a long-term UK resident will achieve a better overall tax result (meaning that less tax will be payable overall) by being subject to UK tax on the arising basis. This is because the individual will generally be subject to US tax on a worldwide basis anyway. For many, while UK tax rates are in excess of US tax rates, the additional UK tax that will be payable on the arising basis will not be in excess of the £30,000 RBC payable if the remittance basis claim is made. This will not always be the case, though, as:
>
> - the individual may have specific issues meaning that some of their foreign income or gains are sheltered from the US tax net, and/or
> - the individual might be sufficiently wealthy that the difference between the higher UK tax rates and the US tax rate will mean that paying the £30,000 is worthwhile.
>
> In addition, some US citizens (or green-card holders) may prefer to pay tax on the remittance basis in the UK rather than try to determine the UK tax treatment with respect to some of the offshore investments they have, and make the necessary disclosure. Since the US and the UK tax systems are different the fact that an individual has to submit a US tax return showing worldwide income and gains will not necessarily mean he or she is in a position to complete a UK return without incurring significant additional compliance costs. Paying the RBC will avoid the need for this work and may result in privacy gains.[19]

10.7 Procedure and time limits for remittance basis claim

Section 42(1) TMA 1970 provides (so far as relevant):

> Where any provision of the Taxes Acts provides for relief to be given, or any other thing to be done, on the making of a claim, this section shall, unless otherwise provided, have effect in relation to the claim.

Section 809B(3) ITA applies this to a remittance basis claim:

> Sections 42 and 43 of TMA 1970 (procedure and time limit for making

19 Bober "The remittance basis charge – US issues" (2011) 9 TQR p.8 accessible (free to STEP members or on subscription) *http://www.step.org*.

> claims), except s.42(1A) of that Act, apply in relation to a claim under this section as they apply in relation to a claim for relief.

I would have thought that s.42 TMA would apply to a remittance basis claim in any event, as even if the claim is not a "claim for relief", it is a claim for a "thing to be done". Perhaps the drafter thought that was not entirely clear; or perhaps the only point of s.809B(3) is to disapply s.42(1A); it does not matter. We must turn to s.42 TMA to find the relevant rules.

10.7.1 *Procedure to make a remittance basis claim*

Section 42 TMA 1970 provides (so far as relevant):

> (2) Subject to [immaterial exceptions] where notice has been given under section 8 ... of this Act [ie a notice to deliver a personal return] a claim shall not at any time be made otherwise than by being included in a return under that section if it could, at that or any subsequent time, be made by being so included...
> (5) The references in this section to a claim being included in a return include references to a claim being so included by virtue of an amendment of the return;

Thus there are different rules depending on whether HMRC have given a notice to complete a tax return.

In the usual case, HMRC do give notice to complete a tax return (form SA316). The remittance basis claim can and must be included in the return. This is done as follows:

(1) Tick box 28 in form SA109 (Residence remittance basis, etc) 2012/13. The caption by this box states: *If you are making a claim for the remittance basis for 2013–14, put 'X' in the box.*
(2) It is also necessary to tick other boxes:
   (a) Box 23 in form SA109 (2013/2014). The caption by this box states: *If you are domiciled outside the UK and it is relevant to your Income Tax or Capital Gains Tax liability, put 'X' in the box.* (There are further relevant boxes if this is the first domicile claim.)
   (b) Box 8 in form SA100 (2013/2014). The caption by this box states: *Were you, for all or part of the year to 5 April 2014, one or more of the following – not resident or not domiciled in the UK and claiming the remittance basis, applying split year treatment, or dual resident in the UK and another country?*

It is not necessary for the remittance basis claim to specify the amount of

unremitted income or gains.[20]

If HMRC do not give notice to complete a tax return, the remittance basis claim could be made informally, eg by letter; but in practice it may not often happen that a person who wishes to make a s.809B claim does not receive a notice to complete a tax return. I suspect it may be more normal practice to voluntarily submit a tax return (despite the absence of a notice requiring one) and make the claim in that return.[21]

10.7.2 *Procedure to withdraw remittance basis claim*

If a tax return is submitted without a remittance basis claim, the claim can be made by amending the return; similarly, if a tax return is submitted with a claim, the claim can be withdrawn by amending the return.

HMRC agree. The RDR Manual provides:

> **32020 Claiming the remittance basis: Making a claim** [July 2010]
> ... If the return is subsequently amended, the claim may be included then or a previously made claim may be amended or deleted (s.42(5) TMA 1970).

However the time limit for amending a tax return is quite short. Section 9ZA TMA provides:

> (1) A person may amend his return under section 8 ... of this Act by notice to an officer of the Board.
> (2) An amendment may not be made more than twelve months after the filing date.
> (3) In this section "the filing date", in respect of a return for a year of assessment (Year 1), means—
> (a) 31st January of Year 2, or
> (b) if the notice under section 8 or 8A is given after 31st October of Year 2, the last day of the period of three months beginning with the date of the notice.

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20 Because s.42(1A) TMA is disapplied. This provided: "... a claim for a relief, an allowance or a repayment of tax shall be for an amount which is quantified at the time when the claim is made." (At first sight it was not necessary to disapply this subsection, as a remittance basis claim is not "a claim for a relief, an allowance or a repayment of tax" so the subsection would not apply in any event. But the remittance basis claim is treated as if it were a claim for a relief, so it was necessary.)

21 A claim in an unsolicited tax return is an effective claim: see *Weerasinghe v HMRC* [2013] UKFTT 144 (TC).

The RDR Manual provides:

> **32020 Claiming the remittance basis: Making a claim** [July 2010]
> ... when the time period for making an amendment has passed, the claim may not be withdrawn even if the making of the claim turns out to have been an error. This is because error or mistake relief does not apply to claims made to use the remittance basis under s.809B ITA 2007 (s.33(2A)(c) TMA 1970).

Section 33(2A)(c) TMA formerly provided that no relief was given under s.33 for an error or mistake consisting of the making of a remittance basis claim. The reference in the Manual is out of date as the legislation was rewritten in 2009. The provisions are now in Sch 1AB TMA, which does not refer expressly to remittance basis claims, but the new provisions only apply where tax has been paid, or assessed, which is not due. That is not the case where making a remittance basis claim was a mistake in the sense that it was not beneficial. So the position remains as before. That is, it is only possible to withdraw a remittance basis claim after the filing date anniversary in the circumstances below.

10.7.3 *Time limit for remittance basis claim*

Section 43(1) TMA provides:

> Subject to any provision of the Taxes Acts prescribing a longer or shorter period, no claim for relief in respect of income tax or capital gains tax may be made more than 4 years after the end of the year of assessment to which it relates.

Section 42(2) TMA 1970 provides (so far as relevant):

> (2) Subject to [immaterial exceptions] where notice has been given under section 8 ... of this Act [ie a notice to deliver a personal return] a claim shall not at any time be made otherwise than by being included in a return under that section if it could, at that or any subsequent time, be made by being so included...

In the usual case where HMRC have given the notice to make a tax return, the claim must (as noted above) be made in the return, and it seems at first sight that the timetable for making (and amending) tax returns controls when the claim has to be made: if it is too late to make or amend the tax return, the claim cannot be made. However the better view is that s.42(2) merely outlines the procedure for making claims and that the time limits

are those set in sections 43 and 43A. Once the deadline for amending the return has passed, the claim cannot be included in the return at that or any subsequent time, and that opens up the possibility of a claim being made outside the return.[22] HMRC agree. The RDR Manual provides:

> **RDRM32030 Claims - Time Limits** [July 2010]
> The time limits for making claims are set out in Section 43 TMA 1970. The general time limit as set out in TMA70/s43(1) for making a claim also applies to making a claim for the remittance basis.
> By way of an example, under the **present** time limits a claim for the remittance basis for 2008-09 must be made by 31 January 2015.
> **Note:** The present limits are changing as a result of changes introduced at Schedule 39 FA 2008. From 1 April 2010 the new time limits will be 4 years after the end of the year of assessment to which it relates. ...The Taxes Acts may prescribe a longer or shorter period in respect of certain claims, and if that is the case then that time limit will override the general rule of S43(1).
> S43(2) extends the time limit in certain circumstances. ...

The Manual adds:

> If there is a likelihood that the claim might not be made within the general time limit for making the claim, then the individual must tell HMRC of the intention to make the claim. This must stipulate:
> - the nature of the claim, and
> - the year for which it is to be made

But I think what the Manual describes as "telling HMRC of the intention to make the claim" actually amounts to making a claim.

10.7.4 *Making or withdrawing a remittance basis claim after time limit*

Section 43(2) TMA allows a late claim following the making of an assessment:

> A claim (including a supplementary claim) which could not have been allowed but for the making of an assessment to income tax or capital gains tax after the year of assessment to which the claim relates may be made at any time before the end of the year of assessment following that in which the assessment was made.

Section 43C(2) TMA provides (so far as relevant):

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22 I am grateful to Peter Finch for his comments on this issue.

Where-

(a) a return is amended under section 28A(2)(b) ... and

(b) the amendment is not made for the purpose mentioned in subsection (1)(b) above [ie not for "the purpose of making good to the Crown any loss of tax brought about carelessly or deliberately by the taxpayer or a person acting on his behalf"]

sections 43(2), 43A and 43B apply in relation to the amendment as they apply in relation to any assessment under section 29.

Amended as s.43C directs, s.43(2) TMA provides:

> A claim (including a supplementary claim) which could not have been allowed but for the making of an [*amended return*] after the year of assessment to which the claim relates may be made at any time before the end of the year of assessment following that in which the [*return*] was [*amended*].

So if:

(1) HMRC raise a late assessment, and

(2) there is no negligence

it is possible to make a late remittance basis claim if the claim is one "which could not have been allowed but for the making of an amended return". That would be the case if there is no income returned against which the claim could be allowed.

Section 43A TMA provides:

(1) This section applies where—

(a) by virtue of section 29 of this Act an assessment to income tax or capital gains tax is made on any person for a year of assessment, and

(b) the assessment is not made for the purpose of making good to the Crown any loss of tax brought about carelessly or deliberately by that person or by someone acting on behalf of that person.

(2) Without prejudice to section 43(2) above but subject to section 43B below, where this section applies—

(a) any relevant[23] claim, election, application or notice which could

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23 Section 42A TMA provides:

"(2B) For the purposes of this section and section 43B below, a claim under Schedule 1AB is relevant in relation to an assessment for a year of assessment if it relates to that year of assessment.

have been made or given within the time allowed by the Taxes Acts may be made or given at any time within one year from the end of the year of assessment in which the assessment is made, and

(b) any relevant claim, election, application or notice previously made or given may at any such time be revoked or varied—

(i) in the same manner as it was made or given, and

(ii) by or with the consent of the same person or persons who made, gave or consented to it (or, in the case of any such person who has died, by or with the consent of his personal representatives),

except where by virtue of any enactment it is irrevocable.

...

Section 43B TMA provides a cap on the relief given by a late claim:

...

(3) In any case where—

(a) one or more relevant claims, elections, applications or notices are made, given, revoked or varied by virtue of the application of section 43A above in the case of an assessment, and

(b) the total of the reductions in liability to tax which, apart from this subsection, would result from the action mentioned in paragraph (a) above would exceed the additional liability to tax resulting from the assessment,

the excess shall not be available to reduce any liability to tax.

(4) Where subsection (3) above has the effect of limiting either the reduction in a person's liability to tax for more than one period or the reduction in the liability to tax of more than one person, the limited

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(3) For the purposes of this section and section 43B below, any other claim, election, application or notice is relevant in relation to an assessment for a year of assessment if—

(a) it relates to that year of assessment or is made or given by reference to an event occurring in that year of assessment, and

(b) it or, as the case may be, its revocation or variation has or could have the effect of reducing any of the liabilities mentioned in subsection (4) below.

(4) The liabilities referred to in subsection (3) above are—

(a) the increased liability to tax resulting from the assessment,

(b) any other liability to tax of the person concerned for—

(i) the year of assessment to which the assessment relates, or

(ii) any year of assessment which follows that year of assessment and ends not later than one year after the end of the year of assessment in which the assessment is made."

amount shall be apportioned between the periods or persons concerned—

(a) except where paragraph (b) below applies, in such manner as may be specified by the inspector by notice in writing to the person or persons concerned, or

(b) where the person concerned gives (or the persons concerned jointly give) notice in writing to the inspector within the relevant period, in such manner as may be specified in the notice given by the person or persons concerned.

(5) For the purposes of paragraph (b) of subsection (4) above the relevant period is the period of 30 days beginning with the day on which notice under paragraph (a) of that subsection is given to the person concerned or, where more than one person is concerned, the latest date on which such notice is given to any of them.

Section 43C TMA provides:

(1) Where—

(a) a return is amended under section 28A(2)(b) ... and

(b) the amendment is made for the purpose of making good to the Crown any loss of tax brought about carelessly or deliberately by the taxpayer or a person acting on his behalf,

sections 36(3) and 43(2) apply in relation to the amendment as they apply in relation to any assessment under section 29.

(2) Where—

(a) a return is amended under section 28A(2)(b) ... and

(b) the amendment is not made for the purpose mentioned in subsection (1)(b) above,

sections 43(2), 43A and 43B apply in relation to the amendment as they apply in relation to any assessment under section 29.

(3) References to an assessment in sections 36(3), 43(2), 43A and 43B, as they apply by virtue of subsection (1) or (2) above, shall accordingly be read as references to the amendment of the return.

A typical case is if no remittance basis claim was made as a taxpayer reasonably considered that some relief applied. Likewise a late claim for DT relief may be made if a taxpayer reasonably considered that some other relief was available.

HMRC agree. The Self Assessment Claims Manual provides:

SACM9015. Non-Culpable Additions [January 2010]

Where you

- amend a return in an ITSA enquiry closure notice or

- make a discovery assessment for reasons other than fraudulent or negligent conduct

the taxpayer can make a relevant out-of-time claim or election within one year from the end of the year of assessment in which the notice is issued. (Sections 43A and 43C(2) TMA).

In section 43A for a claim or election to be relevant to an amendment or assessment it must

- relate to the same year of assessment or
- be made or given by reference to an event in that year (Section 43A(3) TMA 1970).

The taxpayer can also

- revoke a claim or election already made, or
- amend a claim or election, except where it is irrevocable in law.

The effect of the taxpayer making, revoking or amending a claim or election is limited to the additional liability to tax resulting from the assessment or your amendment.

So if an ITSA enquiry increases a taxpayer's self assessment by £1,500 tax, the effect of any out-of-time claims or elections is limited to £1,500 (Section 43B(3) TMA 1970). Any "excess" tax effect of the claim or election "shall not be available to reduce any liability to tax".

10.8 Sub-£2k taxpayer: s.809D

Section 809D ITA provides:

(1) This section applies to an individual for a tax year if-

(a) the individual is UK resident for that year,

(b) the individual is not domiciled in the UK in that year, and

(c) the individual's unremitted[24] foreign income and gains for that year are less than £2,000.

unless condition A or condition B is met.

(1A) Condition A is that conditions A to F in section 828B are met.[25]

(1B) Condition B is that the individual gives notice in a return under

---

24 Section 809D(2) provides a commonsense definition of "unremitted":

"The amount of an individual's "unremitted" foreign income and gains for a tax year is—

(a) the total amount of what would (if this section applied) be the individual's foreign income and gains for that year, minus

(b) the total amount of those income and gains that are remitted to the UK in that year."

25 This relates to lower-paid employees see 22.33 (Lower-paid employee exemption). I do not understand the reason for condition A.

section 8 of TMA 1970 that this section is not to apply in relation to the individual for that year.

Why should anyone wish to make a claim under s.809D(1B) and move from the remittance basis to the arising basis? The reason may be that the remittance basis (for those with modest incomes) involves too much trouble and expense: it may be more cost effective to pay tax on an arising basis. Another reason might be to facilitate double taxation relief.

10.8.1 *Interaction of £2k limit with split-year rules*

Under the split year rules, foreign income from the overseas part of a split year is not subject to UK tax. However in considering whether the £2,000 threshold limit applies in respect of use of the remittance basis of taxation under ITA07/s809D, the level of unremitted foreign income and gains for the entire tax year must be taken into account. This continues the position as it was before the SRT.

This is straightforward but the RDR Manual gives an example to drive the point home:[26]

> **32120 Below £2,000 threshold users: Years of arrival and departure - interaction with ESC A11** [June 2010]
>
> ...
>
> *Example (Ferdinand)*
>
> F enters the UK on 20 October 2010, and is resident for the tax year 2010-11. He claims[27] split-year treatment under ESC A11.
>
> F's RFI is as follows:
>
> | | |
> |---|---|
> | 6 April to 19 October 2010 | £2,200 |
> | 20 October 2010 to 5 April 2011 | £1,300 |
> | Total | £3,500 |
>
> F remits £1,000 to the UK in that year.
>
> At the end of the year his total unremitted foreign income is £2,500.

The HMRC analysis is as follows:

> Even though F has claimed split-year treatment for 2010-11, he still has to include any foreign income that arose before he entered the UK.
>
> As F's unremitted foreign income is above the £2k threshold he cannot use the remittance basis under s809D. If he wishes to use the remittance

26 I have slightly altered the wording of the example for enhanced clarity.

27 It would be more accurate to say F "qualifies" for split-year treatment since the concession does not need a claim. But nothing turns on that.

basis he will need to claim under ITA07/s809B, and will lose his personal allowances and the annual exempt amount.

The same applies under the SRT. In practice, F (if well advised) would not make a claim for the remittance basis but could save a few pounds of tax by remitting £1,500.01 to the UK instead of £1,000.

The same applies for chargeable gains and RDRM32130 sets out an example. But in practice it hardly matters.

10.8.2 *How to claim*

Although there is no formal claim or election, it is necessary to tick the relevant box in the tax return. This is box 29 in the SA109 form (2013/14). The caption by the box reads: *If your unremitted income and capital gains for 2013–14 is less than £2,000, put 'X' in the box.*

It is also necessary to tick box 23 in the SA 109 form (2013/14). The caption by this box states: *If you are domiciled outside the UK and it is relevant to your Income Tax or Capital Gains Tax liability, put 'X' in the box*. (There are further relevant boxes if this is the first domicile claim.)

It is also necessary to tick box 8 in the form SA100 (2013/14). The caption by this box reads: *Residence, remittance basis etc. Were you, for all or part of the year to 5 April 2014, one or more of the following – not resident, not ordinarily resident or not domiciled in the UK and claiming the remittance basis; or dual resident in the UK and another country?*

10.8.3 *Concession for remittances by sub-£2k taxpayer*

HMRC Brief 17/09 provides:

> **Remittance basis users whose foreign income and gains is less than £2,000**
> Individuals making use of section 809D are still taxable on any foreign income or gains remitted to the UK. ...
> It is recognised that some individuals, in particular those on low income, may make small cash remittances to the UK, out of foreign income or gains, and as a result have to complete a Self Assessment tax return possibly to pay only a small amount of tax. This is particularly the case where foreign tax has already been paid on the income or gains. Where an individual who is making use of section 809D remits less than a total of £500 in cash, which arises from foreign income or gains, into the UK during the tax year, then HMRC will accept that such an individual does not need to make a Self Assessment Tax return simply to pay the tax on those cash remittances. However where such an individual is required

> to complete a Self Assessment tax return for any other reason, or HMRC serves them with a notice to make a return, then they will need to include those remittances on the return and pay the tax due. This practice will apply for 2008-09 and subsequent years.

This is a concession (the word concession is not used, perhaps because HMRC are not now supposed to issue concessions). A concession which only applies if HMRC chose not to require a SA return is a new development in tax, and setting the limit at £500 is difficult to defend, but the manner of introduction of the concession precluded any possibility of debate on it.

10.8.4 *Reform?*

HMRC have rejected lobbying to increase the £2k limit:

> In particular, the Government will not look further at the following:
> *Simplification* Increasing the £2,000 de minimis limit to align with the income tax personal allowance
> Government response The Government considers that this would be likely to have a material Exchequer cost. It would also restore the income tax personal allowance and CGT Annual Exempt Amount (AEA) to some individuals with a significant level of income or capital gains and the Government does not think that this can be justified.[28]

The paper does not mention that the decision not to increase the limit since 2008 amounts to a reduction in real terms.

10.9 Non-taxpayers: s.809E

Section 809E(1) ITA provides:

> This section applies to an individual for a tax year if—
> (a) the individual is UK resident for that year,
> (b) the individual is not domiciled in the UK in that year,
> (c) for that year the individual either has no UK income or gains or has no UK income and gains other than taxed investment income not exceeding £100.

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28 HMRC & HMT, "Reform of the taxation of non-domiciled individuals: summary of responses to consultation" (December 2011) para 2.127 *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

(d) no relevant income or gains are remitted to the UK in that year, and

(e) either—

(i) the individual has been UK resident in not more than 6 of the 9 tax years immediately preceding that year, or

(ii) the individual is under 18 throughout that year.

unless the individual gives notice in a return under s.8 of TMA 1970 that this section is not to apply in relation to the individual for that year.

I refer to a person within s.809E as **"a non-taxpayer"**. Thus there are five requirements which must all be met. Requirements (a), (b) and (e) do not need comment.

10.9.1 *(Virtually) no UK income/gains*

The requirement in s.809E(1)(c) is:

> for that year the individual either has no UK income or gains or has no UK income and gains other than taxed investment income not exceeding £100.

Section 809E(2) ITA provides a commonsense definition:

> For the purposes of subs.(1)(c) the individual's "UK income and gains" for the tax year are the individual's income and chargeable gains for that year other than what would (if this section applied) be the individual's foreign income and gains for that year.

There is a paltry exemption for £100 "taxed investment income". This term is defined in s.809E(2A) ITA:

> For the purposes of subsection (1)(c) "taxed investment income" means UK income or gains consisting of payments within s.946 from which a sum representing income tax has been deducted.

10.9.2 *No relevant income or gains remitted*

The requirement in s.809E(1)(d) is:

> (d) no relevant income or gains are remitted to the UK in that year

Section 809E(3) ITA provides the definition:

> For the purposes of subs.(1)(d) "relevant" income and gains are—
>
> (a) what would (if this section applied) be the individual's foreign income and gains for the tax year mentioned in subs.(1), and

(b) the individual's foreign income and gains for every other tax year for which s.809B or 809D or this section applies to the individual.

Para 85 Sch 7 FA 2008 contains transitional provisions for pre-2008 income and gains:

(1) In s.809E(3)(b) of ITA 2007, the reference to a tax year for which s.809B, 809D or 809E of that Act applies to an individual includes a tax year (not later than the tax year 2007-08) in which the individual—
(a) was UK resident, but
(b) was not domiciled in the UK or was not ordinarily UK resident.
(2) In relation to such a tax year, the reference there to the individual's foreign income and gains includes the individual's relevant foreign income if (and only if)—
(a) the individual made a claim under s.831 of ITTOIA 2005 for the year, or
(b) s.65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the year.

The split year rules do not apply, so income from the overseas part of a split year will be included within the definition of relevant income and gains for that year for section 809E purposes.

10.9.3 *What is the purpose of s.809E?*

EN FB 2008 provides:

Individuals entitled to claim the remittance basis who have no UK income or gains, and who don't remit any foreign income or gains, won't have to claim the remittance basis in years they are not liable to the RBC. This avoids them having to complete a self assessment return only so they can claim the remittance basis and then have no tax to pay.

There will not be many non-taxpayers within s.809E – mainly spouses accompanying their partners, children and some students, perhaps.

10.10 Time of foreign domicile

Section 809B(1) ITA requires (in short) that the foreign domiciliary is not domiciled in the UK in the year that the income arises.

It is an interesting question what is the position if a person changes domicile during a year.

10.11 Remittance basis claim charge

10.11.1 *Outline of position from 2012*

The remittance consultation paper provides:

> 2.8 ... the Government proposes to introduce a higher charge of £50,000 for those non-domiciles who claim the remittance basis and have been UK resident in at least 12 of the 14 tax years prior to the year of the claim. It intends that this will take effect from 6 April 2012.
> 2.9 The £30,000 charge will be retained for those who have been resident in at least seven of the nine years prior to the year of claiming the remittance basis, but fewer than 12 years.
> 2.10 The £50,000 charge will work in exactly the same way as the current £30,000 charge, namely:
> - In each tax year the individual will have a choice whether to pay the charge or to be liable to UK tax on their worldwide income and capital gains. Any decision will depend on the individual's personal circumstances, such as the level of their overseas income and capital gains; 6
> - Those who choose to pay the charge will make a claim to the remittance basis on an SA tax return after the end of the relevant tax year;
> - Individuals will be able to opt in and out of the remittance basis from year to year. Choosing the arising basis in one year will not preclude claiming the remittance basis in a future year; and
> - It will not be payable if the individual is under 18 or if they have unremitted overseas income and capital gains of less than £2,000 in the tax year.[29]

10.11.2 *7-year and 12-year residence tests*

Section 809H ITA provides:

> **809H Claim for remittance basis by long-term UK resident: charge**
> (1) This section applies if—
> (a) s.809B (claim for remittance basis to apply) applies to an individual for a tax year ("the relevant tax year"),
> (b) the individual is aged 18 or over in the relevant tax year, and
> (c) the individual meets the 12-year residence test or the 7-year

29 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *http://www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

> residence test for the relevant tax year.
> (1A) See section 809C(1A) and (1B) for when an individual meets the 12- year residence test or the 7-year residence test for a tax year.

That takes us to s.809C ITA which provides:

> (1A) An individual meets the 12-year residence test for a tax year if the individual has been UK resident in at least 12 of the 14 tax years immediately preceding that year.
> (1B) An individual meets the 7-year residence test for a tax year if the individual.
> (a) does not meet the 12-year residence test for that year, but
> (b) has been UK resident in at least 7 of the 9 tax years immediately preceding that year.

I adopt the statutory terminology and refer to individuals who meet the 7 or 12-year residence tests as "**long-term residents**".

The period of residence might be continuous or broken.

While an individual is under 18:

(1) they are not subject to the remittance basis charge; but
(2) any UK resident years do count for the 7-year and 12-year residence tests..

In the year a long-term resident attains 18, the charge is payable in full. The RDR Manual 32230 provides a straightforward example of a case involving a minor.[30]

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30 **32230 Counting years of UK residence - Minors** [March 2014]
...
Example (Pranav)
"P was born on 23 October 1991. He came to the UK as a school boarder in August 2001 (tax year 01-02). He is domiciled outside the UK. He has stayed in education in the UK for every tax year since.

99-00 Not Resident	05-06 Resident
00-01 Not Resident	06-07 Resident
01-02 Resident	07-08 Resident
02-03 Resident	08-09 Resident
03-04 Resident	09-10 Resident
04-05 Resident	

In 08-09 P has foreign income of £300,000 and he claims to use the remittance basis in that year. He is a long-term resident in the UK as he has been UK resident for eight years, but as he is under 18 he may use the remittance basis in 08-09 without paying the remittance basis charge.
In October 2009 (tax year 2009-10) P turns 18. He has foreign income of £400,000. If he wishes to claim the remittance basis for that tax year he will be liable to the

A split year counts as a full year of residence in determining whether an individual meets the long-term residents rule, that is, whether he has been in the UK for at least 7 out of the 9 tax years immediately preceding the current tax year.[31]

The RDR Manual 32220 offers a straightforward example of a case involving a split year.[32]

10.11.3 *Nomination of income and gains*

Section 809C ITA provides:

> **809C Claim for remittance basis by long-term UK resident: nomination of foreign income and gains to which s.809H(2) is to apply**
>
> (1) This section applies to an individual for a tax year if the individual-
>
> (a) is aged 18 or over in that year, and
>
> (b) meets the 12-year residence test or the 7-year residence test for that year.

---

remittance basis charge."

Of course the (implausibly large) income specified is strictly irrelevant to the application of the remittance basis charge: the position is the same whatever is P's income.

31 See 7.1 (Default rule: individual regarded as resident throughout tax year).

32 **32220 Counting years of UK residence (seven out of nine) - Section 809 ITA 2007** [March 2014]

...

"Example (Dominic)

D, a non-dom, is resident in the UK for the tax year 2008-2009.

• D came to the UK in May 1999 (99-00 tax year)

• He left to live in Spain in January 2001 (00-01 tax year)

• He returned to the UK on 12 October 2002 (02-03 tax year)

• He left to work in the Republic of Ireland on 29 April 2004 (04-05 tax year)

• He then returned to the UK on 16 May 2006 (06-07 tax year) and has been resident here since.

D is resident in the UK for the current tax year (08-09). He has chargeable overseas earnings of £150,000 in that year, paid into his Spanish bank account and he does not remit anything. For the last nine tax years he has been resident/not resident as follows:

1 99-00 Resident
2 00-01 Resident (year he went to Spain)
3 01-02 Non Resident
4 02-03 Resident
5 03-04 Resident
6 04-05 Resident (year he went to Ireland)
7 05-06 Non Resident
8 06-07 Resident
9 07-08 Resident

D is a long term resident; if he claims the remittance basis in 2008-2009 he will be liable for the remittance basis charge."

> (2) A claim under s.809B by the individual for that year must contain a nomination of the income or chargeable gains of the individual for that year to which s.809H(2) is to apply.

Following the statutory terminology,[33] I refer to the income or gains so nominated as "**nominated income/gains**". Section 809C continues:

> (3) The income or chargeable gains nominated must be part (or all) of the individual's foreign income and gains for that year.
> (4) The income and chargeable gains nominated must be such that the relevant tax increase does not exceed
> (a) for an individual who meets the 12-year residence test for that year, £50,000;
> (b) for an individual who meets the 7-year residence test for that year, £30,000.

Section 809C(5) ITA provides a commonsense definition of "the relevant tax increase":

> "The relevant tax increase" is-
> (a) the total amount of income tax and capital gains tax payable by the individual for that year, minus
> (b) the total amount of income tax and capital gains tax that would be payable by the individual for that year apart from s.809H(2).

EN Amendments to the Remittance Basis Charge explains the reason for the cap in s.809C(4):

> This stops an individual from nominating too much income and gains and as a result paying a remittance basis charge of more than £30,000 [now the applicable amount].

The legislation does not say what happens if an individual fails to nominate any income/gains or if they nominate income/gains but the relevant tax increase exceeds the applicable amount. The RDR Manual provides:

> **32310 Nomination of foreign income and gains - overview** [January 2014]

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33 Section 809H(3) ITA provides: "'Nominated' income or chargeable gains means income or chargeable gains nominated under s.809C in the individual's claim under s.809C for the relevant tax year." The definition is repeated in s.809I(3) and s.809J(3) ITA. (If a chapter-wide definition had been used the repetition would have been unnecessary.)

... Any claim that does not include a nominated amount is not valid. ...
32330 Relevant tax increase [January 2014]
The remittance basis charge cannot exceed £30,000 for those individuals who have been UK resident in at least 7 out of 9 years or £50,000 for those individuals who have been UK resident in at least 12 out of 14 years. Any nominations which produce an excessive relevant tax increase may invalidate the claim under section 809B to be taxed on the remittance basis.
Also refer to RDRM35100 remittances of nominated income or gains for details about the rules that may apply if the individual remits any nominated income or gains in later years.

The following example from the RDR Manual shows how complicated this will be:

32350 Relevant tax increase - Example 2 [July 2010]
...
Relevant tax increase: Example 2 (Lorna)
L, a non domiciled long-term UK resident makes a claim to use the remittance basis in 201X and must pay the £30,000 remittance basis charge (RBC). She is a higher rate taxpayer paying tax at 40%, with UK source employment income of £80,000.
She also has £150,000 of interest (relevant foreign income) from an overseas investment in Country X paid to her.
Because nominated income is taxed on the "arising basis", a remittance basis user is in the same position as any other UK resident person and is, subject to the ordinary rules that apply in such cases (s.793 ICTA 1988+), entitled to credit against UK tax for certain amounts of overseas tax that is payable on that same income.
Under the domestic law of Country X in which the investment was made, the interest was paid after deduction of 15% withholding tax. The Double Taxation Agreement between the UK and Country X provides that tax on this interest may be retained in the "source" country at the rate of 15%.
L is therefore entitled to a credit, which she takes in the form of foreign tax credit relief (FTCR), against UK tax for the tax withheld in the other country. ...
Foreign tax credit relief calculation – general principles
Ignoring the remittance basis issue for the moment:
L has received foreign interest of £150,000, on which Country X's tax of £22,500 (15% as provided for in the DT treaty) has been deducted.
L's income is chargeable to tax at 40%. The UK tax charge is respect of this £150,000 would be £60,000 (40%×£150,000).
If she claims foreign tax credit relief her net liability to UK tax after the foreign tax credit relief will be:
£60,000 minus £22,500 = £37,500
Relevant tax increase including FTCR
Foreign tax credit relief is only due to the extent that the foreign income on

which it is given is brought into the UK tax charge. So for remittance basis users, relief for foreign tax paid on foreign income chargeable on the remittance basis is given when that income is remitted.

However for remittance basis charge payers like L, any foreign income which she nominates is chargeable on the arising basis so foreign tax credit relief can be given in relation to that nominated income.

Because the "relevant tax increase" must be £30,000, L will need to nominate £120,000 of her foreign interest if she wishes to create an overall remittance basis charge of £30,000.

- FTCR calculation

Foreign tax that relates to the £120,000 nominated (at 15%)	£18,000
UK tax on £120,000 (at 40%)	£48,000
Net liability to UK tax after the FTCR (£48,000 minus £18,000)	£30,000

(refer to note 2 below)

- Relevant tax increase calculation

To determine the relevant tax increase we must complete two calculations.

The first calculation (a) is of the total amount of L's income tax and capital gains tax actually payable in the year, as a remittance basis user and RBC payer.

The second calculation (b) is the total amount of L's income tax and capital gains tax that would be payable by L in the year as a remittance basis user, as if no nomination was required and the RBC was not due that is, as if there was no income tax or capital gains tax payable on her nominated foreign income or gains.

The relevant tax increase is the total of calculation (a) minus calculation (b)

	Calculation (a)			Calculation (b)		
Non-savings income						
20%[1] on	**£34,800**	=	**£6,960**	**£34,800**	=	**£6,960**
40% on	**£45,200**	=	**£18,080**	**£45,200**	=	**£18,080**
	£80,000		£25,040	£80,000		£25,040
Savings						
40% on	£120,000[2]	=	**£30,000**	Note 4		
Total Income Tax Due			**£55,040**[3]			**£25,040**[4]

1 Rates and thresholds used here for the purposes of this example only; use the rates applying in the relevant tax year.

2 This is the foreign income that is nominated, and charged to tax on the arising basis in the year. FTCR is given, which has reduced the tax to £30,000.

3 As a remittance basis user, L has no personal allowances due.

4 L is a remittance basis user so would not be subject to tax on her unremitted foreign income, nor would any FTCR be due.

Relevant Tax Increase is	Total (a)		£55,040
less	Total (b)		£25,040
		Total	**£30,000**

March 2009 Q&As provides:

Q3: HM Revenue & Customs (HMRC) have indicated that individuals do not have to specify which account the nominated income comes from, and from this it could be inferred that without further disclosure of the particulars of the account the taxpayer may be at risk of "tainting" every other source of income of that type. For example if an individual has an account with one bank in Jersey and another bank in a different jurisdiction, he could nominate bank interest on his Jersey account, so that it would be obvious that if he remitted income from his other account, he might not fall foul of re-characterisation provisions. However, this may not be the case if he had three different accounts with the same bank in Jersey and he wishes to nominate income from one of those accounts without disclosing the account number of that account. Can HMRC clarify what their approach to this will be?

A: It is up to the individual to decide how much information to give HMRC on their Self Assessment returns in order to identify the source of the nominated income or gains; if, as in this example, there is more than one account the individual should provide sufficient detail to distinguish between them and identify the "nominated" account. That might be the entire account number, or the account "name", or some other unique identifying feature of the account.

The RDR Manual 32380 provides:

Completing the SA Return - How is this done in practice? [January 2014]

SA109 ‹Residence, remittance basis etc' is the supplementary page to the SA100 main tax return for remittance basis users to complete under Self Assessment.

There is a box to claim the remittance basis on the SA109 and two boxes where the ‹amount of income you are nominating' and the ‹amount of capital gains you are nominating' must be entered. The amount nominated can be either income or gains or a combination of the two.

The source(s) of the amount nominated is the individual's personal choice.

When either or both of these boxes are completed the SA109 notes say that details of the nominations are to be shown in the "Any other information" box.

The required information is:

- the precise amounts of income and gains that have been nominated, (this should include the country of origin and the type and source of the income)
- the computation of the gain (if applicable)

- the exchange rates used[34]
- the calculation of the tax due in relation to the nominated income and gains.

Also if there have been deductions for expenses or losses from either foreign income or foreign gains in arriving at the final taxable amount, full details of the amounts and nature of those expenses or losses must also be provided.

All of this information is required to validate the nomination or nominations that have been made.

10.11.4 *Nominated income/gains charge*

Section 809H(2) ITA provides:

> Income tax is charged on nominated income, and capital gains tax is charged on nominated chargeable gains, as if s.809B did not apply to the individual for the relevant tax year (and neither did s.809D).

This disapplies the remittance basis, so nominated income and gains are taxed on the arising basis. I refer to this as the "**nominated income/gains charge**".

EN FB 2008 provides:

> 14. This charge is in addition to the tax liability for the year in question on any income and gains remitted to the UK, and any UK income or gains taxed on the arising basis. The £30,000 [now the applicable amount] will be paid on nominated income and gains not remitted to the UK in the year. (These income and gains are called "nominated" income and gains because the taxpayer is free to nominate the income and gains not remitted to the UK in the year on which tax of £30,000 is payable. For example, this could be £75,000 of unremitted foreign deposit interest on which UK tax was due at 40 per cent, so leading to an income tax charge of £30,000.)

10.11.5 *Remittance basis deficit charge*

The removal of the remittance basis for nominated income/gains might not yield the desired additional tax for various reasons. The individual might under-nominate, ie, they might not nominate enough income/gains. There is no requirement to nominate enough to give rise to a IT or CGT charge of the applicable amount. Indeed, it is not always possible to know how

34 See 55.8 (Nominated income and gains: currency conversion date).

much that would be. One could nominate just £1, as long as what is nominated is foreign income or gains. HMRC agree. The RDR Manual 32320 provides:

> **32320 Making a Nomination** [January 2014]
> *Insufficient nomination*
> Although an individual may choose to make an insufficient nomination RDRM32360 they must have foreign income and/or foreign chargeable gains from the tax year such that they can nominate something, even if only £1. This fulfils the mandatory requirement that a nomination **must** be made when making the claim.
> *Completing the self-assessment return*
> All claims and nominations are made on the individual's self assessment tax return. The minimum amount that can be nominated **is**£1 of foreign income or gains for the claim to be valid. Where a claim to the remittance basis is made under s809B but no nomination of either foreign income or capital gains is made the claim is invalid.[35]

According to EN Amendments to the Remittance Basis Charge, this was done to enhance confidentiality:

> 7. The legislation provides the option for those who can claim the remittance basis not to disclose anything about their unremitted income or gains as they can make a claim with a nominal £1 amount and do not have to specify what further foreign income or gains remain unremitted.

But it may not be in the interests of the taxpayer to under-nominate, and the confidentiality is illusory because HMRC are likely to make further enquiries.

The removal of the remittance basis for nominated income/gains might not yield the desired additional tax where the individual has some tax reliefs (eg loss relief, interest relief, DTRs, etc).

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35 Similarly March 2009 Q&As provides:
"**Q7:** The question has arisen whether less than £1 (ie pence) can be nominated income. Given current interest rates there is concern that accounts specifically set up to generate nominated income may not generate £1 before 6 April 2009. The concern expressed is that because pence are rounded down on tax returns, it might be your view that there is no nominated income?
A: The minimum nomination of income or gains required to calculate the relevant tax increase is £1. This is the minimum figure to be declared on the relevant supplementary page of the Tax Return."
But where is the statutory authority for HMRC to disregard figures under £1?

Section 809H(4) ITA goes on to ensure that HMRC will receive their desired amount of tax:

> If the relevant tax increase would otherwise be less than the applicable amount,[36] subsection (2) has effect as if—
>
> (a) in addition to the income and gains actually nominated under s.809C in the individual's claim under s.809B for the relevant tax year, an amount of income had been nominated so as to make the relevant tax increase[37] equal to the applicable amount, and
>
> (b) the individual's income for that year were such that such a nomination could have been made (if that is not the case).

I refer to s.809H(4) as the "**deficit charge**". The deficit charge is a tax on deemed income (deemed nominated income) and not on any actual income of the taxpayer (if indeed the taxpayer has other income). Section 809H(6) ITA makes this clear (if necessary):

> Nothing in subs.(4) affects what is regarded, for the purposes of s.809I or 809J, as nominated under s.809C.

I use the term "**remittance basis claim charge**" to mean the two distinct (albeit related) charges:
(1) the nominated income/gains charge, under s.809H(2); and
(2) the deficit charge, under s.809H(4).
It might be more accurate to refer to remittance basis claim *charges* (in the plural). However for many purposes it does not matter that there may be

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36 Section 809H(5B) provides:
"The applicable amount" is–
(a) if the individual meets the 12-year residence test for the relevant tax year, £50,000;
(b) if the individual meets the 7-year residence test for the relevant tax year, £30,000."

37 Section 809H(5)(5B) ITA repeats the definition of "the relevant tax increase" from s.809C(5) (5A):
"'The relevant tax increase' is—
(a) the total amount of income tax and capital gains tax payable by the individual for the relevant tax year, minus
(b) the total amount of income tax and capital gains tax that would be payable by the individual for the relevant tax year apart from subsection (2).
(5A) The references to income tax in subsection (5) do not include income tax under s.424 (gift aid)."
If there had been a chapter-wide definition the repetition would have been unnecessary.

two charges rather than one, (especially since in practice the second may not often arise) and it is convenient to use the singular label for them both.

10.11.6 *Interaction with Gift Aid*

Section 809H(5A) ITA provides:

> The references to income tax in subsection (5) do not include income tax under s.424 (gift aid).

The RDR Manual provides:

> **32450. Charitable Donations and Gift Aid** [January 2014]
> Chapter 2 of Part 8 ITA 2007 provides relief from tax for some gifts of money to charities that are made by individuals. This is known as 'Gift Aid'. One part of the Gift Aid rules is that the donor must pay at least as much UK income tax and/or capital gains tax in the tax year as the amount that is repayable to the charity.
> - Section 414(2)(a) ITA 2007 treats a qualifying donation as if it had been made after deduction of basic rate income tax.
> - If the donor has not paid enough UK income tax and capital gains tax to 'frank' the gift aid donations in a tax year, a further amount of income tax is charged to make up the shortfall (s.424 ITA 2007).
>
> The Remittance Basis Charge
> In exactly the same way as any other amount of income tax or capital gains tax, amounts of tax that are paid to satisfy the Remittance Basis Charge can be used to frank Gift Aid donations. That is because the remittance basis charge is 'income tax charged' or 'capital gains tax charged' on nominated income and/or gains.
> However, where the individual has:
> - chosen to use the remittance basis, and
> - claimed Gift Aid tax relief
>
> any income tax that is charged under s. 424 ITA 2007 is not taken into account when calculating the 'relevant tax increase' (see RDRM32330) that is required to produce the remittance basis charge (s.809C(5A) ITA 2007 and s.809H(5A)).
> Effect
> No matter how it is calculated, the Remittance Basis Charge is always £30,000 [or, in certain circumstances, from 6 April 2012, £50,000] – see RDRM32300.

For this topic, see Kessler and Marre, *Taxation of Charities and Nonprofit Organisations* (9th edition, 2013-14), para 15.41 (Donor pays insufficient tax) (online version *http://www.taxationofcharities.co.uk*).

10.11.7 *How much to nominate?*

It is important not to remit nominated funds to the UK. From that point of view it is convenient to under-nominate, ie nominate a nominal £1 only.

On the other hand, taxpayers who want to offset the remittance basis charge against foreign tax will want to nominate income or gains on which the foreign tax is at least equal to the applicable amount, or as close to the figure as possible; that requires a full nomination and some care in the choice of income/gains which are nominated.

10.11.8 *Remittance basis claim charge in cases of doubt over residence*

A person may be unsure whether or not they are UK resident in a year (residence if often unknowable) but know that they would be a long-term resident if actually UK resident in that year. That person may if appropriate make a remittance basis claim in that year, for the avoidance of doubt, and argue the residence position at leisure; if they are eventually held to be UK resident the remittance basis claim charge is due, but if non-resident the sum is not due. Nothing is lost by making the claim.[38] Section 809B does not apply unless the individual meets the conditions of s.809B(1)(a) and (b) in the year.

Alternatively a person may know that they are UK resident in a year but not know if they are a long-term UK resident in that year (because they are unsure whether or not they were resident in one or more earlier years). That person should make a remittance basis claim but not nominate any income or gains. The claim is valid if they are not long-term UK resident. The claim is invalid if they are long-term UK resident, so the remittance basis claim charge is not due (unless they proceed to make a new election and nomination).

On the other hand a remittance basis claim is effective (and the remittance basis charge payable) even if the individual has less than £2k unremitted income and gains, and so would qualify as a sub-£2k taxpayer. That would be an expensive box to tick in error!

10.11.9 *Minimising the remittance basis claim charge*

Basic tax planning for spouses will be to arrange that income and gains

38 Similar points arise if a person is unsure about their domicile in a year, but in practice that would be less common because domicile (unlike residence) is generally ascertainable.

accrue only to one of them, so that only one has to pay the remittance basis claim charge.

Basic planning for individuals who do not wish to pay the remittance basis claim charge every year is to time disposals and accruals so far as possible that foreign income and gains accrue before the 8th year of residence, and only once every few years subsequently (so a claim is only needed once every few years).

10.11.10 *Remittance basis claim charge: credit against foreign tax*

EN FB 2008 provides:

> 17. As the RBC consists of income tax or CGT paid on the arising basis ... the tax should be recognised as tax (on income or capital gains, as the case may be) for the purposes of our double taxation agreements.

The proposal in the Draft Clauses published January 2008 was for a simple charge of a fixed amount. This would not have qualified as a credit against foreign tax because it was not a tax on income or gains. HMRC presumably agreed, as the provisions were then recast in order that:

(1) The provisions took the form (so far as possible) of a charge on income or gains but

(2) the provisions had the effect (so far as possible) of a fixed charge.[39]

Article 24(1) of the UK/US DTA provides:

> In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income
>
> (a) the income tax paid or accrued to the UK by or on behalf of such citizen or resident ...

It is suggested that the *nominated income/gains charge* can in principle be set against foreign tax since it is an income tax or CGT. However the remittance basis *deficit* charge is not a charge on actual income, and cannot be set against foreign tax. HMRC agree. EN Amendments to the Remittance Basis Charge provides:

> 16. The individual claiming the remittance basis might decide to nominate only £50,000 of bank interest under s.[809C(2)] and pay

39 See too 10.11.12 (Remittance basis claim charge in year of arrival and departure).

£20,000 of the £30,000 under s.[809H(2)] (assuming higher rate tax is due on all the £50,000). Section [809H(4)] would then apply with the effect that further income of £25,000 is treated as nominated to bring a further £10,000 of income tax into charge. However if the individual intended claiming credit for all or part of the £30,000 under a DTA then DTA relief will only be due on the income or gains actually nominated under s.[809C(2)] – £50,000 of income and £20,000 of income tax in this example. The income tax paid on income treated as nominated under s.[809H(4)] = £25,000 of income and £10,000 of income tax in this example, will not qualify for relief under DTAs as it is not tax on specific nominated income.

It follows that a careful choice of what income or gains to nominate is important, because (if foreign tax allows credit for the UK tax) that can make up to £30k or £50k difference to the foreign tax liability.

The RBC might have been regarded as a fixed levy, merely disguised as an income tax by sleight of hand, but in America, the IRS have after some delay[40] accepted the HMRC view. The question is of course one for foreign law, not UK law. The US ruling made August 2011 provides:

Rev. Rul. 2011-19
ISSUE
Whether a credit is allowable under section 901 of the Internal Revenue Code for the Remittance Basis Charge (RBC) of £30,000.[41]
[The ruling outlined the UK tax rules and continues]
LAW AND ANALYSIS
Section 901 generally allows a credit for the amount of any income, war profits and excess profits tax (collectively, an income tax) paid or accrued during the taxable year to any foreign country or to any possession of the United States. A foreign levy is an income tax if and only if (i) it is a tax and (ii) the predominant character of that tax is that of an income tax in the US sense. §1.901-2(a)(1).
A. Single Levy or Separate Levies
Each levy must be analysed separately to determine if it is an income tax under section 901. §1.901-2(d)(1). For purposes of section 901, whether a single levy

40 One would like to know what discussions took place behind the publication of this statement. Perhaps in 2041 the relevant files will be made public.
For HMRC's opening shot in this debate see BN 107 accessible
(2008) Simon's Tax Intelligence, issue 11 (20th March 2008) annex

41 Author's note: The increase in the remittance basis charge in 2012 will not affect the reasoning.

or separate levies are imposed by a foreign country depends on US principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. Where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered for purposes of section 901 to impose separate levies for such classes of persons. For example, regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed under section 871(b) on a US nonresident alien individual's income that is effectively connected with the conduct of a US trade or business is a separate levy from a foreign levy identical to the tax imposed by section 1 on the income of a US citizen or resident, as the tax on nonresidents has a more limited scope and therefore is different in kind from the tax on the worldwide income of US citizens and residents.

Where foreign law imposes a levy that is the sum of two or more separately computed amounts, and each such amount is computed by reference to a separate base, separate levies are considered, for purposes of section 901, to be imposed. Amounts are not separately computed if they are computed separately merely for purposes of a preliminary computation and are then combined as a single base. §1.901-2(d)(1). For example, where excess deductible expenses allocated to one type of income are applied to reduce other types of income, a single levy exists, since despite a separate preliminary computation the bases are combined before computing the tax due. See §1.901-2(d)(3), Examples (3), (4), and (5).

1. The Remittance Basis and the Arising Basis of Taxation Are Separate Levies

Under both the arising basis and the remittance basis of taxation, a non-domiciliary is subject to tax on UK-source and non-UK-source income and gains. However, under the arising basis, a non-domiciliary is subject to tax on worldwide income and gains that arise or accrue in a particular taxable year; while under the remittance basis, a non-domiciliary is subject to tax only on UK-source income and gains and on non-UK-source income or gains that are remitted in a particular taxable year, whether the non-UK-source income or gains arise or accrue in the year remitted or in an earlier year. Thus, the bases of these levies are different in kind, and not merely in degree; therefore, the arising basis and remittance basis of taxation are considered for purposes of section 901 to impose separate levies.

2. The RBC, in Combination with the Remittance Basis of Taxation, is a Single Levy that is a Separate Levy

All non-domiciliaries who elect the remittance basis of taxation are subject to tax on their UK-source and remitted non-UK-source income and gains. In addition, long-term non-domiciliaries must pay the RBC on nominated but unremitted non-UK-source income and gains (and, if the amount nominated generates a tax charge of less than £30,000, on income or gains realized but not nominated and on imputed income such that the tax charge equals £30,000). Losses and deductions allocated to UK-source income or gains, remitted non-UK-source

income or gains, or nominated but unremitted non-UK-source income or gains may offset income or gains in another category in determining the amount of the long-term non-domiciliary's taxable income. Therefore, under §1.901-2(d)(1), despite a separate preliminary computation, the long-term non-domiciliary's UK-source income or gains, remitted non-UK-source income or gains, and unremitted non-UK-source income or gains giving rise to the RBC are combined in determining the long-term non-domiciliary's taxable income; therefore, the tax imposed on the sum of the long-term non-domiciliary's three separately computed amounts of income constitute a single levy (the Long-Term Non-Domiciliary (LTND) Levy).

A. The LTND Levy Is a Tax in the US Sense

A foreign levy is an income tax if and only if it is a tax and the predominant character of that tax is that of an income tax in the US sense. §1.901-2(a)(1). A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. §1.901-2(a)(2)(i). The LTND Levy is a tax because it is required to be paid pursuant to the authority of the government of the UK to levy taxes.

A. The Predominant Character of the LTND Levy Is that of an Income Tax in the US Sense

The predominant character of a foreign tax is that of an income tax in the US sense if the tax is likely to reach net gain in the normal circumstances in which it applies, and liability for the tax is not dependent, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country. §1.9012(a)(3). Liability for the LTND Levy is not dependent on the availability of a credit for the LTND Levy against income tax liability to another country.

Thus, whether the LTND Levy has the predominant character of an income tax depends on whether it is likely to reach net gain in the normal circumstances in which it applies. A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in §1.9012(b)(2), (b)(3), and (b)(4), respectively.

1. Realization

A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed upon or subsequent to the occurrence of events that would result in the realization of income under the income tax provisions of the Code. §1.901-2(b)(2)(i)(A). A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of realization or pre-realization events described in §1.901-2(b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in that paragraph. For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of realization events satisfies the realization requirement even though the base of that

tax also includes imputed rental income from a personal residence used by the owner. §1.901-2(b)(2)(i).

The UK-source and remitted non-UK-source income and gains of a long-term non-domiciliary electing the remittance basis of taxation generally are computed on the basis of amounts that satisfy the realization requirement. In addition, the income or gains nominated for purposes of the RBC must be part (or all) of the non-UK-source income and gains arising or accruing in that taxable year. Income tax is charged on nominated income, and capital gains tax is charged on nominated gains, as if the arising basis applied for the relevant taxable year. In other words, the nominated income and gains are subject to tax, even though they have not been remitted in the taxable year. Thus, the RBC is imposed on nominated income or nominated gains that have been realized or accrued in the taxable year.

If the long-term non-domiciliary realizes or accrues, but fails to nominate, sufficient income or gains, with the result that the tax charge on nominated income would be less than £30,000, an amount of income or gains is deemed to be nominated so as to make the tax charge equal £30,000. Thus, income or gains that have been realized or accrued but not nominated will be subject to the RBC. If a long-term non-domiciliary elects the remittance basis but does not have sufficient realized or accrued income or gains to make the tax charge equal £30,000, the long-term non-domiciliary is deemed to have sufficient realized or accrued income or gains and to have nominated such imputed income or gains to make the tax charge equal £30,000.

Section 1.901-2(b)(2)(i) states that, as provided in §1.901-2(a)(1), a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax on a base that includes imputed rental income will satisfy the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed income. However, a foreign tax based only or predominantly on such imputed income would not satisfy the realization requirement. Although it is possible for a long-term non-domiciliary to elect the remittance basis without having sufficient non-UK-source income or gains to support a £30,000 tax charge, in which case the base of the tax would include imputed income or gains, it is highly unlikely that substantial numbers of long-term non-domiciliaries in this situation would elect to be taxed on the remittance basis. Accordingly, it is reasonable to conclude that the RBC is not based only or predominantly on such imputed income or gains. The RBC in general is imposed on realized income or gains, whether nominated by the long-term non-domiciliary or considered by the UK statute to have been nominated. Thus, judged on its predominant character, the LTND Levy meets the realization test.

1. Gross Receipts

A foreign tax satisfies the gross receipts requirement if, judged on the basis of its

predominant character, it is imposed on the basis of gross receipts or gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value. §1.901-2(b)(3)(i). A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in §1.9012(b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in that paragraph. As is the case with income and gains that are taxed under either the arising basis or the remittance basis, nominated income and gains subject to the RBC generally are based on gross receipts. Therefore, the LTND Levy meets the gross receipts test.

1. Net Income

A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts to permit recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses. §1.901-2(b)(4)(i). Since the LTND Levy is imposed on UK-source income and gains, remitted non-UK-source income and gains, and nominated but unremitted non-UK-source income and gains, all of which consist of gross receipts less costs and expenses, the LTND Levy satisfies the net income requirement.

1. Conclusion

Because the LTND Levy is likely to reach net gain in the normal circumstances in which it applies, it has the predominant character of an income tax in the US sense.

HOLDING

Because the LTND Levy is a tax (within the meaning of §1.901-2(a)(2)), and its predominant character is that of an income tax in the US sense, the LTND Levy, including the Remittance Basis Charge (RBC) of £30,000, is an income tax for which a credit is allowable under section 901. However, a credit for the LTND Levy will be available only if the other legal requirements for obtaining a foreign tax credit are satisfied. For example, an amount paid is treated as a compulsory payment of income tax only to the extent the taxpayer applies the substantive and procedural provisions of foreign law, including elective provisions such as those available under UK law relating to the LTND Levy, in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for income tax. §1.901-2(e)(5).

Taxpayers generally may rely upon revenue rulings to determine the tax treatment of their own transactions and need not request a ruling that would apply the principles of a published revenue ruling to the facts of their own particular cases. However, because each revenue ruling represents the conclusion of the Internal Revenue Service (IRS) as to the application of the law to the specific facts

involved, taxpayers, IRS personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless those cases present facts and circumstances that are substantially the same as those in the revenue ruling. §601.601(d)(2)(v)(e). Accordingly, because the provisions of UK law described in this revenue ruling are facts on which this revenue ruling bases its holding, a taxpayer may not rely on the revenue ruling if the relevant provisions have been amended in any material respect, and the taxpayer is responsible for determining whether any such modification has occurred.[42]

The US ruling concludes with a paragraph which one would not find in the UK:

> **DRAFTING INFORMATION**
> The principal author of this revenue ruling is Teresa Burridge Hughes of the Office of Associate Chief Counsel (International). For further information regarding this revenue ruling, contact Ms. Hughes at (202) 622-3850 (not a toll-free call).

What an good thing it would be if in the UK HMRC statements and regulations similarly identified a principal author who would take responsibility - both credit for the good and blame for mistakes.[43]

10.11.11 *Individual treaty non-resident*

The RDR Manual provides:

> **RDRM32250 Dual residents - treaty non-resident** [March 2014]
> It is possible for individuals to be resident both in the UK and in another country or countries in a tax year. In such a case we look to the provisions of existing Double Taxation Agreements (DTAs) to determine in which country the individual is resident for treaty purposes. So a person may be resident in the UK under UK law, but regarded as 'treaty resident' elsewhere and consequently treated for tax purposes as 'not resident' in the UK.
> An individual who is, under the terms of a DTA, resident in the other country or territory but is also a long-term resident RDRM32200 in the UK (that is someone who has been resident in the UK n at least seven out of the previous nine tax years) and claims the remittance basis is, if their un-remitted foreign income and gains is £2,000 or more, liable to pay the

42 *http://www.legalbitstream.com*.

43 Contrast the rule in the FA 2009 that a senior accounting officer of large companies must take a personal responsibility for the company's tax returns.

> £30,000 remittance basis charge, or for 2012/13 or later the £30,000 or £50,000 remittance basis charge.

It is considered that DT relief is in principle available against the nominated income/gains charge, but not against the remittance basis deficit charge. The effect of claiming DT relief against nominated income or gains is to reduce the remittance basis claim charge on the nominated income or gains, but to increase the deficit charge by the same amount.

This certainly defeats the spirit of any DTA. It may also breach the DTA itself. But the intention of Parliament is clear, and the doctrine of parliamentary sovereignty allows Parliament to breach DTAs.[44] How our treaty partners will react to this will be interesting to see.

The RDR Manual continues:

> **32250 Dual residents - treaty non-resident** [March 2014]
> ...
> In determining the number of years in which an individual has been resident in the UK for the purposes of the long-term resident provisions, you count all years where the individual is resident in the UK under UK domestic law even if the individual was treaty resident in another territory in some or all of those years.

This is correct.[45] The RDR Manual continues with some tax planning advice:

> In most cases, an individual resident both in the UK and in another country and who under the Double Taxation Agreement with the other country is treated as resident in that other country (for the purpose of applying the provisions of the DTA) will be chargeable to tax in the other country on income and gains that originate in that other country and not in the UK. The treatment of any income and gains that originate in third countries (not the UK or the country of treaty residence) will depend upon the terms of the DTA between the UK and the country of residence.
> Where, exceptionally, an individual is chargeable to tax in the UK on such income or gains, they will need to consider whether a claim for the remittance basis of taxation is in their best interests or if, instead, they should pay tax on the arising basis and in the usual way, claim a credit for the tax charged in the other territory.

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44 See *Padmore v IRC (No.2)* [2000] STC (SCD) 356.

45 See 6.2 (Relationship between treaty-residence and UK-law residence).

10.11.12 *Remittance basis claim charge in year of arrival and departure*[46]

There is no split year rule, so the remittance basis claim charge is payable in full if the remittance basis is claimed, even in split years.[47]

What is the reason for that rule? If the remittance basis claim charge is a tax on the nominated income or gains, the split year rule should logically apply. The reason is that the charge is intended only to take the form of a tax on the nominated income or gains, and it is intended to have the effect of a fixed charge.

10.11.13 *Administration*

The RDR Manual provides:

> **32210 Long-term residents and the remittance basis charge - overview** [March 2014]
> ... The remittance basis charge is payable through and collected by the SA regime, and an SA tax return must be filed. The SA109 ‹Residence, remittance basis etc' supplementary return should be completed and filed for this purpose. Also refer to RDRM32020 ‹Making a claim'.

So a long-term resident who wishes to claim the remittance basis will need to file an SA tax return in order to pay the remittance basis charge.

Of course the charge could not be collected through PAYE. For one thing, the charge might be a charge to CGT and even if it is income tax it need not be a charge on employment income. Also the claim on which the charge depends will be made in the tax return some time after PAYE is due.

HMRC Brief 17/09 provides:

> The rules for nominating income and gains upon which the £30,000 is paid, and the rules for identifying what is taxed if those nominated income or gains are later remitted to the UK, can be complex. To help ensure individuals who pay the £30,000 get the right level of customer support [!] from HMRC, we have decided that most individuals who pay the £30,000, or have paid it in the past, will have their tax affairs dealt with in one HMRC office from 2009-10. This will be the CAR Residency office in Castle Meadow, Nottingham.
> Customers who are sent a self assessment return by a different office should make the return to the office issuing that return. Once the return

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46 For the distinct issue of the interaction of the split-year rules and the definition of "long-term UK resident" see 10.11.2 ("Long-term UK resident").

47 See 7.1 (Default rule: individual regarded as resident throughout tax year).

has been received by HMRC we will arrange for the individual's tax records to be transferred to the CAR Residency office in Nottingham and advise the individual and any agent, accordingly. Until such time as individuals or their agents receive such a notification they should continue to deal with their current tax office.

10.11.14 *Interaction with payments of IT on account*

The RDR Manual provides:

> **32390 Payments on account - interaction with the remittance basis charge (RBC)** [January 2014]
> The remittance basis charge is tax on nominated income or nominated gains, (or a mixture of the two) ...
> To the extent that the remittance basis charge consists of income tax, the payment on account position for those paying the charge is the same as that for any other SA taxpayer. This means their payments on account are based their income tax liability for the previous year (TMA1970/s59A(1)).
> The SA109 ‹Residence, remittance basis etc' supplementary pages to the SA tax return must be completed to both claim the remittance basis and nominate income or gains and pay the remittance basis charge.
> *Effect and treatment of income*
> If paying part or all of the remittance basis charge in respect of nominated income, then income tax will be due. The amount which has been nominated from income and produced income tax will need to be taken into account and included in the overall calculation of payments on account for the following year.
> If an insufficient nomination is made to produce the remittance basis charge of either £30,000 or £50,000 (ITA07/s809H(4)) the additional amount treated as nominated will always produce income tax. This also has a bearing on the payments on account position, even though the additional nominated amount is from an unidentified and unspecified amount of income. The additional amount nominated from income will automatically produce income tax that will become part of the individual's payment on account calculation for the following year.
> *Effect and treatment of capital gains*
> Capital gains tax is not included in computing payments on account, so any of the remittance basis charge that is constituted of capital gains tax will not form any part of the following year's payments on account.
> *Example (Ricardo)*
> R, a non-domiciled long-term resident has an income tax liability of £200,000 for tax year 2007-08. Subsequently he makes payments of £100,000 on 31 January 2009 and on 31 July 2009 on account of his liability for 2008-09.
> His tax liability for 2008-09 is £250,000, which includes for the first time the £30,000 remittance basis charge. The remaining £220,000 is income tax on UK sources. R nominated only £21,000 of his foreign income which led to a charge of £8,400 income tax; he also nominated £120,000 foreign chargeable gains which led to a capital gains tax of charge £21,600. Together these amounts make up his £30,000 remittance basis tax charge.

R's payments on account for 2009-10 will be calculated using the £220,000 income tax paid on UK income sources in 2008-09, plus the £8,400 income tax element of the remittance basis charge. This means that he will make payments on account of £114,200 on 31 January 2010 and on 31 July 2010 on account of liability for 2009-10. ...

32400 Payments on account – nominations involving chargeable gains [January 2014]

Capital gains tax included in the calculation of liability for a year is not included in computing payments on account for the next year. Any part of the remittance basis charge that is tax on nominated foreign gains will not form part of the following year's payments on account.

There is an additional box to complete on the SA109, if a nomination of capital gains is made to ensure that the capital gains tax forming part of the remittance basis charge for a year is ignored for the purpose of calculating the next year's payments on account..

This box is called ‹Adjustments to payments on account for capital gains' and must be completed if any nomination of capital gains is made.

This box is not completed if a nomination of income only has been made, as any amount nominated from income will be taken into account in computing the overall payments on account liability for the following year.

The amount entered in the ‹Adjustment to payments on account for capital gains' box on the SA109 is required in order for the payments on account to be calculated correctly for subsequent years:

- where a taxpayer calculates their own liability to tax, the amount for capital gains tax entered in the box to adjust payments on account, should be excluded in their calculation of payments on account
- if the tax calculation summary page is used the first payment on account for the following year will not include any part of the amount entered for capital gains in the adjustment to payments on account box.

Example involving an amount of capital gains in the ‹Adjustment to payments on account for capital gains' box:

R, claims the remittance basis in 2008-09 and nominates both foreign income and foreign gains to pay the £30,000 remittance basis charge.

He nominates as follows:

£21,000 of relevant foreign income	@40%	£8,400
£120,000 of foreign chargeable	@18%	£21,600
		£30,000

The amount of £21,600 for capital gains tax should be entered in the ‹Adjustment to payments on account for capital gains' box as this amount is excluded in calculating payments on account for the following year. Only the £8,400 tax that is chargeable on nominated income is taken into account when calculating the amount due as payments on account.

If the entire amount nominated to pay the remittance basis charge comes from capital gains then the capital gains tax element of the remittance basis charge is not included in the calculation of the payments of account. In this case the full £30,000 from nominated gains will be entered in the ‹Adjustment to payments on

account for capital gains' box.

32410 Payments on account - first-year of paying RBC [June 2010]

The remittance basis charge is only payable from tax years 2008-09 onwards by long-term residents making a claim to use the remittance basis.

For example, if a remittance basis claim is made in 2008-09 and the remittance basis charge is due, then the first year that any payments on account can be considered in relation to the remittance basis charge is 2009-10 unless there is a claim to reduce ...

The fact that their tax liability for 2008-09 will be increased for those paying the remittance basis charge has no effect on the payments on account position for 2008-09 (unless there is a claim to reduce them) but, to the extent that the remittance basis charge is income tax, it will be taken into account when calculating payments on account for 2009-10.

The remittance basis charge for 2008-09 is not due for payment until 31 January 2010 when it can be paid as part of any balancing payment for the year

The same principle applies to the payment on account position in relation to the remittance basis charge for any first year that a claim to the remittance basis is made, and the remittance basis charge is due. Payments on account will not generally be affected until after the first year in which they pay the remittance basis charge (TMA70/s59A(2)).

32420 Payments on account: no remittance basis charge due in following year [June 2010]

When the remittance basis of taxation is **not** claimed in a year following one where the remittance basis has been claimed and the remittance basis charge was paid, the amount of income used to pay part or all of the remittance basis charge may be excluded from the calculations of payment on account.

To allow this to happen, a claim to reduce payments on account may be made on form SA 303. Further information on the rules and the time-limits for making a claim to adjust payments on account can be found in the Self Assessment Manual under SAM1110.

32430 Claim to reduce Payments on Account (PoA) [June 2010]

The payment on account (PoA) position in relation to the remittance basis charge will be affected by any claims to reduce payments on account.

Where the RBC is paid in the previous year on nominated income, the amount feeds through to the individual's payments on account (PoA) for the next year, unless the individual makes a claim to reduce their PoAs on the grounds that their income tax liability for that year will be less than the sum of the two PoAs. For example this could be because they will not claim the remittance basis for the following year. If they subsequently do claim the remittance basis and pay the remittance basis charge in the following year and the income tax due for that year exceeds the sum of the PoAs made we will charge interest on the reduction in the PoA.

This is shown in the example below:

Stage 1

The return shows liability to income tax, which includes the RBC, partly or fully paid in respect of nominated income. The payments on account due on 31 January and 31 July are half of the relevant amount of income tax (TMA70/s59A).

For example, Marie-Clare's 2008-09 income tax liability is £55,000, of which £25,000 related to tax on UK source income, and the remainder is the £30,000 RBC (all in respect of nominated foreign income). Nothing is taxed at source. Her payments on account for 2009-10, payable on 31 January 2010 and 31 July 2010 will each be £27,500.

Stage 2

If the individual does not intend to use the remittance basis for the following year, and so they will not be subject to the remittance basis charge, they can claim to reduce the PoAs.

In the Marie-Clare example, if she does not think she will claim the remittance basis and so will not need to pay the remittance basis charge for 2009-10 she could reduce her payments on account for 2009-10 to £12,500 each, that is 50% of her 2008-09 income tax liability of £25,000 (if the remittance basis charge is excluded). She will of course still have to consider her other income sources and overall expected income tax liability for the year in making this decision.

Stage 3

If the individual subsequently decides to claim the remittance basis and to pay the £30,000 remittance basis charge and a claim to reduce payments on account has been made which resulted in insufficient PoAs being made, then interest will be charged from the due date for the payments on account until a claim to increase payments on account is made or payment is made for the year is paid to stop interest accruing (TMA70/s86).

In the Marie-Clare example, she has claimed to reduce her payments on account to omit the remittance basis charge, so she only makes payments on account of £25,000 (two lots of £12,500). When she files her 2009-10 self-assessment return her UK income has remained, as expected, at £25,000. However she now decides to claim the remittance basis and so she has to pay the remittance basis charge. As she has erroneously claimed to reduce her payments on account in the year, she will be charged interest on the payments that she should have made, that is, on £15,000 from 31 January 2010 and £15,000 from 31 July 2010 until the date these amounts are paid.

See Self-Assessment Manual – Legal Framework SALF303 for further information on claims to reduce payments on account.

Example 1 (Eva)

- E claimed the remittance basis and paid the remittance basis charge in 2008-09, and her income tax liability produces two payments on account for 2009-10 of £120,000 each.
- E has decided that she will not be claiming the remittance basis in 2009-10 so will not pay the remittance basis charge. E makes a claim to reduce the amount due on account of her tax liability to £200,000 due to a drop in income and because she will not pay the remittance basis charge in 2009-10. When E files her 2009-10 return in September 2010 it shows that the tax due on income is £200,000, but these are provisional figures as E is awaiting some details from her foreign bankers in relation to some foreign transactions.
- The two £100,000 payments on account appear "correct" at this stage. In November 2010 E receives the information from her foreign bankers and decides to amend her return and to claim the remittance basis. She nominates

some foreign income and has to pay the remittance basis charge of £30,000, all constituting income tax, bringing her total liability to £230,000.

- E will be charged interest on the £30,000 reduction in her payments on account on the grounds that E should not have reduced them.

Example 2 (Vali)

- V had no foreign income or gains arising in 2008-09, so he did not claim the remittance basis and so he did not need to pay a remittance basis charge in 2008-09.
- V's income tax liability for 2008-09 produces two payments on account of £200,000 for 2009-10. No claim is made to reduce the payments on accounts.
- When V begins to prepare his 2009-10 return he has a liability of £420,000 income tax on UK sources, so his £400,000 payments on account were correct, based on Vali's previous year's income tax liability.
- V has foreign income arising in 2009-10 and he decides to claim the remittance basis in his 2009-10 return. As a long-term but non-domiciled resident V has to pay the remittance basis charge of £30,000 bringing his total liability to £450,000. Interest will not be charged on the additional £50,000 tax due, as long as this is paid by the proper due date.[48]

10.11.15 *Interaction with Scots rates of tax (from 2016)*

HMRC say:

> Long-term UK residents who are not domiciled here can pay an annual charge to be taxed under the remittance basis (currently £30,000). This will not be affected by the introduction of the Scottish rate of income tax. Payments of the charge due from Scottish taxpayers will continue to be paid direct to the UK Exchequer.[49]

10.11.16 *Commentary*

The rules set out in this section can only be described as bizarre. Their purpose is to ensure the deduction of the RBC for foreign (in particular, US) tax. HMRC openly acknowledge this:

> 2.99 The Government sees no case for more fundamental simplification of the nominated income rules. The identification rules ensure that non-domiciles cannot gain a tax advantage by remitting their nominated income or capital gains to the UK before other income and capital gains on which they would be taxed. Removing the nominated income rules would call into question the creditability of the RBC for US tax purposes. Therefore, wider simplification of these rules would carry an

48 See too March 2009 Q&As Q18.

49 HMRC, "Clarifying the Scope of the Scottish Rate of Income Tax Technical Note" (May 2012) para 61.

unacceptable risk.[50]

10.12 Nature of charge on remitted RFI

Section 809F(1) ITA provides:

> This section applies if s.809B, 809D or 809E applies to an individual for a tax year.

That is, the section applies to remittance basis taxpayers. Section 809F(3) ITA provides:

> The individual's relevant foreign income for that year is charged in accordance with s.832 of ITTOIA 2005.

So we turn to s.832(1) ITTOIA which provides somewhat repetitively:

> This section applies to an individual's relevant foreign income for a tax year ("the relevant foreign income") if s.809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year.

We find the rule at last in s.832(2) ITTOIA:

> (2) For any tax year for which the individual is UK resident, income tax is charged on the full amount of so much (if any) of the relevant foreign income as is remitted to the United Kingdom—
>
> (a) in that year, or
>
> (b) in the UK part of that year, if that year is a split year as respects the individual.

At first glance it may seem that IT is charged on remitted RFI and not on unremitted RFI. It is not that simple. The scheme of the rewritten legislation is that for every category of income there is:
(1) a charging provision; and
(2) a provision specifying the amount of income on which tax is charged.
For instance, in relation to dividends from non-resident companies, s.402 ITTOIA provides:

> **402 Charge to tax on dividends from non-UK resident companies**
> (1) Income tax is charged on dividends of a non-UK resident company.
> ...

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50 HMRC & HMT, "Reform of the taxation of non-domiciled individuals: summary of responses to consultation" (December 2011) *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

> **403 Income charged**
> (1) Tax is charged under this Chapter on the...amount of the dividends arising in the tax year.
> (2) Subsection (1) is subject to ... Part 8 (foreign income: special rules).

The (subtle) point is that IT is *charged* on dividends under s.402 ITTOIA. Section 403 ITTOIA does not impose a charge. It merely quantifies *the amount on which income tax is charged.* Likewise s.832(2) ITTOIA does not impose a charge, it merely quantifies *the amount on which income tax is charged*.[51] The distinction does matter. For instance, references to "income chargeable to income tax" in principle include unremitted income taxable on the remittance basis.[52] However the context may show that the word "chargeable" is used in a narrower sense so as not to include unremitted income (un)taxed on the remittance basis.

10.13 Charge on remitted gains

Section 809F ITA provides:

> (1) This section applies if s.809B, 809D or 809E applies to an individual for a tax year...
> (4) The individual's foreign chargeable gains for that year are charged in accordance with s.12 of TCGA 1992.

So we turn to s.12(1) TCGA which provides (somewhat repetitively):

> This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year.

We find the rule at last in s.12(2)(3) TCGA:

> (2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the UK.
> (3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year. ...

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51 Hence the legislation states that tax is charged "in accordance with" s.832 not *under* s.832. See eg ss.13, 14, 16 ITA.

52 The distinction explains why foreign dividend income taxable under remittance basis in 2005/06 and 2006/07 was taxable at the dividend upper rate and not at the higher rate (though this is now of historic interest only); see the 6th edition of this work para 28.4.3.

While non-ordinary residence is sufficient to qualify for the RFI remittance basis, foreign domicile is needed for CGT.

10.14 Remittance in year after income/gains arise

Suppose:
(1) Income or gains accrue to T (a remittance basis taxpayer) on or after 2008/09 and
(2) The sum is remitted in a subsequent year (in which T is still resident).
The income or gains are taxable in the year of remittance. There is no time limit so income or gains may be taxed many decades after they accrue.

10.14.1 *Transitional rule for pre-2008 income and gains*

Suppose:
(1) RFI accrues to T before 2008/09 and
(2) The RFI is remitted in 2008/09 or later (when T is still resident).
In the absence of a transitional rule, the income would not be taxable under s.832 ITTOIA because the condition in s.832(1) would not be met. Sections 809B, 809D or 809E did not apply before 2008. Para 83 Sch 7 FA 2008 fills that gap for RFI:

> (1) This paragraph applies to an individual's relevant foreign income for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if—
> (a) the individual made a claim under s.831 of ITTOIA 2005 for the relevant tax year, or
> (b) s.65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the relevant tax year.
> (2) Section 832 of ITTOIA 2005 (as amended by this Part of this Schedule) applies in relation to the relevant foreign income as if s.809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year.

Thus pre-2008 RFI is taxed under s.832(2) if remitted from 2008/09 (as one would expect).

The same applies to gains. In the absence of a transitional rule, pre-2008 gains would not be taxable from 2008/09 because the condition in s.12(1)(a) TCGA would not be met. Para 84 Sch 7 FA 2008 fills that gap:

> (1) This paragraph applies if s.12 of TCGA 1992 (or any corresponding superseded enactment) applied in relation to a gain accruing to an individual in the tax year 2007-08 or any earlier tax year ("the relevant

> tax year").
> (2) Section 12 of TCGA 1992 (as amended by this Part of this Schedule) applies in relation to that gain as if s.809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year.

10.14.2 *Income arising before 2005/06 remitted before 2007/08: ITTOIA transitional rules*

Para 150 Sch 2 ITTOIA provided:

> A claim may be made under s.831 (claim for relevant foreign income to be charged on the remittance basis) for relevant foreign income to be charged in accordance with s.832 for the tax year 2005–06 or any later tax year, despite that income having arisen in a tax year before the tax year 2005–06; and ss.832 to 834 apply accordingly.

ITTOIA EN Vol 3 para 347 explains:

> This paragraph ensures that Chapter 2 of Part 8 of this Act is not restricted in its operation to income that arose after the tax year 2004–05 (whenever the earlier income is remitted).

Para 150 was not aptly worded, but what it meant was this: if a s.831 claim is made in 2005/06, 2006/07 or 2007/08, pre-ITTOIA income (which was not taxed on receipt because a claim was made under the former s.65 ICTA) is taxed under s.832 ITTOIA if remitted in that year.

10.14.3 *Income arising before 2005/06 remitted from 2008/09*

FD Draft Clauses EN 2008 provided:

> 121. Para 47 deletes paras 150 and 151 of Schedule 2 (transitional provisions), which set out transitional arrangements for the application of the remittance basis to certain relevant foreign income arising before the tax year 2005-06. These are now considered obsolete in light of the amendments in this Schedule.[53]

10.15 Remittance after acquisition of UK domicile

Suppose:
(1) RFI/gains accrue to T (a remittance basis taxpayer).
(2) T acquires a UK domicile and for that reason ceases to be a remittance

53 The equivalent passage in EN FB 2008 para 380 is less informative.

basis taxpayer. T remains UK resident.
(3) T subsequently remits the sum.
This is taxable under the ITA remittance basis.

10.15.1 *Transitional rules for pre-2008 RFI/gains*

The rule for the pre-2008 RFI remittance basis was that there was no IT charge on a remittance after acquisition of a UK domicile. It is considered that the same applied for the pre-2008 CGT remittance basis, though HMRC did not accept that.
Suppose:
(1) RFI/gains accrued to T before 2008/09.
(2) T became UK domiciled before 2008/09.
(3) The income/gains are remitted from 2008/09.
T is taxable on the remitted income under s.832(2) ITTOIA. The tax charge is retrospective in that pre-2008 RFI/gains outside the scope of tax has now fallen within the scope of tax.

What is the position if an individual acquires a UK domicile before 6/4/2008 and remitted the income or gains before then? It is suggested that there is no charge because of the cap on the amount remitted; see 11.29.5 (Cap on amount remitted).

10.16 Remittance in year when taxed on arising basis

Suppose:
(1) RFI accrues to T from 2008/09 in a year in which T is a remittance basis taxpayer.
(2) T subsequently remits the income in a year in which T is not a remittance basis taxpayer (because T's foreign income and gains exceed the £2k limit and T does not claim the remittance basis).
T is taxable on the remitted income under s.832(2) ITA.

10.16.1 *Transitional rules for pre-2008 RFI*

The rule for the pre-2008 RFI remittance basis was that there was no charge on a remittance in a year in which no claim was made for the RFI remittance basis. HMRC accepted that (at least for years when ITTOIA applied). The new rule applies to pre-2008 RFI remitted from 2008/09. The tax charge is retrospective in that pre-2008 RFI/gains outside the scope of tax has now fallen within the scope of tax.

If RFI was remitted before 2008/09, it is considered that there is no charge because of the cap on the amount remitted; see 11.29.5 (Cap on amount

remitted).

10.17 RFI/gains arising when resident, remitted when non-resident

Suppose:
(1) RFI or gains accrue to T (a remittance basis taxpayer).
(2) T remits the sum to the UK in a year when non-resident.
RFI is not taxable in the year of remittance, because the conditions in s.832(2)(a) ITTOIA are not met. Gains are not taxable in the year of remittance because although the conditions of s.12 TCGA are satisfied (remitted gains are treated as accruing when remitted) the individual (being non-resident) is not subject to tax on chargeable gains.

The temporary non-residence rules need to be considered.

10.18 Remittance after death

Suppose:
(1) RFI or gains accrue to T (a remittance basis taxpayer).
(2) T dies, and the sum is received in the UK after the death.
In the following discussion,

"The tax year of death" is the tax year in which T dies.

"Post-death tax year" means any subsequent tax year.

If RFI is received in the UK in a post-death tax year, no IT charge arises because the requirement in s.832(2) ITTOIA is not met: the year of remittance is not one "for which the individual is UK resident".

If gains are received in the UK in a post-death tax year, no CGT charge arises because the requirement in s.12(1) TCGA is not met: the year of remittance is not one for which s.809B, 809D or 809E ITA (remittance basis) applies to the individual.

There is no taxable remittance if funds are received in the UK after the death but in the tax year of death. Property cannot be received in the UK by T (who is dead) or by a relevant person (there are no relevant persons in relation to a dead person); so remittance condition A cannot be satisfied.

For employment income, see 22.25 (Receipt or remittance after death of employee).

10.19 Remittance after source has ceased

Section 832(3) ITTOIA provides:

> Subsection (2) applies whether or not the source of the income exists when the income is remitted.

10.19.1 *Transitional rules for pre-2008 RFI*

The rule for the pre-2008 RFI remittance basis was that there was no charge on a remittance from a source in a year after the source has ceased. Suppose:

(1) RFI accrued to T before 2008/09.
(2) The source of the RFI ceased before 2008/09.
(3) The RFI is remitted from 2008/09.

Is T taxable on the remitted income under s.832(2) ITTOIA? Yes, the tax charge is retrospective in that pre-2008/09 income previously outside the scope of tax has now fallen within the scope of tax. It does not matter when the income arose or the source ceased: income arising in the 1950s could now come into charge, though all records relating to it would have been long discarded.

STEP rightly comment:

> It appears that any source ceased funds, whenever the source ceased will be caught by the new rules. The effect of this is to retrospectively change the nature of these funds and this is unfair. If this is to be the case then taxpayers who have used this technique may have placed the funds in capital accounts which will, as a consequence of the changes to the rules, now be classified as mixed accounts. Not only do the mixed account rules fail to take into account the change in nature of these funds which were capital on 5 April 2008 and income on 6 April 2008, but there does not seem to be any clear way to separate out these funds now as the mixed account rules only apply to remittances to the UK. Whilst STEP does not object to the change in these rules for the future, we do feel that it is unfair to impose additional tax and reporting burdens on taxpayers who used a technique in the past which HMRC recognised and accepted when they used it.[54]

What if the source ceased and T remitted the income before 2008/09? Even if the transitional rule does not provide relief, it is considered that there is no charge because of the cap on the amount remitted; see 11.29.5 (Cap on amount remitted).

HMRC accept that there is no charge on pre-2008 deemed gains.[55] The same reasoning must apply here so it is considered that pre-2008 source-ceased income, which was remitted to the UK prior to 6 April 2008,

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54 STEP Representations on the FB 2008.

55 See 11.30.6 (Transitional rules: pre-2008 gains).

remains non-taxable.

10.20 RFI/gains arising when non-resident, remitted when resident

Suppose:

(1) A non-resident individual receives RFI or gains. The income or gains are not of course taxed as they arise.

(2) The individual becomes UK resident, and subsequently remits that sum when taxable under the remittance basis.

RFI remitted is not taxed on remittance as the condition in s.832(1) ITTOIA is not met. Gains remitted are not taxed on remittance because the condition in s.12(1) TCGA is not met.

FAQ Remittances (April 2008) correctly states:

> **Where a non-domiciled individual not resident in the UK, has purchased assets abroad out of income that has not been taxed in the UK, then moves to the UK and becomes resident, will the importation of those assets in the first year be taxed as a remittance?**
> No. As the untaxed income arose while the individual was not UK resident, there is no charge unless the proposed new s.832A ITA 2007 applies (temporary foreign residence).

10.21 RFI from Ireland

The UK/Ireland DTA also needs to be considered but it is not discussed here. Similar points arise in relation to earnings: see 22.28 (Earnings from Ireland).

10.21.1 *Income from 2008/09*

The position for income from 2008/09 is straightforward. The ITA remittance basis treats Irish source income in the same way as any other foreign income. The FA 2008 repealed the rule of the pre-2008 remittance basis which provided (unlawfully and probably ineffectively[56]) that Irish income was taxed on an arising basis.

10.21.2 *Pre-2008 Irish income remitted from 2008/09*

This change raised the problem of transition. Para 83 Sch 7 FA 2008 provides:

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56 The point is discussed in the 6th edition of this work para 9.51 and the 2012/13 edition para 9.1920 (RFI from Ireland).

> (1) This paragraph applies to an individual's relevant foreign income for the tax year 2007-08 or any earlier tax year ("the relevant tax year") if—
>
> (a) the individual made a claim under section 831 of ITTOIA 2005 for the relevant tax year, or
>
> (b) section 65(5) of ICTA (or any earlier superseded enactment corresponding to that provision) applied in relation to the individual for the relevant tax year. ...
>
> (3) But nothing in section 832 of ITTOIA 2005 applies in relation to any of the relevant foreign income that arose in the Republic of Ireland.

EN FB 2008 provides:

> 399. Sub-paragraph(3) provides that the new section 832 does not apply to relevant foreign income that arose in the Republic of Ireland. This ensures that no double charge can arise in relation to those tax years during which it was not possible to claim the remittance basis for such income. (This might be relevant for example where income arose in one of those years and was charged on an arising basis but was not remitted to the UK until on or after 6th April 2008.)

Para 83(3) disapplies the remittance basis charge for pre-2008 Irish income. In short, if:

(1) Irish source income arose before 2008/09; and

(2) The income is remitted on or after 2008/09

there is no tax charge on remittance.

This applies even if taxpayers successfully argue that pre-2008 Irish income should as a matter of EU law have been taxed on the remittance basis. But that point will not now often arise.

10.22 Remittance basis for trustees: pre 2007 transitional issues

From 2007/08 the remittance basis applies only to individuals, so trustees do not qualify.

Before that time, UK resident foreign domiciled trustees did qualify for the remittance basis on RFI[57] (though I am not sure how widely that was appreciated or used). Pre-2007 income of trustees which qualified for the remittance basis when it arose, is not taxable on remittance after 5/4/2007, because s.832 ITTOIA now applies to individuals. This could be something of a windfall for trustees who qualified for the RFI remittance basis before 2007. But the point will not often arise.

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57 See the 2012/13 edition of this work para 9.21 (Remittance basis for trustees).;

10.23 Forward tax agreements

Details of this arrangement were made public in an article by Malcolm Gunn in *Taxation*, 17 May 2001, under the revealing name "subscription rate method of taxation". The taxpayers involved were very wealthy UK resident non-domiciled individuals.

HMRC required full disclosure of the taxpayer's worldwide assets. The taxpayer then offered to settle the tax liability on foreign sources for a fixed sum. A starting position was that one worked out the taxpayer's UK living expenses; deducted from that the amount of UK income; the balance then represented funds which would be required annually from overseas, on which tax was expected. The forward tax agreement related to foreign income and gains. UK source income remained taxable in the normal way. Malcolm Gunn explained:

> One may be able to negotiate the annual fixed payment downwards on the starting point figure. ... So in the final analysis, it is down to negotiating a deal which both the taxpayer and the Revenue feel they can live happily with.[58]

In the first edition of this book I said:

> It is likely that publication will stop the practice completely. Those who believe that tax should be governed by law will add: Quite right too.

Since then the courts have tried to stop these agreements by holding them to be *ultra vires*.[59] Where such agreements have been made in the past, a taxpayer may have a defence to an assessment if they can show they have suffered prejudice. It is an interesting question how these agreements should deal with transitional issues such as the introduction of the remittance basis claim charge.

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58 Transition from taxation by agreement to taxation by law raises additional problems discussed in Malcolm Gunn's article.

59 *Fayed v Advocate General* 77 TC 273. *Fayed*-style bargaining is however the basis of taxation of wealthy foreigners in many countries, including, I understand, Switzerland, France and Austria. Even in the UK after *Fayed* the temptation is ever present to move from the inconvenience of taxation by law to the convenient (but ultimately corrupt) method of taxation by negotiation.

CHAPTER ELEVEN

THE MEANING OF REMITTANCE

11.1 Meaning of remittance: Introduction

This chapter considers what constitutes a remittance for the purposes of the remittance basis.

11.1.1 *Cross references*

The following topics are considered elsewhere; see:
13.9 (Remittance due to bank error)
23.4 (Repayment of overpaid PAYE)
77.3.9 (Remittance from joint account).

11.2 The ITA remittance basis

The law is in chapter A1 part 14 ITA, which sets out what I call **"the ITA remittance basis"**.

Section 809K(1) ITA provides a list of 6 places where the ITA remittance basis applies:

> Sections 809L to 809Z6[1] apply for the purposes of—
> (a) this Chapter,
> (b) sections 22 and 26 ITEPA (relevant foreign earnings charged on remittance basis),
> (c) s.41A of that Act (specific employment income from securities etc charged on remittance basis),
> (ca) ss. 554Z9 to 554Z11 of that Act (employment income provided through third parties charged on remittance basis),
> (d) s.832 ITTOIA (relevant foreign income charged on remittance basis), and

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1 The reference to "ss.809L to 809Z6" was always strange, as it omitted s.809Z7 (interpretation). Now it is wrong, because the FA 2012 added further sections: it should be taken as a reference to "ss.809L to 809Z10".

(e) s.12 TCGA (foreign chargeable gains charged on remittance basis).[2]

This is not a full list. The ITA remittance basis is incorporated in other places, using the formula:

> See Chapter A1 of Part 14 of ITA 2007 for the meaning of "remitted to the United Kingdom" etc.[3]

As far as I can see, the ITA remittance basis applies everywhere the remittance basis applies.

11.2.1 *Remittance conditions A to D*

Section 809L(1) ITA provides that there is a remittance if one of three conditions, or (more accurately) sets of conditions, are met:

> An individual's income is, or chargeable gains are, "remitted to the UK" if—
>
> (a) conditions A and B are met,
>
> (b) condition C is met, or
>
> (c) condition D is met.

I refer to "**remittance conditions A to D**".

It is considered that s.809L(1) is a comprehensive and not an inclusive definition of remittance. That is, a sum is remitted if and only if one of these three sets of conditions are satisfied. Remittance conditions A to D are so complex, and so broad, that there is no room for any other type of remittance.

In practice remittance conditions A and B are the most important.

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2 Section 809K(2) ITA provides a (somewhat unnecessary) overview in accordance with the principles of Plain English Drafting:
"Those sections—
(a) explain what is meant by income or chargeable gains being 'remitted to the UK' (sections 809L to 809O),
(b) provide for the calculation of the amount remitted (section 809P),
(c) contain rules for attributing transfers from mixed funds to particular kinds of income and capital (sections 809Q to 809S),
(d) contain further provision in relation to certain foreign chargeable gains (section 809T and 809U), and
(e) treat income or chargeable gains as not remitted to the UK in certain cases (see sections 809V to 809Z6)."

3 See s.648(4) ITTOIA; s.554Z11(4) ITEPA.

I refer to a remittance within the meaning of s.809L(1) as **"a taxable remittance"**.

A sum which can be received in the UK without a taxable remittance is referred to as **"clean capital"**; (the expression might be misunderstood, but I adopt this terminology as it is used in the RDR Manual). The most common examples of clean capital are:

(1) Sums which are not income or gains, eg inheritance, borrowing
(2) Sums which are not taxable in the UK, eg income/gains accruing to a non-resident
(3) Sums which are already taxed in the UK, eg UK source income

11.2.2 *Why is the remittance basis difficult?*

The difficulty is inherent in the concept of a remittance basis. Although it is an exaggeration to say that "money has no earmark" it is often very difficult to trace or earmark money.[4] The fungibility between foreign income/gains and other assets makes it hard to determine whether any assets received in the UK should be regarded as the foreign income/gains. But this is what a remittance basis requires to be done.

Before 2008 the matter was largely left to the courts to sort out. It cannot be said that the courts were entirely successful.[5] In 2008 Parliament recast the rules in statutory form. By most measures this has also been unsuccessful. The ITA rules are:

(1) Unstable: they have been amended in every Finance Act from 2009 to 2014 inclusive;
(2) More complex: The topic which took up 78 pages in the 2007/08 edition of this work needs four chapters and 350 pages in the current edition.
(3) Record keeping is vastly increased.

No less than before, careful planning is needed to avoid unfairness.

11.2.3 *Comparison with pre-2008 remittance basis*

The wording of the ITA remittance basis is so different that cases on the pre-2008 remittance basis need careful review to see if they have any

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4 *Lipkin Gorman v Karpnale* [1989] 1 WLR 1340 at p.1382 (CA). The law of tracing illustrates this.

5 Thus Viscount Simonds referred to remittances as "this difficult branch of the law": *Thomson v Moyse* 39 TC 291 at p.328. Likewise Finlay J in *Kneen v Martin* 19 TC 33 at p.41: "This subject is always troublesome...".

relevance to the ITA remittance basis; in practice I have not found any that are still important.

HMRC agree. The RDR Manual provides:

> **31210. Key differences between 'new' (post 5 April 2008) and 'old' regime (pre 6 April 2008)** [December 2011]
> ...The previous case law is now of limited relevance.

There should be no assumption that the law on any point is the same. There are many transactions which are now taxable remittances which were not previously caught; but there are also transactions which were caught but which are now not taxable remittances.[6]

11.3 Relevant person: Introduction

Before discussing the remittance conditions, it is necessary to consider the term "relevant person". All four remittance conditions use the term.

"Relevant person" is defined in s.809M ITA. Section 809M(1) ITA provides:

> This section applies for the purpose of this Chapter.[7]

The term "relevant person" is also used in transitional provisions: para 86(2)(3) Sch 7 FA 2008. Here the drafter did not supply any definition but the context shows that the s.809M definition must be applied. So the definition applies throughout the remittance provisions.

A relevant person strictly means the individual to whom income/gains accrue, as well as certain persons connected to them. But in the discussion below I generally refer to the individual himself as "the individual" and use the term "relevant person" to mean the others within the statutory definition.

Strictly one should not use the term "relevant person" in the abstract. A relevant person can exist only *in relation to an individual*. But where the context is clear it is permissible to refer to a relevant person in isolation (leaving the words "in relation to an individual" and the identity of that individual to be inferred).

Section 809M ITA sets out 8 categories of relevant person. These can

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6 For example, see 11.19.2 (Use as security for debt) where the rules are less rigorous than the pre-2008 remittance basis.

7 This is duplicated in s.809Z(10) ITA: "In this Chapter ... "relevant person" has the meaning given by section 809M".

be split into three groups: close family, family companies and family trusts.

11.4 Relevant person: Close family

The first four categories of relevant person are close family. Section 809M(2) ITA provides:

> A "relevant person" is—
> (a) the individual,
> (b) the individual's husband or wife,
> (c) the individual's civil partner,
> (d) a child or grandchild of a person falling within any of paras (a) to (c), if the child or grandchild has not reached the age of 18.

11.4.1 *Cohabitees*

Section 809M(3) ITA provides:

> For that purpose—
> (a) a man and woman living together as husband and wife are treated as if they were husband and wife;
> (b) two people of the same sex living together as if they were civil partners of each other are treated as if they were civil partners of each other.

This provision treats cohabitees as married persons and so relevant persons. In 2008 this was a relatively new development in tax, but it has now become standard in anti-avoidance provisions. See App 1.5 ("Living together as husband and wife").

11.5 Relevant persons: Companies

The provisions discussed in this section have had a complicated evolution. I omit that here – reluctantly as the story has amusing aspects – but it is now of historic interest only.[8]

Under s.809M(2)(e) ITA the next category of relevant person is:

> (e) [i] a close[9] company in which a person falling within any other

8 For a lesson in how not to legislate, see the 9th (2010/11) edition of this work para 10.4, 10.5.

9 Section 809M(3)(c) ITA provides the standard definition:
"'close company' is to be read in accordance with Chapter 2 of Part 10 of CTA 2010 (see in particular section 439 of that Act)."

paragraph of this subsection is a participator, or

[ii] a company which is a 51% subsidiary[10] of such a close company.

Under s.809M(2)(f) ITA the next category of relevant person is:

(f) [i] a company

[1] in which a person falling within any other paragraph of this subsection is a participator, and

[2] which would be a close company if it were resident in the UK, or

[ii] a company which is a 51% subsidiary of such a company

This is intended to catch family companies but it is widely drawn. An individual would not usually know whether any company is a relevant person in relation to them, because they cannot tell whether it might have a participator who is a trustee of a RP trust.

Companies may also be relevant persons as bodies connected to trusts.[11]

11.5.1 *"Participator"*

The key term here is "participator". Section 809M(3)(ca) ITA provides:

"participator",

[i] in relation to a close company, means a person who is a participator in relation to the company for the purposes of section 455 of CTA 2010 (see sections 454 and 455(5) of that Act), and,

[ii] in relation to a company that would be a close company if it were resident in the UK, means a person who would be such a participator if it were a close company

This incorporates s.455(5) CTA 2010 which provides the wider than standard definition of "participator"; see 85.17 (Definition of participator) and in particular, 85.17.3 (Chain of partly owned companies).

11.6 Relevant persons: Trusts

Under s.809M(2)(g) ITA the next category of relevant person is:

(g) the trustees of a settlement of which a person falling within any other

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10 Section 809M(3)(cb) ITA provides the standard definition:
"'51% subsidiary' has the same meaning as in the Corporation Tax Acts (see Chapter 3 of Part 24 of CTA 2010)."

11 See 11.7 (Body connected with trust).

> paragraph of this subsection is a beneficiary.

This is intended to catch family trusts but it is so widely drawn it covers many if not most trusts in existence.

In the following discussion:

"An RP beneficiary" is a beneficiary falling within any other paragraph of s.809M(2).

"An RP trust" is a trust within s.809M(2)(g), ie one with an RP beneficiary.

Strictly one should not use the term RP trust in the abstract. It can exist only *in relation to an individual*. But where the context is clear it is permissible to refer to a RP trust in isolation (leaving the words "in relation to an individual" and the identity of that individual to be inferred).

Thus in my terminology, if T (or T's spouse, etc) is a beneficiary, the trust is an RP trust in relation to T, or (for short) it is an RP trust.

Section 809M(3)(e) ITA defines "beneficiary":

> "beneficiary", in relation to a settlement, means any person who receives, or may receive, any benefit under or by virtue of the settlement;

Every trust with an unrestricted power to add beneficiaries (which is a standard form) is an RP trust.

If T and their relevant close family (spouse etc) are all excluded, but the power to add beneficiaries extends to a close company in which T is a participator, then the trust is still an RP trust. The company may be a RP beneficiary even though T has no beneficial interest in it.

If the power to add beneficiaries is only exercisable with the consent of an individual, the position is different.

Suppose the beneficiaries are T's children and their issue. If T's children are adult and there are no minor grandchildren, then the trust is not an RP trust. However it becomes a RP trust if a grandchild is born.

A trust is not an RP trust in relation to T just because its terms provide that children or grandchildren of T can benefit after they have reached the age of 18, as long as they cannot benefit before then.[12]

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12 See *Vestey v IRC* 31 TC 1 which decided that a trust with a power to benefit the widow of the settlor was not settlor-interested. At the time that the income arose:

(1) The settlor's wife could not benefit (as she was not a widow).

(2) It was possible that in the future she could benefit (as she might survive the settlor and so become a widow). That did not matter because the legislation (which is comparable to s.809M) was held to apply only if *at the time that the*

If T is not a beneficiary, but T lends interest-free to the trust, it is considered that the trust does not become an RP trust in relation to T just because of the loan. T may receive a benefit (on repayment of the loan).[13] However that benefit arises under or by virtue of making the loan to the trustees, (ie, under or by virtue of the loan agreement): T does not receive a benefit under or by virtue of the settlement.[14]

For charitable trusts, see 11.37 (Gift to charity by remittance basis taxpayer).

Section 809M(3)(d) ITA provides:

> "settlement" and "settlor" have the same meaning as in Chapter 2 of Part 9.

This brings in the standard IT/CGT definition of "settlement".[15] The definition of "settlement" is unnecessary, since this definition applies except so far as the contrary intention otherwise requires; but it does no harm.[16]

The definition of "settlor" is otiose as the word is not used in the definition of "relevant person".

Section 809M(3)(f) ITA provides:

> "trustee" has the same meaning as in section 993 (see, in particular, section 994(3)).

So we need to turn to s.994(3) ITA:

> For the purposes of section 993 "trustee", in the case of a settlement in relation to which there would be no trustees apart from this subsection, means any person—
>
> (a) in whom the property comprised in the settlement is for the time being vested, or
>
> (b) in whom the management of that property is for the time being

---

widow received a benefit she fell within the words "spouse of the settlor".

13 See 27.3.2 ("Settlor-interested" for IT purposes).

14 The same point arises in relation to pre-owned assets, where HMRC accept a similar argument: see 76.8 (POA intangible property charge).

15 See 80.2.2 (Standard IT/CGT definition of settlement).

16 The definition is useful for the avoidance of doubt, since s.809M twice refers to s.993 ITA, where the settlement-arrangement definition applies. Thus the definition makes it clear that the settlement-arrangement definition of settlement is not applicable to s.809M.

vested.[17]

Section 809M(3)(f) (incorporating the s.994(3) definition of trustee) is misconceived. The s.994(3) definition of trustee makes sense in the context of s.993 ITA where settlement means settlement-arrangement (which may not have trustees). It does not make sense in the context of s.809M ITA where settlement means classic settlement, which must have trustees. But no significant harm arises from this mistake.

11.7 Body connected with trust

Under s.809M(2)(h) ITA the last category of relevant person is:

> (h) a body connected with such a settlement.

That is, a body connected with an RP trust, within 809M(2)(g), a trust of which some other relevant person is a beneficiary.

11.7.1 *"Connected with" a settlement*

Section 809M(3)(g) ITA defines "connected with":

> a body is "connected with" a settlement if the body falls within section 993(3)(c), (d), (e) or (f) as regards the settlement.

This must not be confused with the common tax concept of a "connected person".

In order to follow this, one needs to set out the four paragraphs of s.993(3)(c)(d)(e) and (f).

First, s.993(3)(c)(d) ITA provide:

> (3) A person, in the capacity as trustee of a settlement,[18] is connected with ...
> (c) any close company whose participators include the trustees of the settlement,
> (d) any non-UK resident company which, if it were UK resident, would be a close company whose participators include the trustees of the settlement

17 For completeness: s.994(3) concludes: "Section 466(4) does not apply for the purposes of this subsection." That has no relevance here.

18 "Settlement" in s.993 means settlement-arrangement: see s.994(1) ITA. However for a body to qualify as a relevant person under s.809M(2)(h) there needs to be a settlement within the standard IT/CGT definition.

Section 809M(3)(g) is not elegantly drafted. It refers to a body connected with a settlement; whereas s.993 refers to bodies connected with trustees of a settlement; but the meaning must be the same.

At first sight it seems unnecessary for s.809M(3)(g) to refer to s.993(3)(c) or (d), because any company within (c) or (d) would be a relevant person in any event under s.809M(2)(e) or (f).[19] But this does make a difference as can be seen from the examples below. In any case, one needs to have (c) and (d) in mind in order to understand s.993(3)(e). "Participator" in s.993(3)(c)(d) is not defined; it is considered that it bears the normal close company meaning.

Section 993(3)(e) ITA provides:

> (e) any body corporate controlled (within the meaning of section 995) by a company within para (c) or (d)

For the s.995 definition of control, see 85.9 (Control in strict sense).

Lastly, s.993(3)(f) ITA provides:

> (f) if the settlement is the principal settlement in relation to one or more sub-fund settlements, a person in the capacity as trustee of such a sub-fund settlement.

It seems unnecessary for s.809M(3)(g) to refer to s.993(3)(f). Possibly the drafter only intended to refer to s.993(3)(c)(d)(e) and the reference to (f) slipped in by mistake. But since sub-fund settlements are dead-letter tax law (never found in practice) the point does not matter.

11.7.2 *"Body"*

Section 809M(2)(h) ITA refers to a "body" connected with a settlement. The term is wide and somewhat vague. However in order to fall within s.993(3)(c)(d) the body must be a company. In order to fall within s.993(3)(e) the body must be a body corporate. Presumably the word "body" was selected as the apt term to include the (somewhat theoretical) case of trustees of sub-funds under s.993(3)(f).

11.7.3 *Partnership*

A general or limited partnership does not fall within any para of s.809M(2)(a)-(g) ITA.

A general or partnership does not fall within s.809M(2)(h) ITA. What if

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19 Because the trustees are participators.

trustees control a partnership? A general or limited partnership is a body, but it is not "connected with" the settlement within s.809M(3)(g) as it is not a company or body corporate.

So a general or limited partnership as such is never a relevant person. That is not surprising, since a partnership is also not a "person" in the normal sense of the expression.[20]

The legal analysis of a LLP is different, but the end result is the same. A LLP is not a company for tax purposes, so it does not fall within any para of s.809M(2)(a)-(g) ITA. What if trustees control a LLP? A LLP is a body, but it is not "connected with" the settlement within s.809M(3)(g) A UK LLP is a body corporate, but is deemed not to be one for IT and CGT purposes; s.993 clearly assumes that a partnership is not a body corporate.

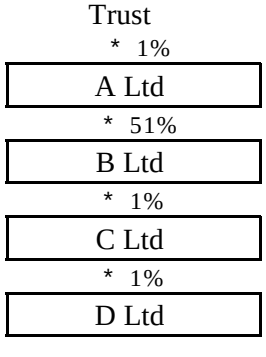
Of course the partners may be relevant persons; see 11.34 (Partnerships).

11.8 Companies as relevant persons: Examples

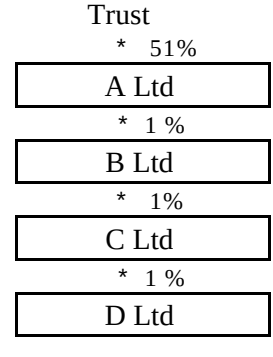
It may be helpful to give some examples of how the relevant person rules apply to trust/company structures. In the following examples:

"An (e) company" is one which is a relevant person under s.809M(2)(e).
"An (f) company" is one which is a relevant person under s.809M(2)(f).
"An (h) company" is one which is a relevant person under s.809M(2)(h).
"A non (e) person" is a person who falls within any other paragraph of 809M(2) ie not a person who falls outside 809M or who is *only* within para (e).
"A non (f) person" is a person who falls within any other paragraph of 809M(2) ie not a person who falls outside 809M or who is *only* within para (f).

Example 1



Example 2



20 See 41.3 (Is a partnership a "person").

Assume the trust is a relevant person (eg the individual is a beneficiary). Assume all the companies are UK resident or non-resident close companies.
A Ltd is an (h) company. It is also an (e) company if UK resident or an (f) company if non-resident. However since it is an (h) company that does not matter; it is a non (e) person and a non (f) person (as those expressions are defined).

Example 1
Assume first that the companies are all non-resident close companies.
B Ltd is an (f) company because a non (f) person - A Ltd - is a participator.
C Ltd is not a relevant person. It is not an (f) company as it does not meet the requirement in (f) that a person "falling within any *other* paragraph" of s.809M(2) is a participator.

The end result is the same if all the companies are UK resident close companies, though the statutory references are different:
B Ltd is an (e) company because a non (e) person - A Ltd - is a participator.
C Ltd is not a relevant person. It is not an (e) company as it does not meet the requirement in (e) that a person "falling within any *other* paragraph" of s.809M(2) is a participator.

Suppose however that B Ltd is UK resident and C Ltd is non-resident. In that case C Ltd is a relevant person:
B Ltd is an (e) company because a non (e) person - A Ltd - is a participator.
C Ltd is an (f) company as a non (f) company - B Ltd - is a participator.

It follows that D Ltd is then an (e) company if UK resident, since a non (e) company - B Ltd - is a participator.

Example 2

The difference in example 2 is that the trustees are participators in B Ltd[21] so B Ltd is an (h) company.

11.8.1 *Corporate relevant persons: Commentary*

Where any of these companies are relevant persons, so are all their 51%

21 See 85.17.2 (Chain of wholly owned companies).

subsidiaries. It will be apparent that the definition of relevant person in relation to companies is far too wide and it is not realistic to think that the rules are being or ever could be applied in practice to large corporate groups of close companies.

11.9 Relevant person transitional rule: Pre-2008/09 income/gains

Para 86(4) Sch 7 FA 2008 provides:

> Subject to sub-paras (2) and (3), in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

This transitional rule only operates for the purposes of s.809L (remittance conditions A and B), so it has to be repeated for the purposes of remittance conditions C and D, and for s.624.[22] In other provisions the transitional rule does not apply: s.809Z2 (Personal use rule); para 86(2)(3) Sch 7 FA 2008. I wonder if that is deliberate or an oversight. These are provisions where it is helpful to have a wide definition of relevant person but it will not often matter.

The RDR Manual provides:

> **31480. Relevant persons and foreign income and gains arising before 6 April 2008** [June 2010]
> *Background*
> The introduction of Chapter A1 Part 14 ITA 2007 has extended the meaning and scope of foreign income and gains that become taxable when remitted to the UK. One change is the introduction of the concept of 'relevant person' at section 809L which, broadly, provides that a taxable remittance will occur when foreign income or gains are brought into or otherwise used in the UK by relevant persons other than the individual himself or herself.
> *Transition*
> The transitional rule provides that in establishing whether there has been a remittance of an individual's income and gains for 2007-08 or any earlier year Conditions A and B, Condition C and Condition D at ITA07/s809L are applied as if references to 'relevant person' are to the individual.

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22 For remittance condition C, see 11.25 (Transitional rules: pre-2008 income/gains). For remittance condition D, see 11.28 (Transitional rules: pre-2008 income/gains). For s.624, see 27.4.1 (Transitional rule for pre-2008 trust income).

Effect

This means that the income or gains remitted either as cash or property have to be brought to, received by or used in the UK for the benefit of the individual concerned before there can be a remittance.

The Manual then provides a straightforward (if factually implausible) example[23] and continues:

> Note: The exclusion of 'relevant persons' from s809L for pre 6 April 2008 income and gains does not apply in considering the other transitional rules in relation to the remittance of relevant foreign income (refer to RDRM31140 Relevant foreign income).

I do not understand the point being made here; the cross reference does not help.

11.10 Relevant and other persons: Compliance

Suppose:

(1) an individual gives income or gains to a relevant person ("R"); and
(2) R remits sums to the UK.

The individual in principle becomes liable to a tax charge. The residence of R does not matter.

However, R is under no duty to inform the individual that R has remitted sums to the UK. R is under no duty to inform HMRC, as any tax liability on the remittance is that of the individual, not of R. But the rules in theory require R to keep records for the lifetime of the individual.

Similar issues arise in relation to remittance condition C. Suppose:

(1) an individual gives income or gains to a non-relevant person ("G", a gift recipient); and
(2) qualifying property is enjoyed by a relevant person (or used in respect of a relevant debt).

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23 "Sanjay is a non-domiciled remittance basis user who transferred £10,000 of his foreign employment income from 2007-08 to his 15 year old grandchild's offshore bank account.

In 2008-09 the grandchild then remits £3,000 of this to the UK to buy himself a new computer. [How the 16 year old minor would operate the account and purchase the (overpriced) computer is not explained, but it does not matter.]

Under the rules at section 809L this would create a taxable remittance of £3,000 by Sanjay because his grandson is a relevant person. However the transitional rule means that there is no taxable remittance of this income because it is employment income from 2007-08."

The individual in principle becomes liable to a tax charge. The residence of G does not matter. G is under no duty to inform the individual or HMRC. But the rules in theory require G to keep records for the lifetime of the individual.

Similar issues arise in relation to remittance condition D, where any property of any third person ("P") is enjoyed by a relevant person (or used in respect of a relevant debt) and there is a connected operation (as defined). The individual in principle becomes liable to a tax charge. The residence of P does not matter. P is under no duty to inform the individual that P has remitted sums to the UK or to inform HMRC. But the rules in theory require P to keep records for the lifetime of the individual.

Of course in practice these rules will not (and indeed could not) be observed except in straightforward cases.

The individual has no indemnity against the relevant person, gift recipient or third party.

Under the pre-2008 remittance basis, if A (a remittance basis taxpayer) transferred A's foreign income to any other person ("B") and B receives that income abroad, there was in general no remittance of that income if B subsequently remits the income to the UK. In the 6th edition of this work I said:

> The law could hardly be otherwise, for A will not usually know what B does with his money after it has been transferred to B.

I was wrong about that! My comment assumed that workability was a necessary requirement of UK anti-avoidance provisions. Now it is sufficient if the law is workable in simple cases. Now if T gives income to a relevant person, who remits, T is taxable.

A relevant person who bears a grudge against an individual (eg a separated spouse) may be able to trigger a significant tax charge out of spite, by deliberately remitting income or gains they have received from the individual. They may alternatively blackmail the individual by threatening to remit unless paid not to do so.

What about a gift recipient (such as an estranged adult child)? There is no charge if they remit income or gains they have received from the individual. What if they apply property they have been given for the benefit of a relevant person, eg a minor child or grandchild of the individual? This arguably does not constitute a taxable remittance under condition B, because the sums are not derived property, but it is caught by remittance condition C.

Also see 11.35 (Proceeds of divorce settlement).

The RDR Manual provides:

> **35030 Conditions A and B - remittances derived from foreign income or gains** [January 2014]
> ... Where an individual gives untaxed foreign income or gains to another person then they should ensure the donee is aware that they must tell the donor if the property or anything subsequently derived from it is bought to the UK in circumstances such that there would be a remittance under ITA07/s809L.

There is no statutory obligation to do this but failure will make compliance difficult.

HMRC say in March 2009 Qs & As Q9:

> If
> [1] the record keeping requirements are felt to be too onerous and
> [2] the probability of remittance to the UK is high
> the donor may wish to consider making a gift of taxed income or gains.

This will not satisfy readers. If "the probability of remittance to the UK is high" then the donor may indeed prefer a gift of taxed income or gains,[24] quite regardless of record keeping requirements. Conversely, what advice would HMRC give if the record keeping was felt to be onerous but the probability of remittance was low? Or if the donee had insufficient taxed income or gains to make the gift?

11.11 Commentary: Let's simplify remittance and relevant person rules

If an individual remits their own income to the UK, they are able to spend it here and there is some sense in taxing them. The same may be said for an individual's spouse and minor children.

The extension to minor grandchildren (though not to adult grandchildren) is a novel development in tax. The policy is inconsistent with other anti-avoidance provisions, and leads to some strange anomalies and nonsense.[25] The intention is perhaps to catch grandparents paying the school fees of their UK resident grandchildren – at least if the school is in the UK. The Blair/Brown administration was not supportive of private education. But that is only a surmise, as the Government never published any explanation.

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24 Or other clean capital.

25 See 11.32 (Payment of school fees).

The coalition Government apparently considered this point:

> 2.128 ... the Government does accept that there is value in giving further consideration to the following suggestions:
> - Excluding minor grandchildren from the definition of a 'relevant person'...
>
> 2.129 The Government will undertake further evaluation of these areas with a view to implementing any changes from April 2013.[26]

In practice nothing happened.

When a family trust or a family company remits its income to the UK, the individual (as beneficiary or shareholder) is not in any way advantaged unless and until the trustees decide to transfer the income to them or to a close family member. In these respects the definition of relevant person is made extravagantly wide. What is the thought process that has led to this situation? Needless to say, there was no discussion of these policy issues when the rules were announced. I infer that it is based on a conception that the remittance basis requires funds to be taxed if and when *funds* come to the UK. The policy ought surely to be to charge tax when funds are available *for personal spending* in the UK, not simply because they are invested here. The reader may think it unfortunate that the manner of the 2008 precluded any debate or consideration about what the remittance basis was intended to achieve.

For these reasons the definition of relevant person ought to be restricted to the individual, their spouse and minor children (and if necessary, though one could argue the matter both ways, the individual's cohabitee).

In the 2010/11 edition of this work I said:

> The main effect of the present rules is to impose a prohibitive tax charge on investment in the UK by the foreign domiciliary or relevant persons.

This is now recognised to an extent by the introduction of the complex and restricted remittance investment relief in 2012.

It is considered that the way forward is to restrict the definition of relevant person to the individual, spouse, minor children and (perhaps)

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26 HMRC & HMT, "Reform of the taxation of non-domiciled individuals: summary of responses to consultation" (December 2011) *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

cohabitee. Remittance investment relief could then be abolished as it would not be needed. That would be a significant simplification, enhance UK investment, and not result in any significant loss of tax. The 2008 reform lost sight of what the remittance basis is in fact intended to catch, and overlooked that the remittance basis was, and (if it serves any purpose) still is, intended to attract wealthy foreigners to come to live *and invest* in the UK.

11.12 Remittance condition A (link to UK)

Remittance conditions A and B go together: condition A requires a link to the UK, and condition B requires a link to the foreign income or gains. Both conditions need to be satisfied to have a remittance under s.809L(1)(a).

Section 809L(2) ITA provides:

> Condition A is that—
>
> (a) money or other property is brought to, or received or used in, the UK by or for the benefit of a relevant person, or
>
> (b) a service is provided in the UK to or for the benefit of a relevant person.

There are eight ways to satisfy remittance condition A. The first six are:

(1) Property is:
- (a) brought to the UK
  - (i) by a relevant person
  - (ii) for the benefit of a relevant person
- (b) received in the UK
  - (i) by a relevant person
  - (ii) for the benefit of a relevant person
- (c) used in the UK
  - (i) by a relevant person
  - (ii) for the benefit of a relevant person

I refer to these as the **"brought" limb,** the **"received" limb,** and the **"used" limb** of condition A. I refer to property within (1) as "**property brought/received/used in the UK**". (One might refer to that as "condition A property" or "UK property" but I think it is clearer to use the clumsy expression **"brought/received/used in the UK."** I leave the words "by/for the benefit of a relevant person" to be implied.)

The last two ways to satisfy condition A are:

(2) A service is:
(a) provided in the UK to a relevant person
(b) provided in the UK for the benefit of a relevant person

11.12.1 *Enactment history*

The wording of remittance condition A is loosely derived from the pre-2008 s.33(2) ITEPA, but the connection is tenuous. The former s.33(2) ITEPA provided:

> *If general earnings are—*
> *(a) paid, used, or enjoyed in the UK, or*
> *(b) transmitted or brought to the UK in any manner or form,*
> *they are to be treated as remitted to the UK at the time when they are so paid, used or enjoyed or dealt with as mentioned in para (b).*[27]

In the current provision, the words "brought/received/used" have replaced "paid/used/enjoyed/transmitted/brought".

The former words "in any manner or form" have been omitted; they are unnecessary as the concept of "derived property" in remittance condition B does the same work.

The words "for the benefit of" are new. The reference to a relevant person is new.

11.12.2 *"Property" and "money"*

The language of the remittance basis provisions is not entirely consistent:
"Money or other property" is used 20 times.
"Property (including money)" is used once.
"Property (other than money)" is used once.

Sometimes the word "property" is used by itself. I think it is clear that the word "property" by itself includes money, that is, it is equivalent to "money or other property". In this book I use the word "property" (by itself) to mean money or other property.

When the expression "money or other property" is used, we do not care about the meaning of the word "money" because if an asset is not "money"

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27 Pre-2008 s.12(2) TCGA was in the same terms. The wording was perhaps intended to extend the concept of "remittance" beyond that which applied for the pre-2008 RFI remittance basis. Though it is just as likely that the drafter only had in mind a plain English paraphrase of the antique language of the former s.65 ICTA 1988. There is no authority discussing these words. The question was raised but left open in *Harmel v Wright* 49 TC 149; it will not now be decided.

it will be "other property".

When the expression "money" is used by itself, or in the expression "property other than money" we do care about the meaning of the word "money".

Except in a few special contexts[28] the words "property" and "money" are not defined and carry their ordinary meaning.

11.12.3 *Property brought to the UK ("brought" limb of condition A)*

The first two ways to satisfy remittance condition A are:

(a) Property is brought to the UK by a relevant person
(b) Property is brought to the UK for the benefit of a relevant person

This limb requires one to identify whether property is brought to the UK, and if so who brings it to the UK, or for whose benefit it is brought. If a relevant person brings it, condition A is satisfied. If someone else brings it, para (a) is not satisfied.

For instance, suppose T owns a chattel outside the UK, and wishes to lend it to a non-relevant person, eg an adult child, in the UK.

(1) If T brings the chattel to the child in the UK, there is a taxable remittance.
(2) If the child collects it abroad, or arranges for a courier to bring it, then para (a) does not apply. No other part of condition A applies, so there is no taxable remittance.

What if T instructs a courier to bring the chattel to the child in UK? One might think that T (by instructing the courier) has brought the chattel to the UK. But comparing this with cases (1) and (2) it is considered that the courier (not T) has brought the chattel to the UK, so there is no taxable remittance. It would be strange if the administrative matter of who instructs the courier should determine taxability.[29]

This could be relevant if a remittance basis taxpayer wished to lend to a museum, as it would not be necessary to meet the conditions of the public access rule. (The public access rule would be needed if the museum was a relevant person.)

Para (b) might apply if N holds property as nominee for T, and N brings the property to the UK.

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28 See 12.27.1 ("Property").

29 This is consistent with the HMRC view discussed in 11.12.7 (Property in transit). For gifts of cash, see 11.12.8 (Gift to non-relevant person).

11.12.4 *Property received in the UK ("received" limb of condition A)*

The next two ways to satisfy remittance condition A are:

(c) Property is received in the UK by a relevant person
(d) Property is received in the UK for the benefit of a relevant person

This requires one to ask where property is received (or more precisely, whether property is received in the UK); the answer is by no means obvious. If property is received in the UK, the question is who receives it, or for whose benefit is it received.

We need the "brought" limb as well as "received". T can receive an asset in the UK without bringing it here (eg on the purchase of a UK situate chattel). Can T "bring" an asset to the UK without receiving it in the UK? Perhaps an example is if T acquires a chattel outside the UK, and packs it in T's luggage; or acquires a car outside the UK and drives it to the UK. T "brings" the chattel or car to the UK, but does not "receive" it here. (It is arguable that an asset can only be received once, so if it is received outside the UK it cannot later be received in the UK, but whether or not that is right, in the case of a chattel or car, there is no identifiable moment of "receipt" in the UK.) So both these limbs of condition A are needed.

Para (d) might apply if N holds property as nominee for T, and N receives the property in the UK.

11.12.5 *Property used in the UK ("used" limb of condition A)*

The next two ways to satisfy remittance condition A are:

(e) Property is used in the UK by a relevant person
(f) Property is used in the UK for the benefit of a relevant person

This requires one to ask whether property is used, where property is used, who is the user, and what exactly is the property which is used.

It is suggested that "used" means enjoyed in specie, and property is used where it is situate.

It is difficult at first sight to see the role of the "used" limb of condition A. Normally if T uses property in the UK, T (or a relevant person) will have brought or received it in the UK, so the "brought" or "received" limbs will be satisfied. But there could arguably be a case where property comes to be held by T without being brought or received in the UK by T[30] and in

30 See 11.12.10 (Acquisition of UK debt/security).

such a case the "used" limb is needed.[31] There could be a case where property is brought to the UK when not a relevant person, and subsequently used by T after he becomes a relevant person.

If a creditor enforces a debt, and receives money due, one does not say that the creditor is "using" the debt in the normal sense of the word, though the creditor could be said to be using rights attached to the debt. But it is not clear where these rights are used. So it is suggested that the used limb does not apply to debts or other choses in action.

If money is spent, it is "used" in the normal sense of the word.[32] However it is not clear where money (other than cash) is used, so it is not clear how one decides whether it is used in the UK. It is suggested that spending money should be dealt with under the receipt limb, or the brought limb of condition A, or under the debt remittance rules, eg using money to pay a debt may be a remittance of the money under the debt remittance rules; but the used limb does not apply: the money is not used in the UK. Non-cash money is in fact a debt, so that is consistent with the paragraph above. In short, in the "used" limb of condition A, "used" means used *in specie*.

11.12.6 *Bank entries*

What if a transfer of money to a foreign bank account involves credits in UK accounting records of the foreign bank? (This is understood to be the position for Channel Island and IOM banks.) Remittance condition A is not satisfied: the funds are not brought/received/used in the UK. The RDR Manual provides:

> **33560 Banking Issues** [December 2011]
> *Banking Transactions*
> Transfers between foreign centres often pass through the UK banking system, for example when a sterling payment is made abroad and the payment is cleared through London in the normal banking process.

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31 There could of course be a case where property is brought or received in the UK by a non-relevant person and used by T eg if T gives RFI to a brother who purchases a house which T occupies. In that case condition A is satisfied under the "used" limb. But in this case, condition B is not satisfied (the house is not property of a relevant person) so the question whether condition A is satisfied does not arise. This situation is covered instead by remittance condition C.

32 That is self evident, but if an example is needed, see s.809VA ITA referring to money being "used" to make an investment.

In such circumstances HMRC do not regard the passage of funds through the UK as being a taxable remittance.

The machinery employed is irrelevant provided that, without express provision, the individual has:

- no right to payment at any intermediate point; and
- no control over the funds transferred by their foreign bank to secure payment at the agreed point.

Similarly, the EI Manual provides:

> **40302 Meaning of "remitted to the United Kingdom"** [Jan 2009]
> *Paid in the UK*
> [1] Earnings are remitted to the UK if they are paid to the employee in cash in this country or if the employee's bank account here is credited with them. Employees may arrange to have earnings paid into offshore bank accounts to avoid this rule.
> [2] Money that is transmitted from the employer's bank in the UK to the employee's offshore bank is not treated as remitted here. It has been in the banking system all of the time; the employee did not have access to it.

The conclusions are correct, though the statements that the money passes "through the UK" or "through the UK banking system" or that the money has "been in the banking system" is layman's language. Banking law draws a sharp distinction between the accountholder's money and the bank's money:

> The funds received by the beneficiary's [customer's] bank through the payment system belong legally and beneficially to itself. They become part of the bank's general liquid assets. They are distinct from any corresponding credit entry that the bank makes to the customer's account on the strength of receiving those funds.[33]

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33 Fox, *Property Rights in Money* (2008) para 7.44. *Foley v Hill* (1848) 2 HLC 28 at p.36 explains the relationship of banker/customer (and borrower/lender generally):

> "Money, when paid into a bank, ceases altogether to be the money of the principal ... ; it is then the money of the banker, who is bound to return an equivalent by paying a similar sum to that deposited with him when he is asked for it. The money paid into the banker's custody... is then the banker's money; he is known to deal with it as his own; he makes what profit of it he can, which profit he retains to himself, paying back only the principal, ... or the principal and a small rate of interest ..."

More recently, *Foskett v McKeown* [2001] 1 AC 102 at p.127: "We speak of money at the bank, and of money passing into and out of a bank account. But of course the

11.12.7 *Property in transit*

The same approach is applied in March 2009 Qs & As to physical assets transported by a courier through the UK:

> **Q17:** Will HMRC apply the same principle, expressed in relation to mechanistic banking transfers which pass through the UK in the banking system, in a case where a courier passes through the UK in transit carrying property not covered by the temporary importation exemption?
> **A:** Yes. In principle, where the "passing through" is a mechanistic part of the courier service provision and, no relevant persons have any rights to use or access the property at any intermediate point; and no control over how property is transported to and from the agreed points. In such circumstances the passage of property which merely "touches" the UK would not be regarded as a sum remitted to the UK.

More analytically, remittance condition A is not satisfied because the owner of the property:
(1) does not receive it in the UK;
(2) does not bring it to the UK (the courier brings it).

11.12.8 *Gift to non-relevant person*

In *Timpson's Executors v Yerbury*[34] (a pre-2008 remittance case):
(1) Mrs Timpson ("T") gave cheques representing her foreign income to her children.
(2) The children cashed the cheques which were credited to their bank accounts in the UK.

Thus, the foreign income was received in the UK, but it was not received by T. This was nevertheless held to be a taxable remittance by T. Romer LJ and (I think) Greene LJ decided *Timpson's Executors* on the basis that there was a taxable remittance if:

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account holder has no money at the bank. Money paid into a bank account belongs legally and beneficially to the bank and not to the account holder. ... We speak of tracing money into and out of the account, but there is no money in the account. There is merely a single debt of an amount equal to the final balance standing to the credit of the account holder. No money passes from paying bank to receiving bank or through the clearing system (where the money flows may be in the opposite direction). There is simply a series of debits and credits which are causally and transactionally linked."

34 20 TC 155 followed in *Walsh v Randall* 23 TC 55.

(1) money is received in the UK by a third party at T's direction, and
(2) immediately before receipt, the money (or funds representing it) belonged to T.[35]

This is no longer the law under the ITA remittance basis. Remittance condition A requires that property is brought/received/used in the UK *by or for the benefit of a relevant person*. So if a remittance basis taxpayer writes a cheque on a foreign bank account, gives it to a donee (not a relevant person) who pays the cheque into their UK bank account, remittance condition A is not satisfied. The receipt of the cheque is not a remittance.[36] The money is received in the UK by the donee (not by a relevant person); and if it is brought to the UK, it is brought in by the donee.

Suppose (instead of a cheque) T makes a gift to a donee (not a relevant person) by electronic transfer from T's offshore account to the UK account of the donee. It is suggested that remittance condition A is not satisfied. It would be strange if there were a difference between payment by cheque and a direct electronic transfer. At first sight it seems that T "brought" the money into the UK (even though T did not receive or use it in the UK). But the better view is nothing is *brought* to the UK. One needs to understand the banking law background. A bank transfer involves the destruction of an asset (T's claim against the bank) and the creation of a new asset (the donee's claim against the bank).[37] The new asset is received

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35 The judgments are discussed in more detail in the 2012/13 edition of this work, but they are not now relevant.

36 See 11.15.13 (Receipt of cheque in UK).

37 "It is something of a misnomer to speak of the transfer of funds, as there is no actual transfer of coins and bank notes from the payer to the payee, and no assignment of the debt owed to the payer by their own bank." Brindle & Cox, *The Law of Bank Payments* (4th ed., 2010), para 3-002; and see 11.12.7 (Property in transit); Fox, *Property Rights in Money* (2008) para 5.23-5.31; *R v Preddy* [1996] AC 815 at p.841D "I start with the proposition that the money in a bank account standing at credit does not belong to the account holder. He has merely a chose in action which is the right to demand payment of the relevant sum from the bank. I use the word money for convenience but it is of course simply a sum entered into the books of the bank. When a sum of money leaves A's account a chose in action quoad that sum is extinguished. When an equivalent sum is transferred to B's account there is created in B a fresh chose in action being the right to demand payment of that sum from his bank."...

"The question remains, however, whether the debiting of the lending institution's bank

in the UK but not brought to the UK.

The practice before 2008 was for remittance basis taxpayers to make the gift abroad (by payment into a foreign bank account of the donee). This will no doubt continue, even though it is not strictly necessary, as HMRC may not agree with this analysis. The RDR Manual provides:

> **RDRM33140 Remittance Basis: Identifying Remittances: Conditions A and B: Condition B - direct remittance of income and gains** [Jul 2010]
> Example 5 (Tyler)
> T, a remittance basis user, donates an amount of money to a Battersea Dogs Home, a UK charity, by making a payment direct to the charity from his US bank account which contains his relevant foreign income. There has been a direct remittance of T's income into the UK; it does not matter that he or any other relevant person does not benefit personally from the money...

In the usual style of the Manual, the example states a conclusion without addressing the relevant statutory provisions, and it is not likely that the author has considered the banking law background.

For gifts to charity, see 11.37 (Gift to charity by remittance basis taxpayer).

11.12.9 *Arm's length payment to non-relevant person*

Similar points apply to an arm's length payment to a non-relevant person. Suppose X (not a relevant person) provides services to T outside the UK, or sells a non-UK situate asset to T, or T subscribes for shares in a company X Ltd.

If T makes a payment to the foreign bank account of X, remittance condition A is not satisfied.

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account, and the corresponding crediting of the bank account of the defendant or his solicitor, constitutes obtaining of that property. The difficulty in the way of that conclusion is simply that, when the bank account of the defendant (or his solicitor) is credited, he does not obtain the lending institution's chose in action. On the contrary, that chose in action is extinguished or reduced pro tanto, and a chose in action is brought into existence representing a debt in an equivalent sum owed by a different bank to the defendant or his solicitor. In these circumstances, it is difficult to see how the defendant thereby *obtained property belonging to another*, ie to the lending institution."

If T pays by giving X a cheque for the amount due, and X pays the cheque into their UK account, remittance condition A is not satisfied. The money is received in the UK by X, not by T. It is not used in the UK by T.[38] If it is brought to the UK, it is not brought by T (but the better view is it is not *brought* to the UK). It is considered that the payment is not received in the UK on behalf of T. T receives the payment on his own behalf.

If (instead of a cheque) T pays by electronic transfer from T's offshore account to the UK account X, it is considered that remittance condition A is not satisfied.

This gives a sensible result. There is no remittance in any real or meaningful sense, and no reason why one would expect a tax charge to arise.

HMRC may not agree. A payment into the foreign account of X is safest, though in practice X may not want to go to the trouble of opening a foreign bank account.

11.12.10 *Acquisition of UK debt/security*

In the following discussion, **"a UK debt/security"** means a debt, or shares or debentures, which is UK situate (because the debtor is UK resident, or the company's register is UK situate). It is assumed that the debtor or company is not a relevant person.

What is the position if T uses RFI to acquire a UK debt/security, ie T lends to the debtor, subscribes for a security, or purchases a debt/security from a third party? Assume for simplicity that the RFI itself is not received in the UK (because payment is made outside the UK).

The "brought" limb of condition A is not satisfied: the UK debt/security is not brought to the UK, and neither is the RFI.

HMRC might rely on the "received" limb. The UK investments are "received" by the relevant person, but are they received "in the UK"? It is arguable that they are not: either they are not received anywhere, or else they are received in the place of the law governing the transfer or creation of the assets concerned (which may or may not be a UK law). So while condition A is only satisfied if the relevant individual actually uses the assets, merely acquiring UK situate assets may not be not enough.[39]

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38 See11.12.6 (Bank entries).

39 If this were wrong then words "used in" in remittance condition C (and perhaps condition A) would be otiose since chattels used in the UK must be received in or brought to the UK.

HMRC may not agree. The RDR Manual provides examples of taxable remittances including:

> **RDRM33050 - Remittance Basis: Practical Examples of Remittances to the UK** [Nov 2013]
> [Taxable remittances include:]
> • You buy shares or bonds in a UK registered plc from a foreign broker with your foreign income.

If receipt of a UK situate asset is receipt of an asset in the UK, then there are some surprising consequences:

(1) There would be a remittance if a person lends to any UK resident (even if not a relevant person) since the lender receives a debt and a debt from a UK resident is usually UK situate.
(2) There might be a remittance if T sells any foreign asset to a UK resident, if the sale price remains outstanding for a time as a debt, as the debt is UK situate; (though it is arguable that short term delays in payment should not count as remittences as the debt (even if UK situate) should be characterised as merely a step in the mechanism of payment and not as an independent receipt.)
(3) There may be a remittance if a foreign asset is sold to a UK resident for some contractual right, as in *Marren v Ingles*.[40]

A cautious approach where possible is to keep the debt/security outside the UK, which might be done by using bearer securities (if possible) and specialty debts, and arranging that the document is kept outside the UK.

11.12.11 *Sale or other disposal of UK debt/security*

If debt/security is not received in the UK, so remittance condition A is not met on the acquisition of the asset, the question arises whether the asset might later be used "in the UK". It is arguable that "use" is appropriate to chattels but not to intangible property. Does the sale of an asset or calling of a debt amount to "use"? If it does, is the asset used "in the UK" just because the asset is situate here? Or is something else required, and if so

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40 See Firth, "A trap for remittance-basis Taxpayers: the situs of choses In action" GITC Review, Vol.XI no.2
http://www.taxbar.com/A_Trap_for_Remittance_-_Basis_Taxpayers_The_Situs_of_Choses_in_Action_Michael_Firth.pdf.pdf

what? The difficulties in all these questions suggest that the better view is that the term "use" does not apply to intangible assets.

11.12.12 *Situs of property for purpose of remittance condition A*

There are no statutory situs rules for income tax, so the common law/private international law rules apply.[41] So money received in a UK branch of a foreign bank is remitted, but money received in a foreign branch of a UK bank is not remitted.[42] Money is remitted if received in:

(1) a UK account in the name of the taxpayer, and held by them beneficially; or
(2) a UK account held in the name of a third party who holds on trust for the taxpayer.

CGT has statutory situs rules. But it is considered that the effect of s.12(5) TCGA is to incorporate the ITA rules, so the CGT situs rules do not apply for the purpose of remittance condition A. That view is confirmed by s.809W(6) ITA which applies the CGT situs rules specifically for the purposes of s.809W(3) ITA. If that view were wrong, there could be a remittance under the CGT remittance basis when a UK resident foreign domiciliary:

(1) places sterling in a foreign bank account, as the account is regarded as UK situate for CGT;[43] or
(2) sells and leaves the purchase price outstanding, since the right to the purchase price is a UK situate asset under the CGT situs rules.

11.12.13 *Non-UK company with UK asset: Secondhand companies*

Suppose T acquires a non-UK company which holds a UK asset. If the UK asset is not enjoyed in specie by T or a relevant person, then Condition A is not satisfied. If the UK asset is (say) a house, which is occupied by T, then remittance condition A is satisfied. However, remittance condition B is not satisfied.

11.12.14 *Service provided in the UK*

The next way to satisfy remittance condition A is:

(e) a service is provided in the UK to a relevant person

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41 See 82.1 (Concept(s) of situs).
42 See 82.23 (Bank account).
43 See 83.12 (Bank account).

The rule requires one to identify the place where services are provided, or at least whether they are provided in the UK. While in some cases this is straightforward, in other cases there is no obvious answer.[44]

The connecting factors could be:

(1) where the work is done
(2) where the supplier is based
(3) where is the property (if any) to which the services relate
(4) where the customer is based

It is considered that the connecting factor should be where the work is done, when that is physical work with a simple physical location. This is consistent with the IT trading source rules.[45] In other cases it should be where the supplier is based.

In practice physical work will generally be done where the supplier is based, so factors (1) and (2) will normally point the same way. But that is not necessarily the case. If one instructs a French firm to put up a building in the UK the service is provided in the UK: if one instructs a UK firm to put up a building in France, the service is provided out of the UK.

Factor (3) cannot be decisive as foreign services relief assumes that a service which relates to property situate outside the UK may be a service provided in the UK.[46]

The RDR Manual is consistent with this view. It provides:

> **34040.Relevant services provided in the UK** [December 2011]
> ... A service is regarded as having been provided in the UK if the providers of that service are based in and give that service in the UK....

"Based in" the UK is my factor (2). I understand that the words *"and give that service in the UK"* is my factor (1), where the physical work is done. This is therefore an easy case where both factors point the same way.

The RDR Manual goes on to give this example:

> *Example 1 (Chandra)*
> C, a remittance basis user, engages an investment manager based in the UK to manage her portfolio of investments in foreign stocks and shares of overseas concerns. ...
> The service - the management of the portfolio - is provided in the UK to

44 It is of course no solution to say that the question is just one of fact: see 18.8 (Objection to multi-factorial approach).

45 See 15.15 (Services).

46 See 12.26 (Foreign services relief).

C...[47]

This is a case where there is no physical work within factor (1), so one falls back on factor (2), where the supplier is based.

Where one travels entirely within the UK, the services are provided in the UK and where one travels entirely outside the UK, the services are provided outside the UK. What is the position if the journey begins in the UK and ends outside, or begins outside the UK and ends within? Possible solutions are:

(1) the services are provided in the UK if any part of the journey is in the UK,
(2) the services are not provided in the UK if any part of the journey is not in the UK,
(3) apportion the journey into two parts.

None of these are satisfactory. (1) and (2) are unfair in favour of HMRC or the taxpayer, and not in accordance with the natural meaning of the words. (3) is wrong as there is only one service.

The best answer is that in this case factor (1) - where physical work is done - does not provide a solution, and one should rely on factor (2) - where the supplier is based.[48] HMRC may agree. The RDR Manual

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47 March 2009 Qs & As made the same point:

Q23: ... If a service provider engages with the Jersey resident trustees of a trust of which a UK resident but non-domiciled individual is a beneficiary and settlor and provides advice which is prepared and issued from the UK, but received and read in Jersey, it is not clear if this would be "a service provided in the UK."...

A: ... The general rule is that, for the purposes of this condition, a service is regarded as being provided in the jurisdiction where the providers of that service are based. Advice which is researched, prepared and issued from the UK would therefore fall within the definition of "provided in the UK" irrespective of where the client might receive it.

Q24: As part of providing advice to clients who have an international aspect to their affairs, a service provider may prepare advice in several different jurisdictions, which may then be issued from only one office, and therefore country, that being the office which has the main relationship with the client.

A: In the case where an offshore service provider provides advice which has been prepared in several different jurisdictions, the same approach will need to be taken to determine whether the test in section 809L is met, and, because the advisors in your scenario are based in the UK, their service will be provided in the UK.

48 The same considerations led the OECD model to a similar rule. Art 8(1) OECD model treaty provides: "Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective

provides:

> **34040. Relevant services provided in the UK** [December 2011]
> ... *Example 4 (Charlotte)*
> C, a remittance basis user, purchases a return air ticket using her foreign income. The ticket is to travel from the UK to Belgium and return. *The ticket was purchased from a UK company* but payment was made into the company's offshore bank account.

The HMRC analysis is as follows:

> Because part of the travel service was provided in the UK (the journey begins and ends in the UK) there is a remittance to the UK [ie the service is provided in the UK].[49]

It is on this analysis significant that the HMRC example specified that the purchase was from a UK company.

In order to decide where a service is provided, it is necessary to identify the service or services which are provided. The VAT distinction between (1) single (though composite) supplies and (2) multiple supplies is applicable here. The RDR Manual gives an example of a multiple supply:

> **34040. Relevant services provided in the UK** [December 2011]
> ... *Example 5 (Sarah)*
> S, a remittance basis user, purchases an air ticket using her foreign income and gains to travel from Sweden to Holland, using a UK based booking agency. Payment is made into the agency's offshore bank account.
> There is a 'service provided in the UK', which is the agent's booking services, so the part of the cost of the service that relates to the agency's booking fee is a remittance (although not the cost of the flight between Sweden and Holland as no part of this service is provided in the UK).

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management of the enterprise is situated."

49 For completeness: there is another version of this example in RDRM 33130:
"*Example 3*
Charlotte, a remittance basis user, purchases an air ticket using her foreign income. The ticket is to travel from the UK to Belgium. The ticket was purchased from an overseas company and payment made into the company's offshore bank account.
Because part of the travel service was provided in the UK (the journey begins and ends in the UK) there is a remittance to the UK."
This is incoherent, since the question assumes there is a ticket from the UK to Belgium, but the answer assumes the journey ends in the UK.

This is correct if there are two services, a booking service and a transport service; but if there is only one supply then it would not be correct.

Basic planning is to use services outside the UK where possible, eg foreign investment advice, foreign accountancy services, foreign travel agencies, and foreign schools.

The last way to satisfy remittance condition A is:

> *(f) a service is provided in the UK for the benefit of a relevant person*

Do the words "for the benefit of" add anything? Is there a case where a service is provided for the benefit of a person but not to that person? Perhaps an example is where a parent P contracts with a school to educate P's child C. The services are perhaps provided to P (who pays for them) but for the benefit of C.

11.13 Remittance condition B (link to foreign income/gains)

Section 809L(3) ITA provides:

> Condition B is that—
> (a) the property, service or consideration for the service, is (wholly or in part) the income or chargeable gains,
> (b) the property, service or consideration—
> (i) derives (wholly or in part, and directly or indirectly) from the income or chargeable gains, and
> (ii) in the case of property or consideration, is property of or consideration given by a relevant person ... [50]

There are eight ways to satisfy remittance condition B. The first six[51] are:

(1) The property received/used/brought to the UK:
  (a) is (wholly or in part) the income or gains,
  (b) is derived property and is property of a relevant person.
(2) The consideration for the service provided in the UK:
  (a) is (wholly or in part) the income or gains, or
  (b) is derived property and is property of a relevant person.
(3) The service:
  (a) is the income or gains or
  (b) derives from the income/gains.

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50 Section 809L(3) continues with paras (c) and (d) which relate to debt remittances, considered separately below.

51 The remaining two relate to the debt remittance rules, which are considered separately below.

11.13.1 *Property and consideration for service*

It is impossible to refer constantly both to property and to services, so I refer to property and leave the reference to services to be read in, as the same points apply to both.

11.13.2 *Property of a relevant person*

Remittance condition B is not satisfied unless the property brought/received/used in the UK either:
(1) is the foreign income or gains; or
(2) is derived from the foreign income or gains.[52]
If the property *is* the foreign income or gains, it does not have to meet the requirement that it is property of a relevant person. If the property is *derived from* the income/gains ("derived property"), it does have to meet that requirement.

Why the distinction? If T transfers income/gains to R, the funds cease to be the income/gains (instead in the hands of R the funds become derived property). That is, if the property *is* the foreign income or gains, the property must necessarily be property of the individual (T) himself (not any one else who is a relevant person in relation to T), so it is not necessary to impose the requirement expressly. That might be the reason; though if so the matter could have been more simply expressed.

Suppose:
(1) T gives foreign income to S (not a relevant person).
(2) S uses the money to buy property used by T.
Condition B is not satisfied: the purchased property is derived property but it is not the property of T or of any relevant person.[53]

The question whether the property either *is* the foreign income/gains or is *derived from* the income/gains also matters for the purposes of s.809P ITA (amount of income remitted).

We need to classify what the relevant person receives as (1) property or (2) a service or (3) neither. This is not always easy. Suppose T pays rent for use of a picture in the UK. Does T receive a service? It is thought not.[54] Does T receive property and if so what? T does not receive the picture, but receives a contractual right, which is arguably property. Or it

52 But where these conditions are not met, remittance condition C or D may apply.
53 But remittance condition C or D may then apply.
54 "Service" is widely defined for VAT, but that definition is not applicable here.

may be that T makes a payment in respect of a relevant debt. A court is likely to hold that there is a taxable remittance under one or other of these routes, though neither analysis is entirely trouble-free.

11.13.3 *Service derives from income/gains*

Next, condition B is met if:

> The service
> (a) is the income or gain; or
> (b) derives from the income or gains.

I am unable to make sense of this. How can a *service* be (or derive from) income or gains? I think the reference to "service" here is misconceived. Perhaps the drafter is considering services which constitute earnings or benefits in kind, or a disposal of an asset in consideration of services. In that case only para (b) is misconceived.

11.14 Property is the income or the gains

11.14.1 *What is the income?*

The question of whether the property brought/received/used in the UK is the income should be straightforward if the income is pure income, such as dividends, interest or income distributions from trusts, because the income should be easy to identify.

Identifying the income is less obvious if the income consists of trading or property income. Trading (or property) income emerges as the result of a trading (or property income) computation. The gross receipts of a trade (or gross rents from a property) are not the income. For example, suppose an individual borrows to purchase land and pays interest or other deductible expenses out of the rent. The income of the individual is the net profit (rent less expenses), it is not the gross rent. So the payment of the interest out of the gross rent is not a remittance of the rental income. The income is the profit (if any) which is left after payment of the interest and other expenses. See *Anson v HMRC* at first instance:

> ... "profits" is not something which one can own as an asset. The profits of an enterprise are an abstract notion, arrived at after a calculation. One cannot find an asset which represents them which one can own; one can only own the assets which, for the time being, reflect them.[55]

55 [2011] STC 2126 at [38].

Similarly in the Court of Appeal:

> ... profits do not arise until an account is struck for a particular period showing that there has been a profit, and that in general an entity will not have particular assets that can be said to be assets which represent the profit which it has made.[56]

Trading profits are regarded as arising at the end of an accounting period, not during the period.[57]

11.14.2 *What is the gain?*

The question of whether the property is the gain is problematic. What is the jurisprudential nature of a gain? The RDR Manual provides:

> **35320 Mixed Funds: Example 4 - remittances before 6 April 2008 Note 3** [June 2010]
> ... unlike income that can be identified separately, a capital gain is merely part of the money received from the sale and has no separate existence within that amount. See Capital Gains Manual CG25380 onwards (and CG25440 in particular).

On one view, a gain is not an item of property: it is merely a figure resulting from a mathematical computation. The quantum of a gain (generally) depends (in part) on the amount or value of the proceeds of a disposal, but that does not entail that the gain is a part of the proceeds. The income of a trade may similarly be said to be distinct from the gross trading receipts. On this view, the proceeds of a disposal are not the gain and are not even derived from the gain. The gain is not a part of the money received from the sale. But whatever the true jurisprudential nature of a gain may be, the provisions are not drafted on that view: they are drafted on the basis that the proceeds of a disposal for full consideration do constitute (1) gain and (2) non-gain (representing base cost and other exemptions) so for remittance purposes, the proceeds of disposal do include the gain.[58] So for remittance purposes, at least, this statement in the Manual is correct.

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56 [2013] STC 557 at [59].

57 *Re Robbins* [1941] Ch 434.

58 The position is more difficult for sales at an undervalue: see 11.30.5 (Sale of asset at undervalue).

11.15 Derived property

Remittance condition B (and C and D) refer to property which *derives (wholly or in part, and directly or indirectly)* from foreign income or gains. I refer to this as "**derived property**" and in this section for convenience I refer to RFI (leaving other types of foreign income/gains to be understood).

The words "directly or indirectly" show that the drafter did not want the word "derives" to be construed narrowly.

Some very general guidance might be drawn from case law on s.22 TCGA ("there is ... a disposal of assets by their owner where any capital sum is derived from assets..."). In *IRC v Montgomery* trustees sold a policy of insurance, which was valuable because a fire had damaged insured land held by the trustees. The proceeds of sale were derived from the policy and not derived from the land:

> What, in the context of [s.22], does "derived" mean? The relevant dictionary meaning of "derivation" is to trace or show the origin, and that is what I think it means here.

A dictionary definitions rarely helps, and it does not do so here.

> It appears to me quite clear that the capital sum paid by [the purchaser] was derived from the sale of the rights under the policies, and that it is not right to go back any further. If it were legitimate to embark on the exercise of tracing the derivation of assets back in the manner of an abstract of title, I do not know where the line could ever properly be drawn. I think that one must ask the simple question, "From what asset of the trustees was the capital sum of £75,192 they received derived?" and the simple answer is that it was derived from the ... policies of insurance.[59]

It is considered that the same should apply in a remittance context, which would arise if (say) the land was derived from RFI but the insurance policy was not. Condition B has the words "directly or indirectly" which were not in the CGT provision, but I do not think that alter the position.

11.15.1 *Enactment history*

I do not think that the enactment history helps much, but for completeness: The word "derived" was used in case law on the pre-2008 RFI remittance

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59 49 TC 679 at p.686.

basis.[60] That is presumably the source of the current wording; or perhaps the drafter started with a blank sheet and came up with the expression "derived".

Under the pre-2008 CGT and employment income remittance bases, tax was charged on sums received in the UK *in respect of* the foreign income or gains. Is that different from "derived from"? It is impossible to answer with precision, since "in respect of" and "derived from" are both imprecise and context-dependent expressions. It is suggested that the meaning (given the context) is the same, but the expression "derived from" more aptly expresses the necessary connection between the foreign income and the property received in the UK.

11.15.2 *Income/gains invested and re-invested*

Suppose T uses RFI to purchase assets. The purchased assets are derived from the RFI. If the purchased assets are sold and the proceeds re-invested in new assets, those new assets are derived from the RFI indirectly. The tracing process can continue for the lifetime of T.

11.15.3 *T gives income/gains to R*

Suppose T gives RFI to R. The funds in the hands of R are not the income, but they are derived from the RFI. If R uses the funds to purchase assets, the purchased assets are derived from the T's RFI , and (as above) that tracing process can continue for the lifetime of T.

11.15.4 *T purchases asset for full consideration from R*

Suppose:

(1) T purchases an asset ("the purchased asset") from a relevant person ("R") for full consideration.

(2) T uses RFI to pay the purchase price.

It is considered that the proceeds of sale in the hands of R is not derived from T's RFI. So there is no taxable remittance if R brings the proceeds of sale to the UK: remittance condition B is not satisfied.[61]

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60 The former Inspectors Manual para 1564 published 9/95 provided: "Income is received in the UK if funds provided in the UK are derived from income arising overseas;" that was based on a comment in *Thomson v Moyse* 39 TC 291 at p. 335.

61 Of course the purchased asset in the hands of T is derived from T's RFI so there would be a taxable remittance if T brings the purchased asset to the UK.

If my view is wrong, there would be a double charge to tax where the purchased asset

Likewise if T provides services to R for full consideration, and T uses RFI to pay the fee. The fee in the hands of R is not derived from the RFI.

This is a sensible rule, because if T uses RFI to purchase an asset from a company, at arm's length, T will often have no way of knowing whether the company is a relevant person, and T can hardly be expected to ask the company what it has done with its own money. Whereas if T *gives* money to R, the request is not so unreasonable.

This view was accepted in another context in *Cohen v Petch* [1999] STC (SCD) 207. Here:

(1) T borrowed money from a building society and used it to purchase an asset from T's mother.
(2) The mother immediately gave or lent the proceeds of sale back to T.
(3) T lent the money to a company.

The son claimed relief for the interest on the building society loan. The Special Commissioner said at p.211:

> ... once the money had been borrowed [by] the taxpayer from the society it was paid to his mother and became her funds. Subsequently, three days later, the sum of £46,600 was returned to the taxpayer by his mother either in the form of a loan or as a gift. The funds, whether or not they are traceable in specie, were no longer the money borrowed from the society. They were funds lent or given by Mrs Daphne Cohen to her son. *There was no longer any link between the money which the taxpayer eventually lent to the company and the money which he borrowed from the society.*

The questions (simplifying the clumsy language of ICTA) were (1) whether the money borrowed from the building society had been used to lend to the trading company, and (2) whether it had been "applied for some other purpose" before being so used.[62] This not the same as the wording of the ITA remittance basis ("derived directly or indirectly"). But the words used by the Commissioner ("no longer any link") do suggest that the derived test would not be satisfied.

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represented RFI of R, that is, where:
(1) R receives RFI (R's income) and uses it to purchase an asset (the purchased asset).
(2) T receives RFI (T's income) and uses it to purchase the asset from R.
Suppose T brings the purchased asset to the UK. There is a taxable remittance of T's RFI. But it would be surprising if R's income was also remitted.

62 The current provisions are s.385(3) ITA and 392(2) ITA.

11.15.5 *T sells asset for full consideration to R*

Suppose:
(1) T uses RFI to acquire an asset ("the RFI asset")
(2) T sells the RFI asset to a relevant person ("R") for full consideration.

It is considered that the RFI asset in the hands of R is not derived from T's RFI. So there is no taxable remittance if R brings the RFI asset to the UK: remittance condition B is not satisfied.[63]

Similarly, suppose:
(1) T sells an asset to a company within s.720 or s.13 or a trust within s.624.
(2) The company uses its income (treated as derived from T's s.720 income) or its gains (treated as derived from T's s.13 gains) or the trust uses its income (treated as derived from T's s.624 income) to pay the purchase price.

The proceeds of sale in T's hands are not derived from the s.720 income, the s.13 gains or the s.624 income.

11.15.6 *T lends income/gains to R*

Suppose T receives RFI and lends it to an individual who is a relevant person ("R"). Are the funds in R's hands derived from T's RFI? There are three possible solutions:
(1) R's borrowed money is always derived from T's RFI.
(2) R's borrowed money is never derived from T's RFI.
(3) R's borrowed money is sometimes derived from T's RFI.

There are strong arguments in favour of solution (2):
(1) R's promise to repay the loan is (in principle)[64] full consideration for the money, whether the loan is on commercial terms or interest free repayable on demand (the promise to repay an interest free loan is full consideration). R's borrowed money is derived from that promise.[65]

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63 Of course proceeds of sale in the hands of T is derived from T's RFI so there would be a taxable remittance if T brings the proceeds of sale to the UK.
If my view is wrong, there could be a double charge to tax.

64 The position would be different if the loan is a fixed-term loan at a low rate of interest as then R's promise to repay is not full consideration; that would be unusual and is assumed not to be the case here.

65 Contrast 76.6 ("Provide").

(2) T acquires an asset (the benefit of the debt) which is derived from the RFI, so it would be surprising if R's borrowed money was also derived from the same RFI.
(3) Suppose R repaid the debt (not out of the borrowed money but out of other funds). On solution (1) the borrowed money would continue to be derived from the RFI, which would be very odd to say the least.

The objection to solution (2) is that it is too good to be true; a remittance is too easily avoidable. There is not much point in having a charge on remittances by relevant persons which arises if T gives RFI to R, but not if T lends RFI to R interest-free. It is considered that there must be some circumstances in which one should regard R's borrowed money as derived from T's RFI. The court might then describe the loan as a mere "conduit".[66] However "conduit" is a metaphor which constitutes a conclusion rather than a basis for reaching that conclusion. The difficulty is to find an appropriate method of distinguishing between cases where one does and does not regard borrowed money as derived from RFI used to make the loan.

It is suggested that one should seek to distinguish between:

(1) loans which have characteristics of an outright payment, where R's borrowed money is regarded as derived from the RFI; and
(2) loans which do not have those characteristics.

A loan has the characteristics of an outright payment if there is no intention to repay the loan, or at least, the loan is likely to remain outstanding during the lifetime of the borrower, or, perhaps, during the period that the borrower is UK resident. A particular instance of that would be where the borrower has insufficient funds to repay the loan (other than the borrowed money). Such "loans" (the facts justifying scare quotation marks) are (from the recipient's viewpoint) more or less equivalent to outright payments.

A loan on arm's length terms is less like an outright payment, at least assuming there is in fact an intention to comply with the terms (pay the interest).

A loan made at arm's length is not like an outright payment.

Similar points arise on a sale with the payment left outstanding (which is commercially equivalent to a loan, though not a loan in the strict sense of

66 As Lord Templeman did in *Harmel v Wright*, 49 TC 149 at p.157, a case on the pre-2008 legislation and so not now directly relevant.

the word).

11.15.7 *T subscribes for shares in R Ltd*

Suppose T uses RFI to subscribe for shares in a company which is a relevant person ("R Ltd"). The shares are clearly derived from the income.

It is considered that the proceeds of the share subscription in R Ltd are also derived indirectly from the income. But (assuming a share subscription on arm's length terms) some obvious difficulties do arise from this view, and the contrary could be argued.

11.15.8 *T purchases shares in R Ltd (secondhand companies)*

Suppose T uses RFI to purchase the shares in R Ltd (a relevant person). R Ltd already owns assets. The assets of R Ltd are not derived property: they do not derive from the RFI.

11.15.9 *T borrows on security of foreign income/gains*

It is helpful first to consider the position for unsecured loans. If T borrows without giving security the borrowed money is derived from the promise to repay. That is so even if T owns assets (say, RFI) and the lender would not lend had T not owned those assets. The fact that the lender only lends because of the RFI does not show that the borrowed money is derived from the RFI. No-one would doubt that.

Suppose T borrows on the security of RFI. Is the borrowed money derived from the RFI? It is considered that in this case the borrowed money is still derived from the promise to repay and not from the security. This is clearly so if T could have borrowed without giving the security.

That is still the case even if T could not have borrowed without giving that specific security. There are three reasons for this view:

(1) The position is analogous to unsecured loans where no-one suggests that borrowed money is derived from the borrower's RFI even T could not have borrowed were it not for that RFI.

(2) A rule which says that borrowed money is derived from a security if and only if the borrower needed the security in order to borrow is not workable: the question whether the security is needed is often imponderable.

(3) The debt remittance rules[67] are designed to cover this aspect of

67 See 11.19.2 (Use as security for debt).

remittances and that suggests that there would not be a remittance under general principles.

For these reasons it is considered that borrowed money is derived from the promise to repay, not from assets used as security, even if T could not have borrowed without giving that security.

In *West v Trennery* 76 TC 713, trustees held shares and borrowed money on the security of the shares. One question was whether the borrowed money was derived property for the purposes of s.77 TCGA (now repealed). So far as relevant, s.77(8) TCGA at that time provided:[68]

> In this section "derived property", in relation to any property, means ... any ... property directly or indirectly representing proceeds
>
> [i] of, or
>
> [ii] of[69] income from,
>
> that property ...

So the question was whether the borrowed money directly or indirectly represented the proceeds of the shares. Lord Millett said:

> 16. The final question is whether the Revenue are correct in contending that the [borrowed] moneys ... constituted derived property within the meaning of s 77(8) in relation to the Einkorn shares. There can be only one answer to this: of course they do. The [borrowed] moneys ... directly represented the proceeds of a mortgage of the Einkorn shares ... If the trustees ... had invested the moneys in stocks and shares, these would have indirectly represented those proceeds. It will be observed that I have equated the proceeds of a mortgage of property with the proceeds of the property itself. But the subsection does not refer to "the proceeds of a sale of that property", but to "the proceeds of that property"; and this covers any proceeds, whether sale or mortgage or otherwise howsoever, by which value is extracted from one property and transferred to another.[70]

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68 In 2006 the definition was amended with retrospective effect, only to be repealed in 2008.

69 At first sight the word "of" appears to be a grammatical error, but it makes sense if one understands the words to mean:

[i] proceeds of, or

[ii][proceeds] of income from,

that property...

70 Likewise Lord Walker said:

"In my opinion the £770,000 [borrowed money] started off as derived property..."

It is considered that this case is of no relevance, since the statutory words on which the decision rests are not present in the remittance basis provisions.

In practice HMRC appear to accept this view; see 11.19.2 (Use as security for debt).

11.15.10 *T uses income/gains to pay debt*

Suppose:

(1) T borrows from L and receives "the borrowed money".

(2) T uses RFI to repay the debt to L so L receives "the repaid money" and T retains the borrowed money..

In the absence of a statutory provision, the borrowed money would not be derived from the RFI. It would not be derived from the RFI at the time of the borrowing. It would not become derived from the RFI later when the debt is repaid.[71] However, s.809R(3) ITA alters this: see 13.3.6 (Income/gains used to pay debt).

It is considered that the repaid money in the hands of L is not derived from the RFI. It is derived from the debt, and (indirectly) from the funds which L used to make the loan to T.

11.15.11 *Income from income/gains*

Suppose:

(1) T receives £1m ("original income").

(2) T invests the original income and receives £50k ("new income").

It is considered that the new income is not derived from the original income. One must stop tracing the original income at that point. Otherwise various odd results will follow:

(1) If T remits the £50k new income, T would pay tax on the £1m original income.[72]

(2) Suppose:

(a) T gives £1m original income to R (a relevant person).

(b) R receives £50k new income.

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71 The position might be different if the two steps formed part of a scheme and were carried out in quick succession. Of course, if the debt were a relevant debt there would be a remittance of the RFI on payment of the debt, under the debt remittance rules.

72 See 11.29.2 (Remittance of derived property).

(c) R brings the £50k new income to the UK.

If the new income is derived from the original income, there will be double taxation:

(i) R will pay tax on the new income (on an arising or remittance basis, depending on whether R is a remittance basis taxpayer; that makes no difference for the purposes of this example).

(ii) T would pay tax on the remittance of the new income by R.

11.15.12 *Gift on to third person*

The position becomes more complex if a second individual is involved. Suppose:

(1) T gives income/gains to A (an individual who may or may not be a relevant person).[73]

(2) A gives the fund to B (a relevant person).

It is suggested that the funds in the hands of B are derived property if steps (1) and (2) form an arrangement. If there is no connection of that kind between T's gift and the transfer to B, the funds in B's hands are not derived property. The chain of derivation stops there. In particular, if B acquires the funds on the death of A, the funds are not derived property.[74]

If T gives income/gains to a trust and the trustees appoint the fund to B, the same approach should be applied, but the two steps do form an arrangement because the trustees is merely carrying out the intention of the settlor and is not a wholly independent mind.[75] So the funds in the hands of B are derived property.

11.15.13 *Receipt of cheque in UK*

Suppose T receives in the UK a cheque which, if cashed, the proceeds would be RFI. For instance, a cheque representing a dividend from a non-resident company, or a cheque drawn on a foreign account holding unremitted income of T.

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73 If A is not a relevant person, A will be a gift recipient, and remittance condition C needs consideration.

74 This view is supported a little by s.48(3C)(b) IHTA: see 62.17.3 (Purchased equitable interest).

75 See *Williams v Muir* [1943] AC 468 at p.483 in relation to a special power of appointment, as contrasted with a general power: "It is as though the settlor had left a blank in the settlement which B fills up for him if and when the power of appointment is exercised. The appointees' interests come to them under the settlement alone and by virtue of that document."

A cheque has a twofold character:

(1) It is an instruction to the payor's bank.

(2) It is also a chose in action which entitles the payee to sue on it.[76]

Under neither character is the mere receipt of a cheque a taxable remittance.[77] So far as the cheque is an instruction to pay:

> It is not enough to complete the beneficiary's title to the proceeds of the transfer that the beneficiary [ie payee] or his or her bank receives the payment instruction. This is the case whether the instruction is embodied in a telex or telephone instruction given by the originator [payor] or a standing order or payment order form The instruction only confers on the originator's bank the necessary mandate to make the payment to the beneficiary as his or her agent and to debit his or her account.[78]

So far as the cheque is a chose in action, a promise to pay, it is a different asset from the funds in the account, and so not derived property. Remittance condition B is not satisfied. Also, the chose in action is not UK situate (even if the paper itself is in the UK) unless the cheque is a bearer instrument or negotiable.[79] So remittance condition A is also not satisfied.

Even if the cheque is presented to a bank in the UK, there is still no remittance if:

(1) the credit is made to the payee's foreign account, not to a UK account; or

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76 Fox, *Property Rights in Money* (2008) para 5.18, 5.64.

77 This continues the pre-2008 law. The RDR (discussing the pre-2008 remittance basis) provides:

"RDRM36110 - Remittance Basis: Remittance Basis up to 6 April 2008: Form of Remittance: Cheques received

If a taxpayer receives a cheque which represents taxable foreign income, before it is treated as taxable remittance it is necessary for the taxpayer to do something with it after it came into his or her hands.

For example, the cheque might be:

- Credited to a UK bank account
- Exchanged for cash (through a bank or otherwise)
- Accepted by a third party in settlement of a debt owed by the taxpayer
- Given away to a relative

A taxable remittance is not made if a cheque is received in the UK but is then sent abroad and credited to a bank account which the taxpayer has overseas."

78 Fox, *Property Rights in Money* (2008) para 5.64.

79 Cheques drawn on UK banks have generally been non-transferable since the Cheques Act 1992.

(2) the payee is not a relevant person.[80]

11.15.14 *Betting*

In a conventional bet, the individual puts up a stake in advance, and the winnings (if any) are (at least partly) derived from that stake.

Spread betting is explained in *Spreadex v Battu*:

> [2] Spread betting is not so much or not merely a bet, although it can be described as such, as a form of contract for differences. It enables a customer to take a position on a market (or an event) for a very small stake. Thus, if the Dow Jones index is, say, at 10,000, one can "buy" or "sell" the market at a spread around the index of, for the sake of example, 10 points either way, 9990 to 10,010. If one buys, one is betting that the market will rise above 10,010. If one sells, one is betting that the market will fall below 9990. If one buys and the market rises, one stands to gain £1 for every point that the index exceeds 10,010. If one sells and the market falls, one stands to gain £1 for every point that the index drops below 9990. If, however, one calls the market wrong, then one will stand to lose £1 for every point the market rises above 9990. Until the bet or "trade" is closed, the gains and losses are merely "running" gains or losses. They are real enough, but constantly changing with every change in the index, and have not yet been fixed. Closing the bet will fix the position, win or lose. Unlike a classic bet, the customer can of course lose more than his stake. Indeed, on the example given, of a sales spread point of 9990 when the market is at 10,000, if the market does not move an inch, the customer will lose £10 for every £1 staked. Nor, again unlike a classic bet, are his winnings fixed at the outset by an agreement on odds. In theory, winnings based on rising markets are infinite (in practice, of course, they are not) and losses based on falling markets are limited only in so far as they cannot exceed the consequences of a fall in the index to zero.[81]

Pelling explains:

> A spread bet is a form of contract for differences. The client agrees with the firm where he holds his account that each will pay to the other a

80 See 11.12.8 (Gift to non-relevant person); 11.12.9 (Arm's length payment to non-relevant person).

81 *Spreadex Ltd v Battu* [2005] EWCA Civ 855.

> specified sum per point (the stake) in respect of movements in a nominated index. In financial spread betting the index could be the FTSE 100 or the Dow, or the price of an individual share such as BP or, conceivably, a much smaller floated company, or the price of a commodity or a rate of exchange between specified currencies. If the client is "long" the firm will pay him the stake multiplied by any increase in the index value between opening and closing, but he will have to pay the firm on the same basis if there is a decrease. If he is "short" the opposite applies. The "spread" is the difference between the long and short, or "buy" and "sell" prices at any given time. Spread bets generally have expiry dates built into them but the client is able to close his position before expiry if he chooses to do so. The firm, however, does not have the same discretion. ...
>
> Not all spread betting is on financial indices. Spread betting markets are made by firms on a huge breadth of sporting events, although in this country anecdotal evidence suggests that the biggest individual positions are still taken on financial indices. In this regard spread betting offers certain advantages over more orthodox financial instruments when it comes to profiting from market movements. First, profits on spread bets are taken free of capital gains tax.[82] Secondly, the "geared" or "leveraged" nature of spread bets means that typically the client only has to put up a fraction of the total cost of a position, which means that he can get bigger exposure for a given sum (in hedging the exposure the firm puts up the balance of the cost from its own resources). Thirdly, spread betting offers the client the opportunity to go "short" if he thinks that the market will fall — something that is not always available with a more straightforward brokerage.[83]

In a spread bet, the individual does not put up any stake, but instead incurs a liability to make a possible payment in the future.

If an individual takes a spread bet and loses, nothing can be received in the UK and there can be no remittance. If an individual takes a spread bet and wins, the winnings are not derived from any foreign income or gains: they are derived from the (contingent) liability which the individual undertook when making the bet. Accordingly, there is no taxable remittance.

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82 See 44.11.4 ("Gambling" and distinction between individuals and companies).

83 Pelling, "The long and the short: common issues in spread betting cases" (2012) 1 JIBFL 18.

11.16 Debt remittance rules

I turn to the second part of remittance condition B. Section 809L(3) ITA provides:

> Condition B is that ...
>
> (c) the income or chargeable gains are used outside the UK (directly or indirectly) in respect of a relevant debt, or
>
> (d) anything deriving (wholly or in part, and directly or indirectly) from the income or chargeable gains is used as mentioned in para (c).

I refer to these rules as the "**debt remittance rules**".

In order to have a debt remittance under condition B, three conditions must be satisfied; in short:

(1) A *relevant debt* (broadly, relating to property brought/received/used in the UK).

(2) Foreign income/gains used *in respect of* the debt.

There is no remittance under the debt remittance rules unless both conditions are satisfied:

(1) if a relevant debt is paid out of a sum which does not constitute foreign income/gains; or

(2) if foreign income/gains are used to satisfy a debt which is not a relevant debt.

The third requirement is that the income/gains are used *outside the UK*; however if the income/gains are used in the UK, there will normally be a remittance under the usual remittance rules, so this is not so important in practice.

11.17 Relevant debt

"Relevant debt" is a key term, which is found in remittance conditions B, C and D . Section 809L(7) ITA provides the definition.

There are six categories of relevant debt:

> In this section "relevant debt" means a debt that relates (wholly or in part, and directly or indirectly) to—
>
> (a) property falling within subsection (2)(a) [property brought/received/used in the UK]
>
> (b) a service falling within subsection (2)(b) [service provided in UK]
>
> (c) qualifying property dealt with as mentioned in subsection (4)(a),

(d) a service falling within subsection (4)(b),
(e) qualifying property dealt with as mentioned in subsection (5)(a), or
(f) a service falling within subsection (5)(b).

To understand this one must read back in the words in the six cross-references:
(a) and (b) relate to remittance condition A
(c) and (d) relate to remittance condition C
(e) and (f) relate to remittance condition D.
When one reads in the words, it is clear that para (f) is otiose: it only repeats para (d).

In para (e) "*Qualifying* property dealt with as mentioned in s.809L(5)(a)", the word "qualifying" is meaningless. The expression "qualifying property" is defined for remittance condition C but not for condition D.

The most important category is para (a). The discussion here concentrates on this category. There are two steps in deciding whether a debt is a relevant debt within para (a):
(1) One must identify the property (if any) to which the debt relates. I refer to that as **"the debt-related asset"**.
(2) One must ask if that asset is "property falling within s.809L(2)(a)" ie is the property brought/received/used in the UK by a relevant person.

The residence of the lender is not relevant. A loan from a UK bank is not a relevant debt if the money borrowed is received and retained outside the UK but it is a relevant debt if the money borrowed is received in the UK. However the debt remittance rules only apply if income/gains are used *outside the UK* in respect of a relevant debt, which is not likely to happen where the loan is from a UK bank: repayment to a UK bank is in principle use of funds in the UK.

"Debt" is not defined. It is suggested that it includes any liability to pay money. If an individual holds a lease, the payment of rent is the payment of a debt. If the land is UK situate, the debt is a relevant debt. A guarantee is not a debt but if the guarantee is called on, it becomes a debt.

11.18 Debt "relating" to property (debt-related asset)

"Relates" requires some nexus between the debt and the debt-related asset; exactly what that nexus is has been left to the courts to sort out.

The words "directly or indirectly" do not add any clarity; indeed I am not sure that it is altogether coherent to speak in the abstract of direct and indirect relationships, for "relates" requires a relationship and an indirectly

relationship is a type of relationship. But the word "indirectly" shows that the drafter did not want the word "relates" to be construed narrowly.

In the following discussion I just use the word "relate" and leave "directly or indirectly" to be understood.

11.18.1 *Some straightforward examples*

Suppose T borrows and receives money. The debt relates to the money. If T receives the borrowed money in the UK, the debt is a relevant debt.

If T borrows and receives the borrowed money outside the UK, the debt still relates to the money but the money is not "property falling within s.809L(2)(a)" so the debt is not a relevant debt. However if T later brings the money to the UK, it becomes "property falling within s.809L(2)(a)" and the debt at that time becomes a relevant debt. HMRC agree.[84]

Under a typical loan facility, T will borrow but may not receive money: T may draw down the borrowing to pay for an asset, the money being paid directly to the vendor. In that case the debt relates to the asset. If at any time T brings/receives/uses the asset in the UK the debt is a relevant debt. It makes no difference whether the loan is drawn down first or (which may be more usual) drawn down directly to pay for the asset.

The RDR Manual provides some examples which are consistent with the above. I set out the relevant parts of the text, relegating the full text to footnotes.

Example 1 concerns borrowing to buy UK shares.

> *Example 1 (Katrina)*[85]
> K borrows money to buy shares in a UK company.

The HMRC analysis is as follows:

> This is a relevant debt as it relates to property (shares) in the UK which is for the benefit of a relevant person.

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84 See the example of Ali at 11.17.6 (Debt-related asset given to another person).

85 The example in full (including its irrelevant detail) is as follows:

> "**33160 Condition B - relevant debt** [May 2012]
> In May 2006 Katrina, a remittance basis user, borrows money from an overseas bank to buy shares in a UK company. This is a relevant debt as it relates to property (shares) in the UK which is for the benefit of a relevant person (Katrina).
> From 6 April 2008 any foreign income or gains that Katrina uses in respect of the loan, for example to service or to repay the loan, are taxable as a remittance."

More analytically, the debt is in the HMRC view a relevant debt on the following grounds:

(1) The debt relates to the shares. (This is correct).
(2) The shares are received in the UK by K. This assumes a receipt of UK situate property is a receipt in the UK.[86]

Example 2 concerns borrowing to buy UK residential accommodation:

> *Example 2 (Gary)*[87]
> G borrows money to buy an apartment in the UK which he occupies.

The HMRC analysis is as follows:

> The loan is a relevant debt because money is used in the UK, and it is respect of property (the apartment) which is used in the UK for the benefit of a relevant person (G).

More analytically, this is in the HMRC view a relevant debt on one or both of the following grounds:

(1) It relates to the flat which is used in the UK by G. (This is correct).
(2) It relates to money which is used in the UK by G. Whether this is correct depends on the details of the purchase arrangement but it does not matter since the debt is a relevant debt under (1)).

Example 3 concerns borrowing to buy a UK chattel for a relevant person.

> *Example 3 (Robina)*[88]
> R borrows money to buy a car for M, a relevant person.

The HMRC analysis is as follows:

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86 See 11.12.10 (Receipt of UK situate investment asset).

87 The example in full (including its irrelevant detail) is as follows:
"On 6 April 2015, Gary, a remittance basis user, borrows money from an overseas bank to buy an apartment in Solihull.
The loan is a relevant debt because money is used in the UK, and it is respect of property (the apartment) which is used in the UK for the benefit of a relevant person (Gary)."

88 The example in full (including its irrelevant detail) is as follows:
"In October 2012 Robina, a remittance basis user, borrows money on a fixed-rate loan from an overseas bank to buy a car for Mark, a relevant person. Robina pays £x each month from 1 November 2012, making 24 monthly payments. She uses her foreign chargeable gains to make these repayments.
The loan is a relevant debt because it is respect of property (the car) which is used in the UK by a relevant person (Mark)."

The loan is a relevant debt because it is respect of[89] property (the car) which is used in the UK by a relevant person (M).

More correctly, there is a relevant debt because:

(1) The debt relates to the car.

(2) The car is used in the UK by a relevant person, M. (Another reason is that the car must have been brought or received in the UK by R or M.)

Example 4 concerns borrowing to pay for two services, one provided in and the other out of the UK; I discuss this at 11.18.13 (Debt relating to UK property in part).

Example 5 concerns borrowing to purchase an asset given to a relevant person; I discuss this at 11.18.6 (Debt-related asset given to another person). Example 6 (Francine) is a straightforward example of borrowing to pay for services in the UK which adds nothing and so is not set out here.

For example 7, see 11.18.12 (Borrowing by relevant person (not the individual)).

11.18.2 *Asset derived from debt-related asset*

Suppose:

(1) T borrows and uses the borrowed money to purchase a non-UK asset ("asset 1").

(2) T later sells asset 1 and uses the proceeds of sale to purchase a UK asset ("asset 2").

The debt relates to asset 1. It is considered that the debt does not necessarily relate to asset 2. The word "relates" requires more than just a historic tracing exercise. It is suggested that the debt relates to asset 2 if and only if steps (1) and (2) form part of an arrangement.

Suppose:

(1) T borrows.

(2) The borrowed funds (or proceeds representing them) are mixed with other funds.

(3) Some of the mixed funds are used to acquire a UK asset (leaving an amount in the mixed fund which equals the borrowed funds).

89 The author of the example probably regarded "relates to" and "in respect of" as synonymous, which no doubt they are; but it is best to use the statutory wording and not a paraphrase.

Does the borrowing relate to the UK asset or to the amount remaining in the mixed fund? Unless steps (1) to (3) form part of an arrangement, the debt does not relate to the UK asset. If the debt does relate to the asset, some commonsense tracing rules must be devised; the ITA mixed fund regime does not apply.

Suppose T borrows invests the borrowed funds, and receives income from the borrowed funds. It is considered that the debt does not relate to the income. So if the income is remitted, it is in principle taxable, but the debt does not thereby become a relevant debt.

11.18.3 *Debt relating to asset later removed from UK or ceasing to exist*

Suppose:
(1) T borrowed to acquire an asset.
(2) T brings/receives the asset in the UK so the debt is a relevant debt.
(3) T later takes the asset outside the UK.

The debt still relates to the asset. It is suggested that the asset is still "property falling within s.809L(2)(a)" ie property brought/received/ used in the UK by T. So the debt is still a relevant debt. The contrary view would give scope for planning/avoidance. Suppose T wanted to use property/chattels in the UK:
(1) T borrows funds.
(2) T uses the funds to purchase property in the UK and chattels which are in the UK or which are brought to the UK.
(3) Interest rolls up on the debt.
(4) Later when T no longer wants to use the property/chattels, the chattels are taken outside the UK, and the property is sold.
(5) The debt is then repaid.

If my view is wrong, the debt has ceased to be a relevant debt by the time it is repaid so there is no remittance, even though T may have enjoyed substantial benefits in the UK.

Suppose:
(1) T borrowed to acquire an asset.
(2) T brings/receives the asset in the UK so the debt is a relevant debt.
(3) The asset ceases to exist (eg it is a short lease which expires, or money which is spent).

It is considered that the debt remains a relevant debt. That is consistent with debt remittance rules for services, for if T borrows to pay for services provided in the UK, the debt is a relevant debt even after the services have ceased to be provided.

11.18.4 *Borrowed money used to repay debt*

Suppose:

(1) T borrows to acquire borrowed money or other property; T has a debt ("debt 1") and an asset ("asset 1"). Debt 1 relates to asset 1.

(2) T borrows more ("debt 2") and uses the borrowed funds to repay debt 1, so T retains asset 1.

Does debt 2 relate to asset 1? It is considered the answer is yes, if the steps form a scheme or arrangement.

11.18.5 *Borrowed money lent on to another person*

The position becomes more complex if borrowed money is lent on to another person. Suppose:

(1) T borrows money from a bank.

(2) T lends the borrowed money to A.

(3) A uses the money to acquire a UK asset ("A's UK asset").

In this case:

(1) T has a debt: the burden of the debt to the bank ("T's debt"). One needs to ask if it is a relevant debt.

(2) A has a debt: the burden of the debt to T ("A's debt"). One needs to ask if it is a relevant debt.

(3) T has an asset: the benefit of A's debt to T: one needs to ask if it is UK situate.

(4) A has an asset: "A's UK asset".

A's debt is a relevant debt: it relates to A's UK asset.

Is T's debt a relevant debt? T's debt relates to the benefit of A's debt. If the benefit of A's debt is a UK situate asset, then T's debt is a relevant debt. Let us assume this is not the case.

T's debt is also a relevant debt if (1) it relates (indirectly) to A's UK asset and (2) A is a relevant person in relation to T. It is suggested that T's debt does not relate to A's UK asset. This is clearly the case if steps (1) and (2) do not form an arrangement. If there is no connection of that kind between T's debt and the UK asset, the debt does not relate to the asset. But even if there is an arrangement, T's debt does not relate to A's UK asset, since T has another asset which relates to the debt. There is no scope for tax avoidance in this conclusion, since the debt remittance rules apply to A.

If my view is wrong, what would the position be if:

(1) T borrows from a bank and lends to A.

(2) A lends the proceeds of the borrowing to B.

(3) B uses the money to acquire a UK asset.

How many assets would T's debt relate to, and how could T keep track of them all?

11.18.6 *Debt-related asset given to another person*

RDR Manual 33160 gives an example of borrowing to purchase an asset which is later given to a relevant person and brought to the UK:

> *Example 5 (Ali)*[90]
> A borrows to purchases a sculpture outside the UK.
> A gives the asset to his wife W.
> W brings the asset to the UK.

HMRC correctly analyse why the debt is a relevant debt:

> There is a debt (the loan from the bank) which relates to property (the sculpture) which is brought to the UK by a relevant person (W).

---

90 The example in full (including its irrelevant detail) is as follows:

"**33160 Condition B - relevant debt** [May 2012]

Ali, a remittance basis user, purchases a sculpture in Sweden in October 2012 (see earlier example). He takes out an interest-free [*sic*] loan with his US bank to fund this purchase, repayable within 1 year. In November 2012 he gives them to his wife as an anniversary gift.

She initially keeps it at her mother's home in Stockholm, but 6 months later in March 2013 Ali's wife decides to bring the sculpture to the UK to display in her UK garden. In October 2013 Ali arranges with the US bank that he will repay the loan by giving them an oil painting which is currently in his apartment in Miami, which he had purchased in May 2011, using his relevant foreign earnings, and some capital inherited from an uncle.

There is a debt (the loan from the US bank) which relates to property (the sculpture) which is brought to the UK by a relevant person (Ali's wife, in March 2013).

The painting which derives, in part, from A's relevant foreign earnings, is used outside the UK in respect of this relevant debt.

There is a taxable remittance in 2013-14, the tax year in which the painting is used to pay the relevant debt."

More analytically, remittance condition B is satisfied under s.809L(3)(d): the picture (which derives from RFE) is used in respect of the relevant debt. The example continues:

"The remittance occurs when the foreign income or gains are regarded as used in respect of the relevant debt (2013-14) not when the property is first used in the UK by a relevant person (2012-13). ...

NB – for the purposes of this example assume there is no chargeable gain on the transfer of the painting to the bank."

Suppose:
(1) T borrows money from a bank.
(2) T gives the borrowed money to R (a relevant person in relation to T).
(3) R uses the money to acquire a UK asset ("R's UK asset").
Is T's debt a relevant debt? T's debt is a relevant debt if it relates (indirectly) to R's UK asset. It is suggested that T's debt relates to R's UK asset if and only if steps (1) and (2) form an arrangement. If there is no connection of that kind between T's debt and the R's asset, the debt does not relate to the asset.[91]

11.18.7 *Borrowed money used to buy secondhand company*

Suppose T borrows and buys all the shares of a company which owns a UK asset ("the Co's asset"). The debt relates to the shares. At first sight it may seem that the debt also relates to the Co's asset. But note that if T uses foreign income to purchase the shares, the income is not remitted. That being the case, it would be anomalous if there were a remittance if T borrows to purchase the shares and then uses foreign income to pay the debt. So the debt should not be regarded as a relevant debt: the debt does not relate to the Co's asset. One does not lightly pierce the corporate veil.

11.18.8 *Borrowed money used to buy partnership interest*

Suppose T borrows and buys an interest in a partnership which owns a UK asset. It is suggested that the debt does not relate to the UK asset.[92]

11.18.9 *Debt for unpaid interest*

Suppose T has two debts:
(1) A debt for capital borrowed (the principal debt).
(2) A debt for interest on the principal debt (the interest debt).
The fact that the principal debt is a relevant debt (assume it relates to property brought/received/used in the UK) does not make the interest debt a relevant debt. This follows from the repeal of the former s.809L(8) ITA in 2009. However see 11.19.1 (Payment of interest).

11.18.10 *Borrowing on security of UK asset*

Suppose T borrows and receives the borrowed money abroad but secures

91 Contrast 11.15.12 (Gift on to third person).
92 See 11.34 (Partnerships).

the debt on property brought/received/used in the UK. It is considered that the debt does not relate to the UK property (within the meaning of the section) so the debt is not a relevant debt. The context shows that the colourless word "relate" is intended to apply to the proceeds of the debt, the borrowed money. Otherwise there would be a remittance when the debt is repaid, which is absurd.[93]

11.18.11 *Debt imposed by law*

Debts may be imposed by law. Court orders on divorces are not relevant debts (they do not relate to property brought received/used in the UK) and indeed the obligation may not be a "debt". So the debt remittance rules do not apply. Similarly, fines imposed by the courts do not in principle relate to property brought/received/used in the UK.

There might, however, be a remittance under ordinary principles when the court order is satisfied.

A tax liability on income or gains may relate to the income or gains. If so a tax liability on foreign income/gains is not a relevant debt, but a tax liability on UK income or gains, or remitted RFI and foreign gains may be a relevant debt.

11.18.12 *Borrowing by relevant person (not the individual)*

Suppose:
(1) R (a relevant person - not the individual) borrows to purchase an asset.
(2) R receives or uses the asset in the UK (so the debt is a relevant debt).
The debt is a relevant debt and if T uses their income/gains to repay it there is a taxable remittance.

It is suggested that this is the case even if R ceases to be a relevant person before T uses their income/gains to repay the debt, since even at that time the debt relates to the asset, and the asset is property falling within s.809L(2)(a); but the contrary is arguable.

The RDR Manual 33160 provides an example:

Example 7 (Kumar)[94]

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93 The debt would not be a relevant debt if T first took the UK security outside the UK, which would be somewhat odd.

94 The example in full (including its irrelevant detail) is as follows:
"**33160 Condition B - relevant debt** [May 2012]
Example 7
Kumar sets up and is a beneficiary of a non resident trust with £1,000,000 capital

K is settlor of a non resident settlor-interested trust.
The trust borrows to buy an asset which K uses in the UK.

The HMRC analysis is as follows:

There is a relevant debt (the loan) which is used to purchase an asset in the UK (property used by a relevant person).

More analytically, the debt is a relevant debt since:
(1) It relates to the UK asset.
(2) The asset is used in the UK by a relevant person (K).
Thus if the debt is repaid out of foreign trust income, K is chargeable under the s.624 remittance basis.

11.18.13 *Debt relating to UK property in part*

If a debt relates partly to property brought/received/used in the UK, the entire debt is a relevant debt. The unfairness is avoided by the rules in s.809P: see 11.29.3 (Debt remittances). But HMRC do not agree. In RDR Manual the facts (stripping out irrelevancies)[95] are as follows:

Example 4 (Karen)
K borrows:
- to pay UK school fees for her 14 year old daughter.
- to pay for a summer school in France for the daughter.

---

which the trustees invest in overseas property which produces income that would be chargeable on Kumar if he remitted it to the UK.
The trust borrows £500,000 from an offshore lender to buy a UK asset which Kumar uses in the UK. The trust pays the interest on the loan with the income from the letting of the overseas property.
There is a relevant debt (the loan) which is used to purchase an asset in the UK (property used by a relevant person). The income used to service the loan is regarded as a taxable remittance, chargeable on Kumar."

95 The example in full (including its irrelevant detail) is as follows:
"**33160 Condition B - relevant debt** [May 2012]
Example 4
In August 2011 Karen, a remittance basis user, uses an interest-free [*sic*] overdraft facility on her Jersey bank account to pay UK school fees for her 14 year old daughter Lauren. She also uses the remainder of the facility to pay for Lauren to attend a summer school in France organised by a French university. Karen repays the overdraft from her relevant foreign earnings between August and November 2011. ...
The daughter therefore has taxable remittances of the relevant foreign earnings used to service and repay the part of the overdraft that is a relevant debt."

K repays the overdraft from her relevant foreign earnings.

The HMRC analysis is:

> There is a debt (the overdraft) which relates in part to a service provided in the UK (the schooling) to a relevant person (the daughter) – this part is a relevant debt. However part of the overdraft facility is not a relevant debt because it does not relate to a service provided to the daughter in the UK, but to a service provided in France.

The author has overlooked the definition of relevant debt in s.809L(7) ITA:

> In this section "relevant debt" means a debt that relates *(wholly or in part*, and directly or indirectly) to—
> (a) property falling within subsection (2)(a),
> (b) a service falling within subsection (2)(b) ...

11.18.14 *Transitional rules*

A pre-2008 debt may be a relevant debt. There is transitional relief if pre-2008 income/gains are used to repay the debt (wherever made). Otherwise transitional relief for pre-2008 debts is limited to residential loans: see 11.38 (Transitional lloan relief: Pre-2008 loans).

11.19 **Use "in respect of" a relevant debt**

Condition B is satisfied if income/gains are used in respect of the relevant debt.

Use "in respect of" a debt requires some nexus between the use and the debt; exactly what that nexus is has been left to the courts to sort out.[96] The words "directly or indirectly" do not add any clarity. Indeed I am not sure that it is altogether coherent to speak in the abstract of use "directly or indirectly" in respect of a debt, for use indirectly in respect of a debt is use in respect of a debt. But the word "indirectly" shows that the drafter did not want the words "in respect of" to be construed narrowly.

If foreign income/gains are used to pay a relevant debt, this is a taxable remittance under the debt remittance rules: money used to pay a debt is used in respect of a debt.

In this section I sometimes refer simply to a debt rather than a relevant debt, ie it may be assumed the debt is a relevant debt.

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96 In *Cunard's Trustees v IRC* 27 TC 122 at p.135 Lord Greene MR described the phrase *in respect of* as "colourless words".

11.19.1 *Payment of interest*

Section 809L(9) ITA provides:

> The cases in which property (including income or chargeable gains) is used in respect of a debt include cases where the property is used to pay interest on the debt.

Suppose T has two debts:
(1) A debt for capital borrowed (the principal debt).
(2) A debt for interest on the principal debt (the interest debt).
It is possible that:
(1) the principal debt is a relevant debt (assume it relates to property brought/received/used in the UK) but
(2) the interest debt is not a relevant debt.[97]
However if T uses foreign income/gains to pay the interest debt, the funds are regarded as used in respect of the *principal* debt, and so are regarded as remitted under the debt remittance rules. In other words, it does not matter whether or not the interest debt is a relevant debt, all that matters is whether the principal debt is a relevant debt.

11.19.2 *Use as security for debt*

Suppose foreign income/gains are charged as security for a debt. There are various possible views.
(1) One view is that the charge constitutes "use" of the funds within the meaning of the debt remittance rule; and (if "used") the funds are used "in respect of" the debt. On this view charging funds as security for a debt constitutes a remittance. Nothing more is needed.
(2) The word "used" might connote "used up" ie consumed; in that sense (unless and until the security is enforced) the funds are not "used", and the charge does not constitute a remittance.
(3) The compromise view is that merely charging funds does not constitute use in respect of the debt: something more is needed combined with the charge, before the income/gains can be said to be used in respect of the debt. The question then is to identify that "something more":
    (a) I have considered the view that funds charged are "used" in circumstances where the loan would not be made without the

97 See 11.18.9 (Debt for unpaid interest).

security, and funds are not "used" if the circumstances are that the loan would be made anyway. On reflection I think that is not an attractive view. Among other objections, the question whether the loan would be made without the security is a hypothetical question which would often be imponderable; and the answer to that question may vary over time.

(b) The RDR Manual adopts another variant of the compromise view:

> **33170 Condition B: collateral[98] in respect of relevant debt** [Dec 2011]
> Foreign income and gains may be used as collateral for a loan which is brought to the UK or otherwise used for a purpose to which ITA2007/s809L(2) applies (that is, there is a relevant debt).
> Such foreign income and gains used as collateral are used 'in respect of' the relevant debt, so there may be a taxable remittance at this point.
> [1] The foreign income or gains used as collateral may be used directly, that is, the lender may receive a charge over cash assets in a bank account.
> [2] However it is more likely they will be offered indirectly, often in the form of an asset such as a property or bond note that is 'derived from' the foreign income or gains.[99]
> [3] This situation only arises where remittance basis users offer their foreign income or gains for use as collateral for a relevant debt, whether to a UK-based or an offshore lender.
> [4] In many cases UK property or non-taxable offshore property is offered as collateral in respect of a relevant debt; there is no remittance of this collateral within Condition B (ITA2007/s809L(3)(c)).[100]
> To determine the amount of remittance where foreign income or gains are used as collateral in respect of a relevant debt refer to RDRM35050.[101]

So far the Manual appears to take the view that charging as security is use in respect of a debt, but the text goes on to qualify that with an exception so large that the rule rarely applies:

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98 [Author's footnote] A note on terminology. The author of this passage is using the word "collateral" as a synonym of "security" though that is (I think) American rather than English legal usage. The word includes any type of security, whether a charge, lien, pledge, or some other form.

99 [Author's footnote]. I rather doubt that [2] is "more likely" than [1] but it does not matter.

100 More analytically: There is no taxable remittance of this collateral because Condition B is not met.

101 See 11.29.4 (Use as security: amount remitted).

> Foreign income and gains used to pay interest on the debt and to repay the borrowed capital are also 'used in respect of' a relevant debt, and will be taxable as a remittance. Thus there are potentially two possible sources of a taxable remittance charge in respect of the relevant debt – the foreign income or gains used as collateral and the foreign income or gains used to repay the debt.
>
> In the majority of commercial situations, neither party to the relevant debt transaction expects or intends that the collateral offered as security will be taken by the lender. Instead it is planned that the loan will be serviced and the capital repaid without recourse to the security charge. In such cases using foreign income or gains to regularly service or make capital repayments in respect of the relevant debt effectively 'masks' the collateral being used. In such cases the only taxable remittance will occur as and when the foreign income or gains are used to service or repay the loan. The payments, and thus the taxable remittances, will be spread over the loan period.

The Manual then gives an example where the facts (stripping out irrelevancies)[102] are as follows:

> *Example 1 (John)*
>
> J, a remittance basis user, borrows £200,000 from a Guernsey bank in 2012/13.
>
> J uses the loan to purchase UK property so the loan is a relevant debt.
>
> J offers as collateral for the loan an offshore bond. He had purchased this bond out of his untaxed RFI.
>
> J repays £18,000 of the loan (interest and some principal) in 2012/13, using his RFE.

The HMRC analysis is as follows:

> J is using the offshore bond as collateral for the loan; the offshore bond derives directly from his foreign income so J is using his RFI in respect

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102 The example in full (including its irrelevant detail) is as follows:
"In 2012/13 John, a remittance basis user takes out a loan for £200,000 from a Guernsey bank. John uses the loan to purchase a horse and a stable/paddock in Chester to indulge his young daughter's latest hobby; so the loan is a relevant debt. John offers as collateral for the loan a 5-year offshore bond, due to mature in 2015. He purchased this bond in 2010 (a year in which he was also a UK resident remittance basis user) using £200,000 of his untaxed relevant foreign income from that year.
John repays £18,000 of the loan (principle (*sic*) plus interest) in 2012/13, using his relevant foreign earnings from his separate employment in Guernsey."

of the relevant debt.

However J is also using his RFE to both service and repay the debt capital; this 'masks' the collateral and so J will only be regarded as remitting the £18,000 RFE in 2012/13.

Note – In the example above, the relevant debt could also be serviced and repaid using non-taxable income or capital sources; in which case there would be no taxable remittances of foreign income or gains. However the servicing/repaying of the loan effectively masks the collateral offered, so there is still no remittance of the collateral in this circumstance.

In some cases, usually involving avoidance or non-commercial arrangements, the relevant debt is not serviced or repaid by the borrower, or only a token amount is offered. In these circumstances the foreign income or gains offered as collateral are being utilised in respect of the relevant debt, that is, to delay or minimise service charges or repayments. As there is only one possible tax charge in respect of the relevant debt, that is the charge HMRC will take. The charge is taken up-front when the collateral is offered. Such arrangements are expected to be rare.

This should not be mistaken with interest-only repayment terms, or commercial arrangements that offer payment breaks and so forth. Always check the terms and general availability of the loan arrangements on offer.

If you think there is a remittance of foreign income or gains offered as collateral in respect of a relevant debt you should obtain copies of all the relevant arrangements, including all loan agreements and repayment schedules.

Thus in the HMRC view, security is not "used in relation to a debt" if the debt is "serviced and repaid" on commercial terms but in other cases it is so used. HMRC give an example of what they regard as caught:

RDRM33050 - Remittance Basis: Practical Examples of Remittances to the UK [Nov 2013]

[Taxable remittances include:]

[1] You take out a loan from an offshore bank secured against your foreign income held by the bank and

[2] use the money to fund your life in the UK.[103]

The loan requires you to repay the capital and interest after 15 years.

The HMRC analysis is as follows:

103 Para [2] means, more analytically, that the borrowed money is brought/received/used in the UK.

> As the loan does not have regular monthly repayments this is a remittance of the foreign income used as security when the loan is taken out.

The 15 year roll-up loan might reasonably be regarded as non-commercial[104] and as avoidance.

What happens if initially the debt is serviced and repaid on commercial terms and that changes over time?

What if the property charged exceeds the amount of the loan? HMRC say that the remittance is limited to the amount of the loan, which is a fair result, but that ignores the difficulty that if any property charged is "used" then all the property charged is used.[105]

For these reasons, it is considered that (in the absence of special features) the grant of security is not use in relation to the debt, until the security is enforced.

There may be some special feature in the arrangements which do constitute "use". Back-to-back loans may be an example; suppose:

(1) T deposits foreign income/gains in a bank ("T's deposit").
(2) T borrows from the bank ("the relevant debt").
(3) No interest is paid on T's deposit and only a small rate of interest is paid on the borrowing.

It is suggested that the income/gains deposited is used in respect of the relevant debt. But even here, it is arguable that there is no use in respect of the relevant debt, as the funds are not used up or consumed. (On the other hand, if commercial interest rates are paid on the deposit and the borrowing, the deposited funds are not used in respect of the debt.)

11.20 Becoming/ceasing to be a relevant person: Conditions A & B

A person may be a relevant person at one time and not at another time. For instance, a child ceases to be a relevant person on becoming 18; a person becomes a relevant person on marriage or cohabitation and ceases to be a relevant person on divorce or separation. A company becomes a relevant person in relation to T if T becomes a participator in the company.

The statute does not expressly address the application of conditions A and B in this situation. We need to find the answer as best we can in the words

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104 In an extreme case the borrower may be acting uncommercially even if the bank is acting commercially: see 32.5.4 (Commercial from whose viewpoint?).

105 See 11.29.4 (Use as security: amount remitted).

of the statute.

11.20.1 *Condition A*

Section 809L(2) ITA provides:

> Condition A is that—
>
> (a) money or other property is brought to, or received or used in, the UK by ... a relevant person...

For present purposes there are three ways of satisfying condition A: property must be (i) brought or (ii) received or (iii) used in the UK by a relevant person. Property is *brought* or *received* in the UK at a particular moment, and it is considered that the person must be a relevant person at that moment.

Suppose:

(1) T uses RFI to make a gift of an asset to S (not a relevant person). S brings or receives the asset in the UK. There is no charge at the time of the gift or of the receipt in the UK.
(2) Later, S becomes a relevant person (eg S becomes a spouse or cohabitee). There is no charge at that time.[106]

Likewise if:

(1) T uses RFI to make a gift of an asset to R (a relevant person). R does not remit the asset to the UK. There is no charge at this time.
(2) Later, R ceases to be a relevant person, and subsequently brings or receives the asset in the UK. There is no charge at that time.

HMRC agree. RDR Manual 33150 example 5 is an example of a person ceasing to be a relevant person. The facts (stripping out irrelevancies)[107]

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106 An interesting question arises if there is a second receipt in the UK later. That is, add to those two steps a third step: S subsequently takes the property outside the UK and then (still a relevant person) brings or receives it in the UK for a second time. Is there a taxable remittance on the second receipt? It is suggested that the answer should be no, though it needs a somewhat purposive construction to reach that result.

107 The example in full (including its irrelevant detail) is as follows:
"**33150 Condition B - remittances derived from income or gain** [January 2014]
Example 5
Caroline is a remittance basis user. In August 2013 she realises some foreign assets and so makes some foreign chargeable gains. She uses all the proceeds (and so uses all these gains) to purchase a motorcycle in Paris which she gives to her husband Joel. It is registered in his name. Joel keeps the bike at his French apartment. A few years later Caroline and Joel divorce, and Joel moves from their home in Liverpool

are:

> In 2013 W uses foreign chargeable gains to purchase a motorcycle in Paris.
> W gives the asset to her husband H. H keeps the bike at his French apartment. [So there is no remittance at this time].
> Subsequently, H and W divorce, and H moves from their home [ie H ceases to be a relevant person].
> In 2017 H brings his bike to the UK.

The relevant part of HMRC analysis is as follows:

> H and W were married and so H was a relevant person in 2013 when W gave him the motorcycle; he could not therefore have been a gift recipient (see Condition C – Gift recipients cannot be relevant persons).

More analytically, condition C is not satisfied.[108]

> By 2017 they have divorced so H is not a relevant person when he brings in the motorcycle [to the UK] for C to use.

More analytically, condition A is not satisfied because H is not a relevant person when H brings the asset to the UK.

11.20.2 *Condition B*

Condition B provides (in part):

> Condition B is that—
> (b) the property, service or consideration [received in the UK]—
> (i) derives (wholly or in part, and directly or indirectly) from the income or chargeable gains, and
> (ii) in the case of property or consideration, is property of or consideration given by a relevant person ...

It is considered that the requirement in (b)(ii) is met only if the person is a relevant person at the time that condition A is met (ie at the time that the property is brought/received/used in the UK). HMRC agree. The RDR Manual 33120 provides an example (already discussed above in

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> to Manchester.
> In September 2017 Joel and Caroline's 16 year old son, Joseph wants to learn how to ride a motorcycle, so Joel imports his bike from Paris to his Manchester home for Joseph to use."

108 See 11.23 (Remittance condition C (gift recipient)).

connection with condition A). The facts (so far as relevant) are as set out above with one additional fact:

> The motorcycle is used in the UK by C who is a minor child of W (a relevant person).

The HMRC analysis is as follows:

> Here, property has been provided in the UK (the motorcycle) for the use of a relevant person (C) ...

More analytically, condition A is satisfied.

> ...and the property derives directly from W's foreign chargeable gains. However the motorcycle is the property of H, who is not a relevant person [at the time that the property is used by the relevant person], so there is no taxable remittance for W.

More analytically, condition B is not satisfied because H is not a relevant person when the asset is used by the relevant person, C.

To drive the point home, the RDR Manual 33150 gives another example making the same point on somewhat far-fetched facts. So far as relevant[109] the facts are:

> In 2011 W uses RFI to purchase prints retained outside the UK.
> W gives the prints to her daughter D who is age 16 and so a relevant person. D retains the prints outside the UK [so there is no remittance].
> D ceases to be a relevant person on becoming 18 but in that year (although still a teenager) D has a child GD (who is a relevant person in relation to W).

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109 The example in full (including its irrelevant detail) is as follows:
"**33150 Condition B - remittances derived from income or gain** [January 2014]
Example 6
In 2011, while visiting New York, Ros, a UK resident remittance basis user, purchases several art prints by H Marecus, an international artist. Ros uses her relevant foreign income to make the purchase. She gives them to her daughter Rachael, who is at that time living and studying in the US, as a 16th birthday present in February 2011. Rachael returns to the UK in May 2011, but leaves the prints at her uncle's New York apartment.
In June 2016 Rachael's 3 year old daughter Abigail decides to start singing lessons in Newcastle. The singing teacher's mother is a collector of Marecus prints, so the teacher agrees with Rachael to accept one of the prints in exchange for the lessons. Rachael arranges for her uncle to send the print from New York directly to the singing teacher's mother in California."

> In 2016 D enters into an (implausible) agreement under which she transfers the prints to the mother of a singing teacher outside the UK in consideration of the teacher giving singing lessons to GD (age only 3) in the UK.

The HMRC analysis is as follows:

> A service has been provided in the UK (the singing lessons) for the benefit of a relevant person (GD) ...

More analytically, condition A is satisfied.

> ...and the consideration for the service (the print) derives from W's RFI. However the consideration is given by D, who is not a relevant person [at the time that condition A is satisfied] and so W has not made a taxable remittance of her relevant foreign income. Rachael is 21 years old and so is not a relevant person in June 2016 when she gives the prints in consideration for a service.

More analytically, condition B is not satisfied.

> Note – D was 16 years old and so is a relevant person in February 2011 when her mother gave her the prints (see also Condition C – Gift recipients cannot be relevant persons).

More analytically, condition C is not satisfied.

The rule of when one applies the relevant person test may work in favour of HMRC. Suppose:

(1) T uses RFI to make a gift of an asset to S (not a relevant person). There is no charge at this time.
(2) S becomes a relevant person, and subsequently brings/receives the asset to the UK. There is a taxable remittance at that time.

HMRC agree. The RDR Manual provides an example where the facts (stripping out irrelevancies)[110] are:

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110 The example in full (including its irrelevant detail) is as follows:
"In June 2010 Sam, a remittance basis user, uses £8,000 of her relevant foreign income to make an overseas purchase of an antique clock from a dealer in Denmark. Sam immediately makes a gift of an antique clock to Chris and Jo, who at that time are living in Denmark. The clock is kept at Chris's family home in Copenhagen. Chris, not being a relevant person, is a gift recipient.
Two years later Jo and Chris split up, and in July 2014, Sam and Chris marry. Chris ceases to be a gift recipient at this time.
In October 2014 Chris brings the antique clock to the UK to the house that is shared with Sam."

> **33240 Gift recipients cannot be relevant persons** [June 2010]
> *Example 2*
> In 2010 T uses RFI to purchase a clock outside the UK.
> T immediately gives the clock to S (not a relevant person) and it is kept outside the UK.
> S, not being a relevant person, is a gift recipient.
> In 2014, T marries S. S becomes a relevant person and ceases to be a gift recipient at this time.
> Subsequently, S brings the clock to the UK.

The HMRC analysis is as follows:

> As S is no longer a gift recipient Condition C is not relevant.
> However as S is now [in 2014] a relevant person there is a taxable remittance chargeable on T when S imports the clock, under Conditions A and B. This is because
> [1] property (the clock) has been brought to the UK by a relevant person (S) [ie condition A is satisfied] and
> [2] that property derives from T's RFI and the property is property of a relevant person (S) [ie condition B is satisfied]

So far we have considered property brought to or received in the UK. That can happen only at a particular moment. On the other hand, property can be *used* in the UK over a period of time. Suppose:

(1) Year 1: T uses RFI to make a gift of an asset to S (not a relevant person). S uses and continues to use the asset in the UK eg she buys a house which she occupies. There is no charge at the time of the gift or at the time of the use.
(2) Year 2: S becomes a relevant person (eg a spouse or cohabitee). She continues to use the property.

Is there a charge in year 2 when S becomes a relevant person? It would be strange if there were a difference between this case and the case of receipt in the UK. It is tentatively suggested that the answer is, no.

11.20.3 *Third persons*

The position becomes more complicated when a third person is involved. Suppose:

(1) T gives RFI to T's spouse W.

The example as published is defective in that it must be assumed (though this is not stated) that Chris gave his interest in the clock to Jo (or perhaps the gift was to Jo and not to Jo and Chris).

(2) There is a divorce and W ceases to be a relevant person.
(3) W transfers the RFI to a trust under which a minor child of T is a beneficiary. The trustee is a relevant person in relation to T.
(4) The trustee transfers the funds to the minor child who receives them in the UK.

Condition B appears to be satisfied since at the time of the receipt in the UK the funds are the funds of a relevant person. But the trust funds may not be derived income.[111]

11.21 Debt becoming/ceasing to be a relevant debt

A debt which is not a relevant debt may become a relevant debt. Condition B is (in short) that income is used in respect of a relevant debt. It is considered that the debt must be a relevant debt at the time the income is used.

Suppose:

(1) Year 1:
  (a) T borrows and receives the borrowed sum offshore.
  (b) T uses RFI to pay the interest (use in respect of the debt).

In year 1 condition B is not satisfied as the RFI is not used in respect of a relevant debt.

(2) Year 2: T remits the borrowed sum to the UK.

In year 2 the debt becomes a relevant debt, but it is considered that the RFI used to pay interest in year 1 does not become remitted at that time. But if RFI is used to pay more interest in year 2, that RFI satisfies condition B.

The problem of a debt ceasing to be a relevant debt is not likely to arise; see 11.18.3 (Debt relating to asset later removed from UK or ceasing to exist).

11.22 The need for remittance conditions C and D

The drafter identified 2 gaps in remittance conditions A and B which are addressed by remittance conditions C and D.

In outline:

(1) The individual may receive funds in the UK which are derived from the foreign income/gains but which are not the property of a relevant person. Then condition B is not met.[112] This problem is met by

111 See 11.15.12 (Gift to third person).

112 It is usually a requirement of condition B that the income/gains are the property of a relevant person; see 11.13.2 (Property of a relevant person).

imposing a remittance if the individual receives in the UK property of a third party (not a relevant person) with some link to the individual:

(a) Remittance condition C applies if the individual receives property of a gift recipient.

(b) Remittance condition D applies if the individual receives property of a third party, called (my terminology) a condition D person.

(2) The individual may receive funds in the UK which are not derived from the foreign income/gains ("non-derived property"). Then condition B is not met. This problem is met by imposing a remittance if the individual receives non-derived property in the UK with some link to the foreign income/gains:

(a) Remittance condition C applies if the individual receives "qualifying property" (which can include non-derived property).

(b) Remittance condition D applies if the individual receives any property; the necessary link is in the requirement of a "connected operation".

11.23 Remittance condition C (gift recipient)

Section 809L(4) ITA provides:

> Condition C is that qualifying property of a gift recipient—
>
> (a) is brought to, or received or used in, the UK, and is enjoyed by a relevant person,
>
> (b) is consideration for a service that is enjoyed in the UK by a relevant person, or
>
> (c) is used outside the UK (directly or indirectly) in respect of a relevant debt.

11.23.1 *Enjoyment by a relevant person*

The requirements in (a) and (b) are similar but not the same as remittance condition A. The differences are as follows:

Condition C requirement	**Condition A requirement**
Property brought/received/used in the UK	Property brought/received/used in the UK *by or for the benefit of a relevant person.*
Property *enjoyed* by a relevant person.	No equivalent in condition A (though the requirement that the property is brought/received/used by or for the benefit of a relevant person is similar.)

The word "enjoyed" in condition C means more or less the same as the word "used" in condition A.[113] I do not think there is a difference though if there were, the vagueness of the words makes it impossible to say what it may be. The reason for the different word is probably that other parts of condition C are derived from the GWR wording, where the word "enjoyed" is used[114] so the word enjoyed is copied across to condition C.

11.23.2 *Enjoyment disregards*

Section 809N ITA provides definitions and other supplementary provisions for condition C. Section 809N(1) ITA provides:

> This section applies for the purposes of determining whether or not income or chargeable gains of an individual are remitted to the UK by virtue of condition C in section 809L.

Section 809N(9) ITA provides three cases where enjoyment is disregarded. Since enjoyment is a requirement of remittance condition C, the disregards amount to exemption from condition C:

> Enjoyment by a relevant person of property or a service is to be disregarded in any of these cases—
>
> (a) if the property or service is enjoyed virtually to the entire exclusion of all relevant persons;
>
> (b) if full consideration in money or money's worth is given by a relevant person for the enjoyment; or
>
> (c) the property or service is enjoyed by relevant persons in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

Para (a) is based on IHT GWR provisions.[115]

Para (b) is the most important of the three disregards, and is also based on GWR:[116] I refer to it as "**the full consideration exemption**".

Para (c) concerns charitable or public gifts; it is hard to see that it is needed but it does no harm.

Suppose:

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113 As to which, see 11.12.5 (Property used in the UK ("used" limb of condition A)).

114 See 63.1 (GWR – Introduction).

115 See 63.6.3 ("Virtually" to the entire exclusion).

116 See 63.7 (Full consideration exemption for GWR).

(1) T gives pre-2008 RFI to T's spouse (not a relevant person and so a gift recipient) and the spouse uses the money to buy a house jointly with T; or
(2) T gives RFI to T's brother (a gift recipient) and the brother uses the money to buy a property jointly with T.
(3) The co-owners occupy the property jointly.

It is considered T does not "enjoy" the co-owner's half share, so condition C is not satisfied in respect of the gifted RFI.

Suppose:

(1) T gives RFI to T's adult son S (a gift recipient), and
(2) S uses the money to purchase a UK residence which is occupied by S, not by T.
(3) S has a minor child, GS, who also lives in the property.

It is considered that the property is not "enjoyed" by GS, who is merely a licensee of S. Any "enjoyment" by GS is incidental to the primary use by S, and should be ignored. It is different if S leaves the property and GS becomes the occupier (but since GS is by then likely to be 18, GS ceases to be a relevant person). HMRC agree. RDR Manual provides:

> **33270 Remittance Basis: Identifying Remittances: Condition C - Gift Recipients: Remittances - enjoyment by a relevant person ignored** [June 2010]
> Each case will depend on its particular facts, but broadly, enjoyment by a relevant person is disregarded, and so there is no taxable remittance under Condition C (if there otherwise would be) where the property or service is enjoyed by the gift recipient virtually to the entire exclusion of all relevant person, that is,
> [1] the gift is genuine and
> [2] any enjoyment by a relevant person is incidental (ITA2007/s809N(9)).

After this somewhat loose paraphrase of the statutory provision, the Manual gives the example we are considering:

> For example a minor child may derive benefit from living in the UK with his parents in a house that was purchased using offshore funds gifted by his grandfather (a remittance basis user) to his father, for his father's own use. It is normal for a young child to live with his parents and therefore, in most cases, no advantage over minor children generally is obtained. In this type of circumstance HMRC would generally accept that the minor

child's enjoyment of the house was merely incidental to that of his father.

11.23.3 *Gift recipient*

The key terms in remittance condition C are "gift recipient" and "qualifying property".

Section 809N(2) ITA provides:

> A "gift recipient" means a person, other than a relevant person, to whom the individual makes a gift of money or other property that—
>
> (a) is income or chargeable gains of the individual, or
>
> (b) derives (wholly or in part, and directly or indirectly) from income or chargeable gains of the individual.

Strictly one should not use the term "gift recipient" in the abstract. A gift recipient can exist only *in relation to an individual (the donor)*. But where the context is clear it is permissible simply to refer to a gift recipient.

A relevant person cannot be a gift recipient. So in practice gift recipients will be individuals who are not members of the individual's close family, such as parents, adult children, friends and relatives. (Family trusts and companies will generally be relevant persons and where they are not, it is unlikely they would or properly could enter into a transaction caught by condition C.)

If T makes a gift to G, and G gives the property to H, H is not a gift recipient in relation to T.

If T makes a gift to a trust, and the trust appoints the property to B, B is not a gift recipient, as T has not made a gift to B.

11.23.4 *"Gift"*

Section 809N(5) ITA extends "gift" to include disposals at an undervalue:

> The individual "makes a gift of" property if the individual disposes of the property—
>
> (a) for no consideration, or
>
> (b) for consideration less than the full consideration in money or money's worth that would be given if the disposal were by way of a bargain made at arm's length;
>
> but, in a case falling in para (b), the individual is to be taken to make a gift of only so much of the property as exceeds the consideration actually given.

In the phrase "full consideration in money or money's worth *that would be given if the disposal were by way of a bargain made at arm's length*" do

the italicised words add anything? It is thought not; these words are otiose but they do no harm.

Section 809N(6) ITA is intended to widen this:

> A reference to the individual making a gift of property includes a case where—
>
> (a) the individual retains an interest in the property, or
>
> (b) an interest, right or arrangement enables or entitles the individual to benefit from the property.

I am unable to make sense of this. The wording is loosely based on s.102A FA 1986 but the context there is different, and s.102A is itself obscure, so that does not shed any light on the matter. Perhaps it is meaningless.

Suppose T makes an interest-free loan to B. The transaction is for full consideration so it is not a gift within s.809N(5). A lender in principle has no interest in the money lent so s.809N(6)(a) does not apply. A loan does not entitle T to benefit from the money lent. B may use that money for himself. It is considered that the loan does not enable T to benefit from the money lent, so s.809N(6)(b) does not apply. B is not a gift recipient.

11.23.5 *"Qualifying property"*

Section 809N(7) ITA defines "qualifying property". There are three categories of qualifying property:

> "Qualifying property", in relation to a gift recipient, is—
>
> (a) the property that the individual gave to the gift recipient,
>
> (b) anything that derives (wholly or in part, and directly or indirectly) from that property, or

Para (a) and (b) are what one would expect, but the definition goes on to include non-derived property which has some nexus to the gifted property:

> (c) any other property, but only if it is dealt with as mentioned in section 809L(4)(a), (b) or (c) by virtue of an operation which is effected—
>
> (i) with reference to the gift of the property to the gift recipient, or
>
> (ii) with a view to enabling or facilitating the gift of the property to the gift recipient to be made.

Section 809N(8) ITA is intended to widen this:

> In subsection (7)—

> (a) the reference in para (b) to anything deriving from property, and
> (b) the reference in para (c) to other property,
>
> includes a thing,[117] or property, that does not belong to the individual but which the individual is enabled or entitled to benefit from by virtue of any interest, right or arrangement.

This is misconceived. Qualifying property will not belong to the individual because it has been given to the gift recipient, so it is not necessary to say that property includes property not belonging to the recipient. Here, as in s.809N(6), the drafter's desire to achieve the widest possible generality, and avoid any possible gaps in the legislation, has led to incoherence.

11.23.6 *Time of remittance*

Section 809L(6) ITA provides a rule which applies for conditions C and D:

> In a case where subsection (4)(a) or (b) or (5)(a) or (b) applies to the importation or use of property, the income or chargeable gains are taken to be remitted at the time the property or service is first enjoyed by a relevant person by virtue of that importation or use.

11.23.7 *Becoming/ceasing to be a relevant person: Condition C*

Section 809N ITA provides:

> (3) The question of whether or not a person is a relevant person is to be determined by reference to the time when a gift is made.
> (4) But, if a person to whom a gift is made subsequently becomes a relevant person, the person ceases to be a gift recipient.

Thus if a gift is made to a relevant person, condition C cannot apply, even if they cease to be a relevant person[118] and so become a gift recipient.

If a gift is made to a non-relevant person, condition C ceases to apply if they become a relevant person. That makes sense because in such a case, remittance conditions A and B may apply.

---

117 The reference to a "*thing or* property" is meaningless. What non-property "thing" could there be?

118 See 11.20 (Becoming/ceasing to be a relevant person: conditions A & B); 11.26.3 (Becoming/ceasing to be a relevant person: condition D).

11.24 Examples of condition C

11.24.1 *Gift followed by loan of gifted asset*

The RDR Manual provides examples numbered (1)(a) and (b); I consider example (b) first as it is the easier of the two. I reword the examples so that T is the taxpayer and G is the gift recipient.

The facts of example 1(b) (stripping out irrelevancies)[119] are:

> *Example 1(b) (Klimt)*
> T gives money derived from chargeable gains to his sister G (a gift recipient).
> G uses the money to buy a car which T's wife uses in the UK.

Condition C is satisfied. The HMRC analysis is:

> The qualifying property here is the car, which derives from the money that T gifted to G.
> That qualifying property is used in the UK and is enjoyed by a relevant person (T's wife).
> The use of the gift means there is a taxable remittance on T.

The same applies if T gives RFI to T's adult son S (not a relevant person)

---

119 The example in full (including its irrelevant detail) is as follows:
33260 Gift recipients - qualifying property [June 2010]
"Example 1(b) (Klimt and Helena)
In May 2015 K, a remittance basis user, gives some of his foreign chargeable gains for that year to his sister H, a gift recipient.
In October 2016 H transfers half of this money to the UK and gives it to K's wife."
There is a similar example in the CG Manual:
CG25342 Meaning Of Remitted To The UK: Gifts Of Money And Assets [April 2010]
"... Torvald claims the remittance basis in 2009-10; in that year he sells a property in Norway and uses the proceeds to buy a car which he gives to his business partner Stig who lives in Oslo. Stig exports the car to the UK and gives Torvald's wife Helga the keys.
In terms of ITA07/S809L(4), the car is qualifying property because it was given by Torvald to Stig. Stig is a gift recipient because he is not a relevant person and he has received a gift of property (the car) that drives from Torvald's chargeable gain. ... The car is brought to the UK and is enjoyed by a relevant person, Torvald's wife. Torvald's chargeable gain on the disposal of his property has therefore been remitted to the UK to the extent that it was used to buy the car. Note that it is the cost of the car, not its market value when it comes to be used in the UK, which fixes the upper limit of the remittance.)"

and S uses it to buy the house in the UK in which T lives. This is not caught by remittance condition B. (The house is derived from the RFI but it is not property of a relevant person.) The house is qualifying property and is caught by remittance condition C.[120]

11.24.2 *Gift followed by gift of gifted asset*

The facts of RDR Manual example 1(a) (stripping out irrelevancies)[121] are:

> T gives money derived from chargeable gains to his sister G (a gift recipient).
> G brings the money to the UK and then gives it to T's wife.

In the HMRC view condition C is satisfied. The HMRC analysis is as follows:

> [1] The qualifying property here is the money that T gifted to G.
> [2] That qualifying property is used in the UK and is enjoyed by a relevant person (T's wife).
> [3] The use of the gift means there is a taxable remittance on T.

Point [2] is not correct. Condition C is that:

> qualifying property of a gift recipient is ... enjoyed by a relevant person,

The money ceases to be qualifying property "of a gift recipient" when G gives it to T's wife. Thus qualifying property of a gift recipient is brought to or received in the UK.[122] But the property which is enjoyed by a relevant person is not property of a gift recipient.

However, on the facts of the example, remittance condition B may be satisfied. That depends on whether the money given to T's wife can be said to derive from T's gains, which would be the case if the two steps of the example are part of a single arrangement.[123]

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120 See 11.31 (Purchase of family home).

121 The example in full (including its irrelevant detail) is as follows:
33260 Gift recipients - qualifying property [June 2010]
"*Example 1(a) (Klimt and Helena)*
In May 2015 K, a remittance basis user, gives some of his foreign chargeable gains for that year to his sister H a gift recipient.
In October 2016 H transfers half of this money to the UK and gives it to K's wife."

122 Though, contrary to the HMRC analysis, it is not *used* in the UK (unless one says that H "uses" the funds by making a gift to K's wife, which is not the normal meaning of the word "uses").

123 See 11.15.12 (Gift to third person).

11.24.3 *Gift followed by loan of non-derived property*

The RDR Manual 35060 [June 2010] next provides an example where the property enjoyed in the UK is non-derived property. The facts (stripping out irrelevancies)[124] are:

> There is an arrangement under which:
> (1) T gives RFI to his aunt G (a gift recipient).
> (2) Later,[125] G allows T's wife to use a property in the UK owned by G, without charge.

One analysis of these facts is that T and G have entered into a contract, under which G promises to allow T's wife to use the land in consideration of T's payment (not properly called a "gift") to G. In that case there is a remittance under remittance conditions A and B. It is however assumed that the arrangement is an informal, non-binding, non-contractual one. That would be implausible if G were a stranger, but not in the case of a friend or relative. In that case condition B is not satisfied.

The HMRC analysis is as follows:

> The house cannot be said to "derive from" the income or gains.

More analytically, condition B is not satisfied.

However condition C is satisfied:

> The house is "other property" [ie non-derived property, within s.809N(7)(c)] used in the UK and enjoyed by a relevant person (T's wife).
> As the operation which brought the house within Condition C was done with reference to the gift or to enable or facilitate the gift it is qualifying property and Condition C is met.

---

124 The example in full (including its irrelevant detail) is as follows: *(Adam and Linda)* L's husband's family has owned a holiday house in Scotland for many years. In February 2012 A, a remittance basis user transfers some of his foreign income and gains to his aunt, L, the gift recipient, which she uses to book herself on an around-the-world cruise. A gives the money to L on the agreement that L will provide his wife Clare, a keen painter, with access to the Scottish property.
Several months later L provides Clare with an agreement saying that she can use the Scottish house, for which Clare pays nothing.

125 The example specifies that "several months" pass between step (1) and step (2) to make the point that one cannot avoid the tax consequences of the arrangement by a few months delay.

There is a remittance and tax is chargeable on T.
The amount of the remittance is determined by s809P(11)(c).[126]

Suppose the order of transactions was reversed:

(1) G grants allows W to use a property in the UK.
(2) Later, after W has left the property, T gives RFI to G.

Condition C is not satisfied at stage (1) since G is not at that point a gift recipient. At stage (2) G becomes a gift recipient but condition C does not become satisfied. However condition D would apply: see 11.27.1 (Loan of asset followed by gift to lender).

11.24.4 *Gifted property used to pay relevant debt*

The last HMRC example is slightly contrived, in order to illustrate the debt remittance rule in application to remittance condition C. The facts (stripping out irrelevancies)[127] are:

T gives property derived from RFI (shares) to his brother G, (a gift recipient.)
G borrows to purchase furniture.
T uses the furniture in the UK.
G uses the property to repay the loan.[128]

The HMRC analysis is as follows:

T has made a gift of property derived from his foreign income (the shares) to G, a gift recipient. The shares are thus qualifying property of a gift recipient.
The loan taken out by G to purchase the furniture is a relevant debt

126 See 11.29.6 (Condition C and D cases: amount remitted).

127 The example in full (including its irrelevant detail) is as follows:
"**33270 Condition C - remittances of relevant income or chargeable gains - relevant debt** *(Fraser and Victor)*
F, who is a remittance basis user, purchases some non-UK shares in January 2012, using his foreign income and gains. F makes a gift of these shares to his brother, V, a fashion designer.
In March 2012 V takes out a loan with an offshore bank to purchase a designer table and chairs. V brings these table and chairs to the London town house that he and his brother F inherited jointly from their father, and where they both now live. F regularly entertains clients and friends at the house.
V uses some of the shares and bonds to pay off the loan.

128 That is, G sells and uses the proceeds to repay the loan; or (less plausibly) transfers the shares to the creditor in satisfaction of the loan.

because it relates to property (the furniture) brought to the UK for the benefit of a relevant person (T).
T benefits because he uses the furniture.
The qualifying property (the shares) of G (a gift recipient) is used outside the UK in respect of this relevant debt. There is a remittance under Condition C.

11.25 Condition C transitional rule: Pre-2008 income/gains

Para 86(4) Sch 7 FA 2008 provides:

> Subject to sub-paras (2) and (3), in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

I refer to this as **"the para 86(4) amendment"**. Amended as para 86(4) directs, condition C (set out in s.809L(4)) provides:

> Condition C is that qualifying property of a gift recipient—
>
> (a) is brought to, or received or used in, the UK and is enjoyed by ~~a relevant person~~ *the individual*,
>
> (b) is consideration for a service that is enjoyed in the UK by ~~a relevant person~~ *the individual*, or
>
> (c) is used outside the UK(directly or indirectly) in respect of a relevant debt.

This is consistent with the remittance condition A and B rules for pre-2008 income.[129] Since the para 86(4) amendment applies only for s.809L, para 87 Sch 7 FA 2008 has to make further amendments to s.809N:

> Section 809N of ITA 2007 (section 809L: gift recipients, qualifying property and enjoyment) has effect in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year as if—
>
> (a) the reference in subsection (2) to a relevant person were to the individual,
>
> (b) subsections (3) and (4) were omitted, and
>
> (c) the references in subsection (9) to a relevant person, all relevant persons, or relevant persons were to the individual.

Amended as para 87 requires, s.809N(2) reads:

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129 See 11.9 (Relevant person transitional rule: pre-2008/09 income/gains).

> A "gift recipient" means a person, other than ~~a relevant person~~, the individual to whom the individual makes a gift of money or other property that—
>
> (a) is income or chargeable gains of the individual, or
>
> (b) derives (wholly or in part, and directly or indirectly) from income or chargeable gains of the individual.

The words "other than the individual" are meaningless because the individual cannot make a gift to himself. So s.809N(2) means:

> A "gift recipient" means a person ... to whom the individual makes a gift of money or other property that—
>
> (a) is income or chargeable gains of the individual, or
>
> (b) derives (wholly or in part, and directly or indirectly) from income or chargeable gains of the individual.

Para 87 does not restrict the definition of "gift recipient": it *widens* it.

The para 87 deletions of 809N(3)(4) are straightforward amendments consequential on the para 87 amendment to s.809N(2).

The last para 87 amendment is also a straightforward consequential amendment. Amended as para 87 requires, s.809N(9) reads

> Enjoyment by ~~a relevant person~~ the individual of property or a service is to be disregarded in any of these cases—
>
> (a) if the property or service is enjoyed virtually to the entire exclusion of ~~all relevant persons~~ the individual,
>
> (b) if full consideration in money or money's worth is given by ~~a relevant person~~ the individual for the enjoyment, or
>
> (c) the property or service is enjoyed by ~~relevant persons~~ the individual in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

The condition C rule for pre-2008 income/gains is not very different from that which applied under the pre-2008 law.

11.26 Remittance condition D (connected operation)

For an introduction to the topic, see 11.22 (The need for remittance conditions C and D).

Section 809L(5) ITA provides:

> [1] Condition D is that property of a person other than a relevant person (apart from qualifying property of a gift recipient)—
>
> (a) is brought to, or received or used in, the UK, and is enjoyed by a relevant person,
>
> (b) is consideration for a service that is enjoyed in the UK by a relevant person, or

(c) is used outside the UK (directly or indirectly) in respect of a relevant debt,

[2] in circumstances where there is a connected operation.

We need some terminology to grapple with this, and in the following discussion:

"The condition D person" is the non-relevant person whose property is used as set out in (a)-(c), ie (in short) enjoyed by a relevant person.

"The enjoyment requirement"is the requirement in s.809L(5)[1] (in short, that a relevant person enjoys property of the condition D person in the UK). The property which the relevant person enjoys need not be derived from the individual's income or gains.

The wording of the enjoyment requirement is (more or less) the same as in remittance condition C.[130] The same enjoyment disregards apply.[131] The same timing rule applies.[132] These aspects need not be considered again here.

The RDR Manual comments on the identity of the condition D person:

> **33430 Connected Operation - definition** [June 2010]
> The property that is brought to the UK, or used outside the UK as consideration for a service or in respect of a relevant debt must not be qualifying property of a gift recipient as this will fall within Condition C. However this restriction relates to the property not the individual, so the same person may be a gift recipient under Condition C and, in other transactions, "a person whose property is used" under Condition D.

11.26.1 *"Qualifying disposition"*

The key term in remittance condition D is "connected operation", and that term relies on the concept of a "qualifying disposition." Section 809O provides the definitions and other supplemental provisions for condition D.

Section 809O(1) ITA provides:

> This section applies for the purposes of determining whether or not income or chargeable gains of an individual are remitted to the UK by virtue of condition D in section 809L.

---

130 See 11.23.1 (Enjoyment by a relevant person).

131 Section 809O(6) ITA repeats s.809N(9) verbatim; see 11.23.2 (Enjoyment disregards).

132 See 11.23.6 (Time of remittance).

Section 809O(4) ITA defines "qualifying disposition":

> A "qualifying disposition" is a disposition that—
> (a) is made by a relevant person,
> (b) is made to, or for the benefit of, the person whose property is dealt with as mentioned in section 809L(5)(a), (b) or (c) [ie made to/for the benefit of the condition D person], and
> (c) is a disposition of money or other property that is, or derives (wholly or in part, and directly or indirectly) from, income or chargeable gains of the individual.

Section 809O(5) provides an exception:

> But a disposition of property is not a qualifying disposition if the disposition is, or is part of, the giving of full consideration in money or money's worth for the dealing that falls within section 809L(5)(a), (b) or (c).

I do not see the need for that, since if there is full consideration for "the dealing that falls within section 809L(5)(a), (b) or (c)" (in short, for the enjoyment by the relevant person) then the full consideration exemption applies.[133] But it does no harm.

11.26.2 *Connected operation*

Armed with the term "qualifying disposition" we can turn to the definition of "connected operation". Section 809O(3) ITA provides:

> A "connected operation", in relation to property dealt with as mentioned in section 809L(5)(a), (b) or (c), means an operation which is effected—
> (a) with reference to a qualifying disposition, or
> (b) with a view to enabling or facilitating a qualifying disposition.

Thus in order to have a connected operation, four requirements must be met:

(1) A qualifying disposition (eg a gift to the condition D person).
(2) An operation (but that is so wide it scarcely counts as a requirement).
(3) A link between the operation and the qualifying disposition: the operation must be effected with reference to/with a view to enabling/facilitating the qualifying disposition.

---

133 See 11.23.2 (Enjoyment disregards). Perhaps the point is that s.809O(5) provides exemption in a case falling within s.809L(5)(c) (relevant debts).

(4) A link between the operation and the condition D person's property: the operation must be "in relation to property dealt with as mentioned in s.809L(5)(a)(b)(c)" ie it must relate to the condition D person's property.

The RDR Manual comments on requirement (3):

> **33430 Connected Operation - definition** [June 2010]
> It is important to note the words "with reference to" and "with a view to enabling or facilitating a qualifying disposition". The nature of the link between the connected operation and the qualifying disposition, or even which comes first, is not specified. This means that a taxpayer cannot avoid a charge to tax by setting up complex structures to disguise foreign income or gains, or to try and "break the link" between something enjoyed in the UK and that income or those gains.

11.26.3 *Becoming/ceasing to be a relevant person: Condition D*

Section 809O(2) ITA provides:

> For the purposes of section 809L(5), the question of whether or not the person whose property is dealt with as mentioned in para (a), (b) or (c) of section 809L(5) is a relevant person is to be determined by reference to the time when the property is so dealt with.

This is consistent with condition C: see 11.23.7 (Becoming/ceasing to be a relevant person: condition C).

11.27 Examples of condition D

11.27.1 *Loan of asset followed by gift to lender*

A straightforward example of condition D would be:

> T wishes to use a UK asset owned by X (not a relevant person). T and X enter into an informal, non-binding arrangement[134] under which:
> (1) X allows T to use the asset.
> (2) After T has ceased to use the asset, T gives RFI to X (the qualifying disposition).

The analysis is:
X is a condition D person.

---

134 If the arrangement is by way of binding contract (which is likely unless T and X are relatives or friends) then remittance conditions A and B are satisfied as T's obligation to X will be a relevant debt.

The enjoyment requirement is met by T's use of X's asset.
T's gift to X is a qualifying disposition.
The connected operation is X's allowing T to use the asset.
So condition D is satisfied.

11.27.2 *Loan of asset followed by gift for benefit of lender*

The RDR Manual provides a more subtle example where the facts (stripping out irrelevancies)[135] are:

> T wishes to use UK land owned by X (not a relevant person).
> There is an arrangement under which:
> (1) X allows T to use the land rent free.
> (2) T transfers an asset derived from T's RFI (a yacht) to a company owned by X, at an undervalue.

This is like my straightforward example, except that T transfers the RFI to a company owned by X (not to X directly).

One analysis of these facts is that T and X have entered into a contract, under which X leases or licenses the land to T in consideration of T's transfer of the yacht to the company. In that case there is a remittance under remittance conditions A and B, on the basis that:

(1) If the rent is paid in advance: T receives an asset in the UK (a lease or licence) which is derived from T's RFI; or
(2) If the rent is paid after the grant of the lease: T has used RFI to pay a relevant debt.

Note that the rent would also be taxable.

It is however assumed that the arrangement is an informal, non-binding, non-contractual one. That might be possible if X is a friend of T or a friendly trust or company. In that case condition B is not satisfied.

---

135 The example in full (including its irrelevant detail) is as follows:
Janet and John
"**35080 Condition D - remittances of foreign income or chargeable gains** [June 2010]
John personally owns a country estate in Cornwall, in an area of outstanding natural beauty. His friend Janet wishes to use the mansion for several important family functions.
Janet is a remittance basis user. She owns a foreign yacht which she bought using her foreign income and gains. On 2 March she disposes of the yacht to a nonresident company for £15,000. John has a controlling interest in that non-resident company. In October, with reference to the transfer of the yacht, John allows Janet full and exclusive use of the estate, rent-free.

The HMRC analysis first considers condition C:

> X is not a gift recipient (the yacht was given to his company, not to X). Condition C cannot therefore apply.

So we turn to condition D. In my terminology, X is the condition D person.

> [1] X is not a relevant person in relation to T.[136]
> [2] There is a qualifying disposition because:
> [a] There is a disposal of property (the yacht) which derived from T's income (ITA07/S809O(4)(c))
> [b] The disposal was made by a relevant person (T) (ITA07/S809O(4)(a))
> [c] The disposal was for the benefit of X (although the disposal was not made directly to X, he benefits from it through his ownership of the company) (ITA07/S809O(4)(b))
> [3] X's property [the land] is enjoyed in the UK by a relevant person (T) (ITA07/S809L(5)(a) and ITA07/S809O(4)(b)).
> In this example T's advantage is due to[137] a connected operation[138] (ITA07/S809O(3)) and Condition D will be met.
> Some or all of the foreign income used by T to acquire the yacht will be remitted.

The author does not consider whether it is some or all of the income which is remitted, which one might have thought an important issue. In principle, all of the income is remitted.[139]

Take the same facts in another order:

> (1) T uses land owned by X rent-free for a period.
> (2) After the end of that period, T transfers RFI to a company owned by X.

---

136 The HMRC analysis adds that "the company is not a relevant person (as T is not a participator)". In fact, whether the company is a relevant person is not determined by the facts expressly given in the example. The company would be a relevant person if any relevant person is a participator. Perhaps we are meant to assume that X is the sole participator in the company and that X is not a relevant person. However it makes no difference whether or not the company is a relevant person (unless the company brings the yacht to the UK).

137 "Due to" is an inaccurate paraphrase of the statutory language, but it does not matter.

138 HMRC do not identify the operation, but I think it is X's licencing the land to T; this is indeed a connected operation.

139 See 11.29.6 (Condition C and D cases).

Condition D is not satisfied at stage (1) as there is no connected operation. There is no charge at stage (2): one could not say that X's property is enjoyed "in circumstances where there *is* [present tense] a connected operation." But if (as would normally be the case) there is a contract between X and T, there would be a remittance under conditions A and B.

11.27.3 *Loan of asset followed by gift to parent of corporate lender*

The CG Manual provides another example. The facts (stripping out irrelevancies)[140] are:

> T wishes to occupy a house in the UK.
> T enters into an arrangement with X Ltd (not a relevant person) under which:
> (1) A subsidiary of X Ltd[141] ("the subsidiary") acquires a house and allows T to live in it rent-free.
> (2) T transfers shares (derived from foreign chargeable gains) to X Ltd.

This is like the RDR Manual example above, except that the asset is lent to T by a subsidiary of X Ltd (not by X Ltd directly).

In my terminology, X Ltd is the condition D person.

Let us ignore the implausibility of the facts. (In practice, the transfer might be the purchase price, in which case the subsidiary would hold the house on trust for T. Or the transfer might be rent. In those cases there is a remittance under usual principles.) Let us assume that the arrangement is an informal, non-binding, non-contractual one.

In that case condition B is not satisfied. The HMRC analysis on this point is:

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140 The example in full (including its irrelevant detail) is as follows:
Antonella
CG25343 - Remittance basis: meaning of remitted to the United Kingdom: other reciprocal arrangements [April 2010]
A has claimed remittance basis in 2009-10. She realises a foreign chargeable gain of £5 million in that year and uses it to buy shares in a company listed on the Zurich stock exchange. She enters into an agreement with her bank in Naples that an Italian subsidiary of the bank will acquire a house in London and allow A and her family to live in it rent-free: as consideration for this she agrees to transfer her Swiss shares to the bank. The family moves into the house on 3 April 2010 and A transfers the shares on 7 April.

141 The Manual specifies that X Ltd is a bank. It is not conceivable that a bona fide bank could enter into an arrangement of this kind, but a friendly company might do so.

> Note that the conditions for a basic remittance are not met because the London property is not, and is arguably not derived from, the chargeable gain, and does not belong to a relevant person.

The Manual then makes a comment which I assume relates to remittance condition C:

> The conditions for a remittance after a gift are not met because the gain or property derived from the gain is not gifted to the subsidiary but transferred for what we assume is full value.

If the transfer is for full value there is a remittance under remittance conditions A and B. But if it is a gift, then X is a gift recipient but the subsidiary is not.

However that may be, we turn to condition D. The HMRC analysis is as follows:

> T is a relevant person, and she makes a disposition of property which derives from her own chargeable gains. The disposition is made
> [i] to (if it is made directly to the subsidiary) or
> [ii] for the benefit of (if it is made to another company in X Ltd's group)
> the person whose property is used to provide the advantage in the UK.
> There is therefore a qualifying disposition.

In fact the example specifies that the shares are transferred to X Ltd. The condition D person (who provides the property) is the subsidiary. The transfer to a parent company is not for the benefit of a subsidiary. So there is no qualifying disposition. The rest of the HMRC analysis does not arise:

> Property belonging to X Ltd's subsidiary is used in the United Kingdom and is enjoyed by a relevant person (eg T or her family).
> Furthermore, the process by which the London House is made available is closely linked[142] to the qualifying disposition ie the transfer of the shares to the bank, so it is a connected operation.
> So a chargeable gain of £5m is treated as accruing to T.

The HMRC example raises the timing issue:

> T moves into the house on 3 April 2010 and T transfers the shares on 7 April.

142 This wording is a paraphrase of the statutory language, but it does not matter.

The HMRC analysis states that the gain is treated as remitted in 2009/10. See 11.23.6 (Time of remittance).

It is difficult to escape the conclusion is that the author of the CG Manual example had only a tenuous grasp of the remittance basis - not altogether surprising given the difficulty of the topic.

11.28 Condition D transitional rule: Pre-2008 income/gains

It will be recalled that Para 86(4) Sch 7 FA 2008 provides:

> Subject to sub-paras (2) and (3), in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

I refer to this as **"the para 86(4) amendment"**. Amended as para 86(4) directs, condition D (set out in s.809L(5)) provides:

> Condition D is that property of a person other than ~~a relevant person~~ *the individual* (apart from qualifying property of a gift recipient)—
>
> (a) is brought to, or received or used in, the UK, and is enjoyed by ~~a relevant person~~ *the individual*,
>
> (b) is consideration for a service that is enjoyed in the UK by ~~a relevant person~~ *the individual*, or
>
> (c) is used outside the UK (directly or indirectly) in respect of a relevant debt,
>
> in circumstances where there is a connected operation.

This is consistent with remittance condition A and B rules for pre-2008 income.[143] Since the para 86(4) amendment applies only for s.809L, para 88 Sch 7 FA 2008 has to make further amendments to s.809O:

> Section 809O of ITA 2007 (section 809L: dealings where there is a connected operation) has effect in relation to an individual's income and chargeable gains for the tax year 2007-08 or any earlier tax year as if—
>
> (a) subsection (2) were omitted, and
>
> (b) the references in subsections (4) and (6) to a relevant person, all relevant persons, or relevant persons were to the individual.

Amended as para 88 requires, s.809O(4) provides:

> A "qualifying disposition" is a disposition that—
>
> (a) is made by ~~a relevant person~~ *the individual*,

143 See 11.9 (Relevant person transitional rule: pre-2008/09 income/gains).

(b) is made to, or for the benefit of, the person whose property is dealt with as mentioned in section 809L(5)(a), (b) or (c), and

(c) is a disposition of money or other property that is, or derives (wholly or in part, and directly or indirectly) from, income or chargeable gains of the individual.

The last para 88 amendment is also a straightforward consequential amendment. Amended as para 88 requires, s.809N(6) reads

> Enjoyment by ~~a relevant person~~ *the individual* of property or a service is to be disregarded in any of these cases—
>
> (a) if the property or service is enjoyed virtually to the entire exclusion of ~~all relevant persons~~ *the individual,*
>
> (b) if full consideration in money or money's worth is given by ~~a relevant person~~ *the individual* for the enjoyment, or
>
> (c) the property or service is enjoyed by ~~relevant persons~~ *the individual* in the same way, and on the same terms, as it may be enjoyed by the general public or by a section of the general public.

11.29 Amount remitted

Section 809P(1) ITA provides:

> The amount of income or chargeable gains remitted to the UK is to be determined as follows.

Five rules then follow.

11.29.1 *Remittance of actual income or gains*

Section 809P(2) ITA provides:

> If the property, service or consideration[144] is the income or chargeable gains, the amount remitted is equal to the amount of the income or chargeable gains.

That seems sensible, indeed self-evident.

11.29.2 *Remittance of derived property*

Section 809P(3) ITA provides:

> If the property, service or consideration derives from the income or

144 The words "property, service or consideration" relate back to the wording of condition B: property means property brought/received/used in the UK, service means a service provided in the UK, and consideration means consideration for a service provided in the UK.

chargeable gains, the amount remitted is equal to the amount of income or chargeable gains from which the property, service or consideration derives.

The RDR Manual provides:

> **35030 Conditions A & B - remittances derived from foreign income/gains** [January 2014]
> ... Where, as in most cases, the property, service or consideration derives from a foreign currency, the taxable amount is the pounds sterling equivalent value (at time of remittance) of the amount of foreign currency (refer to RDRM31190 Exchange rates) used to acquire or pay for the property or service etc. This means that where an item of depreciating value (such as a car) is brought to the UK the amount that is liable to tax is not the current value of the car but the amount of foreign income or gains from which the car derives (example 4). For the same reason, where an item of appreciating value (perhaps a work of art) is brought to the UK, the taxable amount is the amount of foreign income or gains from which the property derived, and not its current market value (example 5).
> The same principle applies where an investment is made in shares or other such financial instruments, and those shares are in, or are otherwise brought, to the UK. The chargeable amount is the amount of foreign income or gains from which the shares derived...

The RDR Manual provides an example where the facts (stripping out irrelevancies)[145] are as follows:

> **35030 Conditions A and B - remittances derived from foreign income or gains** [January 2014]
> *Example 4 (Marianne)*
> M, a remittance basis user, used £25,000 of her foreign chargeable gains to purchase a car.
> M kept the car outside the UK.

145 The example in full (including its irrelevant detail) is as follows:
In example 1 above, Marianne, a remittance basis user, used £25,000 of her foreign chargeable gains to purchase a car. The car is regarded as derived from foreign income and gains.
Instead of bringing it straight to the UK, Marianne kept the car at her Italian villa for use on her visits to Italy. A few years later she then decides to bring the car to the UK for her and her daughter to use. At this time the approximate market resale value of the car is £14,000.

> A few years later M brings the car to the UK.
> The market value of the car is [implausibly] £14,000.

The HMRC analysis is as follows:

> The amount remitted is still £25,000, that being the amount equal to the chargeable gains from which the property – the car – derived.

The author has not addressed the interesting questions which arise if M sells the car abroad and remits the proceeds of sale or buys a new car.

Suppose:

(1) T invests £3m foreign income in an asset,
(2) T sells the asset at a loss and receives only £1m.
(3) T remits the £1m.

Under the pre-2008 remittance basis the amount remitted was £1m only. Is the amount remitted now £3m? The tax exceeds the amount remitted. I doubt if anyone will observe this in practice. Perhaps a purposive approach allows one to read in a requirement that the amount remitted cannot exceed the amount of the money remitted or (because of the loss) what is received in the UK is not derived from the gain.

Conversely suppose:

(1) T invests £3m foreign income in an asset,
(2) T sells the asset at a gain and receives £6m.[146]
(3) T remits £3m.

The amount remitted is only £1.5m, one half of the foreign income.

11.29.3 *Debt remittances*

Section 809P ITA provides:

> (4) If the income or chargeable gains are used as mentioned in section 809L(3)(c), [that is, used in respect of a relevant debt] the amount remitted is equal to the amount of income or chargeable gains used; but this is subject to subsection (10).
> (5) If anything deriving from the income or chargeable gains is used as mentioned in section 809L(3)(c), [that is, used in respect of a relevant debt] the amount remitted is equal to the amount of income or chargeable gains from which what is used derives; but this is subject to subsection (10).

---

146 For simplicity assume the gain on this disposal is not within the charge to CGT (eg the gain is not a chargeable gain or T was non-resident when the gain accrued).

This is the equivalent of s.809P(2)(3) for debt remittances, but here there is an apportionment rule. Section 809P(10) ITA provides:

> If the debt is only partly in respect of[147] the property or service, the amount remitted is (if it would otherwise be greater) limited to the amount the debt would be if it were wholly in respect of the property or service.

Suppose:
(1) T borrows £10m.
(2) T remits £1m of the borrowed sum to the UK.
The *entire* debt is a relevant debt. Suppose then T repays the entire borrowing out of income/gains. Only £1m is treated as remitted.

Suppose T only repaid £1m or £2m of the debt. There is still a remittance of £1m. This example illustrates a planning point: one should avoid debts which relate *partly* to property brought/received/used in the UK. Instead of the above, T should borrow so as to have two separate debts, one of £1m (remitted to the UK) and one of £9m (unremitted). Then the unremitted debt is *not* a relevant debt and can be repaid out of foreign income/gains.

The apportionment rule applies where a relevant debt is partly in respect of the property received in the UK. What if property is used partly in respect of a relevant debt?

The RDR Manual provides:

> **RDRM35040 Remittance Basis: Amounts remitted: Quantification: Conditions A and B - remittances in respect of relevant debt** [June 2010]
> Where foreign income or gains are used outside of the UK in respect of a relevant debt RDRM33040 the chargeable amount is the amount of foreign income or gains so used (ITA07/s809P(4)) (example 1 and 2).
> Similarly, if anything, for example an asset, which derived from foreign income or gains is used outside the UK to service a relevant debt then the amount of the remittance is the amount of the income or gains from which the asset used to service the debt was itself derived (ITA07/s809P(5)) (example 3 and 4).
> Foreign income or gains may be used outside the UK to redeem or service a debt only part of which is a 'relevant debt' within the meaning of ITA07/s809L(7). In such cases, the amount that is taxable as an

147 Section 809P(10) refers to a debt *in respect of* UK property but the definition of relevant debt is one which *relates to* UK property. It is considered that the expressions are synonymous.

'amount remitted' is, if it would otherwise be greater, limited to the amount that is attributable to that part of the debt which is a relevant debt (ITA07/s809P(10)) (example 5).

The taxable amount of foreign income or gain that is treated as having been remitted because of these provisions, taken together with any amounts that have been previously remitted (or treated as having been remitted), cannot be greater than the amount of the original foreign income and gains (ITA07/s809P(12)).

Example 1 (Katrina)

In May 2011, K, a remittance basis user, borrows £12,000 from an overseas bank to buy shares in a UK company. This is a relevant debt.

In tax year 2011-12 K uses £4,600 of her relevant foreign income to pay the interest and to repay some of the amount borrowed. The chargeable amount is £4,600.

Example 2 (Gary)

On 6 April 2015, G, a remittance basis user, borrows money from an overseas bank to buy an apartment in Solihull. Payments are due on the first day of each month from May 2015 onwards. The first 12 payments are on an interest-only basis. G pays £1,000 interest each month to the overseas lender from his overseas account with the same bank, into which G ensures a sufficient amount of his relevant foreign earnings are paid directly to cover the repayments.

From 1 May 2016 the payments increase to a fixed amount of £2,500 each month as G starts to repay the capital amount of the loan as well as the interest. The payments continue to be met from the same account of relevant foreign earnings.

The loan is a relevant debt because it is respect of property (the apartment) which is used in the UK by a relevant person (G).

G has made taxable remittances in 2015-16 of £12,000, that being the relevant foreign earnings used to service the relevant debt. In 2016-17 G has made taxable remittances of £30,000, being the amount used to both service and repay the relevant debt.

Example 3 (Ali)

A, a remittance basis user, purchases some sculptures in Sweden in October 2012 for £80,000; he takes out an interest-free loan of £80,000 with his US bank to fund this purchase, repayable within 1 year.

In November 2012 he gives them to his wife as an anniversary gift. She initially keeps them at her mother's home in Stockholm, but 6 months later in March 2013 she decides to bring these sculptures to the UK to display in her UK garden.

In October 2013 A arranges with the US bank that he will repay the loan

by giving them an oil painting which is currently in his apartment in Miami. A had purchased the painting in May 2011, using £50,000 of his relevant foreign earnings and £30,000 of capital inherited from an uncle. The relevant debt is serviced by the oil painting, which derives, in part, from A's relevant foreign earnings (refer to the earlier example). A has made a taxable remittance in 2013-14 of £50,000.
Note: For the purposes of this example assume there is no chargeable gain on the transfer of the painting to the bank.

Example 4 (Francine)
F, a remittance basis user, has a Spanish-style courtyard created at her house in Brighton. She takes out an unsecured loan of £40,000 from her French bank which she uses to pay the specialist Spanish contractor.
F has several French government bonds, which she purchased entirely from her relevant foreign income, and a German government bond which she acquired using her foreign chargeable gains. These bonds are each worth £10,000.
In September 2010 F gives the German bond to her bank as part repayment of the loan.
The relevant debt is serviced by the German bond which derives wholly from F's foreign chargeable gains, and is used outside the UK in respect of this relevant debt (refer to the earlier examples). F has made a taxable remittance in 2013-14 of £10,000.

Example 5 (Karen)
In August 2011 K, a remittance basis user, uses an interest-free £10,000 overdraft facility on her Jersey bank account to pay £8,000 of UK school fees for her 14 year old daughter Lauren. The remaining £2,000 of the facility is used to pay for Lauren to attend a summer school in France organised by a French university.
K repays the overdraft from her relevant foreign earnings between August and November 2011.
K has made a taxable remittance in 2011-12 of £8,000 relevant foreign earnings, that being the part of the debt that is in respect of a service provided in the UK (refer to the earlier example) which is thus a 'relevant debt'.

11.29.4 *Use as security: Amount remitted*

The RDR Manual provides:

RDRM35050 - Amounts remitted: Quantification: Condition B - Collateral in respect of relevant debt [June 2010]
When foreign income and gains are used as collateral for a relevant debt they are used 'in respect of' the relevant debt, so there may be a taxable

remittance at this point. (refer to RDRM33170).

In fact, the RDR Manual takes the view that circumstances where the grant of security is a taxable remittance will be "rare" and in the author's view, the grant of security is not taxable remittance at all, in the absence of some special circumstances.[148] So it is not usually necessary to consider the amount that is remitted on a grant of security, but the passage is still of some interest. The Manual continues:

> The amount of the foreign income or gains that are so used in respect of the relevant debt will be restricted to the amount of the capital loaned, together with any accrued interest (where applicable). The amounts due will depend, to some extent on the terms on which the security is offered.
>
> *Example 1 (Freda)*
> F, a remittance basis user takes out an interest-free loan for £100,000; with allegedly no requirement for repayment until an indeterminate future date. She uses the loan to purchase a plot of land in the UK, so the loan is a relevant debt.
> F offers as collateral for the loan a French painting, currently in her Parisian apartment. She purchased this painting in an earlier tax year in which she was also a UK resident remittance basis user, using £160,000 of her untaxed relevant foreign income from that year. The painting is still worth £160,000.
> F has used her foreign income as collateral, in respect of a relevant debt. The amount so used is 'capped' at the amount of the debt, which is £100,000 in this case.
> The reason for this is obvious if you consider what would happen in the very unlikely event that the lender immediately 'seized' the collateral in the painting to repay the £100,000 debt in full. The lender would realise £160,000 from the painting; the lender would retain £100,000 to satisfy the debt owed and return £60,000 to F (ignoring accrued interest, penalties and service charges). So only £100,000 of the collateral is used in respect of the debt.

The RDR Manual also looks at debts charged on the security of a mixed fund:

> **35270 Remittances from mixed funds: Collateral in respect of relevant debt** [June 2010]

148 See 11.19.2 (Use as security for debt).

> ... The amount of the foreign income or gains that are used in respect of the debt will be restricted to the amount of the capital loaned, together with any accrued interest. See Chapter 5: Condition B – Collateral in respect of relevant debt.
> Often the collateral offered will be an asset which is itself a mixed fund. In these circumstances the mixed fund ordering rules at section 809Q(4) apply to the asset offered as security. In such a case, the taxable amount is made up of the same amounts of capital and foreign income and gains that were used to purchase the asset in the first place.
> The 'transfer' is the offering of the asset as collateral in respect of the relevant debt and any formal charge is registered to the lender (where appropriate). The analysis is carried out on the date immediately before the collateral is so offered.

Example 1 (omitting irrelevant detail) is as follows:

> *Example 1 (John)*[149]
> In 2014/15 J, a remittance basis user takes out a loan for £200,000 from a Guernsey bank.
> J uses the loan to purchase UK assets. The loan is a relevant debt.
> J offers up, as security for this loan, a charge on his Guernsey farmhouse, which he purchased for £320,000 in 2010-11.

The HMRC analysis is as follows:

> J has used his foreign income and gains as collateral, in respect of a relevant debt. If the use of the collateral creates a taxable remittance, the amount of the remittance is 'capped' at the amount of the debt, which is £200,000.

---

149 (This is a variant of *Example 1 (John)* considered 11.19.2 (Use as security for debt). The example in full (including its irrelevant detail) is as follows:
"In 2014/15 John, a remittance basis user takes out a loan for £200,000 from a Guernsey bank. John uses the loan to purchase a horse and a stable/paddock in Chester to encourage his young daughter's latest hobby. The loan is a relevant debt. John offers up, as security for this loan, a charge on his Guernsey farmhouse, which he purchased for £320,000 in 2010-11.

- £60,000 of the purchase price was met using John's un-remitted relevant foreign income from 2008-09
- £50,000 of the purchase price was met using John's un-remitted relevant foreign income from 2009-10 and £120,000 using foreign chargeable gains from that same year
- The remainder was met using clean capital from a family inheritance in 2007-08 and 2008-09."

The farmhouse is derived from:

Relevant Foreign Income	2008-09 £60,000
	2009-10 £50,000
Foreign chargeable gain	2009-10 £120,000
Clean capital	2007-08 £40,000
	2008-09 £50,000

The mixed fund rules apply to determine the order of remittances. J will be regarded as remitting £50,000 RFI and £120,000 foreign chargeable gains from 2009-10, and £30,000 RFI from 2008-09.

Example 2

As per example 1, except that the farmhouse which J offers as collateral in respect of the relevant debt was purchased for £150,000 in 2010-11. It is now worth £250,000.

J has used his foreign income and gains as collateral, in respect of a relevant debt. If the use of the collateral creates a taxable remittance, the amount of the remittance is 'capped' at the amount of the debt, which is £200,000.

The farmhouse is derived from:

Relevant Foreign Income	2008-09 £60,000
	2009-11 £50,000
Clean capital	2007-08 £40,000

The mixed fund rules apply to determine the order of remittances; J will be regarded as remitting £110,000 RFI.

Any increase in the value of the farmhouse is ignored.

Example 3 (Freda)[150]

F, a remittance basis user receives an interest-free loan[151] of £100,000. She uses the loan to purchase a plot of land in the UK, so the loan is a relevant debt.

F gives, as collateral for the loan, a general right to the bank over her many current and savings accounts and investment portfolio held with them.

Ignoring accrued interest, the 'cap' on the amount of collateral regarded as used in respect of the relevant debt is £100,000. The 'transfer' is the offering of the asset as collateral so an analysis of F's accounts over which the charge is granted would be needed to analyse the credits into each account immediately before the date of transfer, in order to determine the constituent parts of each account for s809Q(4) purposes. In these circumstances the terms and conditions surrounding the loan and

150 This is a variant of *Example 1 (Freda)* above.

151 The grant of an interest-free loan from a bank seems somewhat implausible.

the collateral offered should be examined carefully as this may prioritise the order of the accounts against which any 'collateral' charge will be taken; for example it may prioritise current or savings flexible accounts over high-interest period or notice accounts. The s809Q(4) analysis should reflect this priority.

11.29.5 *Cap on amount remitted*

Section 809P(12) ITA provides:

> If the amount remitted (taken together with any amount previously remitted) would otherwise exceed the amount of the income or chargeable gains, the amount remitted is limited to the amount which, when taken together with any amount previously remitted, is equal to the amount of the income or chargeable gains.

How could the amount remitted (which must derive from the income/gains) exceed the amount of the income or the gains? One case is if income is remitted (the remittance conditions are met) and then the remittance conditions are met again, in relation to the same income or gains. There are many ways that this could happen, but one case concerns re-remittances. Suppose:

(1) Year 1: T (an individual taxable on the remittance basis) receives foreign income. The income is remitted ("the first remittance") and so subject to tax.
(2) Year 2: The income is transferred out of the UK and remitted again ("the re-remittance").

The RDR Manual provides:

> **35030 Remittance Basis: Amounts remitted: Quantification: Conditions A & B - remittances derived from foreign income/gains** [January 2014]
> ...When taken together with any amounts that have been previously remitted (or treated as having been remitted), the taxable amount of income or gain that is treated as having been remitted because of these provisions cannot be greater than the amount of the original foreign income and gains (ITA07/s809P(12)). Where property is brought to or used in the UK by or for the benefit of a relevant person the amount that is liable to tax is the amount of the underlying foreign income or gains from which the property derives (whether directly or indirectly). The taxable remittance will only occur once; this will usually be the time the asset is first brought to, received by or used in the UK by a relevant person.

This is obviously right. But the same would apply if the income/gains were not taxed on the first remittance, eg:

(1) A remittance before 2008 of source-ceased income or of property enjoyed in specie.

(2) A remittance by a non-resident of income/gains accruing during a resident period (the temporary non-residence rules would need consideration).

HMRC agree. December 2008 Qs & As provides:

> **Q9** If a taxpayer undertook a source ceasing exercise during the 2006-07 tax year and then remitted the proceeds before the 2008-09 tax year, if those funds were to then be taken back outside of the UK and re-imported, would this constitute a remittance. In other words, would the earlier source ceasing exercise be looked through despite its timing? It is understood that interest/profit from any new investment would be a remittance.
>
> **A** If the source ceased in 2006-07 and was remitted in 2007-08, then this did not count as a remittance and it will not count as a remittance if it is exported and subsequently re-imported.

HMRC do not cite a statutory authority to justify their answer; s.809P(12) ITA would do, though there are others as well.[152]

11.29.6 *Condition C and D cases: Amount remitted*

Section 809P ITA provides:

> (6) In a case falling within section 809L(4)(a) or (b), the amount remitted is equal to the amount of the relevant income or chargeable gains.
>
> (7) In a case falling within section 809L(4)(c), the amount remitted is equal to the amount of the relevant income or chargeable gains; but this is subject to subsection (10).
>
> (8) In a case falling within section 809L(5)(a) or (b), the amount remitted is equal to the amount of the income or chargeable gains referred to in section 809O(4)(c).
>
> (9) In a case falling within section 809L(5)(c), the amount remitted is equal to the amount of the income or chargeable gains referred to in section 809O(4)(c); but this is subject to subsection (10).
>
> ...
>
> (11) In subsections (6) and (7) "relevant income or chargeable gains" means—
>
> (a) if the qualifying property falls within section 809N(7)(a), the income

152 Para 86(2) Sch 7 FA 2008 would also provide relief here: see 11.38 (Transitional relief for property acquired before 2008).

or gains—
(i) of which the qualifying property consists, or
(ii) from which the qualifying property derives;

(b) if the qualifying property falls within section 809N(7)(b), the income or gains—
(i) of which the property given to the gift recipient consisted, or
(ii) from which that property derived;

(c) if the qualifying property falls within section 809N(7)(c), the income or gains—
(i) of which the property given to the gift recipient consists, or
(ii) from which that property derives.

The RDR Manual offers seven examples but the matter does not seem important enough to be setting out here.

11.30 CGT disposal not for market value

11.30.1 *The CGT background*

CGT is charged on gains accruing to a person on a disposal of assets. Gains are normally computed as the actual consideration for the disposal less allowable expenditure.

In certain circumstances the consideration for a disposal is deemed to be market value consideration, not the actual consideration (if any).[153] In these cases a gain is deemed to accrue which is not a real gain (in the sense that the individual does not actually receive a sum which constitutes or represents the gain). I refer to this as **"a deemed gain"**.

The most common case of a deemed gain is a gift. In money terms (one might say, in economic reality, but I do not think that is a helpful concept) a gift cannot give rise to a gain and normally gives rise to a loss. However, for CGT purposes a gift is treated as made for market value.

11.30.2 *Deemed gains and the remittance basis*

In the absence of express provision a deemed gain arising on a gift could not be remitted, because it does not exist (in the sense that the individual does not receive a sum from the disposal which is the gain or is derived from the gain). Accordingly, s.809T ITA provides:

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153 Section 17(1) TCGA sets out seven sets of circumstances when a disposal is treated as made for market value. (The section also deems certain acquisitions to be for market value, but we are not concerned with that here.)
In certain circumstances a gain is deemed to accrue to an individual even though there is no disposal, but s.809T does not apply to that.

(1) This section applies if—
  (a) foreign chargeable gains accrue to an individual on the disposal of an asset, and
  (b) the individual does not receive consideration[154] for the disposal of an amount at least equal to the market value[155] of the asset.
(2) For the purposes of this Chapter, treat the asset as deriving from the chargeable gains.

It is not expressly stated that s.809T only applies on a disposal made by an individual, but this is implied. Eg on a disposal by non-resident close company, conditions (a)(b) are met, if one reads the words literally:
(a) s.13 gains may accrue to an individual who is a participator, and
(b) the individual does not receive the consideration for the disposal.
But s.809T does not apply. Otherwise provisions such as s.14A(3)(a) TCGA would be unnecessary.

11.30.3 *Gift of asset*

Suppose:
(1) T (a remittance basis taxpayer) gives an asset (foreign situate) to a trust. A gain is deemed to accrue on the disposal as if the asset were sold for market value. (Assume the asset has risen in value and a deemed gain accrues.)
(2) T (or a relevant person) receives the asset in the UK.
The deemed gain is remitted. This reverses the rule for the pre-2008 CGT remittance basis.

For the interaction with the s.87 charge on the capital payment from the trust, see 51.6.7 (Payment derived from old unremitted gains taxable on remittance).

11.30.4 *Sale of asset for market value*

Suppose T sells an asset to a trust for market value. Then s.809T does not apply. It does not matter if T and the trustees are connected persons. The purchase price is or (better) is derived from the gain accruing on the sale,

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154 "Consideration" here obviously means actual consideration, as opposed to deemed market value consideration under s.17(1) TCGA. (Though normally in the legislation the drafter states this expressly; eg s.165(7) TCGA.)

155 Defined s.809Z10 ITA 2007: " In this Chapter ..."market value" has the same meaning as in TCGA 1992 (see in particular sections 272 and 273 of that Act)."

but the asset itself is not (and is not derived from) the gain. So it does not matter if the asset is remitted.

Suppose T sells an asset and the purchase price is left outstanding as a loan. It is considered that T "receives" the consideration, for the benefit of the outstanding loan is the consideration.

11.30.5 *Sale of asset at undervalue*

Suppose T sells an asset to a trust at an undervalue. Assume for the purpose of discussion that the asset has a market value of £200 and has a base cost of £50. So a deemed gain of £150 accrues on the disposal. The asset is treated as derived from the chargeable gains, and there is a charge if the asset is remitted.

If the asset is sold for base cost, £50, it is suggested that the £50 is not derived from the deemed gain, so the £50 sale proceeds could be remitted tax free. But other views are possible.

What if the asset is sold for more than base cost, say £100? In the absence of s.809T, I would say that the purchase price is in part derived from the gain. One might say that since the sale price is half the market value, half of the sale price represents the gain, ie £75. I prefer the view that the purchase price is £50 more than base cost, so that £50 of the purchase price is derived from gain. Does the rule in s.809T, that the asset is derived from the gain, mean that the proceeds of sale are *not* derived from the gain? Logically that should follow, but if that were right then tax could be avoided by sales at a (marginal) undervalue. So the context shows that one should not carry the deeming so far.

The conclusion is that on a sale at an undervalue:

(1) the asset held by the trust derives from the gain *and*

(2) the proceeds of sale (in part) are derived from the gain.

However the cap on the amount remitted avoids double taxation.[156]

This rule applies to all sales at less than market value, even if accidental.

This rule applies if the sale is less than market value even if it is 99% of the market value.

The rule applies even if the disposal is not between connected persons, though in practice s.809T is not likely to apply to a disposal between unconnected persons.

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156 See 11.29.5 (Cap on amount remitted).

11.30.6 *Transitional rule: Pre-2008 deemed gain*

Subject to immaterial exceptions, para 81 Sch 7 FA 2008 provides:

> The other amendments made by this Part of this Schedule have effect for the tax year 2008-09 and subsequent tax years.

A deemed gain accrued to an individual on pre-2008 gifts: it was just not remittable. At first sight this does not help. It is accepted that the ITA remittance basis rules govern pre-2008 income/gains. So after 2008/9 s.809T applies and the gain becomes remittable, though it qualifies for RP relief. It does not matter when (after 1965) the gain arose: gains from disposals made in the 1960s could now come into charge, though all records will have been long discarded. However HMRC do not take that view. The RDR Manual provides:

> **31180 Foreign chargeable gains accruing on disposal made otherwise than for full consideration** [June 2010]
> The new rule at Section 809T ITA 2007 applies to disposals by remittance basis users on or after 6 April 2008.

11.31 Purchase of family home

Suppose:

(1) T gives RFI to T's son S, not a relevant person.
(2) S buys the freehold interest of a house and uses the RFI to pay the purchase price.

The topic raises many remittance issues, discussed throughout this chapter, so it is convenient to draw them together.

11.31.1 *Rent-free occupation*

Suppose S allows T to occupy the house rent-free. It is considered that S "uses" the house (the word "use" is wide enough to cover this even though it would be more normal and better legal English to say S occupies or enjoys the use of the house). Accordingly remittance condition A is satisfied. The house is derived from the RFI, but condition B is not satisfied because the property is not property of a relevant person.

Remittance condition C is satisfied, since the property is qualifying property of a gift recipient, and is used and enjoyed by a relevant person. So the purchase price RFI is remitted.

11.31.2 *Lease granted for full consideration*

Now suppose:

(1) T gives RFI to T's son S, who uses it to buy the freehold interest of a house.

(2) S grants a lease of the property to T for full consideration and T occupies the property. S retains the freehold reversion.

One must ask various questions here.

First, does T use the lease? The answer is that T does "use" the lease (see above). So remittance condition A is satisfied in relation to the lease. However the lease is not derived from the RFI. So condition B is not satisfied. Of course funds T uses to pay for the lease are regarded as remitted.

Next, does T use the reversion? If so condition A is satisfied in relation to the reversion. However that may be, the reversion is not property of a relevant person so condition B is not satisfied.

Conditions C and D are excluded (even if they could otherwise apply) since the full consideration exemption applies.

11.31.3 *Lease granted for less than full consideration*

Now suppose:

(1) T gives RFI to T's son S, not a relevant person, who uses it to buy the freehold interest of a house.

(2) S grants a lease of the property to T for no consideration or for less than full consideration, and T occupies the property. S retains the freehold reversion.

One must ask various questions here.

First, does T use the lease? The answer is that T does "use" the lease (see above) So remittance condition A is satisfied in relation to the lease. If the transactions are part of an arrangement, the lease is derived from the RFI. So condition B is satisfied (as the lease is property of a relevant person). What is the amount remitted? It is the amount from which the lease is derived. It is suggested that that is not the full amount used to pay for the property, but only a part reflecting the value of the lease.

Next, does T use the reversion? If so condition A is satisfied in relation to the reversion. However that may be, the reversion is not the property of a relevant person so condition B is not satisfied.

Turning to remittance condition C, does T enjoy the lease for the purposes of remittance condition C? T does. At first sight this does not

matter as the lease is not qualifying property of a gift recipient (it is not property of a gift recipient). The lease may (depending on the facts) however be qualifying property within s.809N(7)(c). If so the amount remitted is all the RFI (not the value of the lease).

Next, does T use and enjoy the reversion? It is considered that T does, since the lease T enjoys is derived from the reversion, and the lease is the mechanism by which T enjoys the reversion. If that is right, then condition C is satisfied, since the reversion is qualifying property of a gift recipient.

11.31.4 *Another analysis*

Another analysis is that the "property" is the physical house, not the legal interests in the property, but one should not disregard the most basic principles of the law of real property in construing a taxing statute, if any other approach is possible.

11.32 Payment of school fees

Suppose T wishes to pay the school fees of minor grandchildren. Assume the grandchildren are at school in the UK (otherwise there is no problem). A direct payment out of RFI is a remittance as conditions A and B are satisfied.

Suppose T gives funds to T's child (not a relevant person) and the child uses the funds to pay the fees. This is still a remittance as conditions A and B are still satisfied: the funds in the hands of the child are derived from the RFI.

Suppose there is an informal arrangement under which:

(1) T gives funds to T's child;

(2) the child will use *other* funds to pay the school fees.

This is caught by condition C because the funds used to pay the fees are "qualifying property" within s.809N(7)(c). That is, it is used to pay the school fees by virtue of an operation which is effected "with reference to the gift of the property to the gift recipient".

T must therefore make an unconditional gift to T's child ie a gift such that the payment of the school fees is not with reference to that gift; in that case (assuming the fees are not paid out of the gifted property) there is no taxable remittance.

11.33 Remittance before income or gains arise

Section 809U ITA provides:

> Where—
> (a) income or foreign chargeable gains are treated as arising or accruing, and
> (b) by virtue of anything done in relation to anything regarded as deriving from the income or chargeable gains, the income or chargeable gains would otherwise be regarded as remitted to the UK before the time when they are treated as arising or accruing,
> treat the income or chargeable gains as remitted to the UK at that time.

EN Remittance Basis Amendments 482 to 493 states:

> Under the original wording such payments might in certain circumstances become chargeable before the tax year in which the income or gain is treated as arising. The amendment ensures that cannot happen.

This can apply to s.87 gains[157] and to s.731 income, where a benefit is received in a year before the income accrues. It can also apply under the accrued income scheme.

11.34 Partnerships

This section discusses two related questions. Assume P (a remittance basis taxpayer) is a member of a partnership.

(1) *Remittance of funds transferred to partnership.* Suppose:
   (a) P receives foreign income/gains.
   (b) P contributes the funds to the partnership, as partnership capital.
   (c) The partnership brings the funds to the UK.

(2) *Remittance of partnership income/gains*. Suppose:
   (a) The partnership receives foreign income/gains.
   (b) The partnership does not distribute the funds to the partners, but brings the funds to the UK.

In these cases, is there a taxable remittance? The partnership itself is not a relevant person[158] but P is a relevant person and P's partners may be relevant persons too.

There are two possible views:

(1) One regards P as owning an asset (a partnership share). In that case:
   (a) Funds contributed to the partnership are remitted if P receives the partnership share in the UK (because the partnership share is

157 See 51.15 (Section 87 remittance basis).

158 See 11.7.3 (Partnership).

derived from P's foreign income/gains.)

(b) Partnership income/gains brought by the partnership to the UK are not remitted.

(2) One regards P as owning a share of the partnership assets. In that case:

(a) Funds contributed to the partnership[159] are remitted if the partnership brings the funds to the UK.

(b) Partnership income/gains[160] are remitted if the partnership brings the income/gains to the UK.

One might describe the first view as being that partnerships are not transparent for remittance basis purposes, and the second view as one that partnerships are transparent.

11.34.1 *The partnership law background*

In order to understand partnership taxation, one needs to understand the nature of a partner's interest in a partnership (also known as a partnership share).

A partnership share has a twofold nature:

> [1] As between themselves, partners are not entitled individually to exercise proprietary rights over any of the partnership assets. This is because they have subjected their proprietary interests to the terms of the partnership deed which provides that the assets shall be employed in the partnership business, and on dissolution realised for the purposes of paying debts and distributing any surplus.
> [2] As regards the outside world, however, the partnership deed is irrelevant. The partners are collectively entitled to each and every asset of the partnership, in which each of them therefore has an undivided share.[161]

Lindley and Banks on Partnership refers to the two parts of this double nature as internal and external perspectives;[162] but for present purposes it

159 Or at least, the share of the funds attributable to the share in the partnership of P and of other relevant persons who are partners.

160 Or at least, the share of the income/gains attributable to the share in the partnership of P and of other relevant persons who are partners.

161 *IRC v Gray* [1994] STC 360 at p.377.

162 *Lindley & Banks on Partnership* (19th ed., 2010), para 19-03; Law Com, *Partnership Law*, Report no 283 (2003), para 9.66 (Nature of a partner's interest) *http://lawcommission.justice.gov.uk/docs/lc283_Partnership_Law.pdf*

is clearer to describe them as a *chose in action analysis* and a *joint ownership analysis* of partnership share.

Which analysis is adopted can make a difference for tax purposes. There is no general answer: the decision is made according to the context of the provisions concerned. Thus the passage cited above continues:

> It is this outside view [the joint ownership analysis] which identifies the nature of the property falling to be valued for the purpose of capital transfer tax [now IHT].

In the context of *Gray*, the joint ownership analysis gave the sensible result, that where a partnership held land, a partnership interest was (or included) "land" so the Lands Tribunal had jurisdiction to value it.

In the context of remittances, the RDR Manual adopts the chose in action analysis:

> **33530. Partnerships** [December 2011]
> *Investment into partnerships*
> When a partner makes a capital contribution to a partnership they acquire an asset under partnership law, namely an 'interest' or 'share' in the partnership which gives them rights to share in future profits and distributions (of their capital and any surplus) on dissolution of the partnership.[163]

The legal analysis of a LLP is different, but for present purposes the end result is the same. A LLP is not a relevant person. The members of the LLP have no interest in the assets of the LLP, which is beneficial owner of its assets. But for (most) tax purposes a LLP is treated like a common law partnership.

11.34.2 *Non-transparent nature of partnership for remittance basis purposes*

On this basis the RDR Manual adopts the non-transparent view:

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163 Similarly the former Stamp Taxes Manual: "4.442 A partner cannot claim to be the owner of any particular asset or, indeed, any specific share in an asset. A partner's interest is a peculiar form of property known as an interest in a *unum quid* or, in other words, in an indivisible whole. This is not a share in any goods, money or other assets. It is merely a right as a partner, with others, to control the partnership assets and affairs so long as the partnership exists and, upon dissolution, a right to have the assets liquidated, the liabilities discharged and a division of any surplus." *http://www.hmrc.gov.uk/so/manual.pdf*

> **33530. Partnerships** [December 2011]
> *... Offshore partnerships trading or investing in the UK*
> A partnership is not a relevant person. Individuals who are partners together in a partnership are not relevant persons by virtue of their role as a partner (although they may, of course, be relevant persons under other provisions).
> Offshore partnerships, whether trading or investment partnerships, may bring partnership funds into the UK to meet trading or investment expenses in the usual course of partnership business. As the funds are brought in by the partnership they are not brought in by a relevant person. In most cases there will be no benefit to a relevant person from the money or other property brought into the UK by the partnership, nor will a service usually be provided in the UK to or for the benefit of a relevant person, so Condition A of ITA07/s809L is not met.[164] Thus there will be no taxable remittance.

In short, in the Manual's view, partnerships are not transparent for remittance basis purposes. At first glance, one might have thought inconsistent with the rule that partnership income is regarded as income of the partners; in that sense partnerships are said to be transparent.[165] But there is no contradiction, for the issues and statutory provisions are different: there is no general principle of income tax transparency which requires the same answer to both.[166]

The RDR Manual adds four qualifications (which should not be controversial):

> **33530. Partnerships** [December 2011]
> ... [1] In cases where there does appear to be a benefit to an individual partner (or to another relevant person) from money or other property brought into UK by the partnership, or from a service provided in the UK for which the partnership gives consideration then you should examine the transaction and the partnership documents very carefully to identify the source of the partnership funds.
> [2] The provision of the property or service by the partnership may be a remittance of that individual's 'share' in partnership profit. To the extent that the individual's share in partnership profit falls to be regarded as relevant foreign income (see below) there may be a remittance.

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164 This is a loose paraphrase of remittance condition A, but the meaning is clear.

165 See 41.4 (Transparency of partnership for IT).

166 See 84.2.1 (Terminology).

Para [1] is considering whether a capital contribution to the partnership is remitted and para [2] is considering whether partnership income/gains are remitted. Clearly, if a partnership asset is used by the individual in the UK, remittance condition A is in principle satisfied.

> [3] You may also need to examine whether there is a true partnership, or whether in fact it is the individual's foreign income or gains that have been remitted.

Whether there is a partnership is a question of partnership law. That should not cause difficulties, if documentation and implementation are correct, but it depends on the facts.

> [4]...Alternatively there may be a connected operation to which Condition D of ITA07/s809L(5) applies.

This is a shot from the hip. The Manual wisely does not seek to explain how remittance condition D might be satisfied.

11.34.3 *Contribution of foreign income/gains to UK partnership*

The RDR Manual 33530 provides:

> **33530. Partnerships** [December 2011]
> ... It follows [from the statement of the partnership law position] that a remittance basis user who uses his foreign income or gains to make a capital contribution to a UK partnership acquires a UK asset; namely a share in the UK partnership, in exchange for his 'equity' subscription in the partnership. Thus the foreign income or gains that he uses to contribute to the partnership will be a taxable remittance within ITA07/s809L.
> This is so even if the individual places his investment into the partnership's overseas account, and the UK partnership is only investing or trading overseas and not in the UK.

The text does not say what it means by "UK partnership" - presumably it means one an interest in which is UK situate, on common law/international law principles: that is, an unincorporated partnership which is managed and controlled in the UK or a LLP with a UK register.[167]

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167 See 82.34 (Situs of partnership share).

An unspoken assumption here is that receipt of a UK situate asset is a taxable remittance, ie is a receipt of an asset in the UK. That is arguable.[168]

11.34.4 *Remittance of partnership profits*

Where partnership income is RFI[169] the same point arises. There is no taxable remittance if the partnership brings its income to the UK. A partner who is a remittance basis taxpayer can only remit income to the UK after it is distributed to them from the partnership.

See too 13.7 (Mixed funds held by third parties).

11.34.5 *Company held by partnership*

Suppose a partnership holds a company. The partners are participators in the company. The company will be a close company (or a non-resident close company), since partners are connected persons. Accordingly the company is a relevant person in relation to each of the partners. So there is a taxable remittance if property is brought/received/used in the UK by the company; even though there would be no remittance if the same property was brought/received/used in the UK by the partnership which holds the company! This is the case regardless of the size of the partnership. Remittance investment relief may mitigate this problem.

11.35 Proceeds of divorce settlement

11.35.1 *Is a transfer on divorce made for "consideration"?*

The starting point is to understand the family law background.

A transfer in connection with divorce may be made:

(1) Pursuant to a court order
   (a) following a contested hearing; or
   (b) approving a settlement agreed by the parties.
(2) Without a court order but under an agreement between the parties (the transferee agreeing to seek no (or a reduced) court order in return for the transfer).

Assume (as will normally be the case on divorce) that the transfer is made bona fide, at arm's length and with no gratuitous intent. Are transfers of these kinds made for consideration?

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168 See 11.12.10 (Receipt of UK situate investment asset).

169 See 41.5 (Partnership income: remittance basis).

One might have thought that the answer was no. One argument is:
(1) there is only "consideration" where there is a contract[170] and
(2) (a) a court order is clearly not a contract; and

(b) an agreement between the parties is generally not a valid contract.[171] The word consideration is wide enough to apply in the absence of a contract, but in case (1) there is no agreement of any kind. In case (2) a nuptial agreements can in some cases constitute enforceable contracts.[172] But more fundamentally, the quid pro quo which is the essence of consideration is lacking.

Accordingly in *G v G*[173] the High Court held that a transfer pursuant to a Court Order at a contested hearing (type (1)) was not made for consideration, so that CGT hold-over relief was available.

However in *Hill v Haines* [2008] Ch 412 the Court of Appeal held that a transfer pursuant to a Court Order at a contested hearing (type (1)) *was* made for consideration, for the purposes of s.339 Insolvency Act 1986.

Where does this leave *G v G* and CGT hold-over relief? Either it is overruled or else there are (at least) two concepts of consideration, in which case a transfer might be for consideration in one sense but not for consideration in the CGT sense. In that case one could never ask whether a transfer is made for consideration in the general, but only whether it is made for consideration in some specified sense of the ambiguous word.

Each view has some support in *Hill v Haines* (though they cannot both be right). Morritt C said:

> [30] ... the fact that a transfer ordered by the court does not give rise to a payment of consideration so as to reduce the value of hold-over relief *for capital gains tax* [does not entail] a conclusion that a property adjustment order must be regarded as made for no consideration.

In other words, "consideration" in the CGT code has a different meaning.

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170 *C&E Commissioners v Apple and Pear Development Council* [1985] STC 383; *IRC v Plummer* 54 TC 1 at p.57; *Unilever v Smith* [2002] STC 113.

171 See *Aspden v Hildesley* 55 TC 609.

172 See Law Commission consultation paper no. 198, *Marital Property Agreements* (Jan 2011) accessible *http://lawcommission.justice.gov.uk/*; *Granatino v Radmacher* [2011] 1 AC 534.

173 *G v G* [2002] EWHC 1339 [2003] Fam Law 14 [2002] 2 FLR 1143 at [43] accessible *http://www.kessler.co.uk/tfd-archive*.

But Rix LJ preferred the view that *G v G* was wrong.[174] Since Rix also agreed with Morritt, it is clear that he did not give a great deal of attention to this point (which did not need to be decided and which would not have been fully argued). A legal realist would say that each decision was result led, the court first deciding what is the just result and then holding that there was/was not consideration in order to reach that result. But it is considered that the two decisions can be reconciled and the view of Morritt is to be preferred. Rights under the Matrimonial Causes Act are not assets for CGT purposes: no gain arises when a spouse is awarded a capital sum. Accordingly, there is no "consideration" for CGT purposes. However that is a special case and a transfer on divorce is made for consideration in the general sense of the expression.

11.35.2 *The HMRC view*

The CG Manual provides:[175]

> **67192. Hold-over relief: Consideration** [February 2006]
> The disposal of an asset from one spouse or civil partner to the other in the circumstances described in CG67191 [that is, a disposal in a year after separation, which does not qualify for the CGT spouse exemption] is, where there is no recourse to the courts, usually made in exchange for a surrender by the donee of rights which they would otherwise be able to exercise to obtain alternative financial provision. In such cases we take the view that the value of the rights surrendered represents actual consideration of an amount which would reduce the gain potentially eligible for hold-over relief to nil. "Consideration" is not limited to money or money's worth.

After considering the case where there is gratuitous intent, which is so rare that it need not be considered here, the Manual continues:

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174 At [81] "... As for *G v G*, the view expressed by Coleridge J at para 43 regarding potential consequences for the purposes of capital gains tax can hardly be regarded as authoritative in the absence of the revenue. As Coleridge J stated, his view that the wife gave no consideration for the shares transferred to her because 'neither party has any 'rights'… cannot, of course, ultimately bind the Inland Revenue': he merely proceeded "on the footing" that business hold-over relief would be available to the husband. In doing so, he appears to have drawn an unnecessary inference from the decision of this court in the *Xydhias* case."

175 The passage has not been revised after *Hill v Haines,* but as several years have elapsed since that decision, it may be taken as a statement of the HMRC current view.

> However, in cases where there is recourse to the courts and a court makes an order
> - for ancillary relief under the Matrimonial Causes Act 1973 which results in a transfer of assets from one spouse to another, or
> - for property adjustment under the Civil Partnership Act 2004, or
> - formally ratifying an agreement reached by the divorcing parties or by the civil partners of a dissolved civil partnership dealing with the transfer of assets,
>
> we take the view that the spouse or civil partner to whom the assets are transferred does not give actual consideration, in the form of surrendered rights, for their transfer. A Court Order, made in these circumstances, reflects the exercise by the court of its independent statutory jurisdiction and is not the consequence of any party to the proceedings agreeing to surrender alternative rights in return for assets. This approach represents a change in the Revenue's prevailing practice, following consideration of judicial observations made in the case of *G v G* and applies with effect from 31 July 2002. Therefore, where assets are transferred between divorcing parties or between civil partners of a dissolved civil partnership by reason of a Court Order as described above and a claim for gift hold-over relief is made, or remains unsettled, on or after that date, the relief should not be restricted in accordance with Section 165(7) TCGA 1992 on the grounds that actual consideration has been given by the donee.

Thus in the HMRC view:

(1) A transfer made pursuant to a court order, including a consent or *Tomlin* order, is not made for consideration.
(2) A transfer not made pursuant to a court order is made for consideration.

It is considered that the position is in both cases the same:

(1) The transfer is made for consideration in the general sense of the word;
(2) The transfer is not made for consideration for CGT purposes.

11.35.3 *Are proceeds of divorce settlement "derived property"?*

Suppose T transfers RFI to W as part of a divorce settlement. It is suggested that the funds in the hands of W are not derived from the income. They are received for full consideration (in the general sense of that expression). If that is right, remittance condition B is not satisfied even if:

(1) W remits while still a relevant person (before decree absolute);

(2) W applies the funds for the benefit of relevant persons (eg children or grandchildren of T under 18).

However in case HMRC do not agree, W should not bring the funds to the UK until after decree absolute, by which time she has ceased to be a relevant person; and she should ideally not use the funds for the benefit of relevant persons (in relation to H). Then there is clearly no taxable remittance.[176]

11.36 Debit, credit and charge cards

This section considers whether the use of debit, credit and charge cards involves a remittance. The starting point is to understand the legal nature of debit, credit and charge cards. The following analysis draws on *The Law of Bank Payments*.[177]

On the use of a card, three contracts come into being. For present purposes the most important terms of the contracts are as follows:

(1) Cardholder and supplier

This is the contract for goods or services between the cardholder and the person from whom the cardholder purchases goods or services ("the supplier"). This contract is the same whether the cardholder pays by card or by cash.

(2) Card-issuer and supplier

The card-issuer undertakes to honour the card by paying the supplier.

(3) Card-issuer and cardholder

(a) A *debit* card is issued only by a bank. The contract between the card-issuer bank and cardholder authorises the bank to debit the cardholder's bank account with the amount of the card transaction.

(b) Charge and credit cards are different. Here the cardholder is required to make a payment to the card-issuer. A *charge* card requires the cardholder to repay the balance outstanding after a set period.[178] A *credit* card allows the cardholder extended credit.

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176 See 11.20 (Becoming/ceasing to be a relevant person: conditions A and B). As to debt remittance rules, see 11.18.11 (Debt imposed by law).

177 Brindle and Cox, (4th ed., 2010), para 4-014. In any particular case it is strictly necessary to review the specific terms governing the card concerned, but I expect that will not usually make any difference in practice. Store-issued cards are not discussed here.

178 In the case of a bank-issued credit card, the issuer is normally authorised to debit the cardholder's bank account to meet a debt due on the card. But in practice this facility is not used unless needed (or the card effectively becomes a debit card).

It is necessary to distinguish between use of cards to obtain (1) cash, and (2) goods or services.

11.36.1 *Cards used to obtain cash*

If a debit card is used to obtain cash in the UK from a foreign bank account which is in credit,[179] and the card is used at a branch of the bank which issued the card, then there is clearly a remittance of the money. The same applies if the cash is withdrawn from a bank which is not the card-issuing bank, because the third party bank acts as the agent for the card-issuing bank.

The use of a *charge* card to obtain cash in the UK from a foreign bank account is likewise a remittance. The time of the remittance is when the sum is debited from the account, not when the card is used. The position is the same if an individual uses a *credit* card to obtain cash in the UK.

11.36.2 *Cards used to obtain goods or services*

Where a debit card is used to obtain goods or services in the UK, remittance condition A is satisfied. Payment of the debt to the card issuer out of income or gains satisfies remittance condition B.

11.36.3 *HMRC practice*

The RDR Manual provides:

> **36130 Credit Cards and Debit Cards** [June 2010]
> *Credit card issued in the UK*
> If a taxpayer who is chargeable on the remittance basis uses a UK credit card to pay for goods or services, either in the UK or overseas and he or she subsequently settles their credit card bill using foreign income or gains, the payment is a taxable remittance.
> The remittance does not have to be received in the UK by the taxpayer, it is sufficient that it is received by the credit card company in the UK.

This is not correct, but a remittance basis taxpayer should avoid a UK credit card in order to avoid dispute.

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179 If the effect of use of the card is to put an account into debit, there is obviously no remittance on ordinary principles, though the debt remittance rule will in principle apply when the overdrawn account is repaid.

Credit card issued by an overseas bank or other financial institution

Where an overseas credit card is used in the UK, the cardholder is effectively authorising the credit card company to pay the bill for the goods or service in just the same way as if they had instructed the bank to make a payment directly to the person supplying the goods or services. The terms of credit card agreements may differ as to the moment of "indebtedness" between the cardholder and the credit card company. However the use of the credit card to pay for goods used or received in the UK, or services provided in the UK by, to or for the benefit of a relevant person will create a debt.

The use of the individual's untaxed foreign income or gains to pay the credit card company in respect of the relevant debt will be a taxable remittance.

Interest and other such charges should be apportioned accordingly between UK and non-UK goods and services. In most cases a straight proportional split of the interest against each type of expenditure will be acceptable; for example if £400 of the debt relates to UK goods which are taxed as a remittance and £600 to non-UK goods and there is an interest charge in relation to that £1,000 debt of £10, then £4 of the interest is also a taxable remittance. However some cards may apply different rates where cash is withdrawn, or depending of date of purchase, in which case the taxpayer will need to compute the interest due on the "relevant debt" part of the payment only.

Note 1: This section may apply to any credit card debt which the individual satisfies using their foreign income or gains, even if they are not the cardholder.

Note 2: If an overseas credit card is used abroad and the account is settled direct to the card company out of overseas income, no liability to UK tax will arise. But if an asset purchased using the card is brought to the UK and subsequently sold here, there will be a taxable remittance, at the date of disposal, up to the amount of any foreign income used to settle the original account.

Debit card issued by an overseas bank or other financial institution

Payments for goods or services that are made using a debit card (for example a Visa debit card or one issued under the brand name "Cirrus") issued by an overseas financial institution are treated in exactly the same way as a cash transaction.

This means that when goods or services are purchased in the UK using a debit card a taxable remittance is made to the extent of the amount of any overseas income or gains in the bank account. Likewise any cash withdrawals from shops or ATM machines in the UK are taxable cash remittances.

> Payment by cheque drawn on an overseas account or by electronic transfer of any kind are also treated in exactly the same way as cash and are potentially taxable remittances of overseas income and gains.

11.37 Gift to charity by remittance basis taxpayer

A remittance basis taxpayer ("T") making a gift to charity[180] should give:
(1) money (including foreign currency) (qualifying for gift aid relief) or
(2) foreign assets (qualifying for qualifying investment donation relief).
The gift may be made out of foreign income/gains, or property derived from foreign income/gains. If the sum given is money the charity should open a bank account outside the UK.[181] The charity may bring the assets to the UK without a taxable remittance, provided the charity is not a relevant person in relation to T.

A charitable company would only be a relevant person if it is a close company and T or some other relevant person is a participator.[182]

A charitable trust would be a relevant person if T or some other relevant person is a beneficiary.[183] No individual has a legal or equitable (beneficial) interest in a charitable trust, so in the strict sense a charitable trust has no beneficiaries:

> Individuals may benefit from the application of trust moneys but they are not, as individuals, the beneficiaries of the trust and may not enforce its terms.[184]

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180 This includes some EU and EEA charities: see Kessler & Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013), chapter 2 (Definitions of "Charity") online version *http://www.taxationofcharities.co.uk*.

181 I understand that the CAF maintain an offshore account for this purpose (and no doubt some other charities do the same). This may not be strictly necessary: see 11.12.8 (Gift to non-relevant person).

182 See 11.5 (Relevant persons: companies). For the general definition of close company, see 85.19 (Close company: Introduction). For a discussion in relation to charities, see Kessler & Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013), para 10.3 (Definition of close company) (online version *http://www.taxationofcharities.co.uk*).

183 See 11.6 (Relevant persons: trusts).

184 *Re Crown Forestry Rental Trust, Latimer v IRC* [2004] 4 All ER 588 at [29]. Likewise Law Commission, *Capital and Income in Trusts: Classification and Appointment* Consultation Paper No. 175 (2004) para 6.16: "The 'beneficiary' [of a charitable trust] is at all times the public (although the identity of the individuals who incidentally benefit from the carrying out of the charitable purpose may not remain constant)."

There is a statutory definition but that makes no difference. Section 809M(3)(e) ITA provides:

> "beneficiary", in relation to a settlement, means any person who receives, or may receive, any benefit under or by virtue of the settlement.

It is possible (at least theoretically) that (say) the individual becomes destitute and a charity whose objects include the relief of poverty makes them a grant. However that does not bring the individual within the definition. One must say:
(1) The benefit is incidental (the object of the charitable trust being the relief of poverty, not to benefit the individual) and incidental benefits should be disregarded;[185] or
(2) This possibility is not included in the word "may".[186]
If that were wrong, then (in the absence of a settlor exclusion clause) every charitable trust is within the scope of s.624 ITTOIA as a settlor-interested trust; which cannot be correct. The definition must be read in its context. The purpose is to include discretionary beneficiaries or persons who may be added to the class of beneficiaries.

11.37.1 *Reform?*

HMRC say:

> **Philanthropy**
> 2.91 A number of responses from the arts and charity sectors suggested that the business investment relief[187] should be extended to allow

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Likewise *AG v Cocke* [1988] Ch 414 at p.419: "... the nonsense of alleging that there is any beneficiary in any meaningful sense of that word under a public charitable trust of this nature. It seems probable to me that in almost all charitable trusts there are no individual beneficiaries."
I stress this because statute does sometimes refer to "beneficiaries" of a charity, eg: s.525(1)(b) ITA, s.561 ITA; s.117 Charities Act 2011. These are examples of the word being used in a loose non-chancery law sense, where it may apply in the context of charitable companies as well as charitable trusts.

185 See 30.4.13 (Payment of school/university fees).

186 See Kessler, *Drafting Trusts and Will Trusts* (12th ed., 2014), para 13.12 (What does a settlor exclusion cause cover?).

187 As far as I can see, the proposal has nothing to do with business investment relief; the proposal was framed that way because it was made in the context of a consultation on that relief.

non-domiciles to bring overseas income and gains to the UK tax-free for the purpose of making donations to, or investments (?) in, UK charities.

Government response

2.92 The Government is committed to encouraging philanthropy. However, there are already tax-efficient ways for non-domiciles to make donations to UK charities and the Government has not seen any compelling evidence that extending the business investment relief in the way suggested would lead to a significant increase in the level of donations to UK charities by non-domiciles. It is also very likely that complicated legislation and anti-avoidance provisions would be required. The Government therefore does not intend to take any further action on this issue at the present time The Government therefore does not intend to take any further action on this issue at the present time but it will consider how to increase awareness of ways for non-domiciles to make tax-efficient donations under the existing rules.[188]

Thus there is no current prospect of reform.

11.38 Transitional relief for property acquired before 2008

Para 81 Sch 7 FA 2008 provides the starting point:

> The other[189] amendments made by this Part of this Schedule [ie part 1 which sets out the provisions discussed in this chapter] have effect for the tax year 2008-09 and subsequent tax years.

11.38.1 *Property remitted before April 2008: Para 86(2) transitional relief*

Under the pre-2008 RFI remittance basis, there was no remittance of RFI if property was remitted *in specie* (not in the form of money). This is now caught by remittance condition B.

Para 86 Sch 7 FA 2008 provides a transitional relief:

> (1) Section 809L of ITA 2007 (meaning of "remitted to the UK") has effect subject to this paragraph.
> (2) If, before 6 April 2008, property (including money) consisting of or

188 HMRC, *Reform of the taxation of non-domiciled individuals: summary of responses to consultation* (December 2011). *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

189 The word "other" excludes provisions concerning employment-related securities, not discussed here.

> deriving from an individual's relevant foreign income was brought to or received or used in the UK by or for the benefit of a relevant person, treat the relevant foreign income as not remitted to the UK on or after that date (if it otherwise would be regarded as so remitted).

I refer to this as **"para 86(2) transitional relief"** and I refer to the asset brought/received/used in the UK as **"the UK asset"**.

The UK asset may be any property, including money. At first sight, the words "including money" seem otiose: the word "property" alone would in any event include money. But assuming it was desired to apply para 86(2) transitional relief to money brought to the UK before 2008, it made some sense for the statute refer expressly to money, if only for clarity, since para 86(3) transitional relief (discussed below) excludes money.

Why was it desired to apply para 86(2) transitional relief to money? The remittance of *money* to the UK before 2008/09 was in principle a taxable remittance under the old rules so no transitional relief was needed. The reason is that para 86(5) applies a definition of "money" which is artificial in that it includes assets which are not money in the normal sense.[190] Such assets would not have been taxable on remittance before 2008, so the transitional provision is needed to give them exemption now.

Para 86(2) transitional relief continues to apply even if the UK asset is sold. HMRC appear to accept this in relation to para 86(3) transitional relief (see the example of Heidi, below) and the same must apply in relation to para 86(2). The result is something of a windfall, but there it is.

The RDR Manual provides:

> **31460. Property derived from RFI not treated as a remittance (1)** [June 2010]
>
> ***Background***
>
> The introduction of Chapter A1 Part 14 ITA 2007 has extended the meaning and scope of foreign income and gains that become taxable when remitted to the UK. In certain situations, the operation of the previous remittance rules in respect of relevant foreign income meant that it could be brought to the UK without triggering an immediate tax charge.
>
> As an example, if an asset such as a car was purchased abroad using

190 Para 86(5) provides: "money" has the same meaning as in s.809Y of ITA; see 12.27.2 ("Money"). But since the expression here is "property (including money)", the definition of money is not important.

relevant foreign income and the car was then brought into the UK, there would be no income or capital gains[191] tax charge when it is brought in. Instead the charge would only occur if/when the asset was sold or otherwise realised for cash in the UK (also refer to RDRM31250 Changes to old regime - cash only).

Property consisting of, or deriving from, relevant foreign income from tax years up to and including 2007-08 may have been brought into the UK prior to 6 April 2008, and the transitional provisions deal with these situations.

Transition

The transitional position is that the new rules contained in Section 809L do not have effect and that property brought to the UK is not treated as a remittance where:

- Property, including money, was acquired either directly or indirectly using relevant foreign income RDRM31140 and was brought to, received, or used in the UK before 6 April 2008.

Effect

Relevant foreign income brought to or used in the UK by the individual or any other relevant person before 6 April 2008 is not regarded as remitted under Section 809L after 6 April 2008 even if it is still in the UK. So in the example of the car above, even though it is still used in the UK by a relevant person on or after 6 April 2008 it will not be treated as a remittance under Section 809L.

Also, the same money or property can be sent or taken outside the UK and then brought in again. It will not be regarded as a remittance when brought in a second or subsequent time.

The Manual goes on to explain why the transitional relief is restricted to RFI:

> Note: This transitional provision applies only to relevant foreign income because the pre 6 April 2008 position for employment income and capital gains was different. These were always chargeable even if remitted in the form of property rather than cash.

It is debatable whether this correctly states the pre-2008 law, but it does not now matter.

Suppose:

(1) T borrowed to purchase an asset and acquired the asset before 6 April 2008.

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191 There is no question of a CGT charge if the car is purchased out of RFI, so the words "or capital gain" are irrelevant.

(2) T receives the asset in the UK after 6 April 2008.
(3) T repays the borrowing out of RFI after 6 April 2008.

Para 86(2) transitional relief does not apply because the purchased asset is not derived from RFI.

11.38.2 *Property acquired before 12 Mar 2008: Para 86(3) transitional relief*

Para 86(3) Sch 7 FA 2008 provides:

> If, before 12 March 2008, property (other than money) consisting of or deriving from an individual's relevant foreign income was acquired by a relevant person, treat the relevant foreign income as not remitted to the UK on or after 6 April 2008 (if it otherwise would be regarded as so remitted).

I refer to this as **"para 86(3) transitional relief"**.

Para 86(2) transitional relief applies where property (including "money") was *remitted* before 6 April 2008.

Para 86(3) transitional relief where property (excluding "money") was *acquired* before 12 March 2008, regardless of the date of remittance.

The RDR Manual provides:

> **31470. Property derived from RFI not treated as a remittance (2)** [June 2010]
> [The Manual repeats the text of RDR Manual 31460 and continues:]
> ***Transition***
> The transitional position is that the new rules contained in Section 809L do not have effect and that property brought to the UK will not be treated as a remittance where:
> - property (other than money) was acquired either directly or indirectly by a relevant person using relevant foreign income before 12 March 2008 and is brought to or received in the UK after 5 April 2008.
>
> The exclusion of money is important as it ensures that income arising from sources that have ceased is subject to the rule changes.[192] See Section 809Y ITA 2007 for the definition of money in these circumstances.
> ***Effect***
> This provision is similar to that described in RDRM31460. However this provision applies only to the purchase of property abroad before 12

192 Author's note: I am unable to understand this sentence.

March 2008 using relevant foreign income, where that property remained abroad and was not brought to or used in the UK before 6 April 2008.

Example 1 (Heidi)

H bought a car in Germany on 15 October 2007 using her relevant foreign income.

She kept the car at her German apartment until May 2009 when she decided to bring it to the UK to use here. Under the previous rules there would have been no remittance until the car was sold in the UK.

The HMRC analysis is as follows:

Under the new rules at Section 809L the car is regarded as derived from the relevant foreign income and so, without this transitional rule, there would be a taxable remittance of that relevant foreign income in May 2009.

Example 1A (Heidi)

As for example 1 but this time H decides that she needs a bigger car. In August 2009 she sells her car in Germany and brings the proceeds to the UK.

The HMRC analysis is as follows:

The proceeds from the sale of the car derive from H's relevant foreign income and would be regarded as a taxable remittance to the UK under the new rules at Section 809L. But as H's car (the property) was acquired before 12 March 2008 the transitional rule at paragraph 86(3) applies and what would be regarded as remitted is treated as not remitted. The money from the sale of the car that H brings into the UK is not therefore a taxable remittance.

There will be no foreign chargeable gain on the disposal of the car because her private motor vehicle is not a chargeable asset.[193]

Since para 86(3) relief applies to property "other than money" the

193 The RDR Manual is less clear-cut on the position if there is a sale of the asset:

"36230. Cash only [June 2010]

Under the transitional rules introduced in Finance Act 2008 (refer to RDRM31400 for more information about the transitional provisions), any asset purchased out of untaxed relevant foreign income which an individual owned on 11 March 2008 remains exempt from a charge under the remittance basis, for so long as that individual owns it, even if that asset is outside the UK and is imported at a later date. Any asset in the UK on 5 April 2008 is also exempt from a charge under the remittance basis for so long as the current owner owns it, even if that asset is later exported and then re-imported."

definition of "money" is important. Para 86(5) provides: "money" has the same meaning as in s.809Y ITA; this provides a wide and artificial meaning of "money"; see 12.27.2 ("Money").

If para 86(3) is taken literally, it disapplies the remittance basis for all RFI held in non-"money" form before 12 March 2008! For instance, it would apply to RFI invested in shares.

The possibilities are:

(1) "Property (other than money)" should be taken literally, ie any form of property other than "money" (as defined).
(2) "Property (other than money)" should be taken to refer to chattels (as the drafter of the RDR Manual perhaps assumes).
(3) Since Parliament has failed to express any intention with sufficient clarity, it should be dismissed as meaningless.

None of these solutions are easy:

(1) Solution (1) is far reaching, and it is not likely that it represents the actual intention of the drafter. Of course, the FA 2008 was enacted in such a rush that one can safely say that no-one carefully formulated any intention at all on the extent of para 86.
(2) One might infer from the RDR Manual that HMRC intended para 86(3) to apply to RFI used to purchase chattels; but the Manual was written much later, and there was no clear statement at the time the Act was passed, so that may be an afterthought. It is also inconsistent with the words "other than money". To read the section in that way amounts to legislation and not construction.
(3) This is the course of desperation.

It is considered that solution (1) is to be preferred.

11.39 Transitional loan relief: Pre-2008 loans

Para 90 Sch 7 FA 2008 provides a relief which I call "**transitional loan relief**". Para 90(1) provides:

> This paragraph applies if—
>
> (a) before 12 March 2008, money was lent to an individual outside the UK,
> (b) the loan was made for the purpose of enabling the individual to acquire an interest in residential property in the UK (and for no other purpose), and
> (c) before 6 April 2008—
>
> (i) the money was received in the UK,
> (ii) the individual used the money to acquire an interest in

residential property in the UK ("the interest"), and

(iii) repayment
[A] of the debt for the money ("the debt"), or
[B] of payments made under a guarantee of that repayment ("the guarantee"),[194]
was secured on the interest.

Para 90(2) provides the relief:

> Relevant foreign income of the individual used outside the UK before 6 April 2028 to pay interest on the debt is treated as not remitted to the UK.

The individual does not have to occupy the relevant property.

Thus:

(1) Transitional loan relief is restricted to RFI (and does not apply if employment income or gains are used to pay the interest).
(2) The relief is restricted to loans for residential property; (it does not apply even to loans to pay home improvements or SDLT).
(3) The relief is restricted to secured loans.

Suppose:

(1) H borrowed before 2008 to purchase property.
(2) W used her RFI to pay this interest.

Transitional loan relief does not apply as W is not the individual to whom the money is lent.

The effect of the relief in some cases will be to impose a severe tax

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194 Para 90(6) Sch 7 FA 2008 defines "guarantee":
"In this paragraph 'guarantee' includes an indemnity, and 'guaranteed' is to be read accordingly."
March 2009 Qs & As provides:
Q20: We would also welcome confirmation that the provisions in paragraph 90(1)(c)(iii) apply to a non-UK loan drawn down before 12 March 2008 where there are two (or more) guarantees in place for repayment of the debt, of which only one is secured on the UK residential property.
A: We can only reply in general terms to this query. The way in which this provision will apply will be determined in practice by the details of the particular loan or guarantee transactions in question. We would generally treat repayments of a debt secured on the property itself as falling within the provisions of paragraph 90 regardless of what guarantees might also exist. Likewise, any repayments made under such a guarantee will also be covered by the paragraph. However, any repayments made under a guarantee which is not secured on the UK property will not be covered.

penalty on a foreign domiciliary who wishes to move house. It also makes re-financing almost[195] impossible as the relief ceases to apply.

11.39.1 *Refinancing before 2008*

Para 90(4) Sch 7 FA 2008 provides:

> If—
>
> (a) before 12 March 2008, money was lent to the individual outside the UK ("the subsequent loan"),
>
> (b) the subsequent loan was made for the purpose of enabling the individual to repay—
>
> (i) the loan mentioned in sub-para (1), or
>
> (ii) another loan in relation to which sub-paras (2) and (3) apply (by virtue of this sub-paragraph),
>
> and for no other purpose, and
>
> (c) before 6 April 2008—
>
> (i) the individual used the money to repay the loan referred to in para (b)(i) or (ii), and
>
> (ii) repayment of the subsequent loan, or of payments made under a guarantee of that repayment, was secured on the interest,
>
> sub-paras (2) and (3) apply in relation to the subsequent loan (and for this purpose references there to the debt or the loan are to be read as references to the subsequent loan).

11.39.2 *What is the loan for?*

March 2009 Qs & As provides:

> **Q19:** It would be helpful to understand more fully the meaning of the requirement in paragraph 90(1)(b) that the loan was made for the purpose of acquiring an interest in residential property "and for no other purpose" and in particular to what extent any other purpose might cause the whole loan to fall outside paragraph 90.
>
> In a situation where money is lent before 12 March 2008 from a non-UK bank to an individual (resident but not domiciled in the UK) outside the UK under a facility letter for £5 million. £4.5 million of the facility is initially drawn down and the money used by the individual to purchase a residential property in the UK. Assume for these purposes that the loan was secured on a UK residential property.

195 It would be possible for the creditor to assign the benefit of the loan, which may allow some scope for refinancing.

Subsequently (and before 12 March 2008) a second tranche of £0.5 million was drawn down under the same loan facility, also outside the UK. The money from the second draw down was used to refurbish the residential property purchased by the first draw down.

A: The effect of paragraph 90(1) is to provide transitional provisions for loans made for the purpose of acquiring an interest in residential property in the UK. In this scenario, there are effectively two separate loans, even though they were made under a single facility letter: it is the drawdown of the money rather than the facility letter which constitutes the lending of the money. Therefore the first £4.5m drawn-down was money lent to the individual before 12 March and used to purchase a UK residential property and for no other purpose and was secured on that interest. That being the case, the transitional conditions will apply if, and to the extent which, relevant foreign income is used to pay interest on the debt.

However, because the second £0.5m tranche of money was used to refurbish the property rather than to acquire an interest in it, it is does not meet the conditions set out paragraph 90(1)(b). Therefore, any relevant foreign income which is used to pay interest on this part of the debt will be treated as a taxable remittance in the UK.[196]

What if a loan meets the conditions in part? It appears that HMRC accept there can be an apportionment. March 2009 Qs & As provides:

Q21: We would welcome guidance on the principles for calculating the interest on that part of the debt which can be paid from relevant foreign income of the individual outside the UK without triggering a taxable remittance (under paragraph 90(2)). We suggest a reasonable approach is to calculate the interest element based on the loan capital ratio (ie that

196 The RDR Manual provides:

RDRM31501 Remittance Basis: Introduction to the Remittance Basis: Transitional Provisions: Relevant foreign income and offshore loans [Jun 2010]

Example 1

Before 11 March 2008 Jennifer draws down £100,000 from a mortgage loan with a non-UK bank that is secured on a residential property in the UK, with interest payments made out of relevant foreign income. On 10 March 2008 she draws down a further amount of £21,000 from this mortgage (still secured on the UK property) to fund some home repairs.

Although the full £121,000 has been lent before 12 March 2008, only £100,000 relates to the acquisition on the interest in the property, so it is only the interest payments in relation to the £100,000 draw-down of the loan that are not treated as a remittance.

part of the loan which meets the paragraph 90 conditions over total capital of the loan facility), and apply that ratio to the total amount of interest due.

A: The approach you suggest is, in broad terms, one which HMRC would consider acceptable, with the obvious caveat that the actual approach in any specific case would depend entirely on the terms of the loans.

11.39.3 *When is the loan made?*

December 2008 Qs & As provides:

> **Q27 Remittance basis - offshore borrowing** If a mortgage was arranged and contracts for the purchase of the relevant property were exchanged in October 2007 but completion was not until March 31 2008 and the mortgage funds were not drawn down until completion, would this be considered to be an existing mortgage as at 12 March 2008?

HMRC refuse to answer the question:

> **A** The conditions for the grandfathering relief to run would only be met if the "lending" took place before 12 March 2008, providing the funds were received in the UK and used to acquire the interest in the property in question before 6 April 2008. The answer depends on the terms and conditions of the mortgage arrangement, which determine the point at which the funds are regarded as "lent".

The answer does not depend on the terms and conditions of the mortgage arrangement. It depends on when the money was lent which the question states was not until completion. Thus transitional loan relief is not available. This is of course extremely unfair: it may be because of the unfairness that HMRC chose not to answer the question. But the same question is asked later in the Qs & As, and receives a straight answer:

> **Q** A UK non-domiciled came to the UK in July 2007. He made an offer to purchase a residential property in the UK in November 2007. The deal became unconditional in February 2008 and entry was agreed for 16 March 2008. He has an offshore mortgage and the loan offer was made prior to 12 March but of course not drawn until 16 March. Does para 90 of Schedule 7 of FA 2008 apply?
>
> **A** The grandfathering provisions for offshore mortgages apply only where the loan was made before 12 March 2008. This means that the money had to be in the hands of the non-domiciled individual (or for

example in the Solicitor's client account) before that date.

11.39.4 *Joint accounts*

March 2009 Qs & As provides:

> **Q22:** We would welcome confirmation that the remittance protection in paragraph 90 applies where a husband and wife (or civil partners), both of whom are resident but not domiciled in the UK, have a joint non-UK bank account and a joint offshore mortgage. The offshore mortgage meets the conditions set out in paragraph 90 (1).
> If only one spouse (or civil partner) has relevant foreign income and that spouse makes a payment into a joint non-UK bank account using that relevant foreign income and these funds are then used to pay the interest on the offshore mortgage, then it is our understanding that such payment of interest will not constitute a remittance of any of the relevant foreign income by virtue of paragraph 90.
> **A:** We are not able to provide the confirmation you are seeking because whether there is a taxable remittance in this situation will depend on the composition of the joint account and the way in which the mixed fund rules section 809Q apply to it. Therefore we can again only answer in general terms.
> Provided the payment of relevant foreign income by one spouse or civil partner into the joint account is the only income within that account (in other words, section 809Q is not in point) which is then used to pay the interest on the mortgage which meets the conditions within paragraph 90(1), then that payment would also fall within paragraph 90.

11.39.5 *Meaning of residential property*

Para 90(5) Sch 7 FA 2008 provides:

> In this paragraph "residential property" has the same meaning as in Part 4 of FA 2003 (see section 116 of that Act).

So we turn to s.116 FA 2003 to find the complex definition:

> (1) In this Part "residential property" means—
>
> (a) a building that is used or suitable for use as a dwelling, or is in the process of being constructed or adapted for such use, and
>
> (b) land that is or forms part of the garden or grounds of a building within para (a) (including any building or structure on such land), or
>
> (c) an interest in or right over land that subsists for the benefit of a building within para (a) or of land within para (b);
>
> and "non-residential property" means any property that is not residential property.

This is subject to the rule in subsection (7) in the case of a transaction involving six or more dwellings.

(2) For the purposes of subsection (1) a building used for any of the following purposes is used as a dwelling—

(a) residential accommodation for school pupils;

(b) residential accommodation for students, other than accommodation falling with subsection (3)(b);

(c) residential accommodation for members of the armed forces;

(d) an institution that is the sole or main residence of at least 90% of its residents and does not fall within any of paras (a) to (f) of subsection (3).

(3) For the purposes of subsection (1) a building used for any of the following purposes is not used as a dwelling—

(a) a home or other institution providing residential accommodation for children;

(b) a hall of residence for students in further or higher education;

(c) a home or other institution providing residential accommodation with personal care for persons in need of personal care by reason of old age, disablement, past or present dependence on alcohol or drugs or past or present mental disorder;

(d) a hospital or hospice;

(e) a prison or similar establishment;

(f) a hotel or inn or similar establishment.

(4) Where a building is used for a purpose specified in subsection (3), no account shall be taken for the purposes of subsection (1)(a) of its suitability for any other use.

(5) Where a building that is not in use is suitable for use for at least one of the purposes specified in subsection (2) and at least one of those specified in subsection (3)—

(a) if there is one such use for which it is most suitable, or if the uses for which it is most suitable are all specified in the same sub-paragraph, no account shall be taken for the purposes of subsection (1)(a) of its suitability for any other use,

(b) otherwise, the building shall be treated for those purposes as suitable for use as a dwelling.

(6) In this section "building" includes part of a building.

(7) Where six or more separate dwellings are the subject of a single transaction involving the transfer of a major interest in, or the grant of a lease over, them, then, for the purposes of this Part as it applies in relation to that transaction, those dwellings are treated as not being residential property.

(8) The Treasury may by order—

(a) amend subsections (2) and (3) so as to change or clarify the cases where use of a building is, or is not to be, use of a building as a dwelling for the purposes of subsection (1);

(b) amend or repeal subsection (7) and the reference to that subsection in subsection (1).

Any such order may contain such incidental, supplementary, consequential or

transitional provision as appears to the Treasury to be necessary or expedient.

11.39.6 *Withdrawal of relief*

Para 90(3) Sch 7 FA 2008 provides:

> If, at any time on or after 12 March 2008—
>
> (a) any term upon which the loan was made, or any term of the guarantee, is varied or waived,
>
> (b) repayment of the debt, or of payments made under the guarantee, ceases to be secured on the interest,
>
> (c) repayment of any other debt is secured on the interest or is guaranteed by the guarantee, or
>
> (d) the interest ceases to be owned by the individual,
>
> sub-para (2) does not apply in relation to relevant foreign income used as mentioned there after that time.

I am unable to see the point of conditions (b) and (c).

FAQ Remittances (April 2008) stated that the relief only applies so long as "no further advances are made on or after 12 March". This is not correct, but if any further advances are made care must be taken with the documentation to ensure that there is a new loan (not a variation of an existing one) and the debt is not secured on the individual's interest in the property.

The RDR Manual provides:

> **RDRM31502 Transitional Provisions: RFI and offshore loans - Example 2** [Jun 2010] (Charles)
>
> C is a UK resident remittance basis user and has lived in the UK for several years. He has an existing mortgage that was taken out in 2005 with a non-UK bank that is secured on a house in the UK in which C, his wife and children all live. C pays interest on the loan out of his untaxed relevant foreign income.
>
> The existing mortgage facility includes an open credit facility that allows C to borrow (draw-down) additional funds. On 15 March 2008 C uses the credit facility to borrow a further amount of £100,000 that he intends to use to buy an additional interest in his residential property. The terms and conditions of the original loan facility apply to the further draw-down.
>
> The draw down of additional funds after 12 March 2008 represents a further advance of the mortgage under the original terms, so it is not regarded as 'another debt' secured on the property. It is a 'relevant debt' for the purposes of s809L.

> **RDRM31510 Transitional Provisions: Loans in existence before 12 March 2008 - Grandfathering no longer applicable** [Jun 2010]
> ...
> **Example 1** (Judith)
> J is a UK resident, non-domiciled remittance basis user who has an offshore mortgage from an overseas lender that was in place before 12 March 2008 on which she pays interest out of her relevant foreign income.
> Under the terms of her loan agreement interest on the loan is at a fixed rate for two years at the end of which J will automatically transfer to the lenders standard variable rate for the remaining ten year period of the loan agreement.
> The ending of the fixed-rate period and the automatic transfer to the variable rate is not regarded as amending or otherwise varying the loan facility, so the 'grandfathering' provision at FA08/para 90 applies to the loan.

In practice in the usual case the move to a floating rate will happen automatically, and the relief will continue to apply.

> **Example 2 (Jane)**
> J is a remittance basis user who has an offshore mortgage on her UK residential property from an overseas lender that was in place before 12 March 2008. She pays the interest on this loan using her relevant foreign income from her Jersey bank account.
> Under the terms of her loan agreement the loan is a two-year fixed interest loan. In May 2009, at the end of the two year period, J agrees a new loan with the same bank, for a further period of two years. The new loan has the same terms as her previous loan agreement.
> This is a new loan that is not covered by the grandfathering provisions at FA08/para 90. The new loan is a 'relevant debt'; any payments of interest (or capital) that are made from the Jersey account are a taxable remittance.

11.39.7 *Transitional loan relief: Commentary*

No reasons were ever given for the strikingly restricted features of transitional loan relief, so one is left to speculate. If the purpose of the relief is to assist those who have taken out loans on the assumption that the law which existed from 1956 to 2008 would govern the taxation of the interest, and who may now be unable to pay the interest, each of these restrictions are irrational. I surmise that the object was specifically to

bolster the residential property market by preventing forced sales by foreign domiciliaries who are made unable to repay their mortgages: if so only the restriction of relief to RFI is irrational.[197]

Why the restriction to residential property? The reason may be that loans to acquire let property had a benevolent treatment under the pre-2008 remittance basis: the interest could be paid out of foreign income without a remittance, but the interest was deductible against the rent for the purpose of computing the profits of the UK property business. Similar points apply to other cases where interest is deductible. But if that is the aim then it is achieved in a very rough and ready manner. Those who borrowed to buy a house and improve it are particularly unfairly treated.

Perhaps the matter was not thought out at all and the only thinking was to provide the smallest possible transitional relief consistent with appeasing the banking lobby. Perhaps it was to give the appearance of a transitional relief without much substantial relief. In the absence of any reasons being provided by HMRC, all the above can only be speculation.

11.40 Remittance basis planning points

11.40.1 *Planning to avoid mixed funds (segregation of funds)*

The best way to avoid any question of a remittance basis liability is to keep funds which are charged at different rates on remittance separate from each other.

The starting point is to segregate clean capital and other funds. Clean capital may consist of:

(1) Funds held before arrival in the UK.
(2) Gifts[198] and inheritance.
(3) Capital distributions from trusts (if not within the many IT and CGT anti-avoidance provisions which normally requires some care).
(4) UK source income and gains (and, for taxpayers who do not claim the remittance basis every year, foreign income and gains for a year in which no remittance basis claim is made).

If funds are large enough, may be worth segregating:

(1) Income taxable on remittance:

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197 It was probably based on the erroneous belief that under the pre-2008 rules, employment income or gains used to pay interest were regarded as remitted.

198 Unless the donor is a remittance basis taxpayer making a gift of income/gains to a relevant person.

(a) at the top rate
(b) at the top dividend rate
(c) at a lower rate (because of DTR).

(2) Chargeable gains taxable on remittance:
(a) at the full CGT rate
(b) at a lower CGT rate (because of DTR)

(3) Clean capital

Funds can then be remitted from accounts with a lower or nil rate of tax. Income taxable at the top rate can be used abroad or reinvested.

How does one segregate funds?

An easy course is to keep clean capital in a bank account and pay the income into a separate account. The bank account may be in any currency as currency bank account gains are not taxed.

What if the individual does wants to invest in a wider class of assets? Possible solutions are:

(1) Borrowing charged on a clean capital account.

(2) Life insurance policy[199] purchased out of clean capital. The individual may surrender up to 5% of the policy tax free, and that amount is derived from the clean capital, and can be remitted tax free. The growth in the policy reflects the underlying investments but the gains on those investments do not form a mixed fund. The ultimate surrender of the policy is taxable, but if it might be possible to arrange that a time when the policyholder is not UK resident (and not temporarily non-resident).

11.40.2 *Planning when mixed fund exists*

Suppose T already has a substantial mixed fund holding income and gains. Some planning is still possible. T should begin segregating income from the fund, allowing capital gains to accrue within the fund. Subsequent remittances are regarded as taken from those gains first before the income. If the gains are sufficient to exceed the remittances, this will reduce the rate of charge on remittance to CGT rates, as gains of subsequent years are treated as remitted before income of earlier years.

11.41 Reform?

HMRC have rejected calls for simplification and reform:

---

199 But not a personal portfolio bond.

> The Government will not look further at the following:
> *Simplification* Definition of a remittance and the derivation rules
> *Government response* The Government recognises that the definition of a taxable remittance is widely defined but believes any change to narrow the rules would open up opportunities for abuse and an unacceptable risk to the Exchequer.[200]

200 HMRC & HMT, "Reform of the taxation of non-domiciled individuals: summary of responses to consultation" (December 2011) para 2.127 *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

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TAXATION OF NON-RESIDENTS AND FOREIGN DOMICILIARIES 2014-15

VOLUME TWO

by

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THIRTEENTH EDITION

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CHAPTER TWELVE

REMITTANCE RELIEFS

12.1 Remittance reliefs: Introduction

This chapter considers 9 reliefs which allow sums to be received in the UK without a taxable remittance:

(1) Investment relief
(2) Reliefs for payment of tax:
    (a) remittance basis charge
    (b) payment on account
(3) Foreign services relief
(4) Exempt property:
    (a) public access
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    (c) small remittances exemption
    (d) temporary importation
    (e) the repair rule

12.2 Remittance investment relief

The ITA remittance basis in its original 2008 form (more or less) prevented remittance basis taxpayers from investing in the UK, either directly or indirectly through trusts and companies.

Sections 809VA – 809VO ITA, introduced by the coalition government in 2012, provide a relief. The statutory heading is "business investment relief"; I call it **"remittance investment relief"** or just "investment relief".

The development of the relief can be traced through a consultation paper[1]

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1 HMRC, *Reform of the taxation of non-domiciled individuals: a consultation* (June 2011) *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81510/consult_condoc_non_domicile_individuals.pdf*

and a consultation response paper[2] (**"the consultation response document"**). But these are now of mainly historic interest.

HMRC comment on EU law:

> 2.90 The Government is satisfied that the draft legislation to be published in Finance Bill 2012 is compatible with EU law and the State Aid rules.[3]

The relief is not discussed in the RDR Manual, but there is some basic guidance.[4]

12.3 Relevant event

Section 809VA(1) ITA sets out three conditions for relief. The first is in para (a):

> (1) Subsection (2) [remittance investment relief] applies if–
> (a) a relevant event occurs,

The term "relevant event" is not a particularly helpful label but it is convenient to follow the statutory usage.

There are two types of relevant event.

12.3.1 *Relevant event: Investment*

Section 809VA(3) ITA provides:

> A "relevant event" occurs if money or other property–
> (a) is used by a relevant person to make a qualifying investment[5]

12.3.2 *Relevant event: Remittance for purpose of investment*

Section 809VA(3) ITA provides:

> A "relevant event" occurs if money or other property...
> (b) is brought to or received in the UK in order to be used by a

---

2 HMRC, *Reform of the taxation of non-domiciled individuals: summary of responses to consultation* (December 2011). *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

3 Consultation Response Document *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

4 HMRC Guidance Note: Changes to the Remittance Basis (May 2012) *www.hmrc.gov.uk/cnr/guide-remit.pdf*

5 See 12.9 ("Qualifying investments").

relevant person to make a qualifying investment.

Section 809VA ITA imposes a time limit on the period between bringing the money to the UK and making the investment:

> (5) Subsection (2) [remittance investment relief] applies by virtue of subsection (3)(b) to the extent only that the investment is made within the period of 45 days beginning with the day on which the money or other property is brought to or received in the UK.
> (6) Where some but not all of the money or other property is used to make the investment within that 45-day period, the part of the income or gains to which subsection (2) applies is to be determined on a just and reasonable basis.

12.4 Remittance of income/gains by virtue of relevant event

Section 809VA(1) ITA sets out three conditions for relief. The second is in para (b) but this must be read with para (a) to follow the sense:

> (1) Subsection (2) [remittance investment relief] applies if–
> (a) a relevant event occurs,
> (b) but for subsection (2), income or chargeable gains of an individual would be regarded as remitted to the UK by virtue of that event...

12.4.1 *"Income or chargeable gains of an individual"*

HMRC say:

> 2.86 The Government confirms that relief will apply to a qualifying investment using overseas income and gains that arose in any year in which the non-domiciled individual claimed the remittance basis, regardless of their basis of taxation in the year the qualifying investment is made.[6]

The relief applies to income treated as arising to an individual under s.624, or s.720, or gains treated as accruing under s.13, even though the income or gains actually arise to a non-resident trust or company and are invested (and so remitted) by the trust or the company. This was deliberate. HMRC say:

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6 Consultation Response Document *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

> 2.34 It is common for non-domiciles to hold money in offshore trusts but the tax treatment of remittances currently deters some offshore trusts and companies from investing in the UK. For this reason, it is not proposed to limit the new tax incentive to investments made directly by the individual. There will be no restriction on individuals remitting overseas income or capital gains which are held in investment vehicles or trusts. This will allow non-domiciles to invest in UK businesses using funds held in offshore companies and trusts without attracting a tax charge on the remittance.[7]

Suppose:

(1) an individual receives a benefit chargeable under the s.87 remittance basis or the s.731 remittance basis and

(2) the individual uses the benefit to make a qualifying investment.

Investment relief applies, as the income or gains invested are the income or gains of the individual.

Similarly, investment relief applies if:

(1) an individual receives a benefit chargeable under the s.731 remittance basis and

(2) the person abroad uses matched relevant income to make a qualifying investment.

It is not a requirement that the income used to make the investment is the income of the individual: just that income of the individual would be regarded as remitted by virtue of the relevant event.

However in these cases, consideration must be given as to whether the benefit is a related benefit.

Section 809VA(4) ITA deals with the interaction with exempt property:

> Subsection (1)(b) includes a case where income or gains would be treated under section 809Y as remitted to the UK by virtue of the relevant event.

Could that ever happen?

12.4.2 *Regarded as remitted to the UK "by virtue of" the relevant event*

The requirements for relief in s.809VA(2) are:

(1) a relevant event

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7 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

(2) income/gains remitted to the UK and
(3) the remittance is "by virtue of" the relevant event.
Suppose:
(1) T lends to a company or subscribes for shares in a company.
(2) The company uses the funds to purchase a property in the UK.
Step (1) is a relevant event. If it is also a remittance to the UK, the position is straightforward: the relief applies.

Suppose step (1) is not a remittance to the UK (in short, because the company receives the funds outside the UK). There is a taxable remittance at step (2) when the company brings the funds to the UK.[8] However the company does not make a qualifying investment so step (2) is not a relevant event. But it is considered that the remittance is "by virtue of" the relevant event at step (1), so the relief applies. HMRC agree. HMRC remittance investment relief guidance provides:

> 2.28 ... It is possible for a qualifying investment to be made in a close company which is itself a relevant person. In such cases, where the company subsequently uses the invested funds in the UK, such as to purchase stock or to pay employees, the foreign income and gains will not be treated as a taxable remittance, provided they are not used in a way which would itself be a potentially chargeable event.

Suppose:
(1) T borrows to make a qualifying investment. This is a relevant event but no income/gains are remitted to the UK.
(2) T uses income/gains to repay the loan. This is a remittance of the income/gains.

HMRC accept that the relief applies. The CIOT say:

> HMRC have confirmed that using foreign income and/or gains to repay loans where those loans, in turn, funded investments made after 6 April 2012, would in principle qualify for the business investment relief.
> Concerns had been expressed on this point because s809VA(1)(b) gives relief only where (in the absence of the relief) income or chargeable gains would be regarded as remitted by virtue of the investment. Where borrowed monies are used to make the investment, it is not the investment which (in the absence of the relief) triggers the remittance; rather it is the subsequent repayment of that borrowing which triggers the remittance.

8 Assume the company is a relevant person (as a close company would be).

> However, HMRC have confirmed that they take a wide view of the meaning of 'by virtue of' in this context and there is nothing in s809VA which requires that the remittance which would otherwise have occurred should take place in the same year as the relevant event to which it relates. It therefore follows that the remittance and claim can be in a year or years after the relevant event.
> For non-doms wishing to invest in this way, there is therefore scope – through borrowing – to fund that investment through future offshore income/gains.
> Claims should be made in the year(s) that the loan is repaid rather than the year the investment is made and careful records will obviously need to be kept for these purposes.[9]

It would have been better if the statutory expression was "in connection with" the relevant event, not "by virtue of" the relevant event. But a generous construction, together with the flexibility inherent in a causation test, has brought us to the same destination.

12.5 Claims

The third condition for the relief is in s.809VA(1)(c) ITA which provides:

> Subsection (2) [remittance investment relief] applies if ...
> (c) the individual makes a claim for relief under this section.

Section 809VA(8) ITA provides:

> A claim for relief under this section must be made on or before the first anniversary of the 31 January following the tax year in which the income or gains would, but for subsection (2) [remittance investment relief], be regarded as remitted to the UK by virtue of the relevant event.

The claim is made in the tax return. The sidenote to box 37 SA109 (2013/14) reads:

> If you are claiming relief from UK tax for foreign income or gains invested in a qualifying business, enter the total amount invested and the Company Registration Number(s) below

12.6 The relief

Assuming the three conditions in s.809VA(1) are satisfied, we can turn to

---

9 Press release 15 August 2012 [2012] STI 2563 accessible *www.tax.org.uk/media_centre/LatestNews-migrated/BIR_Non-dom-loans*

the relief, which is in s.809VA(2) ITA; but to follow that one needs to read subsections (1) and (2) together:

> (1) Subsection (2) [remittance investment relief] applies if–
> (a) a relevant event occurs,
> (b) but for subsection (2), income or chargeable gains of an individual would be regarded as remitted to the UK by virtue of that event, and
> (c) the individual makes a claim for relief under this section.
> (2) The income or gains are to be treated as not remitted to the UK.

12.7 Avoidance purpose

Section 809VA(7) ITA provides:

> Subsection (2) [remittance investment relief] does not apply if the relevant event occurs, or the investment is made, as part of or as a result of a scheme or arrangement the main purpose or one of the main purposes of which is the avoidance of tax.

Section 989 ITA provides:

> The following definitions apply for the purposes of the Income Tax Acts
> ...
> "tax", if neither income tax nor corporation tax is specified, means either of those taxes.

So it does not matter if one of the purposes of the arrangement is IHT avoidance or CGT avoidance: only IT (or CT) avoidance counts.

The concepts of avoidance and purpose are the same as in the ToA motive defence; see 32.1 (Motive defence).

The HMRC consultation paper provided:

> 2.53 ... there will be provisions to prevent non-domiciles buying a pre-existing business from themselves by selling it to a new company funded by income remitted from overseas. This would create no new business investment in the UK and would merely transfer legal ownership whilst the individual continues to own the business.[10]

10 HMRC, *Reform of the taxation of non-domiciled individuals: a consultation* (June 2011) *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81510/consult_condoc_non_domicile_individuals.pdf*

There are no express provisions to this effect, but the arrangement may constitute avoidance and so the relief would be disallowed.

The CIOT lobbied for repeal of this rule:

> That test is a potential deterrent as nobody can say with certainty what kind of transaction a particular officer of HMRC, or an individual judge, will view as avoidance. ...We would urge removal of section 809VA(7), particularly now that the GAAR has been enacted.[11]

But no-one took any notice of that.

12.8 Investment fails to proceed

A person may bring funds to the UK intending to make an investment which fails to proceed. Then there is no relief under s.809VA(2) as there is no relevant event, but s.809VB provides relief:

> (1) This section applies to any portion of the income or gains to which section 809VA(2) [remittance investment relief] does not apply because the investment was not made within the period mentioned in section 809VA(5) ("the 45-day period").
> (2) That portion is to be treated as not remitted to the UK to the extent that the remaining money or other property is taken offshore within the 45-day period.
> (3) Where some but not all of the remaining money or other property is taken offshore within the 45-day period, the part of the income or gains to which subsection (2) applies is to be determined on a just and reasonable basis.
> (4) If any remaining money or other property is taken offshore within the 45-day period, nothing in subsection (2) prevents anything subsequently done in relation to it (or anything deriving from it) from counting as a remittance of the underlying income or gains to the UK at the time when the thing is subsequently done.
> (5) A reference to the "remaining" money or other property is to so much of the money or other property brought to or received in the UK as is not used within the 45-day period to make the investment (which may in some cases be all of it).

---

11 Business Investment Relief: CIOT comments (September 2013) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2013/09/130918%20Business%20Investment%20Relief%20-%20CIOT%20comments.pdf*

12.9 "Qualifying investments"

This is a key term used throughout the remittance investment relief provisions; in particular, a relevant event requires a qualifying investment. Section 809Z10 ITA provides:

> In this Chapter ... "qualifying investment" has the meaning given by section 809VC (and references to making a qualifying investment are to be read in accordance with that section)

So we turn to s.809VC.

12.9.1 *"Investment"*

"Investment" has an artificial meaning. Section 809VC(1) ITA provides:

> (1) For the purposes of section 809VA, a person makes an investment if–
> (a) shares[12] in a company are issued to the person, or
> (b) the person makes a loan (secured or unsecured) to a company.

This definition only applies for the purposes of s.809VA but it is incorporated by reference in s.809VD(4) ITA.

The purchase of shares from a third party does not amount to an investment: there must be a share subscription.

At present, only corporate investments count as "investment". HMRC say:

> 2.43 The Government is not yet convinced of the case for including partnerships within the relief. It remains concerned that extending the relief in this way could lead to large scale avoidance unless complex anti-avoidance legislation was introduced. The legislation which will take effect from 6 April 2012 will not allow investment in partnerships.
> 2.44 However, in view of the strength of support for extending the relief to investments in partnerships and the increased investment that this might encourage, the Government will consider this issue further to evaluate whether there is any scope for widening the relief to include investment in partnerships in Finance Bill 2013. The Government will not consider extending the relief to sole traders.[13]

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12 Section 809VC(6) ITA provides: "A reference in this section to "shares" includes any securities."

13 Consultation Response Document *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

But the idea of extending relief to partnerships seems to have been dropped.

Section 809VC ITA provides some terminology:

> (2) The company is referred to as "the target company".
> (3) The shares or the person's rights under the loan (or both) forming the subject of the investment are referred to as "the holding"...

Section 809VC ITA deals with timing:

> (7) If a loan agreement authorises a company to draw down amounts of a loan over a period of time—
>
> (a) entry into the agreement does not count for the purposes of this section as the making of a loan, but
>
> (b) a separate loan is to be treated as made each time an amount is drawn down under the agreement.
>
> (8) Accordingly—
>
> (a) a separate investment is treated as made each time an amount is drawn down under the agreement, and
>
> (b) the reference in subsection (3) to the person's rights under the loan applies only to so much of the person's rights as relate to the drawdown of that particular amount.

12.9.2 *"Qualifying" investment*

Section 809VC(4) ITA provides:

> The investment counts as a "qualifying investment" if conditions A and B are met when the investment is made.

I refer below to **"investment conditions A and B"**.

12.10 Investment condition A (trading company/group)

Section 809VD(1) ITA provides:

> Condition A is that the target company is–
>
> (a) an eligible trading company,
>
> (b) an eligible stakeholder company, or
>
> (c) an eligible holding company.

12.10.1 *Eligible trading company*

Section 809VD(2) ITA provides:

> A company is an "eligible trading company" if–
>
> (a) it is a private limited company,

(b) it carries on one or more commercial trades or is preparing to do so within the next 2 years, and
(c) carrying on commercial trades is all or substantially all of what it does (or of what it is reasonably expected to do once it begins trading).

HMRC comment on condition (c):

> 2.21 The Government will require all, or substantially all, of the company's activities to be qualifying activities. Investments will therefore be eligible for the relief provided any non-qualifying activities do not form a substantial part of the company's total business activities. For these purposes this will mean that the non-qualifying activities constitute no more than 20% of the company's business activities. For companies that have yet to start trading at the time the investment is made, the relief will be available where it is reasonable to expect that non-qualifying activities will not be substantial. For most companies, determining whether non-qualifying activity breaches this condition will be based on the company's turnover but this may not be applicable in all cases.[14]

12.10.2 *Eligible stakeholder company*

Section 809VD(3) ITA provides:

> A company is an "eligible stakeholder company" if–
> (a) it is a private limited company,
> (b) it exists wholly for the purpose of making investments[15] in eligible trading companies (ignoring any minor or incidental purposes), and
> (c) it holds one or more such investments or is preparing to do so within the next 2 years.

12.10.3 *Eligible holding company*

Section 809VD ITA provides:

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14 Consultation Response Document. *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*
The paragraph added: "HMRC will provide guidance on how total business activity should be measured." But no guidance was produced.

15 Section 809VD(4) ITA provides: "The reference in subsection (3) to making investments is to be read in accordance with section 809VC." See 12.9.1 ("Investment").

(5) A company is an "eligible holding company" if—
(a) it is a member of an eligible trading group or of an eligible group that is reasonably expected to become an eligible trading group within the next 2 years,
(b) an eligible trading company in the group is a 51% subsidiary of it, and
(c) if the ordinary share capital that it owns in the eligible trading company is owned indirectly, each intermediary in the series is also a member of the group.
(6) "Group" means a parent company and its 51% subsidiaries.
(7) "Parent company" means a company that—
(a) has one or more 51% subsidiaries, but
(b) is not itself a 51% subsidiary of any company.
(8) A group is an "eligible group" if the parent company and each of its 51% subsidiaries are private limited companies.
(9) A group is an "eligible trading group" if—
(a) it is an eligible group, and
(b) carrying on commercial trades is all or substantially all of what the group does (taking the activities of its members as a whole).
(10) The reference in subsection (5) to owning ordinary share capital indirectly is to be read in accordance with section 1155 of CTA 2010.

A group may consist of resident and non-resident companies.[16]

12.10.4 *Private limited company*

Section 809VD(11) ITA provides:

A company is a "private limited company" if–
(a) it is a body corporate whose liability is limited,
(b) it is not a limited liability partnership, and
(c) none of its shares are listed on a recognised stock exchange.

The company need not be UK resident. This is deliberate. HMRC say:

2.38 The Government wants to ensure that non-domiciles can invest in a range of companies, including those incorporated in other countries, and believes this will broaden the positive economic impact of this incentive. Therefore, it does not propose to restrict tax relief to investment in businesses that are resident in the UK or to businesses carrying out trades wholly or mainly in the UK. Relief will be extended

16 Groups for CGT group relief are different: see 53.28 (Group relief).

> to overseas income and capital gains remitted to invest in non-UK resident companies....
> 2.41 The Government does not propose to introduce any other restrictions on the type of holding company that can qualify or the degree of ownership the company has over its subsidiary companies. This means that companies that hold shares in other companies and are resident outside the UK would be included. It also means that private equity companies and venture capital companies could qualify even where they do not have a majority ownership stake in the invested companies....
> 2.52 The Government agrees that restricting investment to non-UK resident companies with a UK PE is not necessary and has decided not to include this restriction.[17]

The company may be a foreign entity. This was deliberate. HMRC say:

> 2.45 Investment in a foreign entity will be eligible for relief where it is a private limited company and the other conditions on qualifying activities are met.

12.10.5 *"Trade"*

Section 809VE ITA provides an extended definition of trade, to allow property investment:

> (1) Section 809VD is to be read in accordance with this section.
> (2) A reference to a "trade" also includes—
> (a) anything that is treated for corporation tax purposes as if it were a trade, and
> (b) a business carried on for generating income from land (as defined in section 207 of CTA 2009).

HMRC said:

> 2.33 Businesses undertaking furnished holiday lettings (FHLs) will not be qualifying businesses for the purposes of the relief. Although FHLs are treated as a trade for certain purposes, they are not taxed as such and will therefore not meet the qualifying conditions.[18]

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17 Consultation Response Document *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

18 Consultation Response Document *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

This is not carried through in the legislation since FHL is a property business. Presumably there was a change of mind.

The residence consultation paper explains:

> **UK businesses**
> 2.38 ... Relief will be extended to overseas income and capital gains remitted to invest in non-UK resident companies ....
> 2.39 While this approach would allow investments to be used for trades outside the UK, non-domiciled investors can already invest in such trades without remitting income or capital gains into the UK. It is therefore likely that in the vast majority of cases, non-domiciles will use do without incurring a tax charge....[19]

12.10.6 *"Commercial" trade*

Section 809VE(3) ITA provides:

> A trade is a "commercial trade" if it is conducted on a commercial basis and with a view to the realisation of profits.

Since this only applies for the purposes of s.809VD, the definition has to be incorporated by reference in Section 809VH ITA.

This is a requirement which comes up in loss relief and in many other areas of taxation. The BI Manual comments on s.66 ITA which imposes a similar requirement in the context of loss relief:

> **BIM85705 – Trade losses – restriction of relief: uncommercial trades – not on a commercial basis** [December 2013]
> The object of S66 ITA 2007 is to deny relief for losses arising from activities which can be seen clearly to lack commercial inspiration. The Chancellor of the Exchequer, at the time the original legislation was enacted, stated in the course of a Parliamentary debate:
>
> > 'We are after the extreme cases in which expenditure very greatly exceeds income or any possible income which can ever be made in which, however long the period, no degree of profitability can ever be reached.'
>
> The restriction applies to trades, professions and vocations but does not apply to losses made in the exercise of functions conferred by or under an Act.

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19 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

The test in S66(2) ITA 2007, whether the trade is commercial, is two legged: the trade must be carried on throughout the basis period for the tax year:

a. on a commercial basis, and
b. with a view to the realisation of profit.

So before considering the test in S66(2) ITA 2007, you must be satisfied that a trade is carried on. Statute provides little guidance on what amounts to a trade. The overall conclusion from case law is that this is a question of fact. You should always examine critically claims that a trade exists where the claim may have been made to get relief that is only available to businesses. Guidance on trades is at BIM20070-BIM20075.

Commercial basis

The first part of the test, that of carrying on the trade on a commercial basis, was considered satisfied in the past if the activities that were carried on amounted to a trade. The basis for this was judicial comments like that of the Lord President in The British Legion, Peterhead Branch, Remembrance and Welcome Home Fund v CIR (35 TC 509):

In my view, a person cannot be said to be engaged in carrying on a trade or a concern in the nature of trade within the meaning of the Income Tax Acts unless, in a reasonable sense, he is conducting business on commercial principles.' (514)

But following the High Court decision in Wannell v Rothwell [1996] 68 TC 719 we now accept that in very unusual cases the activities may constitute a trade even though they are uncommercial.

The meaning of commercial basis was expanded by Robert Walker J in Wannell v Rothwell where he states at page 733B-D:

> `I was not shown any authority in which the Court has considered the expression "on a commercial basis", but it was suggested that the best guide is to view "commercial" as the antithesis of"uncommercial", and I do find that a useful approach. A trade may be conducted in an uncommercial way either because the terms of the trade are uncommercial (for instance, the hobby market-gardening enterprise where the prices of fruit and vegetables do not realistically reflect the overheads and variable cost of the enterprise) or because the way in which the trade is conducted is uncommercial in other respects (for instance, the hobby Art Gallery or Antique Shop where the opening hours are unpredictable and depend simply on the owner's convenience). The distinction is between a serious trader who, whatever his shortcomings in skill, experience or capital, is seriously interested in profit, and the amateur or dilettante. There may well be many borderline cases for

the Commissioners to decide, and such borderline cases could as well occur in Bond Street as at a car boot sale.'

'Commercial' is not the same as'profitable'. We take it to mean, conducted in the way that we would expect a business of the same type to be carried on. A distinction may also be drawn between individual transactions and the trade itself; individual transactions may have the character of commerciality but overall the way in which the trade is conducted may lack commerciality. Indeed, even where the trader is serious about what he does but does not act in the way someone in that type of trade would act, we take the view that the trade is not being conducted on a commercial basis. See BIM85715 where the way in which the trade is carried on changes during the basis period for the tax year. Fact-finding is vital in exploring whether the trade is carried on on a commercial basis. One important question to be addressed is whether there are any non-commercial reasons for becoming involved in a particular business, for example, has the trader a general interest in sailing which might explain the venture into yacht chartering…

View to the realisation of profits

Consideration of other, non-commercial, reasons is also important when examining the second leg to the test in S66(2) ITA 2007. See BIM85710 for guidance on the second leg to this test.

BIM75710 - Computing the amount to assess: trade losses - restriction of relief: trade losses - uncommercial trades - not with a view to the realisation of profit [December 2013]

The second leg of the test in ITA07/S66(2), with a view to the realisation of profits, is expanded in S66(3): if at any time a trade is carried on so as to afford a reasonable expectation of profit, it is carried on at that time with a view to the realisation of profits.

'With a view to' was considered, in the EBT case *Macdonald (HMIT) v Dextra Accessories Limited & others* TCL 3759, to embrace a range of realistic possibilities, indicating that the view must be a reasonable one.

The criterion of the expectation of profit does not specify any period within which the trade must be expected to realise a profit and it is sufficient there is some realistic possibility of profit being earned at some future date, however distant. The fact that it is distant is not a ground for refusing relief. 'Profit' in this context is the commercial profit in the accounts, not the tax adjusted profit; that is, the profit before capital allowances but after depreciation and interest.

There are 2 possible ways to displace the trader's assertion of expectation of profits: if it is not a reasonable expectation, or there is another reason for carrying on the trade.

It is not a reasonable expectation

You may be able to show that there is no possibility of profit ever regardless of however long the trade is carried on, so the expectation of profit is unfounded, by closely examining any business plan, profits projection or whatever is provided as the basis for the trader's expectations of profit. You are justified in pointing to past results when considering whether the trader's expectation of profit is reasonable. Where there has been a change in the way the trade is carried on, see BIM85715.

There is another reason for carrying on the trade

A trader who makes losses with no realistic possibility of making a profit may have some other reason for carrying on the trade. For example, it may be that the trade is a hobby (which in itself may fall foul of the commercial basis part of the test see BIM85705) or gives the trader personal enjoyment. It may also be the case that the trader is simply seeking to offset personal expenditure or to increase the value of a capital asset.

In the Special Commissioners' case of *Delian Enterprises v Ellis* [1999] SpC186 the Revenue was unable to prove that the trader was carrying on a hobby. This was specifically mentioned by the Special Commissioner as a factor in his decision. In another Special Commissioners' case *Brown v Richardson* [1997] SpC129 and TB31F the expressed intentions of the trader were not found to be conclusive. In this case the Special Commissioner found that the income generated was intended to offset expenditure rather than with a view to the realisation of profits.

12.10.7 *Research and development*

Section 809VE ITA provides:

> (4) The carrying on of activities of research and development from which it is intended that a commercial trade will be derived, or will benefit, is to be treated as the carrying on of a commercial trade.
>
> (5) But preparing to carry on activities within subsection (4) is not to be treated as the carrying on of a commercial trade.

12.11 Investment condition B (no benefit)

Section 809VF(1) ITA provides:

> Condition B is that
>
> [a] no relevant person has (directly or indirectly) obtained or become entitled to obtain any related benefit, and
>
> [b] no relevant person expects to obtain any such benefit.

Remittance investment relief has two no-benefit rules:

(1) Investment condition B applies if there is a benefit or expected benefit at the time of the investment.

(2) The extraction of value rule applies if there is a benefit later.[20]

Investment condition B is severe in that any benefit disallows relief on the entire investment.

The no-benefit rule applies even if the benefit is received outside the UK, which is illogical in the context of the remittance basis.

12.11.1 *Benefit*

"Benefit" is not usually defined, but that did not deter the drafter. Section 809VF(2)(a) ITA provides:

> A "benefit"–
>
> (a) includes the provision of anything that would not be provided to the relevant person in the ordinary course of business, or would be provided but on less favourable terms, ...

Section 809VF(2)(b) ITA provides an exclusion

> A "benefit" ...
>
> (b) does not include the provision of anything provided to the relevant person in the ordinary course of business and on arm's length terms.

This is otiose but does no harm.

12.11.2 *"Provision"*

"Provision" is never defined, but that did not deter the drafter. Section 809VF(4) ITA provides:

> For the purposes of subsection (2)–
>
> (a) a reference to the provision of anything is to the provision of anything in money or money's worth, including property, capital, goods or services of any kind, and
>
> (b) "provision" includes any arrangement that allows a person to enjoy or benefit from the thing in question (whether temporarily or permanently).

This is otiose though it does no harm. But one hopes this will not enter

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20 See 12.14 (Extraction of value rule).

the handbook of the office of parliamentary counsel, and so become standard practice, like the standard (but unnecessary) definition of arrangement.

12.11.3 *"Related" benefit*

Section 809VF(3) ITA provides a wide meaning of "related":

> A benefit is "related" if–
>
> (a) it is directly or indirectly attributable to the making of the investment (whether it is obtained before or after the investment is made), or
>
> (b) it is reasonable to assume that the benefit would not be available in the absence of the investment.

12.12 Clawback remittance charge

Section 809VG ITA provides:

> (1) Subsection (2) applies if–
>
> (a) income or chargeable gains are treated under section 809VA(2) as not remitted to the UK as a result of a qualifying investment,
>
> (b) a potentially chargeable event occurs after the investment is made, and
>
> (c) the appropriate mitigation steps are not taken within the grace period allowed for each step.[21]
>
> (2) The affected income or gains are to be treated as having been remitted to the UK immediately after the end of the relevant grace period.

I refer to this as **"the clawback remittance charge"**.

12.12.1 *"Relevant grace period"*

The "grace period" is the deadline for taking the appropriate mitigation steps. As there are various possible grace periods, statute uses the term "relevant grace period" to fix the date on which the clawback remittance charge arises.

Section 809VG ITA provides:

> (3) Where the step required by section 809VI(2)(a) is not taken within the grace period allowed for that step, "the relevant grace period" is the

21 See 12.18 (The grace period).

grace period allowed for that step.
(4) Otherwise, "the relevant grace period" is the grace period allowed for the step required by section 809VI(1) or (2)(b).

12.12.2 *"Affected income or gains"*

"Affected income or gains" matters as these are the income/gains which are treated as remitted under the clawback remittance charge.

Section 809VG ITA provides:

> (5) "The affected income or gains" means such portion of the income or gains mentioned in subsection (1)(a) as reflects the portion of the investment affected by the potentially chargeable event.
> (6) The portion of the investment affected is—
> (a) if the potentially chargeable event is a disposal of a part of the holding (or a part of the remaining holding), a portion equal to the portion of the holding (or remaining holding) being disposed of, and
> (b) otherwise, the whole of the investment.

12.12.3 *Investment partly out of UK funds and partly out of offshore funds*

Section 809VG ITA provides:

> (8) If a qualifying investment is made using the money or other property mentioned in section 809VA(3) together with other funds ...

What is the property "mentioned in s.809VA(3)"? That provides:

> (3) A "relevant event" occurs if money or other property—
> (a) is used by a relevant person to make a qualifying investment, or
> (b) is brought to or received in the UK in order to be used by a relevant person to make a qualifying investment.

I assume s.809VG(8) applies if an investment is made partly out of UK funds and partly out of offshore funds, though that is not what the words actually say.

Assuming the opening words of s.809VG(8) are satisfied, two rules follow:

> (a) that investment is to be treated as two separate investments,
> [i] one made using the money or other property mentioned in section 809VA(3) and
> [ii] one made using the other funds, and

(b) references in the business investment provisions[22] to "the investment" and "the holding" relate only to the investment made using the money or other property mentioned in section 809VA(3).

12.12.4 *Series of potentially chargeable events*

Section 809VG ITA provides:

(9) If the potentially chargeable event mentioned in subsection (1)(b) is not the first such event to affect the investment, the income or gains mentioned in subsection (1)(a) do not include, as respects that investment—

(a) any part already treated under subsection (2) as remitted to the UK as a result of an earlier event,

(b) any part contained in amounts already taken offshore or reinvested by way of appropriate mitigation steps following an earlier event, or

(c) any part contained in amounts already used to make a tax deposit without which an amount mentioned in paragraph (b) would not have been enough to satisfy section 809VI(1) or (2)(b) (see section 809VK).

12.13 Potentially chargeable event

There are four types of potentially chargeable event:
(1) Ceasing to be an eligible company
(2) Disposal of holding
(3) Extraction of value
(4) 2-year start-up rule
I consider items (1)(2)(4) in this section, and item (3), which is the most difficult, in the following section.

12.13.1 *Ceasing to be an eligible company*

Section 809VH ITA provides:

(1) For the purposes of section 809VG, a "potentially chargeable event" occurs if—

(a) the target company is for the first time neither an eligible trading company nor an eligible stakeholder company nor an eligible

22 Defined s.809Z10 ITA: "In this Chapter "the business investment provisions" means sections 809VA to 809VO".

holding company...

An example would be if the company stops trading or becomes quoted.

12.13.2 *Disposal of holding*

Section 809VH ITA provides:

> (1) For the purposes of section 809VG, a "potentially chargeable event" occurs if ...
>
> (b) the relevant person who made the investment ("P") disposes of all or part of the holding,

"Dispose" is not defined and so has its natural meaning, not the CGT meaning.

A person does not dispose of assets on death[23] so death is not a potentially chargeable event.

HMRC remittance investment relief guidance provides:

> **Share for share exchanges**
> 2.61 During corporate restructuring, old shares can be disposed of and new shares in the same company, or another company, issued in their place. The disposal of the old shares is a potentially chargeable event. However, provided both the old and new shares are qualifying investments, the exchange will be treated as an immediate reinvestment in another target company and no potentially chargeable event will occur. The new shares are derived from the original foreign income and gains in the same way as the original shares. (s809VI(7) and VL(3))

If consideration for a disposal is paid by installments, it may be difficult to re-invest (the mitigation step which would avoid a clawback charge). Section 809VH(8) ITA deals with this:

> If consideration for a disposal of all or part of the holding is to be paid in instalments, the disposal is to be treated for the purposes of this section as if it were separate disposals, one for each instalment (and each giving rise to a separate potentially chargeable event).

12.13.3 *2-year start-up rule*

Section 809VH ITA provides:

> (1) For the purposes of section 809VE, a "potentially chargeable event"

23 Contrast 35.5 (Death of individual).

occurs if ...

(d) the 2-year start-up rule is breached.

Section 809VH ITA provides:

(5) The 2-year start-up rule is breached if—

(a) immediately after the end of the period of 2 years beginning with the day on which the investment was made, the target company is non-operational, or

(b) at any time after the end of that period, the target company becomes non-operational.

(6) The target company is "non-operational" at any time when—

(a) it is an eligible trading company but is not trading,

(b) it is an eligible stakeholder company but—

(i) it holds no investments in eligible trading companies, or

(ii) none of the eligible trading companies in which it holds investments is trading, or

(c) it is an eligible holding company but—

(i) the group of which it is a member is not an eligible trading group, or

(ii) none of its 51% subsidiaries in the eligible trading group of which it is a member is an eligible trading company that is trading.

(7) In subsection (6), "trading" means carrying on one or more commercial trades (including the carrying on of any activities treated under section 809VE(4) as the carrying on of a commercial trade).

12.13.4 *Insolvency relief*

Section 809VH ITA provides:

(9) An event listed in subsection (1) does not count as a potentially chargeable event if it is due to an insolvency step taken for genuine commercial reasons (but this does not prevent the extraction of any value in connection with the insolvency step from counting as a potentially chargeable event).

(10) For the purposes of subsection (9), an insolvency step is taken if—

(a) the target company enters into administration or receivership or is wound up or dissolved,

(b) the target company is an eligible stakeholder company and any eligible trading company in which it holds an investment enters into administration or receivership or is wound up or dissolved,

(c) the target company is an eligible holding company and any eligible trading company in the group that is a 51% subsidiary

of it enters into administration or receivership or is wound up or dissolved, or

(d) a similar step is taken in relation to a company mentioned in paragraph (a), (b) or (c) under the law of a country or territory outside the UK.

12.14 Extraction of value rule

Section 809VH ITA provides:

> (1) For the purposes of section 809VG, a "potentially chargeable event" occurs if ...
>
> (c) the extraction of value rule is breached,

Section 809VH(2) ITA provides:

> The extraction of value rule is breached if–
>
> (a) value (in money or money's worth) is received by or for the benefit of P or another relevant person,
>
> (b) the value is received–
>
> (i) from an involved company, or
>
> (ii) from anyone else but in circumstances that are directly or indirectly attributable to the investment or to any other investment made by a relevant person in an involved company, and
>
> (c) the value is received other than by virtue of a disposal that is itself a potentially chargeable event.

The normal way to draft para (a) would be to say that the extraction of value rule is breached if P (or a relevant person) receives a *benefit*. I am unable to see any difference between "benefit" and the novel expression used, *value (in money or money's worth)* though I would have thought that the words "in money or money's worth" were pretty clearly unnecessary.

The normal way to draft para (b)(ii) would be to say that the extraction of value rule is breached if the benefit is received directly or indirectly by reason of, or as a result of, or in consequence of, the investment. I am unable to see any difference between those words and the phrase used., *directly or indirectly attributable to the investment*. Either way, there is a causation test.

Perhaps the drafter though that the innovatory statutory wording was vaguer and wider.

Section 809VH(3) ITA provides a limited exception for taxable benefits:

> But the extraction of value rule is not breached merely because a relevant person receives value that–
>
> (a) is treated for income tax or corporation tax purposes as the receipt of income or would be so treated if that person were liable to such tax, and
>
> (b) is paid or provided to the person in the ordinary course of business and on arm's length terms.

"Involved company" is of course widely defined. Section 809VH(4) ITA provides:

> Each of the following is an "involved company"–
>
> (a) the target company,
>
> (b) if the target company is an eligible stakeholder company, any eligible trading company in which it has made or intends to make an investment,
>
> (c) if the target company is an eligible holding company, any eligible trading company that is a 51% subsidiary of it, and
>
> (d) any company that is connected with a company within paragraph (a), (b) or (c).

HMRC give some examples:

> 2.52 ... the Government proposes to introduce a provision to prevent the value of the investment leaking out to the individual either directly through payments or loans which are not arms-length or through transactions designed to pass value to the individual. For example, it would not be permitted for the company to use the funds invested to guarantee loans made to the individual; nor would it be possible to make payments to a third party which are linked to payments made to the individual.[24]

The CIOT comment:

> If value is extracted, all the relief is clawed back unless the entire holding is sold and the entire proceeds reinvested or removed abroad
> Such is the result even if the value extracted is minimal;
> The pooling rules in section 809VN mean that where the investor has made multiple investments qualifying for BIR [Business Investment

24 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

Relief] in the same company or group, claw back affects all investments unless all are sold and the proceeds removed abroad or reinvested;
The definition of 'involved company' in section 809VH(4) means that value counts as extracted if extracted from any company connected with the BIR investee company, regardless of whether that company had anything to do with the BIR investment or indeed is UK resident;
[The CIOT touch on the extreme width of the definition of connected person - a regular theme in this book.[25]]
The arm's length rule preventing a receipt from counting as value extracted if it is paid in the ordinary course of business only applies if what is received is income for UK tax purposes; and
The rule stating that value does not count as extracted if the extraction is a disposal applies only where what is disposed of is part of the holding ie the shares in or loans to the BIR company itself or other companies in its group.
The combined effect of these provisions may be illustrated by an example:
Mr X, a Chinese national, invests £100,000 in A Ltd, a UK company which he controls and claims and is granted BIR.
His son living in China controls a Chinese property company B Ltd.
A Hong Kong trust of which Mr X is settlor owns a Hong Kong trading company, C Ltd.
Should any of the following occur, the extraction of value rule will be breached and Mr X's entire BIR on the £100,000 will be clawed back:
B Ltd pays Mr X's son a dividend. This is an extraction of value because it is not on arm's length terms.
B Ltd is put into member's voluntary liquidation and its assets distributed to Mr X's son.
C Ltd makes a £1,000 gift to Mr X's son in recognition of Mr X's son's efforts in facilitating a contract in China. This was quite unsolicited but entirely proper as ratified by the trust shareholder.[26]

12.14.1 *Interaction with VCT and EIS relief*

What is the position if the investment confers EIS income tax relief? At first sight, the income tax relief is a receipt of value. The benefit is certainly received in circumstances which are attributable to the

25 See 85.7.3 (Commentary).

26 Business Investment Relief: CIOT comments (18 September 2013) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2013/09/130918%20Business%20Investment%20Relief%20-%20CIOT%20comments.pdf*

investment.[27] The exemption for income-taxable benefits does not apply. However HMRC say:

> 2.89 A claim to relief under this incentive will not affect entitlement to other UK reliefs. An individual who brings overseas income and gains to the UK to invest under this relief will still be able to claim other tax reliefs, such as EIS or VCT, if the conditions for such reliefs are met.[28]

It would be wise to seek HMRC clearance before relying on this view.

12.15 "The appropriate mitigation steps"

Where there is a potentially chargeable event, there is (in short) sill no remittance clawback remittance charge if the appropriate mitigation steps are taken.

Section 809VI ITA provides:

> (1) If the potentially chargeable event is a disposal of all or part of the holding, the appropriate mitigation steps are regarded as taken if the whole of the disposal proceeds have been taken offshore or reinvested.
> (2) For any other case, the appropriate mitigation steps are regarded as taken if—
> (a) P has disposed of the entire holding (or so much of it as P retains when the potentially chargeable event occurs), and
> (b) the whole of the disposal proceeds have been taken offshore or re-invested.

12.16 "Taken offshore" or "re-invested"

12.16.1 *Scope of definition*

Section 809Z9 ITA provides:

> (1) This section applies to a provision of this Chapter that is satisfied if something (for example, disposal proceeds) is taken offshore or used by a relevant person to make a qualifying investment...
> (10) References in this section to something being "invested" are to something being used by a relevant person to make a qualifying

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27 The same conclusion was reached in another context in *Harris v HMRC* [2010] SFTD 1159.

28 Consultation Response Document *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

investment.

(11) The provisions to which this section applies include sections 809UA(2)[29] and 809VB(2)[30], but in those cases—

(a) disregard references in this section to investment, and

(b) in the case of section 809VB(2), the assessment date for the purposes of subsection (5) is the date of the relevant event (see section 809VA(3)(b)).

12.16.2 *Meaning of "taken offshore"*

Section 809Z9(2) ITA provides:

> Things are to be regarded as "taken offshore" if (and only if) they are taken outside the UK such that, on leaving the UK, they cease to be available—
>
> (a) to be used or enjoyed in the UK by or for the benefit of a relevant person, or
>
> (b) to be used or enjoyed in any other way that would count as remitting income or gains to the UK.

The next subsections deal with tracing issues. Section 809Z9(3) ITA explains how money is taken offshore:

> If—
>
> (a) the thing required to be taken offshore or invested is money and
>
> (b) it is paid temporarily into an account pending satisfaction of the provision,
>
> the provision is satisfied only if the money actually taken offshore or invested is taken from the same account.

There is no relief if money is paid from one account to another, or if money is paid into one account and funds from another account are taken offshore. It is difficult to see the reason for the rule.

Section 809Z9 ITA then deals with property other than money:

> (4) If the thing required to be taken offshore or invested is something in money's worth,[31] the provision may be satisfied—
>
> (a) by taking the thing offshore or investing it, or

---

29 See 12.25.3 (Payment on account).

30 See 12.8 (Investment fails to proceed).

31 "Something in money's worth" is a clumsy expression meaning property other than money; the drafter is half remembering the technical conveyancing phrase *consideration of money or money's worth*.

(b) by taking offshore or investing money or other property of the equivalent value.

(5) "The equivalent value" is the market value[32] of the thing in money's worth, assessed as at the date of the sale or other disposal in relation to which the provision is triggered.

Perhaps the point is that the consideration might be property which cannot be taken offshore.

Section 809Z9(6) ITA then deals with deemed consideration:

> If the consideration for a disposal is deemed under section 809Z8(4),[33] the provision may be satisfied by taking offshore or investing money or other property of a value equal to—
>
> (a) the amount of the deemed consideration, less
>
> (b) any agency fees (within the meaning of section 809Z8) that are deducted before the actual consideration is paid or otherwise made available to or for the benefit of a relevant person.

Section 809Z9(7) ITA deals with the interaction with exempt property rules:

> (7) Subsections (4)(b) and (6) do not apply in the case of other property of the equivalent value if the other property is—
>
> (a) exempt property under section 809X,[34]
>
> (b) consideration for the disposal of any such exempt property, or
>
> (c) consideration for the disposal of all or part of the holding (see section 809VC) relating to a qualifying investment.

Section 809Z9(8) ITA deals with the interaction with the mixed fund rules:

> Money or other property taken offshore or invested in accordance with subsection (4)(b) or (6) is to be treated for the purposes of this Chapter—
>
> (a) as deriving from the thing required to be taken offshore or invested, and
>
> (b) as having the same composition of kinds of income and capital as that thing.

12.16.3 *Partly taken offshore and partly invested*

Section 809Z9(9) ITA provides:

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32 Defined s.809Z10 ITA: "In this Chapter ..."market value" has the same meaning as in TCGA 1992 (see in particular sections 272 and 273 of that Act)."

33 See 12.17.3 (Deemed market value consideration).

34 See 12.27 (Exempt property).

A provision to which this section applies may be satisfied—

(a) by taking the whole thing offshore or investing the whole thing, or

(b) by taking one part offshore and investing the other part.

12.16.4 *Re-invested*

Section 809VI(7) ITA provides:

Proceeds are "re-invested" if a relevant person uses them to make another qualifying investment (or the proceeds are themselves a qualifying investment) whether in the same or a different company.

12.16.5 *Gain on disposal of investment*

Section 809VI ITA provides:

(3) But if the disposal proceeds exceed X, subsections (1) and (2)(b) apply only to so much of the proceeds as is equal to X.

(4) "X" is—

(a) the sum originally invested, less

(b) so much of that sum as has, on previous occasions involving the same investment—

(i) been taken into account in determining the affected income or gains under section 809VG(2) [clawback remittance charge],

(ii) been taken offshore or re-invested in order to avoid the application of that section, or

(iii) been used to make a tax deposit without which the amount actually taken offshore or re-invested would not have been enough to satisfy subsection (1) or (2)(b) (see section 809VK).

(5) "The sum originally invested" means the amount of the money, or the market value of the other property, used to make the investment.

(6) Market value[35] is to be assessed for these purposes as at the date of the relevant event (see section 809VA).

HMRC say:

The Government will require that the overseas income or gains used to fund the qualifying investment is identified with the first amount of value

35 Defined s.809Z10 ITA: "In this Chapter ..."market value" has the same meaning as in TCGA 1992 (see in particular sections 272 and 273 of that Act)."

taken out of the business until the total amount invested has been matched. This means that, in general, the investor will not be required to take chargeable gains which arise on disposal out of the UK in order to benefit from the relief. However, if an investor disposes of part of their investment, it may be necessary for them to take the gain arising on that part disposal out of the UK, or to reinvest it in a qualifying business, to meet this requirement.[36]

12.16.6 *Liquidation of target company*

Section 809VI ITA provides:

> (8) In cases where a breach of the extraction of value rule occurs in connection with the winding-up or dissolution of the target company—
> (a) subsection (2)(a) does not apply,
> (b) the reference in subsection (2)(b) to the disposal proceeds is to the value received, and
> (c) references in this section and in succeeding provisions of the business investment provisions[37] to the disposal proceeds are to be read as references to the value received.

12.17 "The disposal proceeds"

Section 809Z8(1) ITA provides:

> (1) In this Chapter, in relation to a sale or other disposal, "the disposal proceeds" means—
> (a) the consideration for the disposal, less
> (b) any agency fees that are deducted before the consideration is paid or otherwise made available to or for the benefit of the person making the disposal ("the transferor") or any other relevant person.

12.17.1 *Agency fees*

Section 809Z8 ITA provides:

> (6) In subsection (1), "agency fees" means fees and other incidental costs of the disposal that are charged to the transferor by any person by or

36 Consultation Response Document *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

37 Defined s.809Z10 ITA: "In this Chapter "the business investment provisions" means sections 809VA to 809VO".

through whom the disposal is effected, but excluding any such fees or costs that—

(a) are charged to the transferor by another relevant person, or

(b) are to be passed on to or otherwise applied for the benefit of a relevant person.

(7) The exclusion mentioned in subsection (6) does not apply to the extent that the fees or costs—

(a) relate to a service actually provided by the relevant person to the transferor in connection with effecting the disposal, and

(b) do not exceed the amount that would be charged for that service if it were provided in the ordinary course of business and on arm's length terms.

12.17.2 *Non-cash consideration*

Section 809Z8(3) ITA[38] provides:

> If the consideration is provided in the form of anything other than money, the amount of the consideration is the market value[39] of the thing at the time of the disposal.

12.17.3 *Deemed market value consideration*

Section 809Z8 ITA[40] provides:

> (4) If the disposal is made other than by way of a bargain made at arm's length, the disposal is deemed to be made for a consideration equal to the market value, immediately before the disposal, of the thing being disposed of.
>
> (5) Without limiting the generality of subsection (4), a disposal made to another relevant person or to a person connected with a relevant person is treated in all cases as made other than by way of a bargain at arm's length.

Usual CGT reliefs such as spouse relief and charity relief do not apply.

12.17.4 *Retention of funds to meet CGT liabilities*

Section 809VK ITA provides:

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38 Flagged by s.809Z8(2) ITA.

39 Defined s.809Z10 ITA: "In this Chapter ..."market value" has the same meaning as in TCGA 1992 (see in particular sections 272 and 273 of that Act)."

40 Flagged by s.809Z8(2) ITA.

(1) This section applies if—
- (a) there is a disposal of all or part of the holding,
- (b) the disposal counts as a potentially chargeable event or is part of the appropriate mitigation steps taken in consequence of a potentially chargeable event,
- (c) a chargeable gain (but not a loss) accrues to P on the disposal, (d) P is chargeable to capital gains tax (but not corporation tax) in respect of that gain, and
- (e) the actual disposal proceeds are less than Y.

(2) The difference between the actual disposal proceeds and Y is referred to in this section as "the shortfall".

(3) "The actual disposal proceeds" means the disposal proceeds but disregarding section 809Z8(4).

(4) "Y" is the sum of—
- (a) the amount (if any) that would, but for this section, be required to be taken offshore or re-invested in order to satisfy section 809VI(1) or (2)(b), and
- (b) the amount found by applying the highest potential CGT rate to the amount (computed in accordance with TCGA 1992) of the chargeable gain accruing to P on the disposal.

(5) The highest potential CGT rate is—
- (a) if the chargeable gain accrues to P as the trustees of a settlement or accrues to the personal representatives of P, the rate specified in section 4(3) of TCGA 1992, and
- (b) otherwise, the rate specified in section 4(4) of that Act (regardless of the rate at which income tax is chargeable in respect of P's income).

(6) If this section applies, the amount that is required to be taken offshore or re-invested in order to satisfy section 809VI(1) or (2)(b) is reduced by the permitted amount.

(7) "The permitted amount" is so much of the shortfall as is used, within the grace period allowed for taking the disposal proceeds offshore or re-investing them, to make a deposit in respect of which a certificate of tax deposit is issued to P under section 12 of the National Loans Act 1968.

(8) A reduction may not be made under subsection (6) unless—
- (a) when details of the deposit are confirmed to HMRC, the confirmation letter states that this section is intended to apply to the deposit, and
- (b) the amount of the deposit is no greater than the shortfall.

12.18 The grace period

There is no clawback remittance charge if "the appropriate mitigation

steps" are taken "within the grace period."

Section 809VJ ITA provides:

> (1) The grace period allowed for the step mentioned in section 809VI(2)(a) is the period of 90 days beginning—
>
> (a) if the potentially chargeable event is a breach of the extraction of value rule, with the day on which the value is received, and
>
> (b) otherwise, with the day on which a relevant person first became aware or ought reasonably to have become aware of the potentially chargeable event.
>
> (2) The grace period allowed for the step mentioned in section 809VI(1) and (2)(b) is the period of 45 days beginning with the day on which the disposal proceeds first became available for use by or for the benefit of P or any other relevant person.

12.18.1 *Exceptional circumstances*

Section 809VJ(3) ITA provides:

> An officer of HMRC may agree in a particular case to extend the grace period allowed for an appropriate mitigation step in exceptional circumstances.

HMRC give one example of exceptional circumstances:

> 2.24 In some cases, it may be difficult for an investor to know that a company's activities have changed and to dispose of their investment within the 45-day period. The draft legislation therefore contains a provision to allow HMRC to extend this grace period where exceptional circumstances mean it would be unreasonable to expect the individual to dispose of an investment within 45 days.[41]

12.18.2 *Extension of grace period*

Section 809VJ ITA provides:

> (4) An officer of HMRC may agree in a particular case to extend the grace period allowed for an appropriate mitigation step in circumstances specified in regulations made by the Commissioners.
>
> (5) Regulations under subsection (4) may have effect in relation to investments made before the day on which the regulations are made.

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41 Consultation Response Document *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

(6) Nothing in subsection (4) or in regulations made under it limits the power conferred by subsection (3).
(7) The powers conferred on officers of HMRC by subsections (3) and (4) include power to agree to extend a grace period for a length of time that is indefinite but is capable of becoming definite by means identified in the agreement (such as the satisfaction of conditions).

The regulations are the Business Investment Relief Regulations 2012. It is dispiriting to see the level of micro-detail under a government which claims to be "determined to cut red tape".[42]

The regulations came into force in August, but apply retrospectively to qualifying investments made on or after 6 April 2012.[43]

Regulation 2 Business Investment Relief Regulations provides:

2. The grace period allowed for an appropriate mitigation step by section 809VJ of the Income Tax Act 2007 may be extended by an officer of HMRC if regulation 3 or 4 applies.

Lock-up agreements

3.—(1) This regulation applies if conditions 1 and 2 are met.
(2) Condition 1 is that—
(a) the target company has ceased to be a private limited company by virtue of having some or all of its shares listed on a recognised stock exchange; or
(b) (i) the target company has become a subsidiary of another company ("the new company"); and
(ii) the new company is a body corporate some or all of whose shares are listed on a recognised stock exchange (or are to be so listed).
(3) Condition 2 is that P is unable to comply with an appropriate mitigation step without breaching the terms of a lock-up agreement.
(4) For the purposes of this regulation "lock-up agreement" means a contract—
(a) entered into by P with one or more relevant parties which is directly related to the listing of shares in the target company or, as the case may be, the new company, on a recognised stock exchange; and
(b) that imposes restrictions on the time or manner in which P may—
(i) dispose of some or all of P's holding in the target company;

42 *www.redtapechallenge.cabinetoffice.gov.uk/about.*
43 Reg. 1, Business Investment Relief Regulations 2012.

or

(ii) dispose of some or all of any shares in the new company received by P in return for P's holding in the target company.

(5) For the purposes of this regulation "relevant party" means—

(a) the target company;

(b) the new company;

(c) professional advisors retained by the target company or the new company in relation to the listing of the shares of the target company (or, as the case may be, the shares of the new company) on a recognised stock exchange.

Statutory and legal bars

4. This regulation applies if—

(a) P is prevented from taking an appropriate mitigation step by a prohibition imposed by or under any enactment; or

(b) the taking of an appropriate mitigation step by P would breach the terms of an order imposed by any court.

12.19 Effect of taking mitigation steps

Section 809VL ITA provides:

(1) This section explains the effect for the purposes of this Chapter in cases where section 809VG(2) [clawback remittance charge] does not apply because the appropriate mitigation steps were taken within the grace period allowed for each step.

(2) If disposal proceeds were taken offshore as part of those steps, nothing in section 809VA(2) [remittance investment relief] prevents anything subsequently done in relation to those proceeds (or anything deriving from them) from counting as a remittance of the underlying income or gains to the UK at the time when the thing is subsequently done.

(3) If disposal proceeds were re-invested as part of those steps—

(a) the underlying income or gains continue to be treated under section 809VA(2) as not remitted to the UK, and

(b) the business investment provisions[44] apply to the reinvestment as they apply to the original investment.

(4) In the application of the business investment provisions to the reinvestment—

44 Defined s.809Z10 ITA: "In this Chapter "the business investment provisions" means sections 809VA to 809VO".

(a) treat the potentially chargeable event mentioned in section 809VG(1)(b) as the relevant event,
(b) treat the underlying income or gains as the income or gains treated under section 809VA(2) as not remitted to the UK as a result of the re-investment, and
(c) treat the amount used to make the re-investment as the sum originally invested.

(5) If the re-investment is made using more than the minimum amount of disposal proceeds required to satisfy section 809VI(1) or (2)(b)—
(a) that investment is to be treated as two separate investments, one made using the minimum amount of disposal proceeds and one made using the excess, and
(b) references in the business investment provisions to "the investment" and "the holding" relate only to the investment made using the minimum amount of disposal proceeds.

(6) "The underlying income or gains" means the affected income or gains (within the meaning of section 809VG) or, if one part of the disposal proceeds is taken offshore and the other part re-invested, a corresponding proportion of the affected income or gains.

(7) A further claim must be made in accordance with section 809VA in respect of the re-investment and, if no such claim is made on or before the first anniversary of the 31 January following the tax year in which the re-investment was made, section 809VG(2) [clawback remittance charge] applies, as respects the original investment, as if the appropriate mitigation steps had not been taken within the grace period allowed for each step.

(8) Section 809VM makes further provision in cases involving a tax deposit.

12.20 Tax deposits

Section 809VM ITA provides:

(1) This section applies in cases where—
(a) section 809VG(2) [clawback remittance charge] did not apply because the appropriate mitigation steps were taken within the grace period allowed for each step,
(b) the amount required to be taken offshore or re-invested in order to satisfy section 809VI(1) or (2)(b) had been reduced under section 809VK, and
(c) but for that reduction, the amount that was actually taken offshore or re-invested would not have been enough to satisfy section 809VI(1) or (2)(b).

(2) The tax deposit that gave rise to the reduction is referred to in this section as "the tax deposit".
(3) Use of the tax deposit to pay the relevant tax liability does not count as remitting the underlying income or gains to the UK (and, accordingly, section 809VA(2) [remittance investment relief] continues to apply to the income or gains).

12.20.1 *CTD clawback charge*

Section 809VM ITA provides:

(4) If any of the CTD conditions is breached, the underlying income or gains are to be treated as having been remitted to the UK immediately after the day on which the breach occurs.
(5) "The underlying income or gains" means such portion of the affected income or gains (within the meaning of section 809VG) as is—
- (a) represented by the payment, in the case of subsection (3), or
- (b) affected by the breach, in the case of subsection (4).

(6) The CTD conditions are as follows—
- (a) the tax deposit must not be used to pay a tax liability other than the relevant tax liability,
- (b) if any of the tax deposit is withdrawn by the depositor, the amount withdrawn must be taken offshore or re-invested within the period of 45 days beginning with the day on which the withdrawal was made, and
- (c) any part of the tax deposit that has been neither used to pay a tax liability nor withdrawn by the due date must be withdrawn by the depositor and taken offshore or reinvested within the period of 45 days beginning with that date.

(7) Where the CTD conditions were not breached because the requisite amount was taken offshore or re-invested within the 45-day period mentioned in subsection (6)(b) or (c)—
- (a) section 809VL applies to the amount taken offshore or reinvested as it applies to disposal proceeds, but
- (b) read the reference in section 809VL(4)(a) to the potentially chargeable event as a reference to—
  - (i) the withdrawal, in a case within subsection (6)(b), and
  - (ii) the due date, in a case within subsection (6)(c).

(8) For the purposes of this section—
- (a) "the relevant tax liability" means P's liability to capital gains tax for the tax year in which the disposal took place,
- (b) "the due date" means the date by which the relevant tax liability is required to be paid,

(c) "re-invested" has the meaning given in section 809VI(7), and
(d) references to withdrawal include repayment for whatever reason.

12.21 Multiple investments in same company or group: pooling

12.21.1 *Multiple claims for relief in same company/group*

Section 809VN(1) ITA provides:

> Subsection (2) applies if at any time income or chargeable gains of an individual are treated under section 809VA as not remitted to the UK as a result of—
> (a) more than one qualifying investment made in the same target company,
> (b) more than one qualifying investment made in companies in the same eligible trading group, or
> (c) qualifying investments made
> [i] in an eligible trading company and
> [ii] in an eligible stakeholder company that holds investments in that trading company.

Where these conditions are met, we turn to s.809VN(2) ITA:

> In the application of section 809VG at that time—
> (a) treat the investments and holdings as if they were a single qualifying investment and a single holding, and
> (b) assume that a disposal of all or part of that deemed single holding affects the deemed single investment in the order in which the qualifying investments were made (that is to say, on a first in, first out basis).

There are two deemings here.

The first deeming is a pooling of the various holdings. If an investor has made multiple investments qualifying for relief in the same company or group, clawback on receipt of a benefit affects all the investments unless they are all taken abroad or reinvested.

The second deeming is that disposals are on a FIFO basis regardless of the asset actually disposed of.

12.21.2 *Qualifying and non-qualifying investments in same company/group*

Section 809VN(3) ITA provides:

> Subsection (4) applies if at any time—
> (a) income or chargeable gains of an individual are treated under

section 809VA as not remitted to the UK as a result of one or more qualifying investments,

(b) in addition to that investment or those investments, a relevant person holds at least one other investment in
[i] the same target company,
[ii] the same eligible trading group or
[iii] a related eligible company,[45] and

(c) that other investment is not a qualifying investment.

Where these conditions are met, we turn to s.809VN(4) ITA:

> In the application of section 809VG at that time—
> (a) treat the investments and holdings as if they were a single investment and a single holding, and
> (b) assume that a disposal of all or part of that deemed single holding is a disposal of a holding from a qualifying investment until the holdings from all the qualifying investments have been disposed of.

These are the same two deemings as s.809VN(2) discussed above; though the second of them is slightly differently worded (I would be grateful if any reader could explain why).

12.21.3 *Investments held by different relevant persons*

Section 809VN(6) ITA provides:

> Subsections (2) and (4) apply whether the investments in question are held by the same relevant person or different ones.

This would apply (for instance) where some investments are made by one close company in which T is a participator, and other investments are made by another.

12.21.4 *Examples*

These rules work in anomolous ways.
Suppose:

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45 Section 809VN (5) provides: "The reference to a "related eligible company"—
(a) in relation to an eligible trading company, is to an eligible stakeholder company that holds investments in that company, and
(b) in relation to an eligible stakeholder company, is to an eligible trading company in which that company holds investments."

(1) An individual ("T") makes an investment (say, a loan) in a company which qualify for remittance investment relief.
(2) T (or a relevant person) purchases other investments (say, shares) in the same company; those purchased shares are not a qualifying investment.
(3) T (or the relevant person) sells the shares.

The two investments are pooled, the sale is treated as a disposal of the loan, so the proceeds must be removed outside the UK.

Suppose:

(1) An individual ("T") makes an investment (say, a loan "the first loan") in a company and does not claim remittance investment relief (eg the loan may have been made before 2012).
(2) T (or a relevant person) lends to the same company ("the second loan") and claims the relief.

Pooling does not apply. Section 809VN(2) does not apply as there is only one claim for relief. Section 809VN(4) does not apply as the first and the second loan are both qualifying investments. (A loan or share subscription may be a qualifying investment even though the investor does not claim the relief.)

12.22 Investment out of mixed fund

Section 809VO ITA provides:

> (1) This section applies if—
> (a) but for section 809VA(2) [remittance investment relief], income or gains would have been remitted to the UK by virtue of a relevant event, and
> (b) section 809Q (transfers from mixed funds) would have applied in determining the amount that would have been so remitted.

That is, s.809VO applies if:

(a) Remittance investment relief applies; and
(b) The investment is made out of a mixed fund.

Suppose:

(1) A mixed fund consisted of

capital	£90
income	£10
total	£100

(2) The investment was £10

In the absence of express provision, the onshore transfer mixed fund rule

would apply. The investment would represent the £10 income, and the mixed fund would cease to be mixed. That would allow scope for planning. So s.809VO provides:

> (2) The relevant event counts as an offshore transfer for the purposes of section 809R(4).

This applies the offshore mixed fund rule. Thus on the facts of the example above:

(1) The investment is a mixed fund of £9 capital and £1 income.
(2) The offshore fund becomes a mixed fund of £91 capital and £9 income.

Section 809VO ITA provides:

> (3) The holding is to be treated as containing a proportion of each kind of income and capital contained in the invested property equal to the fixed proportion.
> (4) "The fixed proportion" is the proportion of that kind of income or capital contained in the invested property by virtue of subsection (2).
> (5) "The invested property" means the money or other property used to make the investment.

12.22.1 *Funds taken offshore*

Section 809VO ITA provides:

> (6) Subsection (7) applies in cases where—
> (a) section 809VG(2) [clawback remittance charge] does not apply because an amount is taken offshore, re-invested or used to make a tax deposit,[46] or
> (b) section 809VM(4) [CTD clawback charge] does not apply because an amount is taken offshore or re-invested.[47]
> (7) The amount taken offshore, re-invested or used to make a tax deposit is treated, immediately after that step, as containing the fixed proportion of each kind of income and capital contained in the holding.
> (8) In cases where section 809VG(2) applies—
> (a) the affected income or gains are so much of the fixed amount of each kind of income or gain mentioned in subsection (1)(a) as reflects the portion of the investment affected by the potentially chargeable event (see section 809VG(6)),
> (b) "the fixed amount" is the amount of that kind of income or gain

46 See 12.12 (Clawback remittance charge).
47 See 12.20 (Tax deposits).

that the holding is treated as containing by virtue of subsection (3), and

(c) section 809Q does not apply in determining the affected income or gains.

These rules could still be exploited for tax planning, but the s.809S TAAR is kept in reserve. Section 809VO ITA provides:

> (9) Section 809R(2) and (3) and section 809S apply for the purposes of this section.

See 13.10 (Mixed fund anti-avoidance rule).

12.23 Clearance applications

It is possible to seek advance clearance that the relief applies, under CAP 1 ("How non-business customers or customers with a query about non-business activities get advice on HMRC's interpretation of recent tax legislation").[48] This is a non-statutory procedure, but a positive response should bind HMRC, assuming full disclosure.

Annex B sets out the list of points which need to be covered in the application:

Annex B - Business Investment Relief advance assurance checklist

Use this checklist if you want to ask HMRC to give you their view on whether a proposed investment can be treated as a qualifying investment as defined in section 809VC of ITA. You can find guidance on the business investment relief on the website *www.hmrc.gov.uk*. Please refer to the Information Note and associated Guidance Note: Changes to the Remittance Basis.

It helps us if you follow the order set out in the checklist in your clearance application and use the numbering on any supporting documents.

How to send us your request by post

Send your request to: Business Investment Relief Team S1278, P O Box 202 Bootle L69 9AL

1. Information about the claimant and their request for advance assurance:

1.1 The claimant's name, address and customer identification number in full, eg, National Insurance number and Self Assessment Unique Taxpayer Reference (UTR). The claimant is the person whose foreign income and gains will be used to make the investment.

1.2 If you are requesting advance assurance on behalf of the claimant state the capacity in which you are acting and your authority to do so where HMRC

48 *www.hmrc.gov.uk/cap/cap1.htm*.

do not already hold this. Provide your contact details for correspondence including your phone number.

1.3 The legislation permits a 'relevant person' to make an investment using the claimant's foreign income or gains. A relevant person is defined in section 809M of ITA 2007. Please provide general information about the 'relevant person'.

If the 'relevant person' is an individual: Name and address, NINO, UTR and the relationship of the 'relevant person' to the claimant.

If the 'relevant person' is a company: registered office, place of tax residence, directors and shareholders (including their names and addresses), any UK tax reference, company registration number and reason for it being a 'relevant person', ie, its relationship to the claimant.

2. Information about the proposed investment(s):

2.1 General information about the company in which the proposed investment is intended to be made: name and registered office address, Company Registration Number, date and place of incorporation and UK tax reference if known

2.2 Details of all trading or other activities which the company, and any subsidiary company(ies), is carrying on or intends to carry on. This should be in as much detail as possible and demonstrate that the company is an eligible trading, stakeholder or holding company. For more information on the eligibility conditions that apply please refer to Condition A in Section 2 of the Guidance Note.

2.3 Details of how the investment will be structured.

2.4 Details about any shares to be issued to the claimant or 'relevant person' by the company and/or details of the nature of any loan(s) to be made by the claimant or 'relevant person' to the company.

2.5 Details of any loan or subscription agreement or other side agreement to be entered into by the claimant or 'relevant person'.

2.6 The anticipated date that the income/gains will be brought to the UK and the date the investment will take place.

2.7 The amount of income/gains to be invested.

2.8 The anticipated SA Return year in which the claimant will claim the relief.

2.9 Copies of all supporting documents including:

- the latest available accounts of the company and of any subsidiary company or investment company, or an explanation of why no accounts are available;
- a copy of any prospectus or similar document (such as a business plan or financial projections) issued by the company to potential investors; and/or
- an up-to-date copy of the Memorandum and Articles of Association for the company with details of any changes to be made

Please identify any part(s) or passage(s) of the documents that you think are particularly relevant.

2.10 Any other information relevant to the request.

3. Advice requested from HMRC

3.1 The nature of the assurance you are seeking from HMRC – set out your opinion of the tax consequences of the particular investment you want HMRC to consider and how you have arrived at that opinion.

3.2 A clear explanation of any point(s) on which you are uncertain. If you have already received professional advice please explain why you are still unclear and share any advice which you are content to disclose.

3.3 Any legal advice you have already received which you are content to disclose.

4. Claimant's confirmations:

Please include with your request confirmations from the claimant that

4.1 To the best of their knowledge and belief, no 'relevant person' will (directly or indirectly) obtain or become entitled to obtain any related benefit, and no 'relevant person' expects to obtain any such benefit as a consequence of making the investment.

[For these purposes, a benefit is defined in section 809VF of ITA.]

4.2 To the best of their knowledge and belief they have told HMRC about all of the facts relevant to the investment/the advice sought and that these are correct.

5. Tax avoidance schemes:

5.1 If there is an avoidance scheme which covers all or part of the transaction please provide details of the arrangement and/or any disclosure made to HMRC with the allocated DOTAS scheme reference number, if applicable.[49]

12.24 Remittance investment relief: commentary

Budget 2011 announced:

> **3.7 Review of non-domicile taxation** ... the rules mean that foreign income and gains are taxed if they are brought to the UK and this is a disincentive to inward investment. The Government will introduce the following reforms:
>
> - remove the tax charge when non-domiciles remit foreign income or capital gains to the UK for the purpose of commercial investment in UK businesses;

It is melancholy to compare the aspiration expressed in these three lines

49 *www.hmrc.gov.uk/cap/annex-b-cap1-checklist.pdf.*

with the achievement in 18 dense pages of legislation. The rules are complex, restrictive, and (perhaps most seriously to potential investors) contain many uncertainties, as anyone who tries to apply them to a complex business deal will immediately discover.

In the consultation paper, HMRC said:

> 2.48 At the same time the Government recognises that complicated anti-avoidance provisions could deter non-domiciles from using this new incentive and believes that both these risks can be tackled by relatively straightforward provisions....
> The Government recognises that complexity can deter investment. Therefore, to make the investment incentive genuinely appealing to non-domiciles, the Government is clear that it should be free of unnecessary restrictions and be simple to use.[50]

I infer that the minister's intention clashed with the deeply ingrained culture of HMRC/HMT, that anti-avoidance is a consideration which out-trumps every other; and the latter prevailed. In consequence, the legislation has not lived up to the promise.

All else being equal, a remittance basis taxpayer will not wish to rely on this relief to invest in the UK, either directly or indirectly through trusts and companies, as investment elsewhere avoids the burden of the rules discussed in this chapter.

For a simple solution to this problem, see 11.11 (Commentary: let's simplify remittance and relevant person rules).

12.25 Relief for payment of remittance basis charge

12.25.1 *Payment of remittance basis charge*

Section 809V ITA provides:

> (1) Subsection (2) applies to income or chargeable gains of an individual if–
> (a) the income or gains would (but for subsection (2)) be regarded as remitted to the UK by virtue of the bringing of money to the UK,
> (b) the money is brought to the UK by way of one or more direct payments to the Commissioners [HMRC], and

50 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

(c) the payments are made in relation to a tax year to which section 809H applies as regards the individual.

(2) The income or chargeable gains are to be treated as not remitted to the UK to the extent that the payments do not exceed the applicable amount (as defined in section 809H).[51]

The RDR Manual provides:

34020. Remittance Basis charge - money paid directly to HMRC [Jan 2014]

Money brought into the UK to pay the remittance basis charge (see RDRM32210) is treated as not remitted to the UK if direct payment is made to HMRC (Section 809V[2] ITA 2007).

This exemption will only apply if the money is paid:

- in respect of the tax due for the year in which the remittance basis has been claimed, and
- the remittance basis charge is due for that tax year.

Only remittances that relate to the remittance basis charge are covered by the exemption. Remittances of foreign income or gains to pay any other liability to UK tax, including for example income tax or capital gains tax on remitted amounts, are themselves chargeable to UK tax as remitted income or gains of the tax year in which the tax is paid to HMRC (although see also RDRM35140 - remittances of nominated income). This includes payments to settle enquiry cases by contract settlement except to the extent of any payments of the remittance basis charge included in the contract settlement but not any interest or penalties on those amounts)

The remittance basis charge can be paid in one or more amounts. However, the amount that benefits from the exemption provided at Section 809V is limited to the amount of the charge – that is either £30,000 or £50,000. The amount due can be paid in one lump sum or in several stages, and may form part of the payments on account paid on 31 January or 31 July, or may be paid as a balancing payment. The exemption applies as long as the payment is in relation to the tax year in which the remittance basis charge is due.

The exemption only applies where the remittance basis charge is paid directly from foreign income or gains held outside the UK, the payment must be made direct to HMRC. This can be done either by:

- cheque (drawn on a foreign bank account)
- electronic transfer of funds.

Taxpayers will need to keep sufficient records to show that payment of

51 See 10.11.2 (7 and 12-year residence tests).

the £30,000 or £50,000 remittance basis charge was made directly to HMRC from an overseas account. A copy of a cheque (or cheques) drawn on the foreign bank account, or the relevant bank statement identifying the bank transfer are examples of acceptable evidence.

The £30,000 remittance basis charge may be paid directly from outside the UK to HMRC by a person other than the individual; the most common example will be a payment by an employer on behalf of an employee. In such cases the £30,000 paid to HMRC may form part of the taxpayer's income, for example if paid by his employer the £30,000 will form part of the employee's earnings. To the extent that these are regarded as foreign chargeable earnings this exemption will apply.

The Manual gives an example where A remits £40k to pay a £30k remittance basis charge

Example (Alex)

A is a long-term UK resident remittance basis taxpayer. He uses the remittance basis in 2008-09 and plans to use it again in 2009-10. A therefore makes payments on account (see RDRM32390) of £100,000 on 31 January 2009 and on 31 July 2009 in respect of his 2009-10 liability.

In July 2009 he pays £40,000 of that payment on account from his 2008-09 foreign income. Payment is made by cheque drawn on an account at a bank in the Isle of Man that was sent direct to HMRC.

A's tax liability for 2009-10 is £200,000 including the remittance basis charge of £30,000, which has been wholly met from the payments on account that he has made. No further tax is due for this year.

Because £40,000 of the tax that A has paid on account was paid directly to HMRC from an overseas account, £30,000 of the £40,000 income remitted may be treated as not remitted to the UK and is not chargeable to tax, unless A has instructed otherwise. The remaining £10,000 will be taxed as a remittance in the normal way. As it was remitted in July 2009 it will be a taxable remittance for the tax year 2009-10, and should be declared as such.

In this example, all of the £40,000 was remitted in July. However the remittances might be split between the payment on account dates, for example £20,000 remitted on 31 January 2009 and a further £20,000 on 31 July 2009. In such cases, unless the taxpayer specifies otherwise, the £10,000 that is not subject to the exemption and so is a taxable remittance will be treated as having occurred at the later date, as this will usually be in the taxpayer's favour.

Refer to RDRM34030 for example of where the 'remittance basis charge' is repaid to A, or otherwise no longer applies

Nominated Income or gains
If taxpayers use nominated income or gains to pay the remittance basis charge of either £30,000 or £50,000 it is treated as not remitted to the UK under section 809V. Because none of the individual's nominated income or gains is treated as having been remitted to the UK in that tax year you do not have to apply the 'ordering rules' at ITAs809I and s809J. See RDRM35100 Remittances of nominated income or gains.

lf the remittance basis charge is repaid by HMRC it is treated as remitted at that point (see RDRM34030) and section 809I will be triggered.

The Manual formerly contained an example of a somewhat unusual situation where A pays the remittance basis charge of B:

Example 1 (Olaf)
O uses the remittance basis in 2008/09 and 2009/10 and 2010/11; but in 2011/12 O chooses not to use the remittance basis.
In 2011/12 O makes payment of £30,000 direct to HMRC from his foreign income that arose during 2009/10. This payment is to pay the remittance basis charge of his sister Giselle, who is a long term resident of the UK and who has made a claim to the remittance basis in 2011/12.
The £30,000 remitted by O may be treated as not remitted to the UK under Section 809V ITA 2007 and so is not chargeable to tax provided that the payments made for a particular year do not exceed £30,000.
The position should be looked at critically if there is evidence of any reciprocity. In the case of doubt or difficulty submit to PTI Advisory Foreign Income and Remittance Basis Team.

This text was removed in January 2014.

12.25.2 *Repayment of remittance basis charge*

Section 809V ITA provides:

> (3) Subsection (2) [relief for payment of remittance basis charge] does not apply to payments if or to the extent that they are repaid by the Commissioners.

The RDR Manual provides:

34030. Remittance Basis charge - repayment by HMRC [January 2014]
There may be some exceptional circumstances where the £30,000 or the £50,000 remittance basis charge is paid to HMRC but then is later repaid, or is otherwise no longer due.
Any foreign income or gains remitted to pay the charge and initially covered by the exemption at s.809V ITA 2007 will be regarded as a remittance when the charge is withdrawn and so will be treated as liable to UK tax at that point (s.809V(2) ITA 2007).

Change of claim

The £30,000 or £50,000 remittance basis charge is most likely to be withdraw where an individual, having made a claim for the remittance basis and paid the charge for that year, subsequently decides not to claim the remittance basis for that year and makes an amendment to their Self Assessment return (TMA1970/Section 9ZA). In such circumstances Section 809H ITA 2007 will not apply for that tax year, so the exemption cannot apply either.

Change of status

The other situation where the £30,000 or £50,000 is likely to be withdrawn or not otherwise due is where it later transpires an individual has claimed the remittance basis for a tax year but was not entitled to do so as they were UK domiciled and ordinarily resident in the UK in that year.

Effect

If the exemption under section 809V was claimed, the foreign income or gains used to pay the remittance basis charge will not have been subject to tax in the year in which they arose/accrued because the individual used the remittance basis in that year. Due to the exemption the income or gains will also not have been subject to tax when brought into the UK. In such situations there are two possibilities:

• the £30,000 or £50,000 payment was made from foreign income or gains from an earlier year in which the individual was entitled to claim the remittance basis and did so. The £30,000 or £50,000 is treated as a taxable remittance and will be taxable in the year in which the remittance to HMRC occurred

• the £30,000 or £50,000 payment was made from foreign income or gains from the present year or an earlier year in which the individual was not entitled to claim the remittance basis. The income or gains will be taxed on the arising basis for the year in which the foreign income or gains actually arose. If the return cannot be amended you may need to deal with such assessments under the 'discovery provisions' at s.29 TMA 1970.

Example 1 (Alex)

In the example above, A's circumstances change and he decides not to claim to be taxed on the remittance basis for 2009-10. His liability for 2009-10 on the arising basis is £195,000.

When A made the payment on account of £40,000 in July 2009 he anticipated that £30,000 of it would be attributed to the remittance basis charge. In the event he did not claim to be taxed on the remittance basis. He does not have to pay the remittance basis charge.

None of the payments on account can therefore be attributed to the remittance basis charge and the £40,000 that A paid from his 2008-09 foreign income (remember that A did use the remittance basis in 2008-09) in July 2009 is a taxable remittance.

Any cases of difficulty should be referred to Specialist PT PTI – Advisory, Foreign Income and Remittance Basis Team.

See 13.14.9 (Nominated income used to pay remittance basis charge).

12.25.3 *Payment on account*

Section 809UA ITA provides:

> (1) Subsection (2) applies to income or chargeable gains of an individual if—
>
> (a) the income or gains would (but for subsection (2)) be regarded as remitted to the UK by virtue of the bringing of money to the UK,
>
> (b) the money is brought to the UK by way of direct payments to the Commissioners on account of income tax,
>
> (c) the tax year ("tax year 2") in respect of which the payments on account are made is a tax year for which section 809H (remittance basis charge for long-term UK resident) does not apply as respects the individual, and
>
> (d) that section applied as respects the individual for the previous tax year ("tax year 1").
>
> (2) The relevant amount of income or chargeable gains is to be treated as not remitted to the UK if money equal to the relevant amount is taken offshore by—
>
> (a) the 15 March following the end of tax year 2, or
>
> (b) such later date as the Commissioners may allow on a claim made by the individual.
>
> (3) A claim under subsection (2)(b)—
>
> (a) may be made only if the individual has made and delivered a return under section 8 of TMA 1970 for tax year 2 and reasonably expects to receive from the Commissioners a repayment of tax paid in respect of that tax year, and
>
> (b) may be made no later than the 5 April following the end of tax year 2.
>
> (4) Money that is taken offshore in accordance with subsection (2) is to be treated as having the same composition of kinds of income and capital as the money used to make the payments on account.
>
> (5) In this section "the relevant amount" means the lower of the following—
>
> (a) the amount brought to the UK as mentioned in subsection (1)(b), and
>
> (b) the applicable amount (as defined in section 809H) for tax year 1...

12.26 Foreign services relief

Section 809W ITA provides a relief which I call "**foreign services relief**".

Section 809W(1) provides:

> This section applies to income or chargeable gains if—
> (a) the income or gains would (but for subsection (2)) be regarded as remitted to the UK because conditions A and B in section 809L are met,
> (b) condition A in section 809L [remittance condition A] is met because a service is provided in the UK ("the relevant UK service"), and
> (c) condition B in section 809L [remittance condition B] is met because section 809L(3)(a) or (b) applies to the consideration for the relevant UK service ("the relevant consideration").

I refer to these conditions as "**services relief conditions A and B**".

Section 809W(2) ITA provides the relief:

> The income or chargeable gains are to be treated as not remitted to the UK if the following conditions are met but this is subject to subsection (5).

There is no relief in relation to remittance conditions C or D but in practice these will not often apply. More importantly, there is no relief if s.809L(3)(c) or (d) apply, which deal with debt remittances. Thus if T borrows, uses the borrowed money to pay for foreign services and repays the borrowing, there is a remittance under the debt remittance rules even though a direct payment for the services would be exempt. This is anomalous. The reason might be the difficulty of applying services condition B to a relevant debt case; if so it is not a good reason as services condition B is itself misconceived.

12.26.1 *Services relief condition A: Relating to property situated outside UK*

Section 809W(3) ITA provides:

> Condition A is that the relevant UK service relates wholly or mainly to property situated outside the UK.

One needs to identify:
(1) the service
(2) the property (if any) to which the service relates
(3) the situs of the property
(4) if the service relates to property in and outside the UK, whether the property is "mainly" outside the UK

Unless the service is provided in the UK there is no need for foreign

property services relief.[52] In the following discussion it is assumed that the service is provided in the UK.

Situs is relatively straightforward. Section 809W(6) ITA incorporates the CGT situs rules.[53] The other requirements can be more difficult.

EN Clause 23 Sch 7 Remittance Basis Amendment 354 provides some obvious examples:

> 7. Condition A would cover for example, fees paid to a UK bank for managing an individual's overseas investment portfolio. It would cover legal or brokerage fees in respect of offshore assets, such as the legal fees on the sale of a foreign house....

This is considering fees paid by the individual, but the same applies to fees paid by a relevant person, such as a settlor-interested trust:

> 13. Among the sort of payments that Condition A might cover would be fees paid by non-UK resident trustees to UK advisers for advice on
> [1] managing the assets held in the trust or
> [2] non-UK assets the trustees are considering purchasing.
> Accountancy fees for preparing non-UK tax returns would also be covered providing the majority of the accountancy services relates to non UK property.

The RDR Manual provides:

> **34060 - Remittance Basis: Exemptions: Relevant services provided in the UK - location of overseas property** [June 2010]
> In applying these rules it is important to determine exactly what the service relates to, not just to whom it is provided.
> For example, services may be said to be provided for non-resident trustees (a relevant person) in respect of shares that the trust owns in a non-resident company (that would, if it were UK resident, be a 'close' company').[54] However if the service actually relates to that company's underlying UK assets then the service does not relate to property

52 See 11.12.14 (Service provided in the UK).

53 Section 809W(6) ITA provides: "sections 275 to 275C of TCGA 1992 (location of assets) apply for the purposes of subsection (3) as they apply for the purposes of TCGA 1992." See 83.1 (Situs of assets for CGT).

54 The author is confused, here and in the examples which follow, in that whether or not the company is a close company is not relevant; though in the kind of case under consideration the company is likely to be a trust holding company and so would be "close". (In this section I use the expression "close" company loosely, to include a non-resident close company, ie one which would be close if UK resident.)

> 'outside the UK'.
> On the other hand, if the service is in connection with legal obligations between the trustees and the non-resident company in respect of, say the shares that are held, for example updating the share register in the local territory, then this is a service relating to property (the company/shares) wholly situated outside of the UK.
> *Example 1 (Petra)*
> P, a remittance basis user, is a participator in a Jersey company that would, if it were in the UK, be a close company. The company is a relevant person.[55] The company owns a portfolio of UK real estate. UK-based advisors produce an investment and tax report in respect of the company's UK activities; the advisors fees are paid overseas using P's foreign income.

The example is factually far-fetched since one would normally expect the company to pay for advice supplied to the company, and (so far as the expense is deductible) there would in principle be no taxable remittance.[56] Assuming (as the example requires) P did pay for advice supplied to P, then the HMRC analysis is as follows:

> The relevant UK service is the provision of advice in a tax report which relates to the Jersey company's UK activities. It is the UK activities which are the subject of the advice, not the overseas company so the exemption cannot apply. We look through to what the work relates to.

The analysis is wrong. The advice relates to property, not activities, but it relates to UK property and so HMRC are correct to conclude that the foreign services relief does not apply. The moral for tax planning is that P should use foreign advisors (who may subcontract to the UK).

> *Example 1(a)*
> The Jersey company in example 1 above also has a French property, which makes up only 10% of its business.
> UK-based advisors produce a separate marketing report in respect of this property. The advisors fees are paid overseas using P's foreign income. The service provided in the UK - in this case the preparation of the report - relates to a non-UK property. So the exemption at ITA07/s809W would apply, assuming the other conditions are also met.

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55 The facts that the company is close, and a relevant person, are irrelevant; see above footnote.

56 See 11.14.1 (What is the income?).

This is straightforward.

> **RDRM34040 - Remittance Basis: Exemptions: Relevant services provided in the UK** [December 2011]
>
> ...
>
> *Example 6 (Micho)*
>
> M, a remittance basis user, employs UK-based agents to prepare his US tax return. He uses his foreign income to pay for this service, paying directly into the agent's offshore bank account. This is a service provided in the UK.
>
> Advice on the completion of a non-UK tax return would generally be within the exemption providing the majority of the advice relates to non-UK property; for example:
>
> 1. M's major source of income is UK salary and other UK employment benefits, and most of the work relates to this.
>
> This is service work relating to non-asset related income, eg employment income, so whether UK employment or not there is no property so the exemption at s809W cannot apply.

The HMRC analysis is wrong as an employment contract is property.[57] However the UK contract of employment is likely to be subject to UK law, and so UK situate, and so the conclusion that the services exemption does not apply is correct. The moral, again, is that M should use foreign advisors. The Manual continues:

> 2. Most of the work undertaken is in respect of his UK sources of income and gains, albeit these are small compared to his world wide income and gains.
>
> The service relates to investment income/gains from UK sources so it is outside the exemption.

The HMRC analysis is wrong as the issue is CGT situs, not source, but in practice the two are normally the same.

> 3. Most of the work undertaken is in respect of advice relating to investment income/gains from non-UK sources.
>
> The service provided relates to investment income/gains from non-UK sources, so it is within the exemption if all other conditions are met.

Perhaps more importantly, fees for preparing UK tax returns will similarly be exempt if they relate mainly to non-UK assets.

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57 *O'Brien v Benson's Hosiery* 53 TC 254.

In some cases, it would be helpful for invoices to identify expressly the property to which the services charged for relate.

12.26.2 *"Wholly or mainly"*

The RDR Manual provides:

> **34040. Relevant services provided in the UK** [December 2011]
> ... For the purposes of applying the exemption "wholly or mainly" means more than half. Wholly or mainly relates to the service provided, not the property, and is, in general, judged by reference to work done, normally time spent.
> However, if advisers value the measurement of work done using a variety of factors, such as, for example a basis of both time and fee rate (eg use of a team specialising in international property), it is appropriate that this should be reflected in the considerations of "wholly or mainly". Other factors may include the fee and time rate if specialist advice was required, split of assets between UK and foreign situs, and the place of research or administration.[58]

The RDR Manual provides an example:

> **34040. Relevant services provided in the UK** [December 2011]
> ... *Example 2 (Ritika)*
> R, a remittance basis user, engages an investment manager based in the UK to manage her investment portfolio which covers assets both in and outside the UK and which changes throughout the year. ... Whether Condition A is met depends on whether the service provided relates wholly or mainly to property situated outside the UK.
> If the advice relates to assets and investments held by R, and/or her obligations that ensue from these (eg completing valuation/ownership details to comply with requirements in the jurisdiction where the assets are based), and the advice relates to both UK-situs and offshore situs assets, it will depend on the split of the assets.
> For example, if she holds, say, 60% foreign assets, and the advice given relates to all of the assets held in the portfolio, then the 'wholly or mainly' test would be met.
> If the advisors are considering changes in R's portfolio or the acquisition of UK assets and their research is UK-centric, then the 'service' provided in the UK is likely to relate to UK property, regardless of what is eventually acquired.

---

58 The same point is made in EN Clause 23 Sch 7 Remittance Basis Amendment 354.

The tax planning moral is that R should instruct the investment managers to invest in non-UK property, but in practice she will want to do that for other reasons anyway; or (better) appoint foreign managers and then R can forget about the requirements of foreign services relief.

12.26.3 *Services relief condition B (payment to foreign bank account)*

Section 809W(4) sets out services relief condition B:

> Condition B is that the whole of the relevant consideration is given by way of one or more payments to one or more bank accounts held outside the UK by or on behalf of the person who provides the relevant UK service.

No relief is available if any part of the fees are paid in any other manner, for instance by way of set-off.

The service provider will generally remit the payment to the UK immediately on receipt. That does not affect the customer's tax position. The customer will not know, and will not be entitled to know, what the supplier does with its own money.

12.26.4 *Services relief condition B: Commentary*

I am unable to see the purpose of services relief condition B. It continues the rule in *Timpson's Executors v Yerbury* applicable under the pre-2008 remittance basis. Perhaps the policy was that nothing which was a remittance under the pre-2008 rules should cease to be a remittance under the ITA remittance rules. If so the policy was misguided. The opportunity should have been taken to create an entirely new and coherent set of rules. As it is, suppliers of services relating to foreign property will need to open foreign bank accounts and the individual must ensure that they pay all the fees into that account; a pointless and inconvenient bureaucratic requirement, but there it is.

In practice it will often be easier to appoint foreign advisors so as not to have to bother about the relief.

12.26.5 *Identifying "the service"*

It is necessary to identify what is the service before identifying what is the property to which the service relates:

(1) There may be one service relating to UK and non UK property, in which case one applies the "wholly or mainly" test.

(2) There may be separate services, one (or more) relating to UK property, and one (or more) relating to foreign property, in which case the services relating to the foreign property only can qualify for exemption.

Of course either analysis may better suit the taxpayer or HMRC, depending on the result of the wholly or mainly test. The VAT distinction between single (though composite) and multiple supplies is applicable here.

The RDR Manual provides:

> **34040. Relevant services provided in the UK** [December 2011]
> ... If
> [1] the services (and thus the consideration due for that service) can be clearly and specifically identified as relating either to UK assets or to non-UK assets and
> [2] it is possible to separately identify this from the fees structure and invoicing,
> the work relating to UK assets will not be regarded as meeting the "wholly or mainly" test at Condition A in section 809W.[59] This does not necessarily require a separate advice letter, report or invoice ("split-invoice") to be issued, as long as the individual is clearly able to identify from the invoice to what his payments relate.

If that is right, a remittance basis taxpayer should not use a UK investment manager, say, as the commission on the purchase of UK situate securities would not be exempt, even if the securities as a whole are mainly non UK situate. A UK investment manager should be used only if no UK situate securities are purchased.

Where there are two or more separate supplies, some exempt, some not, it is necessary to identify the consideration given for each supply. The RDR Manual discusses apportionment:

> **34040. Relevant services provided in the UK** [December 2011]
> If there is a split contract for services relating to UK and non-UK assets you should accept the computations if the split bears a reasonable resemblance to the actuality of service provided.
> Any attempt to use artificial or otherwise unrealistic cost structures, for example to increase the costs attributed to non-UK property advice work against UK-property advice work should be strongly resisted.

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59 [Author's footnote] It follows that the work relating to the foreign assets does meet the wholly or mainly test (even if the foreign assets are a minority of the whole).

12.26.6 *Exceptions: s.730 and s.87 benefits*

Section 809W(5) ITA provides:

> Subsection (2) does not apply if the relevant UK service relates (to any extent) to the provision in the UK of—
>
> (a) a benefit that is treated as deriving from the income by virtue of section 735, or
>
> (b) a relevant benefit within the meaning of section 87B of TCGA 1992 that is treated as deriving from the chargeable gains by virtue of that section.

I cannot see what the legislation is aiming at here. The following conditions must all be satisfied:

(1) A service is provided in the UK.
(2) The service relates to non-UK property.
(3) The service relates to the provision *in the UK* of a benefit within s.731 or a capital payment for CGT.

Points (2) and (3) appear to be contradictory. I would be grateful to any reader who could suggest a plausible scenario where s.809W(5) could apply. (If there were such a case, one would need to go on to consider why relief should be withdrawn, but in the absence of any such case, it is difficult to address that question.)

It is suggested that s.809W(5) ITA should be repealed.

12.27 Exempt property

Section 809X(1) ITA provides:

> Exempt property which is brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies[60] is to be treated as not remitted to the UK.

There are five categories of exempt property. These relate to:

(1) Works of art with public access
(2) Clothing etc for personal use
(3) Property brought to UK for repair
(4) Temporary importation to UK
(5) Small remittances exemption (£1,000)

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60 Section 809L(2)(a) applies if "money or other property is brought to, or received or used in, the UK by or for the benefit of a relevant person."

The exemption does not extend to remittance condition C or D but they will not often apply.

12.27.1 *"Property"*

Section 809Z6 ITA provides some definitions. Section 809Z6(1) ITA provides:

> This section applies for the purposes of sections 809X to 809Z5.

Section 809Z6(2) ITA provides:

> "Property" does not include money.

This is an artificial definition of "property" in that the word in its natural sense does include money.

In the remittance basis provisions outside s.809X to 809Z5, the word "property" is used without a definition, and does include money.[61] This breaches the somewhat elementary principle of good drafting, not to use the same word with different meanings. The consequence is to cause confusion and make discussion more difficult, as greater care is needed in one's choice of terminology. In this chapter:

- the word "property" (by itself) does include money;
- where I want to refer to "property" in the artificial s.809Z6(2) sense, I use the expression "property (excluding money)".

12.27.2 *"Money"*

Section 809Z6(3) ITA defines money:

> In subsection (2) "money" includes—
> (a) a traveller's cheque,
> (b) a promissory note,
> (c) a bill of exchange, and
> (d) any other—
> (i) instrument that is evidence of a debt, or
> (ii) voucher, stamp or similar token or document which is capable of being exchanged for money, goods or services.

This is an artificial definition of "money" in that none of these five categories would be "money" in the ordinary meaning of the word.

The definition is over-complex, given the limited importance of the

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61 See 11.12.2 "Property" and "Money".

exempt property rules, but there it is.

The definition is expressed to apply only for the purposes of s.809Z6(2), through which it applies for the purposes of s.809X to s.809Z5. It is also needed in s.809Y, where it is repeated verbatim. (If the definition had been expressed to apply to the whole ITA remittance code the repetition would have been unnecessary.) It also applies in para 86 Sch 7 FA 2008, where it is incorporated by reference. In the remittance basis provisions elsewhere the word *money* is used without any definition, and has its ordinary meaning. So once again, care is needed in ones choice of terminology. In this chapter:

- when the word *money* is used in the artificial s.809Z6(3) sense, I refer to it as "money" with scare quotation marks.
- when the word *money* is used in its ordinary sense, I write it without quotation marks.

12.27.3 *Property "being in the UK"*

Section 809Z6(4) ITA defines "being in the UK":

> References to property being in the UK are references to the property—
> (a) being in the UK after being brought to, or received in, the UK in circumstances in which section 809L(2)(a) applies, or
> (b) being used in the UK in circumstances in which section 809L(2)(a) applies.

Section 809L(2)(a) applies if "money or other property is brought to, or received or used in, the UK by or for the benefit of a relevant person."

12.27.4 *"Lost, stolen or destroyed"*

Section 809Z6(5) ITA provides:

> References to property being lost, stolen or destroyed are to the property being lost, stolen or destroyed whilst in the UK.

12.27.5 *"Compensation payment"*

Section 809Z6(6) ITA provides:

> "Compensation payment", in relation to property that has been lost, stolen or destroyed, means any payment of compensation (whether under an insurance policy or otherwise) in respect of the property.

12.27.6 *Compensation payment "released"*

Section 809Z6(7) ITA provides:

> A compensation payment is "released" on the day on which it first becomes available for use in the UK by or for the benefit of any relevant person.

12.27.7 *"Recovered"*

Section 809Z6(8) ITA provides:

> Property that has been lost or stolen is "recovered" on the day on which it becomes available to be used or enjoyed in the UK by or for the benefit of a relevant person.

12.28 Public access rule

12.28.1 *Introduction*

Suppose an individual has purchased works of art out of foreign income or gains. It may be possible to lend these works to UK institutions without a taxable remittance[62] but s.809Z ITA provides an additional exemption for works of art brought to the UK for public display. Perhaps it is intended for the case where the institution is a relevant person. Section 809X(3) ITA provides:

> Property is exempt property if it meets the public access rule (see section 809Z).

Section 809Z(1) ITA provides:

> Property meets the public access rule if conditions B and C are met.

I refer to **"public access conditions B and C"**.

The former conditions A and D were deleted by the FA 2013. Former condition A had restricted the relief (in short) to works of art. It is now available (in short) for any property put on public display at an approved gallery or museum. Former condition D had incorporated VAT rules by reference which required several pages to set out and which the 2012/13 edition of this work had described as "quite pointless".

12.28.2 *Public access condition B (public access)*

Section 809Z(3) ITA provides:

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62 See 11.12.3 (Property brought to the UK ("brought" limb of condition A)).

Condition B is that—

(a) the property is available for public access at an approved establishment,

(b) the property is to be available for public access at an approved establishment and, in connection with its being so available, is in transit to, or in storage at, public access rule premises, or

(c) the property has been available for public access at an approved establishment and, in connection with its having been so available, is in transit from, or in storage at, public access rule premises.

The key terms here are "available for public access" and "approved establishment." Both are defined.

12.28.3 *Available for public access*

Section 809Z(4) ITA provides:

> Property is "available for public access" at an approved establishment if the property is—
>
> (a) on public display at the establishment,
>
> (b) held by the establishment and made available to the public on request for viewing or for educational use, or
>
> (c) held by the establishment for public exhibition in connection with the sale of the property.

The RDR Manual outlines the statutory provision and continues:

> **34140 - Remittance Basis: Exemptions: Public access rule - Condition B - available for public access - definition** [Jan 2014]
> ... Some property qualifying under the public access rule will be on permanent display at an approved establishment. Other works will have been lent to a museum or art gallery as part of temporary exhibition - perhaps of the work of a particular artist.
> The second bullet above [para (b)] might apply to articles that are too fragile to be on permanent display.
> Prior to 6 April 2012, property brought into the UK for public display in connection with its sale to satisfy the public access rule meant that if that property was sold in the UK a charge arose ....
> Since 6 April 2012, property brought to the UK for public display and subsequently sold in the UK may not result in a UK charge to tax if all of the conditions as set out at s809YA are met ...

12.28.4 *Approved establishment*

Section 809Z(5) ITA defines approved establishment. There are two types:

> An "approved establishment" is—
>
> (a) an approved museum, gallery or other institution within the meaning of Group 9 of Schedule 2 to the Value Added Tax (Imported Goods) Relief Order 1984, or

If one turns to the VAT (Imported Goods) Relief Order 1984 one might expect to find a definition of "approved museum, gallery or other institution." There is none, but article 2 does say that "approved" means approved by the secretary of state. In practice approval is granted by the National Import Reliefs Unit and its practice is set out in HMRC Notice 361 (Importing museum and gallery exhibits free of duty and VAT).

Section 809Z(5) ITA continues:

> An "approved establishment" is ...
>
> (b) any other person, premises or institution designated (or of a description designated) by the Commissioners.

The RDR Manual provides:

> **34130 - Remittance Basis: Exemptions: Public access rule - Condition B - approved establishment - definition** [December 2011]
> ...Any questions about what constitutes an 'approved establishment' or requests for approval as an 'approved establishment' (ITA07/s809Z(5)(b)) should be made to Specialist Personal Tax, PTI Advisory - Remittance Basis Technical Team.
> There is no set form which needs to be completed to request designation as an approved establishment, but all applications should be made in writing and provide sufficient detail about the relevant circumstances relating to making property available for public access, including particulars of the appropriate person, premises or institution wanting to be designated as an approved establishment and full contact details.

12.28.5 *Public access premises*

Lastly, s.809Z(6) ITA defines public access rule premises:

> "Public access rule premises" are—
>
> (a) premises in the UK at which the property is to be, or has been, available for public access, or
>
> (b) other commercial premises in the UK used by the approved establishment for the storage of property in advance of its being,

or after its having been, available for public access at the approved establishment.

12.28.6 *Public access condition C (time limit)*

Section 809Z ITA provides:

(7) Condition C is that, during the relevant period, the property meets condition B for no more than—
(a) two years, or
(b) such longer period as the Commissioners may specify.
(8) "The relevant period" means the period—
(a) beginning with the importation of the property, and
(b) ending when it ceases to be in the UK after that importation.
(8A) But if the property is lost or stolen—
(a) the relevant period ends with the time at which it is lost or stolen, and
(b) a new relevant period begins with its importation or the time at which it is recovered.
(9) "Importation" means the property being brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies.

The definition of "importation" recognises that there may be an importation to the UK to which s.809L(2) does not apply, in which case time does not begin to run. The RDR Manual provides:

34150 Public access rule - Condition C - two year period [December 2011]
...
The relevant period starts with the importation of the property and ends when the property ceases to be in the UK after that importation.
For these purposes, property is treated as brought into the UK or imported if it is brought to the UK in circumstances such that it would be treated as a remittance to the UK within Condition A of s.809L ITA2007 (refer to RDRM33120 Condition A - property) if it were not for this public access rule (or any other rule exempting it) (s.809Z(9) ITA2007).
The two year period will not necessarily start with the importation of the property as the property may not have been available for public access when it was first imported into the UK. For example it may be brought in under the temporary importation rule prior to public access.
Again the two year period will not necessarily end when the property ceases to be in the UK as the property may cease to be available for public access before the property actually leaves the UK. For example it may instead qualify under the repair rule after a period of public access.

Example 1 (Faizal)[63]

F is a remittance basis user. He is asked by a London museum, which is an approved establishment, if he will contribute a vase that he owns to an exhibition that the museum intends to stage. The vase is derived from F's relevant foreign income.

F arranges for the vase to be shipped to the UK from Switzerland. In May the vase is received by the museum and is put into storage for one month after which exhibition begins. The exhibition lasts until the following year in October, at the end of which the vase is returned to Switzerland. The vase has been in the UK for 18 months in total. The vase is exempt property so F has not made a chargeable remittance.

Example 2

The circumstances are the same as Example 1 but this time, at the end of the exhibition, the vase is not returned to Switzerland. Instead, F asks for the vase to be sent to a restorer in Newcastle to be cleaned. The restorer keeps the vase in his business premises for a further eight months [!] and then in the following June F arranges for it to be sent back to Switzerland.

The vase has been in the UK for 26 months. The vase, purchased using F's relevant foreign income is exempt property under the public access rule for the 18 months from its arrival in the UK in May to the October in the following year.

Between October and the following June it is within temporary importation rule (as it is with the repairer) and so remains exempt property. As the 2 year time 'repair' limit at Condition C has not been exceeded the vase remains exempt property throughout and F has not made a taxable remittance.

Any requests under the terms of s.809Z(7)(b) ITA 2007 to extend the period during which property may remain in the UK under the terms of the public access rule should be made to CAR: PTI Advisory, Foreign Income and Remittance Basis Team

12.29 Personal use rule (clothing and jewellery)

Section 809X(4) ITA provides:

> Clothing, footwear, jewellery and watches are exempt property if they meet the personal use rule (see section 809Z2).

Section 809Z2 ITA provides:

> (1) Clothing, footwear, jewellery or watches meet the personal use rule

63 I omit a few irrelevancies in setting out the text of this example.

if they—

(a) are property of a relevant person, and

(b) are for the personal use of a relevant individual.

(2) In this section—

(b) "relevant individual" means an individual who is a relevant person by virtue of section 809M(2)(a), (b), (c) or (d) (the individual with income or gains, or a husband, wife, civil partner, child or grandchild).

The words "*by virtue of section 809M(2)(a), (b), (c) or (d) (the individual with income or gains, or a husband, wife, civil partner, child or grandchild)*" are otiose because an individual who is a relevant person is necessarily a relevant person by virtue of those provisions; but no harm is done.

12.30 Repair rule

Section 809X(5)(a) ITA provides:

Property is exempt property if— ...

(a) the property meets the repair rule (see s.809Z3).

Section 809Z3 ITA provides:

(1) Property meets the repair rule for the whole of the relevant period if, during the whole of that period, the property meets the repair conditions.

(2) Property meets the repair rule for a part of the relevant period if—

(a) during the whole of that part of that period, the property meets the repair conditions, and

(b) during the whole of the other part of that period, or the whole of each other part of that period, the property meets the repair conditions or the public access rule.

(3) Property meets the repair conditions if the property—

(a) is under repair or restoration,

(b) is in transit from a place outside the UK to repair rule premises, in transit between such premises, or in storage at such premises, in advance of repair or restoration, or

(c) is in storage at such premises, in transit between such premises, or in transit from such premises to a place outside the UK, following repair or restoration.

(4) "Repair rule premises" means—

(a) premises in the UK that are to be used, or have been used, for the repair or restoration referred to in subsection (3)(b) or (c), or

(b) other commercial premises in the UK used by the restorer for the

storage of property in advance of, or following, repair or restoration of property by the restorer.

(5) "Restorer" means the person who is to carry out, or has carried out, the repair or restoration referred to in subsection (3)(b) or (c).

(6) Property meets the repair conditions, or the public access rule, during the whole of a period, or the whole of part of a period, if the property meets those conditions or that rule—

(a) on the whole of, or on part of, the first day of that period or part period,

(b) on the whole of, or on part of, the last day of that period or part period, and

(c) on the whole of each other day of that period or part period.

(7) "The relevant period" has the same meaning as in section 809Z.

The relief applies only to the property being repaired. There is no relief for the service of repair. A remittance basis taxpayer would be mad to bring an asset to the UK in order to make use of UK repair or restoration services. Even if the importation of the asset did not give rise to a remittance the payment for the repair would give rise to a remittance. All yacht and similar restoration work, for instance, from remittance basis taxpayers is lost to the UK. But there it is.

12.31 Temporary importation rule

Section 809X(5)(b) ITA provides:

> Property is exempt property if— ...
>
> (b) the property meets the temporary importation rule (see s.809Z4)

Section 809Z4(1) ITA provides:

> Property meets the temporary importation rule if the total number of countable days (subject to any increase under subsection (3B)) is 275 or fewer.

Section 809Z4(2) ITA defines "countable day":

> A "countable day" is a day on which, or on part of which, the property is in the UK by virtue of being brought to, or received or used in, the UK in circumstances in which section 809L(2)(a) applies (whether the current case, or a past case, when the property was so brought, received or used).

One needs to keep a lifetime record for every asset.

UK days before 2008/09 are not countable days, but that will not

normally matter because chattels received in the UK before 2008 qualify for transitional relief.[64]

Section 809Z4(3) ITA deals with the interaction with other remittance reliefs:

> A day is not a countable day if, on that day or any part of that day—
> (za) the property meets the public access rule,
> (a) the property meets the personal use rule,
> (b) the property meets the repair rule,
> (ba) subsection (3A) applies to the property,
> (c) the notional remitted amount[65] in relation to the property is less than £1,000, or
> (d) all or any part of the income or chargeable gains contained in the property (or from which the property derives) is treated, or continues to be treated, under section 809VA(2), 809Y(8)(b) or 809YC(2) or 809YF(4) as not remitted to the UK.

Section 809Z4(3A)(3B) ITA deal with lost or stolen property:

> (3A) This subsection applies to the property if—
> (a) it is not available to be used or enjoyed in the UK by or for the benefit of a relevant person because it has been lost, stolen or destroyed,
> (b) (if lost or stolen) it has not been recovered, and
> (c) no compensation payment has been released in respect of it.
> (3B) If—
> (a) property that has been lost or stolen is recovered,
> (b) the first day after the day on which it is recovered is a countable day, and
> (c) excluding that countable day there have already been 231 or more countable days in relation to the property,
> the number of countable days specified in subsection (1) is read as being increased by the number necessary for there to be 45 countable days beginning with the countable day mentioned in paragraph (b).

The RDR Manual provides an example:

> **34220 Temporary importation rule - countable days** [June 2010]
> ... Example (Jez)
> On 15 January 2010 J, a remittance basis user, brings a rare oil painting

64 See 11.38 (Transitional relief for property acquired before 2008).

65 This term is defined in s.809Z5 ITA: see 12.32 (Small remittances rule).

into the UK to hang on the wall of his castle. J had purchased the painting two months earlier using his foreign employment income.
On 1 July 2010 he allows the painting to be put on public display at the National Gallery, London. The painting remains on display for six months, until 31 December 2010, after which it is immediately shipped to J's office in Dubai on 1 January 2011.
The conditions for meeting the public access rule for the period 1 July 2010 to 31 December 2010 have been satisfied.

The HMRC analysis is as follows:

Bringing the painting into the UK would ordinarily be a taxable remittance under section 809L but we need to consider the exemption rules. During the period 15 January to 30 June 2009 the painting was not available for public access. This period is immediately followed by a period of public access from 1 July 31 December 2009.
The 15 January to 30 June 2009 period falls to be considered under the temporary importation rule (167 days).
For the period 1 July 2009 to 31 December 2009 the property is exempt property under the public access rule and therefore this period does not count towards the 275 day limit.

12.32 Small remittances rule

Section 809X(5)(c) ITA provides:

Property is exempt property if ...
(c) the notional remitted amount (see s.809Z5) is less than £1,000,

I refer to this as **"the small remittances rule"**.
Section 809Z5(1) ITA defines "notional remitted amount":

The "notional remitted amount", in relation to property, is the amount that would be taken to be remitted to the UK in relation to the property (if section 809X did not apply in relation to the property).

Each item of property qualifies for the £1,000 limit. HMRC agree. The RDR Manual provides:

34180 Exempt Property - Notional remitted amount less than £1,000
[June 2010]
... Example (Jacob)
J, a remittance basis user, uses his foreign income to purchase a mobile phone for £250 a fountain pen for £485, and a new suitcase for £630. He brings all the items back to the UK.
The mobile phone, pen and suitcase all derive from J's foreign income so

> would be taxable as remittances when brought into the UK under ITA07/s809L. However each item's notional remitted amount (£250, £485 and £630 respectively) is under the £1,000 limit, so section 809Z5 provides that the phone, the pen and the suitcase are regarded as exempt property. J has not therefore made a chargeable remittance.
> In J's case the total cost of all the property brought to the UK exceeds £1,000. However the exemption limit applies to each item of property, [unless it forms part of a set.]

£1,000 was quite a substantial limit, but it has not been increased so its real value is gradually being whittled away by inflation.

Section 809Z5(2)(3) formerly continued with rule relating to sets of property which in the 7th edition of this book I described as unnecessary. HMRC presumably agreed, since this was repealed with effect from 22 April 2009.

12.33 Exempt property clawback charge

12.33.1 *Clawback charges*

Section 809Y ITA provides:

> (1) Property that ceases to be exempt property is to be treated as having been remitted to the UK at the time it ceases to be exempt property.
> (2) Property ceases to be exempt property in any of the following cases.

There are three cases where the clawback charge may apply.

12.33.2 *Clawback charge 1: Sale in UK*

Section 809Y ITA provides:

> (3) The first case is where the whole or part of the exempt property is sold or otherwise converted into money[66] whilst it is in the UK.

An exchange for a non-money asset is not a sale.

12.33.3 *Clawback charge 2: Exemption requirements cease to apply*

Section 809Y ITA provides:

> (4) The second case is where the property—
> (a) is exempt property only because it meets one or more of the

66 For the definition see 12.27.2 ("Money").

relevant rules,[67]

(b) ceases to meet that rule, or all of those rules, whilst it is in the UK, and

(c) does not meet any other relevant rule.

12.33.4 *Clawback charge 3: Compensation payment*

Section 809Y(4B) ITA provides:

> The third case is where a compensation payment is released in respect of exempt property that has been lost, stolen or destroyed.

12.33.5 *Exception to clawback cases 1 & 2: Lost property*

Section 809Y(4A) ITA provides:

> (4A) Where exempt property has been lost, stolen or destroyed, the first and second cases do not apply in relation to the property during any period—
>
> (a) beginning with the time at which it was lost, stolen or destroyed, and
>
> (b) (if lost or stolen) ending with the time at which it is recovered.

12.33.6 *Relief for arm's length sale if proceeds taken abroad*

Section 809YA - 809YD ITA provide a relief for arm's length sales where the proceeds are taken out of the UK.

Section 809YA(1) ITA provides:

> Section 809Y(1) does not apply to property if—
>
> (a) it ceases to be exempt property because the whole of it is sold whilst it is in the UK, and
>
> (b) conditions A to F are met.

I refer to **"sales relief conditions A-F"**.

12.33.7 *Sales relief conditions A - C: Unconditional sale to 3rd party*

Section 809YA ITA provides:

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67 Section 809Y(5) ITA provides:
"relevant rule" means-
(a) the public access rule,
(b) the personal use rule,
(c) the repair rule, and
(d) the temporary importation rule.

(2) Condition A is that the sale is to a person other than a relevant person.
(3) Condition B is that the sale is by way of a bargain made at arm's length.
(4) Condition C is that, once the sale is completed, no relevant person—
(a) has any interest in the property,
(b) is able or entitled to benefit from the property by virtue of any interest, right or arrangement, or
(c) has any right (whether conditional or unconditional) to acquire any interest mentioned in paragraph (a) or ability or entitlement mentioned in paragraph (b).

12.33.8 *Sales relief condition D: Prompt receipt of sale proceeds*

Section 809YA ITA provides:

(5) Condition D is that the whole of the disposal proceeds are released (whether in one go or in instalments) on or before the final deadline.
(6) "The final deadline" is the first anniversary of the 5 January following the tax year in which the property ceases to be exempt property (within the meaning of section 809Y).

12.33.9 *Sales relief condition E & F: Proceeds taken outside UK or invested*

Section 809YA ITA provides:

(7) Condition E is that—
(a) the whole of the disposal proceeds are taken offshore or used by a relevant person to make a qualifying investment within the period of 45 days beginning with the day on which the proceeds are released, or
(b) if the disposal proceeds are paid in instalments, each instalment is taken offshore or used by a relevant person to make a qualifying investment within the period of 45 days beginning with the day on which the instalment is released.
(8) But if any of the disposal proceeds are released in the period of 45 days ending with the final deadline, Condition E is satisfied, as respects those proceeds, only if they are taken offshore or used by a relevant person to make a qualifying investment on or before the final deadline.
(9) Condition F is that, if Condition E is satisfied wholly or in part by using disposal proceeds to make a qualifying investment, the remittance basis user makes a claim for relief under section 809YC(2) on or before the first anniversary of the 31 January following the tax year in which the property is sold.

Section 809YB ITA provides power to extend the time limit for investment:

> (1) An officer of HMRC may agree in a particular case to extend any period within which disposal proceeds (or instalments) must be taken offshore or used by a relevant person to make a qualifying investment in order to satisfy Condition E.
> (2) The power to agree to an extension is exercisable only in exceptional circumstances and only if the remittance basis user requests such an extension.

12.33.10 *"Released"*

Section 809YA ITA(10) provides:

> For the purposes of this section, proceeds or instalments are "released" on the day on which they first become available for use by or for the benefit of any relevant person.

12.33.11 *Anti-avoidance*

Section 809YA(11) ITA provides:

> This section does not apply if the sale is made as part of or as a result of a scheme or arrangement the main purpose or one of the main purposes of which is the avoidance of tax.

12.33.12 *The relief*

Section 809YC ITA provides:

> (1) This section has effect if section 809Y(1) does not apply to property by virtue of section 809YA.
> (2) The income and gains treated under section 809X as not remitted to the UK continue to be treated after the sale as not remitted to the UK even though the property has ceased to be exempt property.
> (3) But nothing in subsection (2) prevents anything done in relation to any part of the disposal proceeds after that part is taken offshore (or used to make a qualifying investment) from counting as a remittance of the underlying income or gains to the UK at the time when the thing is done.
> (4) Treat the disposal proceeds as containing or deriving from an amount of each kind of income and gain mentioned in section 809Q(4)(a) to (h) equal to the amount of that kind of income or gain contained in the exempt property when it was brought to, or received or used in, the UK (as mentioned in section 809X).

(5) Where Condition E was met by using the disposal proceeds to make a qualifying investment—
(a) the business investment provisions apply to the income and gains that continue, by virtue of subsection (2), to be treated as not remitted as they apply to income or gains that are treated under section 809VA(2) as not remitted, and (b) if the investment was made using more than just the disposal proceeds, treat only the part of the investment made using the disposal proceeds as "the investment" for the purposes of those provisions.

Section 809YD ITA provides:

(1) This section applies to an individual ("P") if—
- (a) a chargeable gain (but not a loss) accrues to a person on a sale of exempt property,
- (b) but for section 809YA, section 809Y(1) would have applied to the property by virtue of the sale, and
- (c) P is either—
  - (i) the person to whom the gain accrues, or
  - (ii) a person to whom a part of the gain is treated as accruing under section 13 of TCGA 1992 (members of non-resident companies).

(2) The relevant UK gain is to be treated for the purposes of this Chapter as if—
- (a) it were a foreign chargeable gain of P, and
- (b) in the case of section 809E, it were not part of P's UK income and gains.

(3) Accordingly, if section 809F applies to P for the applicable tax year, the relevant UK gain is charged in accordance with section 12 of TCGA 1992 as if it were a foreign chargeable gain.

(4) The relevant UK gain is—
- (a) in a case falling within subsection (1)(c)(i), the gain accruing to P,
- (b) in a case falling within subsection (1)(c)(ii), the part of the gain treated as accruing to P.

(5) The applicable tax year is —
- (a) if section 10A of TCGA 1992 (temporary non-residents) applies in P's case and the relevant UK gain is within subsection (2) of that section, the year of return as defined in that section,
- (b) otherwise, the tax year in which the relevant UK gain accrues.

(6) In applying this Chapter to the relevant UK gain—

(a) treat the amount of any gains mentioned in section 809Q(4)(e) contained in the disposal proceeds by virtue of section 809YC(4) as increased by the amount of the relevant UK gain,
(b) disregard section 809U, and
(c) anything done in relation to any part of the disposal proceeds before the part is taken offshore or used to make a qualifying investment (or both) does not count as a remittance to the UK of any of the relevant UK gain.

(7) The relevant UK gain is to be treated for the purposes of the following provisions of TCGA 1992 as if it fell within the definition of foreign chargeable gains in section 12(4) of that Act—
(a) section 10A,
(b) section 12,
(c) section 14A, and
(d) sections 16ZB to 16ZD.

(8) This section has effect despite section 14A(2) of TCGA 1992.

(9) This section does not apply with respect to a chargeable gain if P gives notice to HMRC under this subsection.

(10) A notice under subsection (9)—
(a) must be in writing and must identify the gain in question,
(b) must be given on or before the first anniversary of the 31 January following the applicable tax year, and
(c) may not be revoked after that first anniversary.

This presumably reflects some effective lobbying by the auctioneer industry. Of course it is far too complicated.

12.33.13 *Exempt property used to make investment*

Section 809Y ITA provides:

(6) Subsection (1) does not apply to property that ceases to be exempt property by virtue of the first or second case if—
(a) the property, or anything into which it is converted,[68] is used by a relevant person to make a qualifying investment within the period of 45 days beginning with the day on which it ceased to

68 This is given a commonsense definition in s.809Y(7): "The reference in subsection (6)(a) to anything into which property is converted is—
(a) if the property is disposed of, the disposal proceeds, and
(b) if the property is converted into money in some other way, the money into which it is converted, (including where the disposal or conversion occurs after the property ceases to be exempt property)."

be exempt property, and

(b) the remittance basis user[69] makes a claim for relief under this subsection on or before the first anniversary of the 31 January following the tax year in which the property ceases to be exempt property.

Section 809Y(8) ITA incorporates the investment remittance relief rules:

(8) If subsection (1) does not apply by virtue of subsection (6)—

(a) the property (or thing into which it was converted) used to make the investment is to be treated as containing or deriving from an amount of each kind of income and gain mentioned in section 809Q(4)(a) to (h) equal to the fixed amount,

(b) the income or gains treated under section 809X as not remitted to the UK continue to be treated as not remitted to the UK even though the property has ceased to be exempt property, and

(c) the business investment provisions[70] apply to the income and gains as they apply to income or gains treated under section 809VA(2) as not remitted to the UK.

(9) "The fixed amount" is the amount of that kind of income or gain contained in the property when it was brought to, or received or used in, the UK (as mentioned in section 809X).

Section 809Y(10) ITA provides an apportionment rule:

If the investment is made using more than just the property (or thing into which it was converted), treat only the part made using the property (or thing into which it was converted) as "the investment" for the purposes of the business investment provisions.

12.33.14 *Exempt property qualifies for Gift to the Nation relief*

For completeness, s.809YE ITA provides:

(1) Section 809Y(1) does not apply to property if—

(a) it ceases to be exempt property in the second case mentioned in that section, and

(b) by no later than the time when it ceases to be exempt property, it has been donated in the circumstances described in paragraph 1 of Schedule 14 to FA 2012 (gifts to the nation).

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69 Defined s.809Z10: "In this Chapter "the remittance basis user", in relation to income or chargeable gains of an individual, means that individual."

70 Defined s.809Z(10) ITA: "In this Chapter "the business investment provisions" means sections 809VA to 809VO".

(2) Where section 809Y(1) does not apply to property by virtue of this section, the property is to continue to be treated as not remitted to the UK even though it no longer meets any of the relevant rules

12.33.15 *Compensation taken out of UK or invested*

Section 809YF ITA provides:

(1) Section 809Y(1) does not apply to property if—
- (a) it ceases to be exempt property because a compensation payment in respect of it is released, and
- (b) conditions A and B are met.

(2) Condition A is that the whole of the compensation payment is taken offshore or used by a relevant person to make a qualifying investment within the period of 45 days beginning with the day on which the payment is released.

(3) Condition B is that, if Condition A is satisfied wholly or in part by using the compensation payment to make a qualifying investment, the remittance basis user makes a claim for relief under subsection (4) on or before the first anniversary of the 31 January following the tax year in which the payment is released.

(4) If section 809Y(1) does not apply to property by virtue of subsection (1), the income and gains treated under section 809X as not remitted to the UK continue to be treated after the compensation payment is released as not remitted to the UK even though the property has ceased to be exempt property.

(5) But nothing in subsection (4) prevents anything done in relation to any part of the compensation payment after that payment is taken offshore (or used to make a qualifying investment) from counting as a remittance of the underlying income or gains to the UK at the time when the thing is done.

(6) Treat the compensation payment as containing or deriving from an amount of each kind of income and gain mentioned in section 809Q(4)(a) to (h) equal to the amount of that kind of income or gain contained in the exempt property when it was brought to, or received or used in, the UK (as mentioned in section 809X).

(7) Where Condition A was met by using the compensation payment to make a qualifying investment—
- (a) the business investment provisions apply to the income and gains that continue, by virtue of subsection (4), to be treated as not remitted as they apply to income or gains that are treated under section 809VA(2) as not remitted, and

(b) if the investment was made using more than just the compensation payment, treat only the part of the investment made using the payment as "the investment" for the purposes of those provisions.

CHAPTER THIRTEEN

MIXED FUNDS

13.1 Mixed funds: Introduction

It is helpful first to outline the problems which the mixed fund rules are intended to address. Suppose a person holds a fund which includes different types of income/gains, or income/gains of different years:

(1) If the person remits part of the fund to the UK, it is necessary to know:
   (a) which type of income or gains have been remitted (as different rates may apply)
   (b) which year's income or gains have been remitted (as different rates and different rules may apply to income of different years).

(2) If the person transfers some assets out of the fund, without remitting the assets to the UK, there is no immediate tax charge. However it is necessary to know which income/gains are regarded as in the remaining fund, and which in the transferred assets, if there are later remittances of the remaining fund or the transferred assets.

The mixed fund rules are intended to answer these questions.

I coin the following terminology:

"The ITA mixed fund rules" means the rules set out in s.809Q to 809S ITA.

"The pre-2008 mixed fund rules" means the rules applicable before 2008/09.

13.1.1 *Cross references*

The following points are considered elsewhere:

11.40 (Remittance basis planning points).
22.26 (OWR mixed funds rule).
49.5.4 (Entrepreneurs' relief: mixed fund rules)
77.6 (Remittances from joint accounts).

13.2 Definition of "mixed fund"

Section 809Q(6) ITA provides:

> In this section "mixed fund" means money or other property which, immediately before the transfer, contains or derives from—
>
> (a) more than one of the kinds of income and capital mentioned in subsection (4), or
>
> (b) income or capital for more than one tax year.

This is only a section-wide definition so the drafter has to repeat it in s.809R(7) ITA:

> In this section 'mixed fund' means money or other property containing or deriving from—
>
> (a) more than one of the kinds of income and capital mentioned in section 809Q(4), or
>
> (b) income or capital for more than one tax year.

This is not quite a verbatim repetition, but the omission of the words "immediately before the transfer" does not seem material.

One must first identify what is the fund, and then identify the constituents which it contains (or derives from).

13.2.1 *Identifying the fund*

The typical mixed fund is a bank account with diverse entries.

A mixed fund need not necessarily be a bank account. If money representing a mixed fund is invested in an asset, the asset is the mixed fund. For instance, if a person uses foreign income and capital to purchase a foreign property, or shareholding, the foreign property or shareholding is a mixed fund.

A portfolio of securities may constitute a single fund if it is managed by one investment manager and held under one account name and number. In some cases it may be unclear whether a number of securities should be classified as distinct assets or together constitute a single fund; any reasonable analysis consistently adopted ought to be acceptable.

Funds are distinct, ie, not mixed, if they are held in separate accounts or sub-accounts at one bank. HMRC agree. The RDR Manual provides:

> **35230 Remittances from mixed funds** [May 2012]
>
> *No Mixed Fund*
>
> Also, a mixed fund does not exist just because the individual has several

> accounts with the same banking institution, if each account is separately constituted and contains only one of the relevant types of income from only one year. This will usually include bank accounts set up as sub-accounts under an "umbrella" agreement.
> If income and capital sources from a tax year are maintained separately (sometimes referred to as "kept clean" or "clean capital") no mixed fund is created, and so these rules will not apply.[1]

This is consistent with the banking law background:

> A person's claim to money in his or her account is identifiable by an account name and/or number, and subject to the bank's right to combine accounts,[2] is distinct from any other claim he or she may have against the same bank.[3]

Accordingly one can in principle avoid mixing income with other funds by arranging that the income is paid to a separate bank account. If one does that, it will be possible to remit the other funds, keeping the income unremitted. The position is different for capital gains. A capital gain has no separate identifiable existence so the proceeds of a disposal giving rise to a gain are always a mixed fund.[4] For accrued income profits see 37.9 (AIP remittance basis).

13.2.2 *Interested credited to account and immediately withdrawn*

The RDR Manual provides:

> **33560. Banking Issues** [December 2011]
> *Interest credits to a capital account*
> Often interest on a maturing deposit is credited to the same account comprising the principal capital investment, but under the bank's normal

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1 The Manual then gives a straightforward example: "For example, an individual maintains three separate accounts with the same offshore institution:
Account A into which he pays his relevant foreign earnings for the tax year
Account B into which he pays some inherited money (clean capital)
Account C into which he pays some relevant foreign income for the tax year
As long as these accounts do not become mixed funds, the individual can bring money into the UK from Account B and that will be accepted as a being a transfer of "clean" capital, and so will not be a taxable remittance."

2 [Footnote original] See generally J Wadsley and GA Penn, *Penn and Shea's Law Relating to Domestic Banking* (2nd ed., 2000), para 11-083 *et seq*.

3 Fox, *Property Rights in Money* (2008), para 1.108.

4 See 11.14.2 (What is the gain?).

> internal system the interest is then immediately and identifiably transferred to an income account.
> Where a mixed fund such as this is created fleetingly by an operation of the banking system, HMRC will accept that the interest credit will not taint the principal and so the mixed fund rules in s809Q to s809S do not apply.

At first sight this practice may seem concessionary. However, it is a sensible commercial construction of the statute to say that a sum only "fleetingly" in an account should not to be said to become "mixed".

13.3 Ingredients of a mixed fund

We turn to s.809Q(4) ITA to see what kinds of income and capital may make up a mixed fund:

> The kinds of income and capital are—
> (a) employment income (other than income within para (b), (c) or (f)),
> (b) relevant foreign earnings (other than income within para (f)),
> (c) foreign specific employment income (other than income within para (f)),
> (d) relevant foreign income (other than income within para (g)),
> (e) foreign chargeable gains (other than chargeable gains within para (h)),
> (f) employment income subject to a foreign tax,
> (g) relevant foreign income subject to a foreign tax,
> (h) foreign chargeable gains subject to a foreign tax, and
> (i) income or capital not within another paragraph of this subsection.

I refer to these nine categories as "**the mixed fund categories**". The order in which these categories is placed is important: I call this "**the mixed fund priority order**".

A remittance basis taxpayer needs to classify every mixed fund into these nine categories for 2008/09 and for every subsequent year. This requires vastly more record keeping than the pre-2008 mixed fund rules.

Income which accrues to a non-resident individual is not RFI[5] (even foreign interest, dividends, etc which would be RFI if received by a UK

5 Because it does not meet the condition in s.830(1)(b) ITTOIA; see 10.3.1 (Relevant foreign income).

resident). Similarly, earnings received by a non-resident are not employment income.[6] Such income falls into the bottom category (i).

Chargeable gains from non-UK assets which accrue to a non-resident individual *are* foreign chargeable gains.[7] Such gains will fall within category (e) or (h) depending on whether they are subject to a foreign tax.

What if a UK resident individual receives foreign income or gains which are taxable in the year of receipt, either because they are remitted to the UK or because no remittance basis claim is made in that year? The sums do not cease to be foreign income or gains, so they remain in their relevant categories (a) to (h).

13.3.1 *"Foreign tax"*

I refer to income/gains which are subject to a foreign tax as **"foreign-taxed"**. This affects the mixed fund categories in the following way:

	Not foreign-taxed	**Foreign-taxed**
RFE	para (b)	para (f)
FSEI	para (c)	para (f)
RFI	para (d)	para (g)
Gains	para (e)	para (h)

The object is to increase UK tax by deferring the remittance of foreign-taxed items, so deferring foreign tax credits. This (surely unfair) policy comes at a considerable cost in complexity, since it roughly doubles the number of mixed fund categories and the record keeping.

Section 809Q(5) ITA defines "foreign tax":

> In subsection (4) "foreign tax" means any tax chargeable under the law of a territory outside the UK.

At first I thought that tax deducted under the EU Saving Directive is not "foreign tax". The EU is not a territory outside the UK. But if tax is deducted in, say, Luxembourg, the better view is that the tax is chargeable under the law of *Luxembourg* so the tax is a foreign tax. That is clearly so if the EU directive does not have direct effect in the MS concerned and it would be strange if the position were different when the directive does have direct effect.

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6 Unless within s.27 ITEPA (duties performed in UK or overseas Crown employment).

7 See 49.1 (Territorial scope of CGT) and 10.3.5 (Foreign chargeable gains).

13.3.2 *"Subject to a foreign tax"*

The RDR Manual provides:

> **35240 Remittances from mixed funds - Identifying nature of remittance** [June 2010]
>
> ...
>
> Occasionally UK resident remittance basis users' UK employment income may be "subject to foreign tax", that is to say another country (usually their country of nationality or citizenship) will also tax them on this income. In these cases HMRC will accept that the individual's UK source employment income may still be regarded as within para (a) in the mixed fund, unless the individual requests otherwise, in which case it will remain to fall within para (f) as employment income subject to a foreign tax.

This is obviously an extra-statutory concession.

> This is only relevant where the other country has in fact subjected the UK employment income under consideration to their tax. In some cases no tax will, in fact, have been due in or paid to the other country due to various exemptions and provisions, (for example the US has a "foreign earned income exclusion" provision to employment income below a certain level), so the UK employment income will be within para (a) anyway.

This is not correct as it is not consistent with the approach applied elsewhere in deciding what is "subject to tax": see 59.17 ("Subject to tax"). But it will normally suit taxpayers to treat UK earnings as category (a) so it will not be contested.

13.3.3 *Category (i)*

This is the residuary category. Section 809Q(8) ITA provides:

> References in this section and section 809R to anything deriving from income or capital within para (i) of subsection (4) do not include—
>
> (a) income or gains within any of paras (a) to (h) of that subsection, or
>
> (b) anything deriving from such income or gains.

13.3.4 *Finding the income and capital for the year*

Step 1 in s.809Q(3) ITA provides:

> For each of the categories of income and capital in paragraphs (a) to (i)

> of subsection (4), find (applying section 809R) the amount of income or capital of the individual for the relevant tax year in the mixed fund immediately before the transfer.

Income for a tax year is not difficult to identify, for the tax system requires one to attribute income to a tax year and provides rules for that purpose. Chargeable gains for a tax year are not difficult to identify, for gains accrue on a particular date, and in particular cases there are rules to identify the date.

What about "other capital" falling within category (i)? That would include:

(1) gifts, inheritance
(2) borrowed money
(3) gains on disposals of UK situate assets
(4) chargeable event gains on a surrender of a life policy

It is considered chargeable event gains are capital for the year in which they are received. Suppose:

(1) Year 1: T uses RFI to purchase a foreign policy for £1m.
(2) Year 5: T surrenders the policy for £2m and realises a chargeable event gain of £1m (taxable on the arising basis[8]). T remits £1m.

The £1m remitted is category (i) (other income or capital) of year 5, so there is no further charge on the remittance.[9]

13.3.5 *Derived property*

Section 809R ITA provides:

> **809R Section 809Q: composition of mixed fund**
> (1) This section applies for the purposes of step 1 of section 809Q(3) (composition of mixed fund).
> (2) Treat property which derives wholly or in part (and directly or indirectly) from an individual's income or capital for a tax year as consisting of or containing that income or capital.

At first I thought that was self-evident but in fact it is useful. For instance, suppose:

(1) Year 1: T receives £1m capital and uses it to purchase shares.
(2) Year 2: T sells the shares for £2m.

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8 See 33.4.4 (Remittance basis taxpayer).

9 The £1m remitted is not regarded as derived from the RFI: see 11.15.11 (Income from income/gains).

The proceeds of sale are a mixed fund consisting of:
(1) Gains of year 2; and
(2) Capital of year 1 (not year 2) because that derives from the capital of year 1.

HMRC agree: see the example of Jason in 13.4.8 (Single transfer: mixed fund RFI of earlier years and gain of later year).

13.3.6 *Income/gains used to pay debt*

Section 809R(3) ITA provides:

> If a debt relating (wholly or in part, and directly or indirectly) to property[10] is at any time satisfied (wholly or in part) by—
>
> (a) an individual's income or capital for a tax year, or
>
> (b) anything deriving (directly or indirectly) from such income or capital,
>
> from that time treat the property as consisting of or containing the income or capital if and to the extent that it is just and reasonable to do so.

Suppose:
(1) T borrows from L and receives "the borrowed money" outside the UK.
(2) T uses RFI to repay the debt to L so T retains the borrowed money.

The debt is not a relevant debt, so the repayment at stage (2) is not a taxable remittance under the debt remittance rules.

In the absence of a statutory provision, one would not say that the borrowed money was derived from the RFI, or that the borrowed money consists of or contains the RFI.[11] However the debt relates to the borrowed money. So the borrowed money is treated as consisting of or containing the RFI so far as is just and reasonable. When is that just and reasonable? The drafter has given up here. It seems just and reasonable in principle, and it would certainly be so in cases of avoidance. Cases where it is not just and reasonable to apply the rule in s.809R(3) include:
(1) If the sums involved were small.
(2) If it was not practical to make that tracing exercise (but the requirement that the debt must "relate" to the borrowed money is

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10 The phrase "debt relating ... to property" is taken from the definition of relevant debt; for discussion, see 11.18 (Debt "relating" to property).

11 See 11.15.10 (Income/gains used to pay debt).

another route to the same destination).

(3) If the borrowed money was received in the UK. Then the debt would be a relevant debt and the repayment at stage (2) is a taxable remittance under the debt remittance rules. The taxpayer cannot argue that s.809R(3) prevents a remittance under the debt remittance rules as that would not be just and reasonable.

The same analysis applies if:

(1) T purchases a non-UK asset from L and left the purchase price outstanding as a debt.

(2) T uses the RFI to repay the debt.

The asset will be treated as consisting of or containing the RFI so far as just and reasonable.

It is curious that the rule in s.809R(3) has been made a part of the mixed fund rules, and does not apply more generally.

13.4 Onshore transfer mixed fund rule

13.4.1 *Scope of onshore transfer rule*

Section 809Q ITA provides:

> (1) This section applies for the purposes mentioned in subsection (2) ...
> (2) The purposes referred to in subsection (1) are—
> (a) determining whether condition B in section 809L is met, and
> (b) if it is met, determining (under section 809P) the amount of income or chargeable gains remitted.

Accordingly, the onshore transfer mixed fund rule does not apply for the purposes of remittance basis conditions C or D. This was presumably because those conditions do not always require the use of foreign income/gains or property derived from it. Fortunately conditions C and D will not often apply. So in practice the mixed fund rule applies for most remittance purposes. When conditions C and D are in point, one applies the pre-2008 mixed fund case law rules.

13.4.2 *Onshore transfer*

Section 809Q(1) ITA provides:

> This section applies ... where condition A in section 809L is met[12] and—

12 That is, in short, property is received/used in the UK by a relevant person; see 11.12 (Remittance condition A (link to UK)).

> (a) the property or consideration for the service is (wholly or in part), or derives (wholly or in part, and directly or indirectly) from, a transfer from a mixed fund, ...

The drafter has confused a transfer and the property transferred by a transfer, but the meaning is clear enough. Expanding this, and focussing on property rather than services (which are rarer) it should be read to mean:

> This section applies ... where condition A in section 809L is met and—
> (a) [i] the property ... is (wholly or in part) ... [property transferred by] a transfer from a mixed fund, or
> [ii] the property ... derives (wholly or in part, and directly or indirectly) from [property transferred by] a transfer from a mixed fund...

The next part of s.809Q(1) deals with debt remittances:

> This section applies ... where condition A in section 809L is met and—
> (b) a transfer from a mixed fund, or anything deriving (wholly or in part, and directly or indirectly) from such a transfer, is used as mentioned in section 809L(3)(c).

I refer to a transfer to which s.809Q applies as an **"onshore transfer"**. That term is not always apt[13] but it will do as a short label. The RDR Manual occasionally uses the expression "remittance transfer".

In short, there is an onshore transfer in six cases:

(1) A relevant person receives UK property which:
  (a) is from a mixed fund or
  (b) is derived from a mixed fund
(2) A relevant person receives a UK service, consideration for which:
  (a) is from a mixed fund or
  (b) is derived from a mixed fund
(3) A relevant debt:
  (a) is satisfied out of a mixed fund or
  (b) is satisfied out of a fund derived from a mixed fund.

13.4.3 *"Transfer"*

Transfer is not defined but the context shows that it means any payment

13 For instance, the transfer of funds received in the UK by a non-relevant person counts as an offshore transfer and not as an onshore transfer.

or transfer out of the mixed fund, whether or not for consideration.

If (the usual case) the mixed fund is a bank account, it means any withdrawal from the account.

If the mixed fund is a managed account of securities, it would not include sales or purchases within the account, but any transfer out of the account.

Section 809Q(7) ITA defines the amount of a transfer:

> References in this section to the amount of the transfer include the market value of it.

Strictly one must value the asset transferred, not the transfer, but the meaning is clear.

13.4.4 *Onshore transfer mixed fund rule*

We can turn at last to the rule itself. Section 809Q(3) ITA provides:

> The extent to which the transfer is of the individual's income or chargeable gains is to be determined as follows.

Section 809Q(3) ITA then sets out five steps. It is easier to follow the steps if one has an example in mind. Suppose T (a remittance basis taxpayer) receives £100 per annum of each of the mixed fund categories and pays them into one mixed fund:

Category	**Type of income**	**Year 1**	**Year 2**
Para (a)	UK earnings	£100	£100
Para (b)	relevant foreign earnings	£100	£100
Para (c)	FSEI	£100	£100
Para (d)	relevant foreign income	£100	£100
Para (e)	foreign chargeable gains	£100	£100
Para (f)	foreign-taxed earnings	£100	£100
Para (g)	foreign-taxed RFI	£100	£100
Para (h)	foreign-taxed gains	£100	£100
Para (i)	other income and capital	£100	£100

There is therefore a mixed fund of £1800. Suppose T remits nothing in year 1 and £1,000 to the UK in year 2. This is an onshore transfer. One follows the steps thus:

> *Step 1*
> *For each of the categories of income and capital in paras (a) to (i) of subsection (4), find (applying section 809R) the amount of income or capital of the individual for the relevant tax year in the mixed fund immediately before the transfer.*

"The relevant tax year" is the tax year in which the transfer occurs.

In the example, the relevant tax year is year 2. I consider this further below but for present purposes assume that "the amount of income or capital of the individual in the mixed fund immediately before the transfer" is as set out in the table above.

Step 2
Find the earliest paragraph for which the amount determined under step 1 is not nil.

The earliest paragraph is para (a) and the amount determined under step 1 is £100.

If that amount does not exceed the amount of the transfer, treat the transfer as containing the income or capital within that paragraph (and for that tax year).

T's transfer is treated as containing £100 employment income category (a) for year 2.

Otherwise, treat the transfer as containing the relevant proportion of each kind of income or capital within that paragraph (and for that tax year).
"The relevant proportion" is the amount of the transfer divided by the amount determined under step 1 for that paragraph.

(Had the transfer been (say) £50 then the relevant proportion would have been £50 ÷ £100 = 50% so the transfer would have been treated as containing £50 employment income category (a) for year 2.)

Step 3
Treat the amount of the transfer as reduced by the amount taken into account under step 2.

The amount of the transfer is reduced to £900.

Step 4
If the amount of the transfer (as reduced under step 3) is not nil, start again at step 2.
In step 2, read the reference to the earliest paragraph of the kind mentioned there as a reference to the earliest such paragraph which has not previously been taken into account under that step in relation to the transfer.

Following this iterative process a total of nine times, the transfer is treated

as containing:

(a)	employment income	£100
(b)	relevant foreign earnings	£100
(c)	foreign specific employment income	£100
(d)	relevant foreign income	£100
(e)	foreign chargeable gains	£100
(f)	foreign-taxed employment income	£100
(g)	foreign-taxed RFI	£100
(h)	foreign-taxed gains	£100
(i)	other income and capital	£100
Total		**£900**

The amount of the original £1,000 transfer is by this stage treated as reduced to £100. We move to the next step:

> *Step 5*
> *If the amount of the transfer (as reduced under step 3) is not nil once steps 2 and 3 have been undertaken in relation to all paragraphs of subsection (4) for which the amount determined under step 1 is not nil, start again at step 1.*
> *In step 1, read the reference to the relevant tax year as a reference to the tax year immediately before the last tax year for which step 1 has been undertaken in relation to the transfer.*

Thus we repeat step 2 a last and tenth time, reading "the relevant tax year" to mean year 1. So the transfer of £1,000 from the mixed fund is treated as being:

Category	**Type of income**	**Year**	**Amount**
Para (a)	UK earnings	2	£100
Para (b)	relevant foreign earnings	2	£100
Para (c)	FSEI	2	£100
Para (d)	relevant foreign income	2	£100
Para (e)	foreign chargeable gains	2	£100
Para (f)	foreign-taxed earnings	2	£100
Para (g)	foreign-taxed RFI	2	£100
Para (h)	foreign-taxed gains	2	£100
Para (i)	other income and capital	1	£100

In order to reach this answer for one single transfer we have had to carry out 37 steps.[14] Yet it will be common for there to be hundreds or

14 Steps 1–4 were each carried out 9 times and step 5 once.

thousands of transfers from any mixed fund.

13.4.5 *Commentary: drafting style*

The effect of the onshore transfer mixed fund rule is that transfers from a mixed fund are treated as being made in the mixed fund priority order, taking more recent years before earlier years. Why didn't the statute simply say so? For a discussion of the drafting style, see 51.10.7 (Commentary: step-based drafting). But the fundamental problem is not the drafting, but conception of the mixed fund rule.

13.4.6 *HMRC examples: onshore transfers*

The RDR Manual provides examples. I set them out more or less verbatim, but rearrange and omit some irrelevant detail for clarity.

13.4.7 *One transfer from mixed fund: RFE, RFI and UK EI of one year*

The first example involves a single onshore transfer out of a mixed fund containing RFE, RFI and UK employment income of one year.

RDRM 35280 Example 1 (Amelia) [June 2010]
A, a remittance basis user, has an offshore account with mixed funds as follows:
- foreign earnings from two employers totalling £40,000 per month, half of which is subject to foreign tax [mixed fund categories (b) and (f)]
- relevant foreign income of £10,000 per quarter, which is not subject to foreign tax [mixed fund category (d).
- some of her UK employment income (£50,000 per month) which has already been subject to tax in the UK is paid into the same offshore bank account [mixed fund category (a)]

On 15 October 2010 A purchases an aircraft for £460,000, which she brings to the UK.

Since the account was opened in the tax year, we have an account with 20 credits and one debit (an onshore transfer) thus:

2009-10		**Credit (Debit)**	**Balance**	**Category**
30 Apr	UK salary	£50,000	£50,000	(a)
30 Apr	Overseas salary NFT[15]	£20,000	£70,000	(b)
30 Apr	Overseas salary FT[16]	£20,000	£90,000	(f)
31 May	UK salary	£50,000	£140,000	(a)
31 May	Overseas salary NFT	£20,000	£160,000	(b)
31 May	Overseas salary FT	£20,000	£180,000	(f)
2 Jun	RFI	£10,000	£190,000	(d)
30 Jun	UK salary	£50,000	£240,000	(a)

15 Not foreign-taxed.
16 Foreign-taxed.

30 Jun	Overseas salary NFT	£20,000	£260,000	(b)
30 Jun	Overseas salary FT	£20,000	£280,000	(f)
31 Jul	UK salary	£50,000	£330,000	(a)
31 Jul	Overseas salary NFT	£20,000	£350,000	(b)
31 Jul	Overseas salary FT	£20,000	£370,000	(f)
31 Aug	UK salary	£50,000	£420,000	(a)
31 Aug	Overseas salary NFT	£20,000	£440,000	(b)
31 Aug	Overseas salary FT	£20,000	£460,000	(f)
2 Sept	RFI	£10,000	£470,000	(d)
30 Sept	UK salary	£50,000	£520,000	(a)
30 Sept	Overseas salary FT	£20,000	£540,000	(f)
30 Sept	Overseas salary NFT	£20,000	£560,000	(b)
15 Oct	Aircraft purchase	(£460,000)	£100,000	

Step 1 Identify the "amount of transfer" in the relevant year (2010-11) £460,000
Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer:

Para (a) UK employment income	£300,000
Para (b) Relevant foreign earnings (not subject to a foreign tax)	£120,000
Para (d) RFI (not subject to a foreign tax)	£20,000
Para (f) Employment income subject to a foreign tax	£120,000

Step 2 Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund: Para (a) £300,000

Step 3 Where the amount transferred is greater than the amount identified at Step 2 the amount transferred is treated as reduced by the amount identified in Step 2.

£460,000
-£300,000
£160,000

Step 4 Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.

Step 2 repeated: Para (b) £120,000
Step 3 repeated Amount transferred further reduced to: £40,000

Step 4 In the order of preference listed above repeat Steps 2 and 3.

Step 2 repeated: Para (d) £20,000
Step 3 repeated Amount transferred further reduced to: £20,000

Step 4 In the order of preference listed above repeat Steps 2 & 3.

Step 2 Para (f) £120,000

Step 3 If the amount at Step 2 is equal to or more than the remaining amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain £nil

There has been a transfer to the UK of £460,000. Of this, £300,000 is from UK employment income which has already been taxed, so will not be taxed again. There have also been taxable remittances of A's relevant foreign earnings (£140,000 (£20,000 of which was subject to a foreign tax) and relevant foreign income (£20,000)).

£100,000 of taxed foreign employment income (para f) remains in the offshore account fund.

Moral: A should have kept her taxed foreign earnings separate so that they could be remitted. The tax on that remittance would be less because the foreign tax credit would be available. If A had kept all the sources of income separately, she would also have been saved the significant administrative costs of the computation.

13.4.8 *Single transfer: Mixed fund RFI of earlier years and gain of later year*

The next example is a single onshore transfer from a mixed fund with RFI of earlier years and a chargeable gain of a later year.

> **RDRM 35290 Example 2** (Jason) [June 2010]
> In Year 1 J purchases shares in a foreign company for £8m. The £8m represents J's 'clean' capital, being perhaps an inheritance or similar such windfall.
> In Year 3 J later sells the shares for £10m, which produces a £2m chargeable gain. The sale proceeds are credited in Year 3 to his overseas bank account that contains some relevant foreign income from the last two tax years, but no other monies.
> There is now a mixed fund, containing:
> £8m capital from Year 1,
> £2m a foreign chargeable gain from Year 3
> relevant foreign income from Years 2 and 3.
> Later in Year 3 J, a remittance basis user, brings £5m to the UK from that account. The ordering rules in ITA07/s809Q mean that all of the relevant foreign income and the £2m gain from Year 3 is treated as remitted before any of the capital can be considered as remitted.
> If the mixed fund also included other amounts of income or capital gains for that tax year (Year 2 or 3), those amounts must also be taken into account before any of the 'capital' element of the proceeds, (that is the £8m that is not a gain) realised by the sale of shares can be considered.

The moral is that Jason should have kept the proceeds of the share sale in a separate account. Then the £5m remittance would have been £2m gain and £2m capital.
Even better, he should have disposed of the shares by two separate disposals of £5m each, and remitted the proceeds of the first disposal. Then remittance would have been £1m gain and £4m capital.

13.4.9 *Example: Transfers from mixed fund accruing over 2 years*

The next example involves a single onshore transfer out of a mixed fund of RFE, RFI and UK earnings and chargeable gains, accruing over a two year period.

RDRM 35300, 35310 Example 3 (Jeff) [June 2010]
J has:
- UK salary of £10,000 a month paid into an overseas bank account [mixed fund category (a)]
- a salary for overseas employment and his net salary for that work of £5,000 a month is paid into the same bank account. Both salaries are paid on the last day of each month [mixed fund category (f)]
- Dividends from a shareholding in a foreign company are also paid into the account [assumed subject to a foreign tax - mixed fund category (g)]

In Year 0, J had purchased shares in a foreign company for £8m. The £8m is accepted as representing J's "clean" capital, an inheritance. J sells the shares in Year 2 for £10m, which produces a £2m chargeable gain [mixed fund category (e) and (i)].
J's remittances to the UK from this fund in that year are £10m.
His UK salary is credited net of PAYE and NIC. His overseas salary is subject to a foreign tax deducted at source, and is credited net. His overseas dividends are credited gross.

		Credit (Debit)	**Balance**	**Category**
Year 1			£nil	
31 Mar	UK salary (net of tax)	£10,000	£10,000	(a)
31 Mar	Overseas salary FT	£5,000	£15,000	(f)
Year 2				
30 Apr	UK salary	£10,000	£25,000	(a)
30 Apr	Overseas salary	£5,000	£30,000	(f)
15 May	Dividend	£2,000	£32,000	(g)
15 May	UK salary	£10,000	£42,000	(a)
31 May	Overseas salary	£5,000	£47,000	(f)
18 Jun	Sale of shares (£8m capital and £2m gain)	£2,000,000		(e)
	(no foreign tax)	£8,000,000	£10,047,000	(i)
30 Jun	UK salary	£10,000	£10,057,000	(a)
30 Jun	Overseas salary	£5,000	£10,062,000	(f)
25 Jul	Dividend	£2,000	£10,064,000	(g)
31 Jul	UK salary	£10,000	£10,074,000	(a)
31 Jul	Overseas salary	£5,000	£10,079,000	(f)
31 Jul	Bank interest	£5,000	£10,084,000	(d)
14 Aug	Transfer to UK account	(£10,000,000)	£84,000	
31 Aug	UK salary	£10,000	£94,000	(a)
31 Aug	Overseas salary	£5,000	£99,000	(f)

Applying the ordering rules in S809Q to the account immediately before the transfer:
Step 1 Identify the "amount of transfer" in the relevant tax year
(Year 2) £10,000,000
Analyse mixed fund to identify the separate amounts
of income, capital gains and capital present for each
tax year immediately before the date of the transfer:

Para (a) Employment income (including UK employment income) not subject to a foreign tax	Year 1 – £10,000 Year 2 – £40,000
Para (d) Relevant foreign income (not subject to a foreign tax)	Bank interest Year 2 - £5,000
Para (e) Foreign chargeable gains (not subject to a foreign tax)	Year 2 - £2,000,000
Para (f) Employment income subject to a foreign tax	Year 1 - £5,000 Year 2 - £20,000
Para (g) Relevant foreign income subject to a foreign tax	Foreign dividends Year 2 - £4,000

Step 2 Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund:

Para (a)	£40,000
Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.	£10m less £40k = £9,950,000

Step 4 Find the next paragraph/amount for that tax year.
In the order of preference listed above repeat Steps 2 and 3.

Step 2	**Para (d)**	£5,000
Step 3		£9,955,000

Step 4 In the order of preference listed above repeat Steps 2 and 3

Step 2	**Para (e)**	£2m
Step 3		£7,955,000

Step 4 In the order of preference listed above repeat Steps 2 and 3

Step 2	**Para (f)**	£20,000
Step 3		£7,935,000

Step 4 In the order of preference listed above repeat Steps 2 and 3

Step 2	**Para (g)**	£4,000
Step 3		£7,931,000

Step 4 In the order of preference listed above repeat Steps 2 and 3

Step 2 If the amount is more than the [residual] "relevant amount", treat the whole of the remittance as coming from that item of income or gain. **Para (i)** £8m

The result of this exercise is that

- All of J's UK salary in tax year 2 is deemed to have been brought to the UK first.
- Similarly all of his foreign income and gains of tax year 2 are treated as remitted to the UK and chargeable to tax at the appropriate rates of tax – allowing credit for foreign taxes charged on that same income as appropriate.
- £7,931,000 capital has also been brought to the UK.

Until such time as further amounts of income and gains are credited to the overseas account, the mixed fund contains £69,000 of capital (from the sale of shares) together with £15,000 income of the previous tax year (Year 1).

The next part of the example has two more transfers from the mixed fund.

Remittances from mixed funds – identifying nature of remittance – Example 3a (continuation) [June 2010]

Immediately after the £10m transfer in Year 2 (see example 3) J's mixed fund contains £69,000 of capital (from the sale of shares) and £5,000 overseas employment income of the previous tax year (Year 1).

For the rest of Year 2, J continues to have his UK salary of £10,000 a month and his relevant foreign earnings of £5,000 a month paid into that same account. Both salaries are paid on the last day of each month. There are no further credits or debits from the account in Year 2.

J also writes two cheques to pay bills. These amounts are identified as being 15 October to buy a car and 3 February to pay for building work on his UK property. The final debit on the account (£100,000) is for the purchase of shares in a UK company. All three of these amounts are remittances from a mixed fund to which the rules in s809Q apply.

His UK salary is credited net of PAYE and NIC. His overseas salary is subject to a foreign tax deducted at source, and is credited net. His overseas dividends are also credited to the account net of overseas withholding taxes.

		Credit (Debit)	**Balance**	**Category**
Year 2	Balance b/f		£99,000	
30 Sept	UK salary (net of tax)	£10,000	£109,000	(a)
30 Sept	Overseas salary (net of tax)	£5,000	£114,000	(f)
31 Oct	UK salary	£10,000	£124,000	(a)
31 Oct	Overseas salary	£5,000	£129,000	(f)
30 Nov	UK salary	£10,000	£139,000	(a)
30 Nov	Overseas salary	£5,000	£144,000	(f)
31 Dec	UK salary	£10,000	£154,000	(a)
31 Dec	Overseas salary	£5,000	£159,000	(f)
31 Jan	UK salary	£10,000	£169,000	(a)
31 Jan	Overseas salary	£5,000	£174,000	(f)
28 Feb	UK salary	£10,000	£184,000	(a)
28 Feb	Overseas salary	£5,000	£189,000	(f)
31 Mar	UK salary	£10,000	£199,000	(a)
31 Mar	Overseas salary	£5,000	£204,000	(f)
Year 3				
30 Apr	UK salary	£10,000	£214,000	(a)
30 Apr	Overseas salary	£5,000	£219,000	(f)
15 May	Dividend	£2,000	£221,000	(g)
31 May	UK salary	£10,000	£231,000	(a)
31 May	Overseas salary	£5,000	£236,000	(f)
30 Jun	UK salary	£10,000	£246,000	(a)
30 Jun	Overseas salary	£5,000	£251,000	(f)
30 Jun	purchase UK shares	(£150,000)	£101,000	
3 Jul	Transfer to UK	(£5,000)	£96,000	

Note 1

The direct debit on 30 June (£150,000) is a remittance from a mixed fund. Applying the ordering rules in S809Q to the account immediately before the transfer:

Step 1 Identify the "amount of transfer" in the relevant tax year (Year 3) **£150,000**

Analyse mixed fund to identify the separate amounts of income,

capital gains and capital present for the relevant tax year (Year 3) immediately before the date of the transfer:

Para (a) Employment income (including UK employment income) not subject to a foreign tax £30,000

Para (f) Employment income subject to a foreign tax £15,000

Para (g) Relevant foreign income subject to a foreign tax £2,000

Step 2 Identify the earliest paragraph above for the relevant year (Year 3), which has an amount of income or gain in the mixed fund:

Para (a) £30,000

Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.

£150,000
- £30,000
£120,000

Step 4 Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.

Step 2 Identify the earliest paragraph: **Para (f)** £15,000

Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.

£120,000
- £15,000
£105,000

Step 4 Repeat Steps 2 and 3.

Step 2 Identify the earliest paragraph: **Para (g)** £2,000

Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.

£105,000
- £2,000
£103,000

At this stage all of the amounts credited to the account in Year 3 have been matched against remitted amounts. Income and capital of the next previous year (Year 2) must now be considered - so return to Step 1 for Year 2.

Step 1 Identify the separate amounts of income, capital gains and capital present for Year 2 before transfer:

Para (a) Employment income (including UK employment income) not subject to a foreign tax Year 1 – £10,000 Year 2 – £80,000

Para (f) Employment income subject to a foreign tax Year 1 – £5,000 Year 2 – £40,000

Para (i) Capital Year 2 – £69,000

Step 2 Identify the earliest paragraph above for the relevant year (Year 2) , which has an amount of income or gain in the mixed fund: **Para (a)** £80,000

Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.

£103,000
- £80,000
£23,000

Step 4 Find the next paragraph/amount for that tax year.
In the order of preference listed above repeat Steps 2 and 3.

Step 2 Identify the earliest paragraph:	**Para (f)**	£40,000
Step 3 If the amount is more than the [residual] "transfer amount", the whole of the remittance comes from that paragraph.		£23,000

The £150,000 transfer is therefore regarded as a remittance of:

£110,000	UK employment income	(within para a)
£38,000	relevant foreign income	(within para f)
£2,000	relevant foreign earnings	(within para g)

Note 2

The transfer on 3 July of £5,000 to meet daily living expenses will similarly be regarded as coming from the "earliest paragraph" in the mixed fund, which is paragraph (f) containing relevant foreign earnings from Year 2.

The result of this exercise is that:

- J's UK salary in Year 3 is deemed to have been brought to the UK first and is not a taxable remittance.
- Similarly all of his relevant foreign income and overseas employment income of Year 3 are treated as remitted to the UK and chargeable to tax at the appropriate rates of tax – allowing credit for foreign taxes charged on that same income as appropriate.

Reconciliation

The mixed fund still contains:

£69,000	capital (from the sale of shares in Year 2) together with
£12,000	relevant foreign earnings from Year 2, and
£10,000	UK employment income from Year 1
£5,000	relevant foreign earnings from Year 1
£96,000	

Moral: J should have kept his capital receipt separate and remitted from that. That would have reduced the rate of tax on the remittance and saved the costs of the computation.

13.5 Offshore transfer mixed fund rule

Section 809R(4) ITA provides:

> Treat an offshore transfer from a mixed fund as containing the appropriate proportion of each kind of income or capital in the fund immediately before the transfer.
> "The appropriate proportion" means the amount (or market value) of the transfer divided by the market value of the mixed fund immediately before the transfer.

I refer to this as **"the offshore transfer mixed fund rule".**

13.5.1 *"Transfer"*

"Transfer" is not defined.

It should have the same meaning as in s.809Q[17] so there is a transfer where the funds in the hands of the transferee are regarded as derived from the mixed fund, but not otherwise. For the meaning of derived in this context, see 11.15 (Derived property).

13.5.2 *"Offshore" transfer*

Section 809R(5) ITA defines "offshore transfer":

> A transfer from a mixed fund is an "offshore transfer" for the purposes of subsection (4) if and to the extent that section 809Q does not apply in relation to it.

So far the definition seems clear. One must ask whether s.809Q applies. Section 809Q applies (in short) if a sum is received in the UK by a relevant person.[18] A transfer to a UK bank account is an onshore transfer. So a transfer to a foreign account appears to be an offshore transfer. But suppose:

Year 1: a sum is transferred to a foreign account ("the first transfer")

Year 2: the sum (now in the foreign account) is transferred to a UK account ("the second transfer").

It appears that in year 1 the first transfer is not an onshore transfer, but in year 2 it becomes one.[19] To avoid this result, s.809R(6) ITA provides:

> Treat a transfer from a mixed fund as an "offshore transfer" (and section 809Q as not applying in relation to it, if it otherwise would do) if and to the extent that, at the end of a tax year in which it is made—
>
> (a) section 809Q does not apply in relation to it, and
>
> (b) on the basis of the best estimate that can reasonably be made at that time, section 809Q will not apply in relation to it.

If condition (a) and (b) of this subsection are *both* satisfied, there are two consequences:

(1) One must treat the transfer as an offshore transfer.

(2) One must treat section 809Q as not applying in relation to it, if it otherwise would do.

Unless condition (a) and (b) are both satisfied, this subsection does not apply.

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17 See 13.4.3 ("Transfer").

18 See 13.4.2 (Onshore transfer).

19 Because remittance condition A is met, and the property received in the UK derives indirectly from the first transfer.

The condition in subsection (6)(a) is clear enough. One asks whether s.809Q applies at the end of the tax year. Eg this condition is met if:

(1) T transfers a sum from a mixed fund to a new offshore account on 6th April 2008, and

(2) the money is still there on 5th April 2009, or the money has been used to purchase a non UK asset.

Subsection (6)(b) is a challenge. At the end of the tax year, one must ask whether one can say that s.809Q will not apply in relation to the transfer. In relation to some transfers one can say with certainty that s.809Q will not apply. If the transferor draws a sum from a mixed fund to pay for a dinner outside the UK, then s.809Q will not apply to it because nothing will be received in the UK. That is an offshore transfer.

If a person transfers a sum to an offshore account and does expect to spend it in the UK that is an onshore transfer when remitted to the UK.

13.5.3 *Recomputation problem*

I use the term "**problematic transfer**" (for reasons which will become clear) to describe a transfer made in the following circumstances (by no means unusual):

(1) In year 1 T transfers a sum from a mixed fund to an account outside the UK.

(2) At the end of year 1 the transferred sum is not received in the UK.

(3) T cannot say at the end of the year 1 that "section 809Q will not apply in relation to" the problematic transfer. This may be because:

  (a) At the end of year 1, T does expect to spend the sum in the UK but not until a later year, say, year 5; or

  (b) T does not know whether T intends to remit the sum to the UK.

  At the end of year 1, the problematic transfer is not an onshore transfer. It is an offshore transfer within the definition in s.809R(5). Admittedly it is not within subsection 809R(6) but that subsection does not stop any transfer being an offshore transfer, if applicable it treats non-offshore transfers as offshore transfers.

(4) Suppose in a later year (say year 5) T transfers the sum to the UK. I refer to this as its **"subsequent remittance**."

On one view, the problematic transfer changes status at the time of its subsequent remittance and becomes an onshore transfer. That is workable if in the meantime T has not made any other onshore transfers from the mixed fund. It is not workable if in the meantime T has made other transfers from the mixed fund, because:

(1) T needed to know at the time what income or gains those other transfers included.
(2) There cannot possibly be a recomputation of the tax effect of the other transfers in earlier years on the basis that the problematic transfer has turned out to be an onshore transfer after all. I think that is obviously impractical, but for good measure it is also inconsistent with s.809R(9) ITA which provides:

> If section 809Q applies in relation to more than one transfer from a mixed fund, when undertaking step 1 in relation to the second or any subsequent transfer take into account the effect of step 2 of section 809Q(3) (composition of transfer) as it applied in relation to each earlier transfer.

It is almost impossible to make a coherent and workable tax regime out of this intractable statutory material, which is not surprising given the way in which it was enacted. I think the best solution is to say that s.809R(6)(b) is misconceived, that a problematic transfer is only an onshore transfer if s.809Q applies to it in the year of the transfer. If at the end of the year it is an offshore transfer, its status does not change later. This can be justified on the basis that IT is an annual tax.

The alternative view is that the problematic transfer does change its status and becomes an onshore transfer, on the occasion of its subsequent remittance. One carries through the implications for tax purposes so far as that is possible, so the result is that tax is charged as if the problematic transfer was made after the subsequent transfers.

If that were so, another issue arises. Suppose when asked whether the sum will be remitted, T says (as may well be said) that T will remit it if represents an offshore transfer. The question whether a sum will be remitted to the UK may depend on the tax position, ie if it represents an offshore transfer it will be remitted and if it represents an onshore transfer it will not. It is therefore impossible to answer the s.809R(6)(b) question, whether the sum will be remitted, on the view that a problematic transfer becomes an onshore transfer when remitted; for if it is an offshore transfer it will be remitted (and so is an onshore transfer) but if it is an onshore transfer it will not be remitted (and so is an offshore transfer).

13.5.4 *HMRC explanation*

EN Clause 23 Schedule 7 Remittance Basis Amendments 463 to 481 explains s.809R(4) ITA:

> 7. Amendment 465 introduces a new subsection [4], dealing with cases where transfers are made wholly offshore. The new rules aim to ensure that where a transfer is made offshore from fund A to fund B, and remittances to the UK are then made from fund A or fund B, the normal ordering rules for mixed funds apply, as they would have done had the transfer to Fund B not been made before the remittance.

In fact the offshore transfer mixed fund rule does nothing of the sort. The EN continues:

> 8. So if fund A consisted of equal amounts of untaxed income and capital, and half the fund was transferred to fund B, it cannot be argued that fund A or B consisted solely of capital, and remittances from fund A or B were not therefore taxable. Instead, where there is an offshore transfer, so that the normal mixed fund ordering rules do not apply, fund B is to be treated as containing the same proportion of the different categories of income and capital as the original fund, in relation to the amount transferred.

13.5.5 *Transfer partly offshore partly onshore*

Section 809R(8) ITA provides:

> If section 809Q applies in relation to part of a transfer, apply that section in relation to that part before applying subsection (4) in relation to the rest of the transfer.

In practice this will rarely if ever occur.

13.5.6 *HMRC examples: onshore and offshore transfers*

The RDR Manual provides a straightforward example of onshore and offshore transfers from an account with different categories of income and gains:

> **RDRM 35430** [June 2010]**, 35440** [February 2011]
> **Example 1** (Ahmid)
> A, a remittance basis user has an offshore bank account into which is paid both UK source (taxed) income and his foreign income and gains. A makes regular **transfers from this account to his UK account to meet his UK living expenses.**

		Credit (Debit)	Balance	Category	Note
10 Apr	XYZ (CI) Ltd – proceeds from sale of shares	£1,000,000	£1,000,000	(e)	1
15 Apr	RFI dividend	£10,000	£1,010,000	(g)	
30 Apr	UK salary	£10,000	£1,020,000	(a)	2
30 Apr	Bank interest	£5,000	£1,025,000	(d)	

30 Apr	Overseas salary (net of tax)	£5,000	£1,030,000	(f)	
3 May	Transfer to UK a/c	(£5,000)	£1,025,000		2
15 May	Offshore dividend	£2,000	£1,027,000	(g)	
31 May	UK salary	£10,000	£1,037,000	(a)	
31 May	Overseas salary (net of tax)	£5,000	£1,042,000	(f)	
31 May	ABC (IoM) Ltd – purchase of shares in foreign company	(£1,000,000)	£42,000		3
3 Jun	Transfer to UK a/c	(£5,000)	£37,000		4
30 Jun	UK salary	£10,000	£47,000	(a)	
30 Jun	Overseas salary (net of tax)	£5,000	£52,000	(f)	
3 Jul	Transfer to UK a/c	(£5,000)	£47,000		5
31 Jul	UK salary	£10,000	£57,000	(a)	
31 Jul	Overseas salary (net of tax)	£5,000	£62,000	(f)	
3 Aug	Transfer to UK a/c	(£5,000)	£57,000		6
15 Aug	Cheque – ZZZ Cars Ltd London	(£25,000)	£32,000		7

Note 1

The sale price of the shares includes a gain over the original purchase price of £150,000 that has not been taxed. The purchase was made long before 6 April 2008 and was made using accumulated foreign income and gains which were treated as clean capital.

The mixed fund provisions do not apply to foreign income or gains that arose or accrued before 6 April 2008 (Sch 7 FA 2008 para 89). This means that it is not possible to apply the "mixed fund" rules to the £850,000 used to buy the shares.

Note 2

Using the ordering rules at ITA07/s809Q(1), the remittance to the UK on 3 May is matched against the UK salary from that tax year credited to the account on 30 April, as this is the "earliest paragraph" of income or gains within the mixed fund.

Working this through:

The £5,000 transfer to the UK on 3 May is a "transfer" from a mixed fund within section 809Q. Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer:

Para (a)	employment income	£10,000
Para (d)	RFI	£5,000
Para (e)	Chargeable gains	£150,000
Para (f)	Earnings subject to a foreign tax	£5,000
Para (g)	RFI subject to tax	£10,000
Para (i)	Income or capital not within another para	£850,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income. Although money has been brought into the UK, there is no taxable remittance as the money has already been taxed.

Note 3

The purchase of shares on 31 May is an "offshore transfer"; by the end of the tax year the shares purchase have not, nor on best estimate are they likely to be, a remittance transfer [in my terminology an onshore transfer] so that s809Q applies.

The account is treated as including the amounts of foreign income and gain that were present immediately before the transfer (ITA07/s809R(4)). The transfer has no effect on the amount remitted in the current tax year but may need to be taken into account in a later tax year.

Immediately before the offshore transfer the mixed fund consists of:

Para (a)	employment income	£ 15,000
Para (d)	RFI	£5,000
Para (e)	Chargeable gains	£150,000
Para (f)	Earnings subject to a foreign tax	£10,000
Para (g)	RFI subject to tax	£12,000
Para (i)	Income or capital not within another para	£850,000
		£1,042,000

The offshore transfer consists of an appropriate proportion of each kind of income, gain or capital, within the mixed fund, that is:

Para (a)	employment income	£14,396
Para (d)	RFI	£4,798
Para (e)	Chargeable gains	£143,953
Para (f)	Earnings subject to a foreign tax	£9,597
Para (g)	RFI subject to tax	£11,517
Para (i)	Income or capital not within another para	£815,739
		£1,000,000

Note 4

The £5,000 transfer on 3 June to the UK is a "transfer" to the UK from a mixed fund, and is within s809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer:

Para (a)	employment income	£604
Para (d)	RFI	£202
Para (e)	Chargeable gains	£6,047
Para (f)	Earnings subject to a foreign tax	£403
Para (g)	RFI subject to tax	£483
Para (i)	Income or capital not within another para	£34,261

The transfer is regarded as coming from each of the paragraphs in order; that is £604 from para (a), and a taxable remittance of £4,396, being £202 from para (d) and £4,194 from para (e).

Note 5 and 6

Both of these £5,000 transfers are to the UK. There have been credits to the fund between the last transfer (note 4) and this transfer and the fund now contains some employment income (para a) and additional amounts of foreign earning subject to foreign tax (para f) in addition to the residue following the last transfer.

The £5,000 transfers made on 3 July and 3 August are regarded as coming from the earliest paragraph of income, that is para (a) – £10,000 of UK employment income credited to the account on 30 June.

Note 7

The cheque remittance on 15 August is £25,000. This amount was used to buy a car from a UK company. This is also a remittance within s809Q. Immediately before the transfer the mixed fund consists of:

Para (a)	employment income	£10,000
Para (d)	RFI	£nil
Para (e)	Chargeable gains	£1,853
Para (f)	Earnings subject to a foreign tax	£10,403
Para (g)	RFI subject to tax	£483
Para (i)	Income or capital not within another para	£34,261

The cheque remittance is regarded as coming from each of the paragraphs in order; that is £10,000 from para (a), £1,853 from para (e) and £10,403 from para (f), £483 from para (g) and £2,261 from para (i).

The remaining £32,000 at 15 August is also within para (i)

13.5.7 *Example 1(a)*

Example 1(a) – Transfer to another account To continue the offshore account in example 1:

Date		**Credit (Debit)**	**Balance**	**Category s.809Q(4)**	**Note**
	Balance b/f		£32, 000		
31 Aug	Overseas salary (net of tax)	£5,000		f	
31 Aug	UK salary	£10,000		a	
3 Sept	Transfer to UK a/c	(£5,000)			1
15 Sept	Cheque – XYZ Travel Services (CI) Ltd	(£10,000)			2
30 Sept	Overseas salary (net)	£50,000		f	
30 Sept	Overseas Dividend	£350,000		g	
30 Sept	UK salary	£180,000		a	
3 Oct	Transfer to UK a/c	(£5,000)			3
15 Oct	Transfer to Swiss a/c	(£350,000)			4

Note 1

Immediately before the transfer on 3 September the mixed fund contained:

Para (a)	Employment income	£10,000
Para (f)	Earnings subject to a foreign tax	£5,000
Para (i)	Income or capital not within another para	£32,000

The transfer is regarded as coming from the 'earliest paragraph', that is para (a), so the £5,000 is UK employment income. Although money has been brought into the UK, there is no taxable remittance as the money has already been taxed,

Note 2

The next payment from the account is £10,000 for the family holiday flights to the USA. The full payment is a remittance because the service provided is in the UK – the flights begin or end in London.

The transfer is regarded as coming from each of the paragraphs in order; that is £5,000 from para (a) and a taxable remittance consisting of £5,000 from para (f).

Note 3

Immediately before the remittance on 3 October the mixed fund contained:

Para (a)	Employment income	£180,000
Para (f)	Earnings subject to a foreign tax	£50,000
Para (g)	RFI	£350,000
Para (i)	Income or capital not within another para	£32,000

The transfer is regarded as coming from the 'earliest paragraph', that is para (a), so the £5,000 is UK employment income.

Note 4

The transfer of £350,000 to a new Swiss bank account is an offshore transfer. Immediately before the offshore transfer on 15 October the IoM bank account (mixed fund) is regarded as containing:

Para (a)	Employment income	£175,000
Para (f)	Earnings subject to a foreign tax	£50,000
Para (g)	RFI	£350,000
Para (i)	Income or capital not within another para	£32,000
		£607,000

The offshore transfer consists of an appropriate proportion of each kind of income, gain or capital, within the mixed fund, that is:

Para (a)	Employment income	£100,906
Para (f)	Earnings subject to a foreign tax	£28,830
Para (g)	RFI	£201,812
Para (i)	Income or capital not within another para	£18,452

The Swiss bank account is another 'mixed fund', containing the income, gains and capital of the transferred amount. Assuming nothing else is added or taken away from the Swiss account in the interim, if in a couple of years time A decides to remit £120,000 to the UK from his Swiss bank account, the same ordering rules will apply to the Swiss fund, so the remittance is regarded as consisting of £100,906 from para (a) and £19,094 from para (f).

13.5.8 *Example 2*

The next example has another mix of offshore and onshore transfers.

RDRM 35450 [June 2010]

Example 2 (Lorraine)

L, a remittance basis user, opens an offshore bank account in Bermuda into which is paid both UK source (taxed) income and her foreign income and gains. L makes a few transfers from this account to her UK account to meet UK living expenses. She also transfers money from this account to her other offshore account in Jersey, as well as using it for several offshore purchases.

Account 1 Bermuda

		Credit (Debit)	Balance	Category	Note
Year 1					
15 Jan	Capital	£1,000,000	£1,000,000	(i)	1
30 Jan	UK salary	£10,000	£1,010,000	(a)	
30 Jan	Bank interest	£5,000	£1,015,000	(d)	
30 Jan	Overseas salary (net of tax)	£5,000	£1,020,000	(f)	
3 Feb	Transfer to UK a/c	(£5,000)	£1,015,000		2
28 Feb	Dividend	£2,000	£1,017,000	(g)	
28 Feb	UK salary	£10,000	£1,027,000	(a)	
28 Feb	Overseas salary	£5,000	£1,032,000	(f)	
3 Mar	Purchase of shares in foreign company	(£800,000)	£232,000		3
10 Mar	Transfer to UK a/c	(£5,000)	£227,000		4
31 Mar	UK salary	£10,000	£237,000	(a)	
31 Mar	Overseas salary (net of tax)	£5,000	£242,000	(f)	
2 Apr	Transfer to UK a/c	(£5,000)	£237,000		5
Year 2					
30 Apr	UK salary	£10,000	£247,000	(a)	
30 Apr	Overseas salary (net of tax)	£5,000	£252,000	(f)	
3 Mar	Transfer to UK a/c	(£5,000)	£247,000		6
15 Mar	Transfer to UK a/c	(£100,000)	£147,000		7
31 May	UK salary	£10,000	£157,000	(a)	
31 May	Overseas salary (net of tax)	£5,000	£162,000	(f)	
8 Jun	Transfer – A2Z travel services	(£20,000)	£142,000		8

Year 1

Note 1

The £1,000,000 credited to the account on 15 January was inherited under L's great aunt's will, and is "clean" capital.

Note 2

The £5,000 transfer to the UK on 3 May is a "remittance" from a mixed fund within section 809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer:

Para (a)	employment income	£10,000
Para (d)	RFI	£5,000
Para (f)	Earnings subject to a foreign tax	£5,000
Para (i)	Inherited capital	£1,000,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

Note 3

The purchase of shares on 3 March (£800,000) is an "offshore transfer". By the end of the tax year the shares purchased have not been sold, brought to the UK or otherwise used so that s809Q applies.

The account is treated as including the amounts of foreign income and gain that were present immediately before the transfer (ITA07/s809R(4)). The transfer has no effect on the amount remitted in the current tax year but may need to be taken into account in a later tax year.

Immediately before the offshore transfer the mixed fund consists of:

Para (a)	Employment income	£15,000
Para (d)	Relevant foreign income	£5,000
Para (f)	Earnings subject to a foreign tax	£10,000
Para (g)	Relevant foreign income subject to tax	£2,000
Para (i)	Inherited capital	£1,000,000
		£1,032,000

The "offshore transfer" (the shares purchase) consists of an appropriate proportion (100/129) of each kind of income, gain or capital, within the mixed fund, that is:

Para (a)	employment income	£11,628
Para (d)	RFI	£3,876
Para (f)	Earnings subject to a foreign tax	£7,752
Para (g)	RFI subject to tax	£1,550
Para (i)	Income or capital not within another para	£775,194
		£800,000

Note 4

The £5,000 transfer to the UK on 10 March is a "remittance" from a mixed fund within section 809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for each tax year immediately before the date of the transfer the mixed fund consists of:

Para (a)	employment income	£3,372
Para (d)	RFI	£1,124
Para (f)	Earnings subject to a foreign tax	£2,248
Para (g)	RFI subject to tax	£450
Para (i)	Income or capital not within another para	£224,806
		£232,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), £3,372, para (d) £1,124 and para (f) £504. Of this amount, £1,124 and £504 are taxable remittances.

Note 5

The next remittance on 2 April is again £5,000. Two further amounts have been credited to the account which now consists of

Para (a)	employment income	£10,000
Para (f)	Earnings subject to a foreign tax	£6,744
Para (g)	RFI subject to tax	£450
Para (i)	Income or capital not within another para	£224,806

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

The account now consists of:

Para (a)	employment income	£5,000
Para (f)	Earnings subject to a foreign tax	£6,744
Para (g)	RFI subject to tax	£450
Para (i)	Income or capital not within another para	£224,806
		£237,000

At the end of the tax year, L has made taxable remittances of: £1,628 (para (d) £1,124 and para (f) £504). She has also made two offshore transfers:

Year 2

At the start of the next tax year, L continues to make remittances to the UK from the overseas account. The "mixed fund" rules mean that income gains and capital of a tax year are treated in priority to income gains and capital of a previous year.

Note 6

The £5,000 transfer to the UK on 3 May is a "remittance" from a mixed fund within s809Q(1). Applying the ordering rules in that section, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 2 immediately before the date of the transfer:

Para (a)	employment income	£10,000
Para (f)	Earnings subject to a foreign tax	£5,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

Note 7

On 15 May, L transfers £100,000 to her UK bank account. This is a "remittance" from a mixed fund within section 809Q(1).

Applying the ordering rules section 809Q, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 2 immediately before the date of the transfer:

Para (a)	employment income	£5,000
Para (f)	Earnings subject to a foreign tax	£5,000

So £10,000 of the transfer comes from these two paragraphs of Year 2 income. The outstanding balance of £90,000 must be identified by applying the ordering rules section 809Q, and analysing the mixed fund to identify the separate amounts of income, capital gains and capital in the account for tax Year 1 immediately before the date of the transfer:

Para (a)	employment income	£5,000
Para (f)	Earnings subject to a foreign tax	£6,744
Para (g)	RFI subject to tax	£450
Para (i)	Income or capital not within another para	£224,806

So the remaining £90,000 of the transfer will regarded as consisting of monies from para (a) £5,000, Para (f) £6,744, Para (g) £450 and Para (i) £77,806 from Year 1.

The mixed fund now consists of:

Para (i)	Income or capital not within another para	£147,000

13.5.9 *Example 3: Repayment of loan from mixed fund*

The next HMRC example involves an offshore transfer which is repayment of a loan (not a relevant loan) from a mixed fund.

RDRM 35470 [June 2010]
Example (Frankie)
F, a remittance basis user, has a bank account in Jersey into which is paid both UK source (taxed) income and foreign income and gains. F makes transfers from the Jersey account to his UK account to meet his UK living expenses.
On 28 May, F acquires a loan from his Jersey bank that he uses to purchase an asset in Jersey for £200,000 – Note 3. He repays the [capital of the] loan from this account.

		Credit (Debit)	Balance	Category	Note
6 Apr	Clean capital	£80,000	£80,000	(i)	
15 Apr	RFI NFT	£10,000	£90,000	(d)	
30 Apr	UK salary	£10,000	£100,000	(a)	
30 Apr	RFI bank interest	£5,000	£105,000	(d)	
30 Apr	RFE NFT	£5,000	£110,000	(b)	
3 May	Transfer to UK a/c	(£5,000)	£105,000		1
15 May	RFI	£2,000	£107,000	(d)	
31 May	UK salary	£10,000	£117,000	(a)	
31 May	Overseas salary	£5,000	£122,000	b	
3 Jun	Transfer to UK a/c	(£5,000)	£117,000		2
28 Jun	bank loan repayment[20]	(£15,000)	£102,000		3 & 4
30 Jun	UK salary	£10,000	£112,000	(a)	
30 Jun	Overseas salary	£5,000	£117,000	(b)	
3 Jul	Transfer to UK a/c	(£5,000)	£112,000		5
28 Jul	bank loan repayment	(£15,000)	£97,000		6
31 Jul	UK salary	£10,000	£107,000	(a)	
31 Jul	Overseas salary	£5,000	£109,000	(b)	
3 Aug	Transfer to UK a/c	(£5,000)	£102,000		7
15 Aug	Cheque – ZZZ Cars	(£25,000)	£77,000		8
28 Aug	bank loan repayment	(£15,000)	£62,000		9
31 Aug	Overseas salary	£5,000	£67,000	(b)	
31 Aug	UK salary	£10,000	£72,000	(a)	
3 Sep	Transfer to UK a/c	(£5,000)	£67,000		10

The first two transfers are straightforward:

Note 1
Using the ordering rules at ITA07/s809Q, the remittance to the UK on 3 May is

20 In this example there are monthly repayments of the capital of the loan, but no payments of interest.

matched against the UK salary from that tax year credited to the account on 30 April, as this is the "earliest paragraph" of income or gains within the mixed fund.

Note 2

The remittance on 3 June is also matched against the UK salary from that tax year credited to the account before that date.

We now turn to the point of the example:

Note 3

The £200,000 used to pay for the assets is borrowed capital and is not in itself a remittance or an offshore transfer.

The reason that the payment of £200k is not an offshore transfer is that the sum is not mixed into the mixed fund. If it had been paid into the account (and withdrawn from there to purchase the asset) the position would have been entirely different.

However, subsequent payments of interest and capital used to repay the loan are offshore transfers.

Note 4

At the time immediately before the first repayment of the debt occurs on 28 June, the mixed fund is composed as follows:

Clean capital	£80,000	
UK salary	£10,000	see note 4(a)[21]
Relevant foreign earnings	£10,000	
Relevant foreign income	£17,000	
	£170,000[22]	

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

Clean capital	£10,256
UK salary	£1,282
Relevant foreign earnings	£1,282
Relevant foreign income	£2,180
	£15,000

The property acquired by F using the loan is now regarded as containing this income. [23]

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21 Note 4(a) provides: "Although £20,000 of F's UK salary has been credited to the account, £10,000 has already been remitted prior to 28 June (see Notes 1 and 2)."

22 *Sic;* the Manual has a typographic or an arithmetical error here.

23 See 13.3.6 (Income/gains used to repay debt).

The next remittance is straightforward:

Note 5
The next remittance on 3 July is again £5,000 that is matched against the UK salary credited to the account before that date.

Now comes the second loan repayment:

Note 6
At the time immediately before the repayment on 28 July, the "mixed fund" is composed as follows:

Clean capital	£69,744
UK salary	£13,718
Relevant foreign earnings	£13,718
Relevant foreign income	£14,820
	£112,000

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

Clean capital	£9,339
UK salary	£1,838
Relevant foreign earnings	£1,838
Relevant foreign income	£1,985
	£15,000

The property acquired by F is now regarded as containing this income.

Next come two straightforward onshore transfers:

Note 7
A further £5,000 remittance on 3 August is again matched against UK salary.

Note 8
The payment of £25,000 to ZZZ Cars is to buy a car and is a taxable remittance. Immediately before the transfer the mixed fund is composed as follows:

Clean capital	£60,405
UK salary	£16,880
Relevant foreign earnings	£16,880
Relevant foreign income	£12,835
	£107,000

This £25,000 remittance is matched firstly against UK salary (£16,880), then against relevant foreign earnings (£8,120).

Next another loan repayment

Note 9

At the time immediately before the repayment on 28 August, the mixed fund is composed as follows:

Clean capital	£60,405
UK salary	£nil
Relevant foreign earnings	£8,760
Relevant foreign income	£12,835
	£82,000

The repayment of the monthly bank loan of £15,000 is an offshore transfer, consisting of an appropriate proportion of each kind of income within the mixed fund, that is:

Clean capital	£11,049
Relevant foreign earnings	£1,603
Relevant foreign income	£2,348
	£15,000

Note 10

The fifth remittance on 3 September is again £5,000 that is matched against the UK salary from that tax year credited to the account before that date.

The account now contains £77,000, being

Clean capital	£49,356
UK salary	£5,000
Relevant foreign earnings	£12,157
Relevant Foreign Income	£10,487

For the purposes of this example, assume that on 8 September F wins the Jersey local lottery ("clean capital") and uses his winnings to pay off the outstanding loan.

Three years later, F brings the property acquired with the loan to the UK. The property is a mixed fund, and it is regarded as containing the income and capital used to pay off the loan, that is:

UK salary	£3,120
Relevant foreign earnings	£4,723
Relevant foreign income	£6,513
Clean capital.	£185,644
F has remitted foreign income of	£11,236

The moral which follows from these examples is the imperative of not mixing funds of different types of income or gains, so far as possible.

13.6 Mixed fund with different types of RFI

Suppose an individual holds in one mixed fund two different types of RFI,

both subject to foreign tax but one suffers a higher rate of foreign tax than the other. The ITA mixed fund rules give no guidance because both fall into the same mixed fund category. It is considered that the *Duke of Roxburghe* 20 TC 711 approach applies. A remittance from this mixed fund should be regarded as made first of all out of the income which qualifies for more UK double tax relief.

However, it would be better practice to pay the two types of income into separate accounts. Then this issue does not arise and a remittance from the appropriate account can easily be identified as qualifying for the appropriate relief.

13.7 Mixed funds held by third parties

So far we have considered the ITA mixed fund rules where an individual transfers from a mixed fund containing their own income or gains. The position is more complex when a third party is involved. This may arise in (at least) six circumstances:

(1) A gain accrues to non-resident company within s.13 TCGA, so that a s.13 gain accrues to an individual participator, taxable on the s.13 remittance basis. That gain forms part of a mixed fund (ie the gain is mixed with other funds of the company). There is a taxable remittance if the company remits its gain to the UK. If the company remits part of the fund to the UK, do the mixed fund rules apply to determine whether the part remitted is the gain?

(2) Income arises to a person abroad within s.720, so that s.720 income arises to an individual transferor, taxable on the s.720 remittance basis. That income forms part of a mixed fund (ie the income is mixed with other funds of the person abroad). There is a taxable remittance if the person abroad remits its income to the UK. If the person abroad remits part of the fund to the UK, do the mixed fund rules apply to determine whether the part remitted is the income?

It is suggested that the ITA mixed fund rules can apply in these two circumstances. Step 1 of s.809Q(3) requires one to find the income or gains of the "individual" but the funds in the hands of the third person are treated as derived from the s.720 income or s.87 gains of the individual, so applying s.809R(2) ITA the funds in the hands of the third party are treated as consisting of that income or gains. This view may favour the taxpayer, particularly for a company which is within s.720 but not s.13. Suppose:

(a) A settlor-interested trust holds a company within s.720.

(b) The settlor/transferor is subject to tax on the company income under the s.720 remittance basis, ie if the company remits income to the UK.

(c) The company holds a mixed fund consisting of:

Income of year 1:	£100
Gains of year 2:	£100
	£200

(d) The company remits £100 to the UK.

The sum remitted is regarded as the gain, so there is no charge under the s.720 remittance basis.

Had the transferor held the company directly (not via the trust) the remittance would have given rise to a CGT charge under the s.13 remittance basis.

Similar points arise for a company which is within s.13 but not s.720, though that is now rarer because of the s.13 motive defence.

(3) Income or gains accrue to an individual and the individual gives the income or gains to a relevant person ("R"). The income or gains form part of a mixed fund (ie the income or gains are mixed with other funds of R). There is a taxable remittance if R brings the gifted funds to the UK. If R remits part of the fund to the UK, do the mixed fund rules apply to determine whether the part remitted is the income or gains?

(4) An individual makes a gift of an asset to a relevant person ("R"), on which a deemed gain arises. The asset is treated as derived from that gain and there is a taxable remittance if R remits the asset to the UK. The asset forms part of a mixed fund (ie the asset is mixed with other funds of R). If R remits part of the mixed fund to the UK, do the mixed fund rules apply to determine whether the part remitted is T's income or gains?

Suppose R and the individual ("T") are UK resident at all times. Suppose:

(1) T gives income, say, RFI, ("T's income") to R.

(2) R mixes T's income with gains of R (accruing in the same year).

(3) R remits part of the mixed fund.

Has R remitted T's income or R's gains? It is in R's interest to argue that R has remitted T's income, and in T's interest to argue that R has remitted R's gains.

One must categorise R's mixed fund into the mixed fund categories. The part derived from T's income seems to fall into two categories: it is both RFI of T (within category (d)) but it is also capital of R. However it does

not fall within the final category (i) since that refers to capital *not within another paragraph of this subsection*. So this item is treated as income within category (d). It is considered that R has remitted T's income first.

This rule normally works in favour of HMRC, but if T is not UK resident at the time of the remittance, it works in favour of R.

A similar problem arises in the case of a joint account, where the income of joint account holders is mixed; see 77.6 (Remittances from joint accounts).

(5) Income/gains accrue to an individual ("T") and the individual gives the income/gains to a non-relevant person ("P"). The common example will be a gift of pre-2008 income/gains to a trust. The trustees are not a relevant person in relation to those income/gains. But there will be a taxable remittance if T receives the income/gains. What if the income/gains form part of a mixed fund held by the trustees? It is suggested that the mixed fund rules apply.

(6) Income/gains accrue to a partnership, and the partnership makes a distribution to the partners. It is suggested that the mixed fund rules apply.

13.8 Unremitted income transferred to trust

Suppose:

(1) A remittance basis taxpayer ("S") receives foreign income[24] ("the old income") which is not remitted to the UK and so not taxed.

(2) S transfers the old income to a non-resident trust.

(3) The trustees invest and realise gains ("trust gains") in a subsequent tax year. For simplicity, assume that no income arises to the trustees, or any income which arises to them is segregated and paid out to S.

(4) The trustees make a distribution to S which is received in the UK.

If the distribution is an income receipt of S, it is taxed as an annual payment on ordinary principles;[25] that does not count as a taxable remittance of the old income as the receipt of new income should not be regarded as derived from the old income.[26] (It may not matter whether the distribution is taxed under either way, so long as it is not taxed on both, but it might matter eg if the old income was dividend income, as the rates of tax are different for annual payments.)

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24 Some similar points would apply if T settles gains.

25 See 25.3 (Tier 3: Discretionary income payment: charge on beneficiary).

26 See 11.15.11 (Income from income/gains).

Suppose the distribution is a capital receipt of S. This raises the question of the interaction of:

(1) the ITA remittance basis charge on the old income and

(2) s.87 charge which arises if S receives a capital payment.

The first question is whether the distribution is derived from the old income. One applies the mixed fund tracing rules. If the payment is out of a mixed fund holding the old income and the capital gains, the capital gains are treated as distributed first, as they are gains of a later year. So if the distribution is less than the gains in the mixed fund, the distribution is not the old income. The distribution is a capital payment, matched to the trust gain, and subject to CGT under s.87. If the distribution exceeds the gains in the mixed fund, it is partly derived from the old income and the old income comes into charge. It is considered that a distribution derived from the old income received in the UK is not a capital payment.[27]

The application of the rules becomes very intricate. Take the following (simplified) example:

S has £900 of old income arising before year 1 ("S's old income"). S transfers this to a non-resident trust. The trust gains and distributions are as follows:

Year	Gift to trust	Trust Gains	Distribution	Total Fund
0	£900			£900
1		£100	nil	£1,000
2		nil	£200 to W	£800
3		£200	nil	£1,000
4		nil	£400 to S	£600

Assume the distributions are received in the UK and that S and W are UK resident. (If received outside the UK and (un)taxed on the remittance basis then no difficulty arises.)

For simplicity, I ignore the trust's CGT annual exemption.

The tax analysis is as follows:

Year 2

The tax analysis of £200 distribution to W in year 2 is (relatively) straightforward. The £200 distribution to W in year 2 does not constitute a taxable remittance of the old income, for IT purposes, because

27 See 51.6.5 (Payment in form of income (un)taxed on remittence basis).

remittance condition A in s.809L is not satisfied. Assume W is not a relevant person.[28]

The £200 distribution is a capital payment which is matched with the £100 trust gain. W is therefore treated as receiving s.87 gains of £100. The remaining £100 of the £200 distribution is unmatched in year 1, and carried forward. We need not consider the mixed fund rules at this point.

Year 3

The remaining £100 of the £200 distribution which was unmatched in year 2 is matched to the trust gain in year 3. W is treated as receiving a s.87 gain of £100 in year 3. The remaining trust gain of £100 is unmatched in year 3 and carried forward to be matched to future capital payments.

Year 4

The tax analysis of the £400 payment to S in year 4 is more complicated.

First, to what extent is the payment derived from S's old income? For IT purposes, what were the constituents of the fund from which the payment was made, immediately before the £400 payment to S? Here we do need to consider the mixed fund rules.

The trustees made a transfer of £200 to W of out a mixed fund:

S's old income but the trustees capital	£900
gain of year 1	£100
total	£1,000

That is an offshore transfer (as defined) since s.809Q does not apply to it; see s.809R(5) and s.8090Q(1). So the transfer consisted of:

one fifth of the capital	£180
one fifth of the gain	£20
total	£200

So the trustees fund before the £400 transfer in year 4 consisted of:

S's old income but the trustees capital	£720
gain of year 1	£80
gain of year 3	£200
total	£1,000

Applying the mixed fund rule, the £400 payment to S consists of the gains before the old income (because they are gains of a later year) so it consists of:

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28 If S's old income is pre-2008 income, W could be the wife of S, as (for pre-2008 income) a relative is not a relevant person.

gain of year 1	£80
gain of year 3	£200
S's old income but the trustees capital	£120
total	£400

£280 of the capital distribution is not derived from the old income. Of that sum, £100 is matched to the outstanding trust gains, and the balance (£180) is carried forward to be matched against future trust gains.

£120 of the payment is matched to S's old income and is subject to income tax as remitted income. That is not a capital payment.[29]

13.9 Remittance due to bank error

The RDR Manual provides:

> **33560 Banking Issues** [December 2011]
> *Bank Errors and Mistakes*
> Where a bank acts contrary to express instructions by an account holder, and that mistake inadvertently results in a taxable remittance to the UK by the account holder, the account holder and the bank may alter the transaction in line with the original instructions given.
> If the bank does this, HMRC will treat the earlier [mistaken] transaction as not having taken place and the new transaction as being the original transaction in looking at whether there has been a taxable remittance from that account.

This is soundly based on *Duke of Roxburghe's Executors v IRC* 20 TC 711 where a taxpayer received and held offshore:

(1) income subject to UK tax on an arising basis ("taxed income");[30] and
(2) foreign income which qualified for the remittance basis, and which was therefore taxed if remitted ("untaxed income").

These were wisely held in separate accounts and so a remittance out of the taxed income account would not be taxable. The taxpayer correctly directed the bank to make a remittance to the UK out of her taxed income account. Unfortunately the bank made a remittance out of the wrong account, so the sum remitted could (largely) be traced to untaxed income!

The Court of Session identified the sum remitted as taxed income because the taxpayer had *intended* the remittance to come out of taxed

29 See 51.6.5 (Payment in form of income (un)taxed on remittence basis).

30 Being foreign source income of a class not then qualifying for the remittance basis and so subject to UK income tax on an arising basis.

income.[31]

The statement also applies in other circumstances of bank error, eg if a bank was instructed to pay a dividend into a foreign account and accidentally paid it into the UK.

Contrast 13.14.8 (Accidental remittance of nominated income/gains).

13.10 Mixed fund anti-avoidance rule

Section 809S contains a rule which I call "**the mixed fund anti-avoidance rule**".

13.10.1 *Condition for application of mixed fund anti-avoidance rule*

Section 809S(1) ITA provides:

> This section applies if, by reason of an arrangement the main purpose (or one of the main purposes) of which is to secure an income tax advantage or capital gains tax advantage, a mixed fund would otherwise be regarded as containing income or capital within any of paras (f) to (i) of section 809Q(4).

There are two requirements here.

Firstly, there must be an arrangement[32] with the specified purpose. IT advantage and CGT advantage have the standard (wide) definitions.[33] The

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31 "The Duchess was entitled to have the remittance debited against any fund belonging to her and under her control and that she did so effectually by the *instructions* to debit it against money not derived from the [untaxed] income." Lord Normand at p.726 (emphasis added).

This was also the view of Lord Fleming at p.732: "I base my decision ... on the ground that it was the legal right of the Duchess to make the appropriation against any particular fund belonging to herself, and that in law she made that appropriation when she directed the Bank making the remittance to charge it against her funds in their hands which had already borne British Income Tax."

A second ground of the decision was that a remittance out of a mixed fund with taxed and untaxed income is in general to be treated as out of the taxed income regardless of the intention of the taxpayer. The second ground is now reversed by the ITA mixed fund rules.

32 Section 809S(3) ITA contains the usual (unnecessary) commonsense definition of "arrangement":

"'Arrangement' includes any scheme, understanding, transaction or series or transactions (whether or not enforceable)."

33 Section 809S provides:

(4) "Income tax advantage" means—

(a) a relief from income tax or increased relief from income tax,

terms are not limited to tax avoidance in the strict sense.

Secondly, by reason of the arrangement, a mixed fund would otherwise be regarded as containing income or capital within mixed fund categories (f) to (i). The English is mangled, but the meaning must that in the absence of the arrangement, a mixed fund would contain income or capital within those categories.

The mixed fund anti-avoidance rule applies only if the mixed fund contains income or capital within mixed fund categories (f) to (i). So if a mixed fund consisted of (say) RFI within category (d) and chargeable gains within category (e), the anti-avoidance provision does not apply. This is a little surprising and it might be that s.809S(4) contains a typographical error, (f) being a slip for (a). But it is not obvious that there has been an error, as there is rather more scope for manipulation of the rules in a mixed account which contains categories (f) to (i). So a court should construe the section to mean what it says. In practice the point is not so important as a mixed fund will usually contain some item within categories (f) to (i).

13.10.2 *Application of the mixed fund anti-avoidance rule*

Section 809S(2) ITA provides:

> Treat the mixed fund as containing so much (if any) of the income or capital as is just and reasonable.

(b) a repayment of income tax or increased repayment of income tax,
(c) the avoidance or reduction of a charge to income tax or an assessment to income tax, or
(d) the avoidance of a possible assessment to income tax;
and for this purpose "relief from income tax" includes a tax credit.

(4A) For the purposes of subsection (4)(c) and (d) it does not matter whether the avoidance or reduction is effected—
(a) by receipts accruing in such a way that the recipient does not pay or bear income tax on them, or
(b) by a deduction in calculating profits or gains.

(5) "Capital gains tax advantage" means—
(a) a relief from capital gains tax or increased relief from capital gains tax,
(b) a repayment of capital gains tax or increased repayment of capital gains tax,
(c) the avoidance or reduction of a charge to capital gains tax or an assessment to capital gains tax, or
(d) the avoidance of a possible assessment to capital gains tax.

Subsection (4A) was added in 2010; while it is a standard provision in other contexts, I am unable to see how it could ever apply here.

Section 809S is clearly intended to override the offshore mixed fund transfer rule although this is not expressly stated.[34]

Suppose:

(1) T has an account ("the first account") with a mixed fund containing £2m, 50% income and 50% capital.

(2) T transfers £1m (half the total amount) to another account (an offshore transfer). T intends to keep that amount offshore.

(3) T then remits the funds in the first account to the UK.

Applying the offshore transfer mixed fund rule the first account, which is remitted, consists of 50% income and capital, so on remittance 50% of the sum received is tax free. In the absence of the offshore transfer, the whole of the £1m remitted would have been subject to income tax.

The offshore transfer is an arrangement which secures an IT advantage. Assuming this was one of the main purposes, the condition for the application of the mixed fund anti-avoidance rule is satisfied.

One then has to ask what is "just and reasonable". The drafter has given up here and left the courts to sort it out.[35] One might say that it is reasonable to apply the pre-2008 mixed fund rules. That can hardly be described as unjust or unreasonable. But it is considered that the expression "just and reasonable" should be construed in accordance with the policy of the onshore transfer mixed fund rule. So the arrangement should be disregarded: it would be just and reasonable to raise tax as if the offshore transfer from the first account had not been made. To put it another way, it is just and reasonable that transfers whose main purpose is to obtain a tax advantage should not do so.

If that were wrong, what would happen if there were a second transfer from the first account: in this way one could reduce the income element of any mixed fund to a relatively small sum by a series of offshore transfers.

13.11 Transitional rules for pre-2008 mixed fund

The ITA mixed fund rules raise transitional issues which the FA 2008

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34 The mixed fund anti-avoidance rule could also override the *onshore* transfer mixed fund rule, but it is not likely ever to be just and reasonable to substitute any other set of rules.

35 CIOT express the point more strongly: Response to consultation paper "Reform of the taxation of non-domiciled individuals"; "Section 809S is so widely drawn as to be almost meaningless."

addresses only in general terms, leaving HMRC, taxpayers and the courts to sort the matter out as best they can.

Para 89 Sch 7 FA 2008 provides:

> Sections 809Q to 809S of ITA 2007 (transfers from mixed funds) do not apply for the purposes of determining whether income or chargeable gains for the tax year 2007-08 or any earlier tax year are remitted to the UK (or the amount of any such income or chargeable gains so remitted).

13.11.1 *Pre-2008 transfer from mixed fund with pre-2008 income/gains*

Suppose:

(1) A mixed fund contains pre-2008 income/gains.

(2) A transfer is made from that fund to the UK before 2008.

One obviously applied the pre-2008 mixed fund rules (discussed in the next section) to identify what was remitted at the time of the transfer and the same rules determine what income/gains remain in the fund (which may be remitted post 2008).

13.11.2 *Post-2008 transfer from mixed fund with pre-2008 income/gains*

Suppose:

(1) A mixed fund contains pre-2008 income/gains (no post-2008 income/gains have been added).

(2) A transfer from that fund is made after 2008.

One needs to determine what part of that fund is remitted to the UK. Para 89 means that one disregards the ITA mixed fund rules (and instead applies the pre-2008 mixed fund rules discussed in the next section).[36] HMRC agree.[37]

13.11.3 *Post-2008 transfer from mixed fund with pre- and post-2008 income/gains*

Suppose:

(1) A mixed fund contains pre-2008 and post-2008 income/gains.

(2) A transfer from that fund is made after 2008.

One needs to determine what part of that fund is remitted to the UK. The

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36 This view is the more natural reading. Also, if it were wrong (so one had to apply the ITA mixed fund rules) it would be necessary to classify the constituents of the mixed fund held at 6/4/08 by date and by the nine mixed fund categories, going back without limit of time. Records in many cases will not exist.

37 See 13.14.2 (Transfer of fund with pre- and post-2008 entries).

analysis comes in two stages.

(1) First one has to determine whether the transfer consists of pre-2008 or post-2008 income/gains.

(2) (a) If the transfer consists of pre-2008 income/gains, one applies the pre-2008 mixed fund rules to identify what is remitted.

(b) If the transfer consists of post-2008 income/gains, one applies the ITA mixed fund rules to determine what is remitted.

Which set of rules apply at stage 1? It is suggested that one first applies the ITA mixed fund rules so far back as 2008/09 and then the pre-2008 mixed fund rules. HMRC agree.[38]

13.12 Pre-2008 mixed fund rules

We can now turn to consider the pre-2008 mixed fund rules. There were few statutory provisions. There were a few old cases, supplemented by practice, and outside areas governed by clear rules, I expect HMRC would accept any reasonable view.

13.12.1 *Remittance from mixture of taxed and untaxed income*

The RDR Manual provides:

> **36320. Remittances from a mixed fund** [June 2010]
> ... Where an overseas 'mixed fund' contained an amount that has already suffered UK tax, for example UK salary dealt with under PAYE, the practice (*Sterling Trust v CIR* 12 TC 868) was that a taxpayer was entitled to say that he or she has remitted income which has already suffered UK tax (to the extent that such income exists in the fund) in priority to income which is assessable on the arising basis [ie in priority to income which is assessable if remitted].[39]

This is soundly based on *Duke of Roxburghe's Executors v IRC*.[40]

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38 See 13.14.2 (Transfer of fund with pre- and post-2008 entries).

39 The same point is made in RDR Manual 35320 [June 2010] (Mixed Funds: Example 4 - remittances before 6 April 2008, Note 2).

40 20 TC 711 discussed in another context at 13.9 (Remittance due to bank error). Although the taxpayer in *Roxburghe* kept the funds in two accounts at the bank, the result would have been the same if the taxed and untaxed income had been held in a single bank account. This was accepted without argument in *Walsh v Randall* 23 TC 55: see para 3 of the Special Commissioners' decision, and it is accepted in this passage from the RDR Manual.

13.12.2 *Remittance from mixture of untaxed income and income qualifying for DT relief*

Suppose an individual holds in one pre-2008 mixed fund:

(1) income which is subject to foreign tax and qualifies for UK double tax relief; and

(2) untaxed foreign income taxable in full on the remittance basis.

It is considered that the *Roxburghe* approach applies. A remittance from this mixed fund should be regarded as made first of all out of the income which qualifies for UK double tax relief.

13.12.3 *Remittance from mixture of capital and income*

In *Scottish Provident Institution v Allan* 4 TC 591, the taxpayer held offshore:

(1) Capital which had been invested in secured loans in Australia, and which would not be taxable if remitted; and

(2) Interest arising from those loans, which qualified for the remittance basis, and which was therefore taxed if remitted.

A sum was remitted to the UK and the question was whether this sum was the untaxed income or the capital. The background was this:

(1) The income and capital had been paid into a single account (mixed).

(2) The remittances (from the Australian agents) had been accompanied by letters stating that the sums remitted represent repayments of the loans, ie capital. The loans had in some cases been repaid only very shortly before the remittance.

(3) The sum remitted (£200,000) was small compared to the amount of the loans and the interest received (each about £1.5m).

It was held that the remitted sum was the income, not capital. The Lord Chancellor said:

> It is obvious that the mere nicknaming the sum received and ascribing to it, because it is so named, the character of capital and not of income, cannot defeat the right of the Crown to have the tax levied upon that which in substance and truth is [income] ...[41]

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41 4 TC 591 at p593. Similarly Lord Davey: "I must say that that is a draft upon my credulity, a strain upon my powers of belief, which they will not bear. I agree that the mere calling it capital for the purpose of the Inland Revenue Department will not make into capital that which is essentially and in truth ... the interest received on the securities."

Two points shine out:

(1) The description of the remittance as capital does not make the remittance capital if "in truth" it is income. This is obviously right, an application of the Shakespearean principle that "a rose by any other name ..." However, this principle does not address the more fundamental question of *how* the courts determine what is income and what is capital.

(2) The answer to this second question is that the courts look to the substance.

However, it is one thing to look for the substance, and another to find and identify it. Why, in substance, was the remittance from the income, not from the capital? The answer may be found in the speech of Lord Robertson: "The facts of the case must furnish the inference."

The following facts were relevant:

> [1] First of all there is the fact of remittance in two consecutive years ...
> [2] There is no suggestion that any exceptional reason required remittances of capital, in either year or in both.
> [3] On the other hand it is certain that the amount of invested capital left behind in the Colony, after these remittances, is larger than before; so that the capital is fully accounted for.
> [4] Well then, what is done with this so-called capital remitted? The answer is, exactly what would be done with profits.

This is explained by Lord Shand in argument:

> If it is capital you have brought back and distributed as bonus, you have been paying back capital, which I should think you have no authority to do.

This is why Lord Robertson concluded:

> The inference from these facts is that the moneys remitted were in fact profits, [ie income] ...

The former Inspectors Manual para 1566 gave the HMRC view:

> Where a person maintains abroad a fund (for example, a bank account) containing income assessable on the remittance basis, a capital lodgement to the fund is normally considered to lose its identity in the fund. A subsequent remittance from such a mixed fund, therefore, represents income up to the full extent of the income content of the fund (see *Scottish Provident Institution v Allan* 4 TC 409 and 4 TC 591, and

> especially the Lord Chancellor's remarks on 'mere nicknaming' at 4 TC 593). Only when the income content of the fund is exhausted will any balance remitted be regarded as capital. Where this is not accepted, the full facts of the case should be reported to Revenue Policy, International (Cases IV and V), Victory House.

The Inspectors Manual over-simplified the law as expounded in *SPI v Allan.* There is no rule that the remittance out of a mixed fund of income and capital is to be treated as income first. Suppose a taxpayer remits a substantial amount, exceeding the income, and applies it capital expenditure, such as an investment in the UK, or the purchase of a house. It is considered that the "substance" of the matter, applying Lord Robertson's approach, is that the remittance is one of capital. The position is even stronger if the taxpayer first uses an amount equal to the income of a mixed account on expenditure abroad of an income nature.

The RDR Manual now provides:

> **36320. Remittances from a mixed fund** [June 2010]
>
> For tax years up to 5 April 2008, there are no statutory rules to determine what amounts remitted from 'mixed funds' actually consisted of.
>
> On occasion this created difficulty in determining, for UK tax purposes what a remittance to the UK actually consisted of, for example, was it non-taxable income, employment income, interest, chargeable gains or capital.
>
> *Scottish Provident v Allan*
>
> Broadly HMRC practice was based on House of Lords decisions, in particular that of *Scottish Provident v Allan* (4 TC 409/591). In the Court of Exchequer, Lord McLaren said (page 419)
>
> > 'un-appropriated remittances must be dealt with according to the ordinary course of business, and these remittances must be presumed to be paid in the first place out of interest so far as they are income, and in the second place of principal or capital. I think that rule results from the fact that no prudent man of business will encroach upon his capital for investment when he has income un-invested lying at his disposal'.
>
> The House of Lords considered that the question of whether any amount of income had actually been received in the UK is essentially one of fact, that is, of tracing in the first instance, or, where direct tracing proves to be impossible, of inference from the known facts.
>
> In the absence of any evidence to the contrary, the principle is that where capital and income have been paid into a single fund overseas so

> that they are no longer distinguishable, remittances to the UK out of the fund will be presumed to be income to the extent that there is income existing in the fund at the time that the remittance was made.
> ... Only when the income content of the fund is exhausted will any balance remitted be regarded as capital.[42]

Note that *SPI v Allan* was a case where the mixed fund was capital and income. The case can have no application where the mixed fund consists of different kinds of income or different kinds of capital.

At first sight there is some tension between *SPI v Allan* and *Duke of Roxburghe* 20 TC 711. In the first, "mere nicknaming" was contemptuously dismissed; in the second, it was the "legal right" of the Duchess to direct whether the remittance was from one part of a mixed fund or the other. The cases agree, however, that the matter is one of "substance". It is submitted that the cases can be reconciled in this way: in a marginal case, the description of the remittance given by the taxpayer may be decisive. Where the substance of the transaction shows that a remittance is one of income or capital, "mere nicknaming" will not alter the position.

13.12.4 *Remittances out of mixed capital funds*

Suppose an individual holds in one pre-2008 mixed fund:

(1) capital which does not represent any chargeable gain within the scope of CGT; and
(2) the proceeds of a disposal on which a chargeable gain accrued.

A remittance from this fund should for CGT purposes be treated as coming out of the tax free source first.

13.12.5 *Remittance of gain or remittance of base cost?*

Suppose a foreign domiciliary purchases a foreign asset for £1m; they sell it for £3m and realises a pre-2008 chargeable gain of £2m. If they remit the entire £3m proceeds, the entire £2m gain is charged to CGT. But what is the position if they remit only £1m and retain the balance abroad? The RDR Manual provides:

> **36320. Remittances from a mixed fund...** [June 2010]
> *Capital Gains*

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42 The same passage is found in RDRM 35320 Note 2.

> For years up to 5 April 2008, where a remittance is made to the UK from a mixed fund into which the proceeds from the sale of an asset (such as a shareholding) has been paid the remittance contains a due proportion of any capital and of any capital gain arising from the disposal.
> That is because, unlike income that can be identified separately, a capital gain is merely part of the money received from the sale and has no separate existence within that amount. Refer to the Capital Gains Manual CG25380 onwards (and CG25440 in particular).[43]

The last sentence is correct to say that a capital gain has no separate existence. I do not think it even exists as "part of the money received from the sale". It is not a separate or separable item of property existing at all. The gain is merely the result of a computation. The proceeds of a disposal represent the gain, but they do not constitute the gain, just as trading receipts do not constitute the profits of a trade. So it is considered that the HMRC view is correct.

13.13 Pre-2008 mixed funds: HMRC examples

The RDR Manual gives two examples concerning pre-2008 mixed funds.

13.13.1 *Pre-2008 transfer from a pre-2008 mixed fund*

The first example involves a pre-2008 transfer from a pre-2008 mixed fund. One therefore applies the pre-2008 mixed fund rules.[44]

> **35320 Mixed Funds: Example 4 - remittances before 6 April 2008**
> **Example 4** (Martyn) [June 2010]
> The "mixed fund" rules in s809Q do not apply to amounts that are in an account before 6 April 2008 (FA2008/para 89).
> M has lived in the UK for many years. He has paid UK tax on the remittance basis for all relevant tax years and has decided that he will do so again for 2008/2009.
> M has his UK salary paid into his overseas bank account. He also has a salary for overseas employment and his net salary for that work of £5,000 a month is paid into the account. Dividends from a shareholding in a foreign company are also paid into the account.
> On 18 March M sold some of his foreign shares as he was thinking of purchasing a new property. He deposited the proceeds of £5,000,000 from the sale into his overseas account. This amount is made up of £4m capital and £1m gain (no

43 The same point is made at para 35320 (Mixed Funds: Example 4 - remittances before 6 April 2008 Note 3).

44 See 13.11.1 (Pre-2008 transfer from mixed fund with pre-2008 income/gains).

deduction of foreign tax).

Tax Year 2007-2008		**Credit (Debit)**	**Balance**	**Note**
	Balance b/f		£47,000	1
31 Dec	UK salary (net of tax)	£10,000	£57,000	
31 Dec	Overseas salary (net of tax)	£5,000	£62,000	
3 Jan	Transfer to UK account	(£5,000)	£57,000	2
31 Jan	UK salary	£10,000	£67,000	
31 Jan	Overseas salary	£5,000	£72,000	
3 Feb	Transfer to UK account	(£12,000)	£60,000	2
15 Feb	Dividend	£2,000	£62,000	
29 Feb	UK salary	£10,000	£72,000	
29 Feb	Overseas salary	£5,000	£77,000	
3 Mar	Transfer to UK account	(£8,000)	£69,000	2
18 Mar	Share Sale £4m capital, £1m gain	£5,000,000	£5,069,000	3[45]
31 Mar	UK salary	£10,000	£5,079,000	
31 Mar	Overseas salary	£5,000	£5,084,000	
3 Apr	Transfer to UK account	(£10,000)	£5,074,000	2

Note 1: Identity of balance brought forward

The balance brought forward of £47,000 is made up of	
UK salary	£15,000
overseas salary	£25,000
overseas dividends	£7,000
	£47,000[46]

The Manual then considers the tax analysis of the four UK transfers. The key fact is that M never remitted more than the UK salary already received in the account (the transfers totalled £35k and salary totalled £55k). The Manual provides:

> **Note 2: Transfers to UK account**
> ... So to establish the taxable amount of remittances made in the example above in 2007-2008 the account must be analysed. In this case the analysis is straightforward. M has brought £35,000 to the UK between December 2007 and March 2008 to meet his day to day UK spending needs. Applying the *Sterling Trust v IRC* practice outlined above,[47] the £35,000 can be regarded as remittances consisting solely of his UK

45 For this note, see 13.12.5 (Remittance of gain or remittance of base cost?).

46 The Manual adds: "all items arising in, and credited during that tax year. M has paid the relevant amount of UK tax based upon his UK sources of income and the amounts of foreign income and gains that he has remitted to the UK." But that is not relevant to the example.

47 See 13.12.1 (Remittance from mixture of taxed and untaxed income).

salary that has already been taxed under PAYE. Because he has claimed the remittance basis of taxation in respect of his relevant foreign income or foreign earnings for 2007-2008 he has no further amount of UK tax to pay on these amounts that stay in the Offshore account.

The example is repeated in RDR Manual 36330 [June 2010] (Remittances from a mixed fund - Example 1).

13.13.2 *Transfer from fund with pre- and post-2008 entries*

The next example is a post-2008 transfer from a mixed fund containing pre- and post-2008 income/gains.

35330 Remittances from mixed funds involving income/gains before 6 April 2008 - Example 4a [June 2010]

Continuing from the example 4 above, on 5 April 2008 M's Offshore account contains:

2007- 2008	UK salary	£20,000
	Overseas salary	£45,000
	Overseas dividends	£9,000
	Sale of shares: Capital	£4,000,000
	Sale of shares: Gain	£1,000,000
		£5,074,000

2008-2009		**Credit (Debit)**	**Balance**	**Category**	**Note**
6 Apr	Balance b/f	£5,074,000			
30 Apr	UK salary (net)	£10,000	£5,084,000	Para (a)	
30 Apr	Overseas salary (net)	£5,000	£5,089,000	Para (f)	
3 May	Transfer to UK acc	(£5,000)	£5,084,000		1
15 May	Dividend	£2,000	£5,086,000	Para (g)	
31 May	UK salary	£10,000	£5,096,000	Para (a)	
30 May	Overseas salary	£5,000	£5,101,000	Para (f)	
30 Jun	UK salary	£10,000	£5,111,000	Para (a)	
30 Jun	Overseas salary	£5,000	£5,116,000	Para (f)	
30 Jun	Direct Debit to UK	(£100,000)	£5,016,000		2

Note 1 analyses the £5k remittance made 3 May:

Applying the ordering rules in S809Q to the account **immediately before the** transfer:

Step 1 Identify the "amount of transfer" in the relevant tax year (2008-09)	£5,000
Identify the separate amounts of income, gains and capital present for the relevant tax year (2008-09) immediately before the transfer:	
Para (a) Employment income not subject to a foreign tax	£10,000
Para (f) Employment income subject to a foreign tax	£5,000
Step 2 Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	
Para (a)	£10,000
Step 3 Where the amount of the remittance is less than the amount	

identified at Step 2 the amount remitted is treated coming entirely from that paragraph. There is no need to continue to step 4. £5,000

The remittance is regarded as coming from the "earliest paragraph", that is para (a), so the £5,000 is UK employment income, so there is no taxable remittance of foreign income nor further tax to pay upon remittance.

Note 2 analyses the £100k remittance made 30 June. At this point the example becomes more challenging:

M decided to buy a residential property. He remits £100,000 to pay some legal fees [!] for the purchase on 30 June. Although M considers that this amount has come from the sale of shares in 2007-2008 the ordering rules in s809Q require the remittance to be taken into account first against all income and gains of the year in which the remittance is made.

Step 1 Identify the "amount of transfer" in the relevant tax year (2008-2009)	£100,000
Identify the separate amounts of income, gains and capital present for the relevant tax year (2008-09) immediately before the transfer:	
Para (a) Employment income not subject to a foreign tax	£25,000
Para (f) Employment income subject to a foreign tax	£15,000
Para (g) Relevant foreign income subject to a foreign tax	£2,000
Step 2 Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund:	
Para (a)	£25,000
Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2.	£100,000
	- £25,000
	£75,000
Step 4 Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.	
Step 2 Identify the earliest paragraph: **Para (f)**	£15,000
Step 3 Where the amount of the remittance is greater than the amount identified at Step 2 the amount remitted is treated as reduced by the amount identified in Step 2	£75,000
	-£15,000
	£60,000
Step 4 In the order of preference listed above repeat Steps 2 and 3.	
Step 2 Para (g)	£2,000
Step 3	£60,000
	- £2,000
	£58,000

At this stage all of the amounts credited to the account in 2008-09 have been matched against £100,000 remittance transfer [in my terminology an onshore transfer] in that year. But £58,000 has been brought to the UK that has not been "matched" under the s809Q rules (and cannot be matched because of FA2008/para89).
The remaining £58,000 is regarded as coming from the 2007-08 credits to the account.

The ordering rules at section 809Q cannot be used, so instead the general principles outlined in Note 2 of example 4 above will apply.

HMRC then explain the applicable pre-2008 mixed fund rules:

This £58,000 will usually be regarded as a remittance of M's income and is, first and foremost (*Sterling Trust* principle) his taxed income and then (*Scottish Provident v Allan* principle) any other income - that is his foreign employment income or dividends - as he selects.
However in this case M may equally be able to demonstrate that the remaining £58,000 comes from the proceeds of the sale of shares, as he particularly sold the shares in order to fund this house purchase. If that is the case, the remaining remittance will consist of £11,600 foreign chargeable gain (1/5 due proportion – see note 3 in example 4).[48]

HMRC do not say whether the £58k remittance is income or capital. How is M to "demonstrate that the £58k comes from the proceeds of the sale of shares" given that the payment was out of a mixed fund? The correct approach is to say that the substance is one of a remittance of capital since the purchase is for the house, ie has the nature of capital expenditure.[49] Thus the £58k remittance is capital.

The moral of the example is that M should not have paid the proceeds of the share sale into a mixed account. If it had been paid into a separate account, and the £100k paid from there, the position would have been simpler and better.

13.14 Remittance of nominated income or gains

13.14.1 *Outline*

EN FB 2008 provides:

> 14... If, in subsequent years, that "nominated" income or gains upon which the RBC has been paid is, in fact, remitted to the UK, then that income or gains will not be taxed again. However, there are ordering rules to ensure that if "nominated" income or gains is, in fact, remitted when other untaxed income and gains remain unremitted, then that unremitted income and gains is treated as being remitted before the "nominated" income and gains.

These rules are not (or not just) mixed fund rules, as they may apply even if funds are not mixed; but it is convenient to deal with them in this

48 See 13.12.3 (Remittance from mixture of capital and income).
49 See 13.12.3 (Remittance from mixture of capital and income).

chapter.

13.14.2 *"Nominated income and gains" and "nomination year"*

The expression "nominated income and gains" is defined in s.809I(3) ITA. The drafter thought that this was a section-wide definition only, so repeated the definition in s.809J(3) ITA. (If the definitions had been made ITA-wide definitions this repetition would not have been necessary.) The definition provides:

> (3) In this section the individual's "nominated income and gains" are the total income and chargeable gains nominated by the individual under section 809C for the relevant tax year or any earlier tax year (each such year for which the individual has made a nomination under that section being referred to as a "nomination year").

The definition is discussed in 10.11.3 (Nomination of income and gains).

13.14.3 *"Remittance basis income and gains"*

Section 809I(4) ITA gives this term a fairly commonsense meaning:

> An individual's "remittance basis income and gains" are the foreign income and gains of the individual for all the tax years (up to and including the tax year mentioned in subsection (1)(a)) for which section 809B, 809D or 809E applies to the individual, apart from the individual's nominated income and gains.

Nominated income/gains do not count as remittance basis income/gains because they are taxed on an arising basis. The drafter thought that this was a section-wide definition only, so repeated the definition in s.809J(4):

> (4) In step (1) of subsection (1) the individual's "remittance basis income and gains" are the foreign income and gains of the individual for all the tax years (up to and including the relevant tax year) for which section 809B, 809D or 809E applies to the individual, apart from the individual's nominated income and gains.

13.14.4 *Nominated income/gains categories*

The taxpayer must classify all their remittance basis income and gains into 8 categories, which I will call **"the nominated income/gains categories"**. The categories are set out in s.809J(2) ITA. These are almost the same as

the nine mixed fund categories[50] but:

(1) there are casual differences of wording which do not affect the meaning; and

(2) there are (incredibly) small differences of substance (I do not see why – if any reader can suggest a reason I would be interested to know).

I here set out a table which compares the two (the differences are italicised):

Nominated income/gains categories	**Mixed fund categories**
	(a) *employment income (other than income within para (b), (c) or (f))*
(a) relevant foreign earnings (other than those subject to a foreign tax)	(b) relevant foreign earnings (Other than income within para (f))
(b) foreign specific employment income (other than income subject to a foreign tax)	(c) foreign specific employment income (other than income within para (f))
(c) relevant foreign income (other than income subject to a foreign tax)	(d) relevant foreign income (other than income within para (g))
(d) foreign chargeable gains (other than gains subject to a foreign tax)	(e) foreign chargeable gains (other than chargeable gains within para (h))
(e) *relevant foreign earnings subject to a foreign tax*	(f) employment income subject to a foreign tax
(f) *foreign specific employment income subject to a foreign tax*	
(g) relevant foreign income subject to a foreign tax	(g) relevant foreign income subject to a foreign tax
(h) foreign chargeable gains subject to a foreign tax	(h) foreign chargeable gains subject to a foreign tax
	(i) income or capital not within another paragraph

Section 809J(6) ITA provides a commonsense definition of "foreign tax" for the purpose of the nominated income/gains categories. The same definition is used for the mixed funds categories and I discuss the

50 See 13.3 (Ingredients of a mixed fund).

definition there.[51]

13.14.5 *Condition for application of nominated income remittance rules*

Section 809I ITA provides:

> (1) This section applies if—
>
> (a) any of an individual's nominated income and gains is remitted to the UK in a tax year,
>
> (b) any of the individual's remittance basis income and gains has not been remitted to the UK in or before that year, and
>
> (c) the £10 test is met for that year.

13.14.6 *The £10 test*

Section 809I ITA provides:

> (5) The £10 test is met for the tax year mentioned in subsection (1)(a) ("year X") if, taking each nomination year separately, the cumulative total as respects at least one nomination year exceeds £10.
>
> (6) In relation to a nomination year–
>
> (a) "the cumulative total" means the sum, for all the tax years in aggregate up to and including year X, of the amounts of relevant income and gains remitted to the United Kingdom in those tax years from that nomination year, and
>
> (b) "relevant income and gains" means the income and chargeable gains nominated by the individual under section 809C for that nomination year.

This is therefore a de minimis rule.

The 2011 remittance consultation paper explains the background:

> 2.67 Non-domiciles who have been UK resident in at least seven of the past nine tax years are liable to an annual charge of £30,000 if they claim the remittance basis. The rules governing the payment of this charge can be very complicated and result in significant administrative burdens and inconvenience for the taxpayer.
>
> 2.68 Those who elect to pay the charge are required to nominate an amount of their overseas income and capital gains which is taxable on the arising basis and is deemed to generate an additional tax charge of £30,000.
>
> 2.69 There are complicated rules to ensure that an individual cannot subsequently remit any of the income or capital gains which they have

51 See 13.3 (Ingredients of a mixed fund).

nominated before other overseas income and capital gains which would be taxed in the UK when remitted. This must be in addition to the UK tax to which they are otherwise liable on income and capital gains arising in the UK or remitted to the UK. This nomination ensures that the £30,000 is a tax charge on overseas income and gains rather than a standalone levy.

2.70 Individuals can encounter significant administrative difficulties where they fail to keep their nominated income and capital gains segregated from other income and capital gains. In such situations, an individual might inadvertently remit some of their nominated income and capital gains to the UK. This will mean that they become subject to complicated identification rules which trace the origin of each payment and ensure that the nominated amounts are always the last to be remitted. In the absence of these rules, it would be possible for an individual to reduce significantly the amount of tax they pay on the income or capital gains which they remit to the UK.

2.71 To avoid some of these complexities, it is common for an individual to open an overseas bank account which has the sole purpose of holding funds to generate sufficient income to be nominated for the purposes of the annual charge. Whilst this should allow the individual to avoid the identification rules, the need to set up a special overseas bank account involves additional expenditure and administrative obligations. Moreover, even where an individual has a dedicated bank account for their nomination, it cannot be guaranteed that they would never inadvertently make remittances from the account.

2.72 The Government recognises that this can result in excessive and unhelpful complexity which is hard for the taxpayer to understand. It therefore proposes to amend the legislation to allow individuals to remit the first £10 of income or capital gains which they nominate free of tax and without becoming subject to the identification rules. This will enable them to nominate up to £10 of their foreign income or capital gains for the purposes of the £30,000 charge without having to ensure they do not subsequently remit any part of that nominated amount to the UK. Many individuals only nominate a small amount of foreign income or capital gains and so this simplification would remove the risk of them inadvertently remitting the nominated income and triggering the identification rules.

2.73 This would significantly reduce the need to maintain an overseas bank account solely for the purposes of nominating income and capital gains, whilst making the nomination rules less administratively onerous.

2.74 The remaining rules applying to nominated income and capital

gains will remain unaltered.[52]

The EN accompanying the draft clauses provides:

> 130. Where [remittance basis taxpayers] remit the foreign income and gains which they have nominated under section 809C before any other unremitted foreign income and gains, the order in which income and gains are remitted is determined by sections 809I and 809J.
> 131. The amendments made by Part 4 of the Schedule allow such individuals to remit up to £10 each year of their income or gains which they have nominated without having to ensure they do not subsequently remit any part of that nominated amount into the UK.
> 132. An illustration of how the new rules work is set out below.
> 133. In year 1, an individual nominates £5 income and gains from that year which they remit to the UK. As the total amount of nominated income and gains remitted is less that £10, they do not meet the £10 test and section 809I does not apply.
> 134. In year 2, the individual nominates £20 from year 1, of which they remit £7. The amounts of nominated income and gains from year 1 exceeds £10, so section 809I will apply.

The example is somewhat far-fetched, since an individual would either nominate a nominal £1 or £10 or else nominate a substantial amount.

13.14.7 *Nominated income remittance rules*

Assuming that the conditions for the application of the nominated income remittance rules are satisfied, we move on to s.809I(2) ITA which provides:

> Income tax and capital gains tax are charged, for that year and subsequent tax years, as if
> [a] the income and chargeable gains treated under section 809J as remitted to the UK by the individual in that tax year had been so remitted
> [b] (and income and chargeable gains of the individual that were actually remitted in that year had not been).

So we turn to s.809J ITA, which sets out artificial or fictional remittance rules which I call **"the nominated income remittance rules".** (It would

52 HMT & HMRC, "Reform of the taxation of non-domiciled individuals: a consultation" (June 2011) accessible *http://www.hm-treasury.gov.uk/d/consult_condoc_non_domicile_individuals.pdf.*

be more accurate to call this "the nominated income/*gains* remittance rules", but for convenience I shall where possible refer to income (rather than income/gains) and leave gains to be understood.)

Section 809J(1) provides:

> **809J Section 809I: order of remittances**
> (1) If section 809I applies, the following steps are to be taken for the purpose of determining the income or gains treated in a tax year ("the relevant tax year") as remitted to the UK by the individual.

The section sets out six steps. It is easier to follow the steps if one has an example in mind.

Suppose T (a remittance basis taxpayer) has remittance basis income and gains of £10k per annum of each of the nominated income/gains categories thus:

Category	**Type of income (in short)**	**Year 1**	**Year 2**
(a)	relevant foreign earnings	£10k	£10k
(b)	foreign specific employment income (FSEI)	£10k	£10k
(c)	relevant foreign income	£10k	£10k
(d)	foreign chargeable gains	£10k	£10k
(e)	foreign taxed relevant foreign earnings	£10k	£10k
(f)	foreign taxed FSEI	£10k	£10k
(g)	foreign taxed RFI	£10k	£10k
(h)	foreign taxed gains	£10k	£10k

Suppose T has in addition to the above £30k nominated income and gains per annum.

T remits nothing in year 1. In year 2 T remits:
(a) £1k from T's nominated income/gains.
(b) £80k from T's remittance basis income/gains.

This brings the nominated income remittance rules into action.

> *Step 1*
> *Find the total amount of—*
> *(a) the individual's nominated income and gains, and*
> *(b) the individual's remittance basis income and gains,*
> *that have been remitted to the UK in the relevant tax year.*
> *This amount is "the relevant amount".*

In the example the relevant tax year is year 2. Applying the facts of the example, the relevant amount is £81k.

> *Step 2*
> *Find the amount of foreign income and gains of the individual for the relevant tax year (other than income or chargeable gains nominated under section 809C) that is within each of the categories of income and gains in paras (a) to (h) of subsection (2).*
> *If none of sections 809B, 809D and 809E apply to the individual for that year, treat those amounts as nil (and accordingly go to step 6).*

"The amount of foreign income and gains of the individual for the relevant tax year (other than income or chargeable gains nominated under section 809C)" means the remittance basis income/gains. (The drafter has forgotten to use the term which was defined (twice) for this purpose; but it does not matter.) The amount in the example is as set out in the table above.

> *Step 3*
> *Find the earliest paragraph for which the amount determined under step 2 is not nil.*

The earliest paragraph is para (a).

> *If that amount does not exceed the relevant amount, treat the individual as having remitted the income or gains within that paragraph (and for that tax year).*

The individual is treated as having remitted £10k relevant foreign earnings, category (a) for year 2.

> Otherwise, treat the individual as having remitted the relevant proportion of each kind of income or gains within that paragraph (and for that tax year).
> "The relevant proportion" is the relevant amount divided by the amount determined under step 2 for that paragraph.

(Had the total remittance been (say) £5k then the relevant proportion would have been £5k÷£10k = 50% so the transfer would have been treated as containing £5k RFE category (a) for year (1).)

> *Step 4*
> Reduce the relevant amount by the amount taken into account under step 3.

The relevant amount is reduced to £71k.

> *Step 5*
> If the relevant amount (as reduced under step 4) is not nil, start again at

step 3.

In step 3, read the reference to the earliest paragraph of the kind mentioned there as a reference to the earliest such paragraph which has not previously been taken into account under that step.

Following this iterative procedure a total of eight times, the transfer is treated as containing:

(a) relevant foreign earnings	£10k
(b) foreign specific employment income	£10k
(c) relevant foreign income	£10k
(d) foreign chargeable gains	£10k
(e) foreign taxed RFE	£10k
(f) foreign taxed SEI	£10k
(g) foreign taxed RFI	£10k
(h) foreign taxed gains	£10k
Total	**£80k**

The relevant amount is by this stage reduced to £1k. We move to the next step:

Step 6

If the relevant amount (as reduced) is not nil once steps 3 to 5 have been undertaken in relation to all paragraphs of subsection (2) for which the amount determined under step 2 is not nil, start again at step 2.

In step 2, read the reference to the foreign income and gains of the individual for the relevant tax year as a reference to such of the foreign income and gains of the individual for the appropriate tax year as had not been remitted[53] *by the beginning of the relevant tax year.*

"The appropriate tax year" is the latest tax year which is—

(a) before the last tax year for which step 2 has been undertaken, and

(b) a tax year for which section 809B, 809D or 809E applies to the individual.

Thus we repeat step 2 a last and ninth time, reading "the relevant tax year"

---

53 Section 809J(5) ITA provides:

In step 6 of subsection (1) the reference to income or gains being remitted is—

(a) as respects any tax year before section 809I applies, to income or gains being remitted to the UK, and

(b) as respects any tax year in relation to which that section applies, to income or gains treated under this section as so remitted.

to mean year 1. So the remittance of £81k is treated as being:

(a) relevant foreign earnings	£11k
(b) foreign specific employment income	£10k
(c) relevant foreign income	£10k
(d) foreign chargeable gains	£10k
(e) foreign taxed RFE	£10k
(f) foreign taxed SEI	£10k
(g) foreign taxed RFI	£10k
(h) foreign taxed gains	£10k
Total	£81k

March 2009 Qs & As provides:

> **Q3:** HMRC have indicated that individuals do not have to specify which account the nominated income comes from, and from this it could be inferred that without further disclosure of the particulars of the account the taxpayer may be at risk of "tainting" every other source of income of that type. For example if an individual has an account with one bank in Jersey and another bank in a different jurisdiction, he could nominate bank interest on his Jersey account, so that it would be obvious that if he remitted income from his other account, he might not fall foul of re-characterisation provisions. However, this may not be the case if he had three different accounts with the same bank in Jersey and he wishes to nominate income from one of those accounts without disclosing the account number of that account. Can HMRC clarify what their approach to this will be?
>
> **A:** It is up to the individual to decide how much information to give HMRC on their Self Assessment returns in order to identify the source of the nominated income or gains; if, as in this example, there is more than one account the individual should provide sufficient detail to distinguish between them and identify the "nominated" account. That might be the entire account number, or the account "name", or some other unique identifying feature of the account.

March 2009 Qs & As makes an obvious point:

> **Q6:** If I use nominated income or gains to pay the remittance basis charge of £30,000 it would appear that does not trigger the provisions in sections 809I and 809J. Is that right?
>
> **A:** If £30,000 of the nominated income or gains is brought to the UK to pay the remittance basis charge, it is treated as not remitted to the UK under section 809V. Therefore section 809I does not apply because none of the individual's nominated income or gains is regarded as having

been remitted to the UK in that tax year. If the £30,000 is repaid by HMRC then it is treated as remitted at that point and so section 809I will be triggered.

13.14.8 *Accidental remittance of nominated income/gains*

The RDR Manual provides:

> **35140 Remittances of nominated income or gains - miscellaneous** [January 2014]
> If an individual accidentally remits any nominated income or gains to the UK then HMRC will (using its discretionary powers) allow them to undo their mistake, by reversing the transfer without unreasonable delay and in any event before the end of the tax year, for example by paying the income or gains back to the original account, so that the ordering rules at s809I and s809J will not apply.
> HMRC will only use its discretion in such situations as long as there have been no relevant transactions or other benefits conferred on a relevant person in the interim. Otherwise the s809J ordering rules will apply.
> For example, if £20,000 is transferred in error from an overseas bank to a UK bank account and two weeks later the account owner realises the mistake and immediately transfers that £20,000 directly back to the overseas bank account, HMRC will accept that s809I and s809J do not apply. However if, for example, the £20,000 was spent in the UK and then £20,000 from another UK account was transferred back to the overseas account then s809I and s809J do apply.

This recognises the unfairness of the nominated income remittance rules. Contrast 13.9 (Remittance due to bank error).

13.14.9 *Nominated income used to pay remittance basis charge*

The RDR Manual provides:

> **35140 Remittances of nominated income or gains - miscellaneous** [June 2010]
> If an individual accidentally remits any nominated income or gains to the UK then HMRC will (using its discretionary powers) allow them to undo their mistake, by reversing the transfer without unreasonable delay and in any event before the end of the tax year, for example by paying the income or gains back to the original account, so that the ordering rules at s.809I and s.809J will not apply.

13.14.10 *HMRC example*

The RDR Manual provides:

> **35150 Remittances of nominated income or gains** [July 2010]
>
> *Example 1* (Alexandria)

	Foreign gains Para (d)	Jersey RFI Para (c)	Jersey RFE Para (a)	Nomination (from Jersey RFI)
2010-11	£250,000	£75,000	£200,000	£75,000 RFI
2011-12	£300,000	£80,000	£120,000	£75,000 RFI[54]
2012-13	Nil	£75,000	£280,000	£75,000 RFI
2013-14	£130,000	£80,000	£150,000	£75,000 RFI
Totals	£680,000	£310,000	£750,000	

> *In 2013-14 A actually and identifiably remits*
> £30,000 Jersey relevant foreign income that she nominated in 2010-11,
> £140,000 foreign chargeable gains from 2011-12 and
> £50,000 relevant foreign earnings from 2013-14.

The ordering rules are triggered. The "relevant year" is 2013-14

Step 1 Identify nominated income and gains remitted in the relevant year	£30,000	**Relevant Amount**	£220,000
Identify the remittance basis income and gains remitted in the relevant year	£190,000		
Step 2			
Find the total amount of the individual's foreign income and gains (excluding those nominated) for the relevant tax year	**Para (a)** Relevant foreign earnings (not subject to a foreign tax)		£150,000
	Para (c) Relevant foreign income (not subject to a foreign tax)		£5,000
	Para (d) Foreign chargeable gains (not subject to a foreign tax)		£130,000
Step 3 Identify the earliest of paragraphs (a) to (h) above for which the amount determined in Step 2 is not nil.	**Para (a)**		£150,000
Step 4 Where the relevant amount is greater than the amount identified above the relevant amount is reduced by	£220k less £150k = £70,000		

54 The author ignores the complication that the rate of income tax has risen to 50%.

the amount identified

Step 5 If the relevant amount is not nil go back and repeat Step 3. Take the reference to the first of paragraphs (a) to (h) as a reference to the earliest paragraph not previously taken into account under Step 3.

Step 3 repeated	**Para (c)**	£5,000
Step 4 repeated	Relevant Amount reduced to:	£65,000

Step 5 In the order of preference listed above repeat Steps 3 and 4.

Step 3 repeated	**Para (d)**	£130,000

Step 4 If the relevant amount is less than the amount identified, treat the whole of the remaining amount of the transfer as coming from that item of income or gain.

So A will be taxed on £220,000 of remittances as if she had actually remitted the following

		2010-11	**2011-12**	**2012-13**	**2013-14**
Foreign chargeable gains	Accruing in year	£250,000	£300,000	Nil	£130,000
	Actually remitted	£Nil	£140,000	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	£65,000
Relevant foreign income Nominated	Arising in year	£75,000	£75,000	£75,000	£75,000
	Actually remitted	£30,000	£Nil	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	£Nil
Relevant foreign income Not nominated	Arising in year	£Nil	£5,000	£Nil	£5,000
	Actually remitted	£Nil	£Nil	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	£5,000
Relevant foreign earnings	Accruing in year	£200,000	£120,000	£280,000	£150,000
	Actually remitted	£Nil	£Nil	£Nil	£50,000
	Treated as remitted	£Nil	£Nil	£Nil	£150,000

If in future years she actually remits any of these monies, the ordering rules will treat her as having remitted something else instead (refer to RDRM35160 - example 1 continuation).

35160 Remittance of "nominated" income or gains [July 2010]

Example 1 - Continued

Moving forward, in 2014-15 A has relevant foreign earnings of £80,000, but no other foreign income or gains. She decides not to use the remittance basis in that year.

In 2014-15 A actually brings into the UK;

£5,000 Jersey relevant foreign income that she did not nominate in 2013-14 (note 1)

£80,000 relevant foreign earnings from 2013-14 and

£80,000 relevant foreign earnings from 2014-15

Although A is not using the remittance basis in 2014-15, the ordering rules at s809J ITA 2007 are still required to determine what she is to be taxed as having remitted in that year. The relevant year is 2014-15.

Ordering rules at 2014-15

Step 1 Identify nominated income and gains remitted in the relevant year (2014-15)	£nil	**Relevant Amount**	£85,000
Identify the remittance basis income and gains remitted in the relevant year	£85,000 (see note 2)		
Step 2 Find the total amount of the individual's foreign income and gains (excluding those nominated) for the relevant tax year If the remittance basis was not used in that year (that is sections 809B, 809D or 809E did not apply), treat those amounts as nil and go to step 6	Nil		

Step 6

If the relevant amount is not nil, start again at step 2. Take the reference to "relevant year" to be a reference to foreign income of gains of the individual for the earliest 'appropriate year' previous to the lat tax year from which Step 2 was undertaken.

Step 2 Find the total amount of the individual's foreign income and gains (excluding those nominated) for the appropriate tax year (2013-14) (see note 3)	**Para (d)** Foreign chargeable gains (not subject to a foreign tax)	£65,000
Step 3 Identify the earliest of paragraphs (a) to (h) above for which the amount determined in Step 2 is not nil.	**Para (d)**	£65,000
Step 4 Where the relevant amount is greater than the amount identified above the relevant amount is reduced by the amount identified	Relevant Amount reduced to:	£85k less £65k = £20,000

Step 5 If the relevant amount is not nil go back and repeat Step 3. Take the reference to the first of paragraphs (a) to (h) as a reference to the earliest paragraph not previously taken into account under Step 3.

Step 6

If the relevant amount is not nil after Steps 3-5 have been completed for the year, start again at step 2. Take the reference to 'relevant year' to be a reference to foreign income of gains of the individual for the earliest 'appropriate year' previous to the lat tax year from which Step 2 was undertaken.

Step 2 Find the total amount of the individual's foreign income and gains (excluding those nominated) for the appropriate tax year (2012-13)	**Para (a)** Relevant foreign earnings (not subject to a foreign tax)	£280,000
Step 3 Identify the earliest of paragraphs (a) to (h) above for which the amount determined in Step 2 is not nil	**Para (a)**	£280,000

Step 4 If the relevant amount is less than the amount identified, treat the whole of the remaining amount of the transfer as coming from that item of income or gain

So in 2014-15 A is treated as having remitted
£20,000 relevant foreign earnings
£65,000 foreign chargeable gains.
NB – The £80,000 relevant foreign earnings from 2014-15 that she brings in will be taxed on the arising basis in that year.

Note 1 In 2013-14 A has £80,000 of Jersey relevant foreign income, of which £75,000 were nominated; if this £80,000 were all in the one single account, and there was nothing else in the account then, under the principle of this section the first £5,000 remitted in 2014-15 is accepted as being "not-nominated" income.
In this example it is of little practical difference because the s809J ordering rules have already been "triggered" in 2013-14 by her remittance of nominated income (from 2010-11).
But if the ordering rules had not already been triggered, then because, this £5,000 Jersey relevant foreign income in 2014-15 can be accepted as being "un-nominated" income first and foremost, so A's remittance of this £5,000 would not, of itself, have triggered the s809J ordering rules in this year.
Note 2 A's remittance basis income and gains are her total foreign income or chargeable gains for all tax years up to the "relevant tax year" (2014-15) in which she used the remittance basis under section 809B, section 809D or section 809E. It therefore excludes her relevant foreign earnings from 2014-15 because she is not using the remittance basis in that year.
Note 3 the ‹foreign income and gains 'for' the appropriate year exclude any:
- ‹nominated' income or gains, or
- income or gains that were actually remitted to the UK before the beginning of the appropriate tax year or
- income or gains that were treated as remitted to the UK previously under section 809J before the beginning of the appropriate tax year.

In A's case, the £5,000 Jersey relevant foreign income from 2013-14, and the £80,000 relevant foreign earnings from 2013-14 that she actually remitted in 2014-15 were treated as having been remitted in 2013-14 by the ordering rules (refer to the earlier part of example 1 RDRM35150).
Summary

		2010-11	**2011-12**	**2012-13**	**2013-14**	**2014-15**
Foreign chargeable gains	Accruing in year	£250,000	£300,000	£Nil	£130,000	£Nil
	Actually brought to UK	£Nil	£140,000	£Nil	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	£130,000	£Nil
Relevant foreign income Nominated	Arising in year	£75,000	£75,000	£75,000	£75,000	£Nil
	Actually brought to UK	£30,000	£Nil	£Nil	£Nil	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	£Nil	£Nil
Relevant foreign income Not nominated	Arising in year	£Nil	£5,000	£Nil	£5,000	£Nil
	Actually brought to UK	£Nil	£Nil	£Nil	£5,000	£Nil
	Treated as remitted	£Nil	£Nil	£Nil	£5,000	£Nil

Relevant	Arising in year	£200,000	£120,000	£280,000	£150,000	£80,000
foreign	Actually brought to UK	£Nil	£Nil	£Nil	£130,000	£80,000
earnings	Treated as remitted	£Nil	£Nil	£20,000	£150,000	£Nil

13.15 Nominated income: commentary

In short, the effect of the nominated income remittance rule is that remittances are treated as being made in the nominated income/gains priority order, taking more recent years before earlier years (regardless of the actual remittances). As in the case of the "steps" of the mixed fund rules, one is tempted to ask: why didn't the statute simply say so?

But the drafting is the least of the problems of the nominated income remittance rule. The author of the EN anticipates criticism that this is administratively difficult and offers some tax planning advice:

> 14...The rules dealing with this in sections 809I and 809J will require additional records to be maintained from 6 April 2008 or the first year of residence in the UK, if later.
> 15. The record keeping necessary for sections 809I and 809J can be avoided if individuals ensure that "nominated" income or gains upon which the RBC is paid are not remitted to the UK, or only remitted after the remittance of all other unremitted income and gains since the first year of residence from April 2008. If an individual is confident they will never need to remit that "nominated" income or gains, paying the RBC will not involve any extra complexity or record keeping.[55]

Even if this advice were correct it would not help the majority of remittance basis taxpayers, but they should not complain about administrative complexity: they are responsible for the problem, which they brought on themselves by making a claim for the remittance basis:

> 16. As mentioned earlier, those eligible can choose whether or not to claim the remittance basis for each particular year, depending on whether it is to their advantage to do so.

But even the administrative inconvenience is not the serious problem of the rule. The effect of the rule is that if the individual remits a penny of their nominated income/gains, one disregards entirely the actual

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55 The last sentence is not correct. It is not enough that an individual is "confident that they will never need to remit that nominated income or gains". The individual must be able to demonstrate to HMRC that they have not remitted, and that requires record keeping.

remittances and charges on the basis of the fictional rules. Thus an individual who actually remits gains is taxed as if they remitted income (as long as they also remits a penny of nominated income). It is therefore in principle desirable to take care not to remit any nominated income/gains. The funds may be used abroad or used to pay the remittance basis charge.

13.16 ITA mixed fund rules: commentary

The ITA mixed fund rules operate on a daily, indeed minute by minute basis, as the rules must be applied at the time of every onshore and offshore transfer. They do not operate within a given tax year on a pro rata basis (contrast the s.87 or s.731 matching rules). If a client's account contains thousands of entries, the computations must be done thousands of times. The reader who has studied the chapter to here, and who contemplates applying these rules to the actual circumstances of a client, will agree that the mixed fund rule is unworkable.

Joint Forum on Expatriates Tax and NICs Note of Meeting 18 September 2008 records the same view:

> Delegates asked whether HMRC would be prepared to allow for apportionment on an annualised (rather than a monthly) basis. The legislation concentrates on transfers from mixed funds on the occasion of each and every transfer. HMRC did not think it was possible to override the intention of the legislation but agents considered that it would be unworkable to examine each and every debit and credit on the basis envisaged within a new legislation. ...
>
> The overwhelming view put forward by external delegates was that without the availability of a methodology along the lines of SP 5/84 it would be impractical for any inward expatriate to claim access to the remittance basis because it would not be possible to perform the calculations required by the legislation.[56]

In their defence, HMRC make two points:

> [1] HMRC reminded delegates that use of the remittance basis is voluntary as from 6 April 2008 and [2] that HMRC had been asked to bring in rules on remittance from mixed funds and rules relating to overseas transfers.

But as to point [1], the fact that the remittance basis is voluntary is no

56 Accessible *http://www.hmrc.gov.uk/consultations/expat-mins-180908.htm*

excuse for unworkable tax law. HMRC have overlooked[57] that the remittance basis is intended to make the UK an *attractive* place for foreign domiciliaries to reside. There is no need to comment on point [2].

A few months later HMRC issued SP 1/09 so the step thought impossible proved to be possible after all.[58] But while helping employees who qualify for overseas workday relief, that does not help the rest of the body of remittance basis taxpayers who face the same problems. Why were workday relief employees singled out for special treatment? The reason was presumably down to effective lobbying rather than any rational policy consideration.

The mixed fund legislation needs to be rethought from beginning to end – an immensely challenging task, which could not possibly have been done in the few days available as Schedule 7 FA 2008 hurtled to the deadline for enactment. However HMRC have rejected this:

> In particular, the Government will not look further at the following:
> *Simplification* Reviewing and simplifying the mixed fund rules
> *Government response* Although the Government appreciates that these rules can (!) be complicated to operate, it is essential to be able to identify different types of income, gains and capital as they are remitted from a single account. The Government cannot envisage an alternative approach to achieve this purpose which would not entail similar complexity or a significant Exchequer cost.[59]

It is suggested that the rule ought to be that the person remitting from a mixed fund can determine what constituent of the fund the remittance consists of. That would be a significant simplification. The cost to the exchequer could be recovered by an adjustment in the remittance basis claim charge. The reform would be especially welcomed by those who actually try to comply with the present rules.

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57 An alternative inference is that a conscious decision was made to undermine the remittance basis by making it impracticably difficult to operate.

58 See 22.26 (OWR mixed fund rule).

59 HMRC & HMT, "Reform of the taxation of non-domiciled individuals: summary of responses to consultation" (2011) para 2.127 *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

CHAPTER FOURTEEN

INCOME SOURCES AND CATEGORISATION

14.1 The categories of income

ITTOIA classifies income into:
(1) categories (covered by a Part of ITTOIA); and
(2) sub-categories (covered in a chapter of a Part of ITTOIA)
I refer to these as **"income categories"**. The main categories of income are the following:

	ITTOIA	
CATEGORY/SUBCATEGORY	**PART**	**CHAPTER**
Trading Income	2	
Property Income	3	
Savings & Investment Income	4	
Interest		2
UK dividends		3
Non-UK dividends		4
Deeply discounted securities		8
Life policies: chargeable event gains		9
Miscellaneous Income	5	
Royalties		2
Settlor-interested trusts[1]		5
Estates in course of administration		6
Annual payments		7

Each of these topics has its own chapter in this work. This chapter draws together some general comments which apply to more than one type of income.

Income must be classified or categorised into one of the categories. Categorisation is important because different rules often apply to the

1 Before the Tax Law Rewrite, this was a distinct category of income, taxed under schedule D case VI. Whether ITTOIA was right to classify it as a separate category is doubtful, but it does not much matter.

different categories of income.

The categorisation scheme of ITTOIA is not the most simple or logical. It is influenced by the pre-rewrite schedular system. In particular, "miscellaneous income" is a ragbag of categories some of which might have been better placed elsewhere. But generally speaking, the ITTOIA categorisation works – at least, once the reader is familiar with it.

14.2 Location of source of income: Territorial scope of IT

For tax purposes:
(1) All income has a source.
(2) Every source has a geographical location.

A note on terminology: Statute formerly used a variety of expressions[2] but now the standard terms to refer to location of a source are: "source in/outside the UK" or "income arising in/outside the UK"; these expressions are synonymous.[3]

The location of a source of income matters for several purposes. The most fundamental of these is the territorial scope of income tax. For Part 4 ITTOIA (savings & investment income) s.368 ITTOIA provides:

> (1) Income arising to a UK resident is chargeable to tax under this Part whether or not it is from a source in the UK.
> (2) Income arising to a non-UK resident is chargeable to tax under this Part only if it is from a source in the UK.

For Part 5 ITTOIA (miscellaneous income) s.577(1)(2) repeats the same point verbatim. The territorial limitation for other categories of income is discussed in the chapter on the relevant category.

This is a statutory statement of a principle which was formerly in part in statute and (where absent) was implied by the courts.[4] It rests ultimately

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2 e.g. in section 65 ICTA 1988 (repealed) the test was whether a possession or security was "out of the UK", but that was understood to mean "having a source out of the UK"; see 18.7.2 (Changes made by the tax law rewrite).

3 An argument that there was a distinction between the source of income and the place where the income arose was rightly rejected in *Bayfine v HMRC* [2011] STC 717 at [63]. This is also the view in Hong Kong: see 14.7 (Non-UK tax cases). The suggestion to the contrary by the FTT in *Perrin v IRC* [2014] UKFTT 223 (TC) at [24] is *per incuriam*.

4 ITTOIA EN Vol II explains:
"29. ...Since *Colquhoun v Brooks* 2 TC 490 the courts have followed Lord Herschell's judgment that (p.499):

on a rule of international tax law.[5]

The location of a source matters for various other purposes. In particular, income must have a source outside the UK to qualify as RFI and so to qualify for the remittance basis.[6]

There is no statutory definition of "source". The word is too basic to be usefully defined. The word has been paraphrased as "origin"[7] and "chief" or "originating" cause[8] but these paraphrases are of no practical assistance.

14.3 Approach to locating a source of income

Different considerations naturally apply to locating the source of different categories of income.

Location is generally governed by case law, though occasionally statute

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> The Income Tax Acts ... themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the UK or the person whose income is to be taxed must be resident there.
>
> 30. Whether Lord Herschell's words referred to the statutory rules of the time or to a general statement of the law, it is as the latter that they have been subsequently applied by the courts. For example in *Perry v Aston* 19 TC 255 Lord Russell of Killowen states (p.280):
>
> > There must, of course, be the necessary limitation which is inherent in all our Income Tax legislation, namely, that what is taxed under or by virtue of this provision can only be either (1) income which is here, or (2) income of a person resident here.
>
> 31. Additionally there is the general principle of UK law that, unless the contrary intention appears, an enactment is taken as not applying to matters outside the UK."

5 United Nations *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* (2003): "The jurisdiction to impose income tax is based either on the relationship of the income (tax object) to the taxing state (commonly known as the source or situs principle) or the relationship of the taxpayer (tax subject) to the taxing state based on residence or nationality.

Under the source principle, a State's claim to tax income is based on the State's relationship to that income. For example, a State would invoke the source principle to tax income derived from the extraction of mineral deposits located within its territorial boundaries. Source taxation is generally justified on the ground that the State has contributed to the creation of the economic opportunities that allow the taxpayer to derive income generated within the territorial borders of the State. Of course, jurisdiction to tax is also about power, and a State generally has the power to tax income if the assets and activities that generated it are located within its borders...."

6 See 10.3.1 ("Relevant foreign income")

7 *Hart v Sangster* 37 TC 231 at p.235.

8 *IRC v Philips' Gloeilampenfabrieken* [1955] NZLR 868.

chips in.

The IT rules for the location of an income source are different from the situs of asset rules for IHT/private international law.[9] It would aid clarity of thinking not to use the same word in both contexts, so in this book I use the term "**location**" of a source of income (abbreviated to location of income) and keep *situs* for IHT/international law concepts and CGT. But the usage of "situs" in an income tax context is too well established to alter easily, and no difficulty ought to arise as long as one bears in mind that IHT/international law situs of assets, and IT location of source of income, may be different (though the rules often overlap).

The location of a source is also important for double tax treaties.[10] However DTAs sometimes lay down their own rules for locating a source (for treaty purposes) so it may be necessary to distinguish between UK domestic law source location and treaty-source location.

It is considered that a source of income should be regarded as located in only one jurisdiction. This rule is necessary if source rules in tax law are to achieve the object of avoiding double taxation.

14.4 Does a source of income actually have a location?

The concept of the location of a source of income is sometimes said to be misconceived:

> Income itself does not have a geographical location.[11]

This is not an accurate statement of tax law. Every source of income has a location. In most cases it is easy to identify the location, as the same passage goes on to state:

> By long standing convention,[12] however, income is assigned a geographical location by reference to the location of the assets and activities that are used to generate the income. When all of those assets and activities are located in one State, that State may be considered to be the unambiguous source of the income.

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9 See 82.1 (Concept(s) of situs).

10 See "Treaty Problems Relating to Source" [1998] BTR 222.

11 Para 2, United Nations Manual for the Negotiation of Bilateral Tax Treaties between developed and Developing Countries) 2003.

12 Contrast the (misconceived) view that the situs of a chose in action is fictional: see 82.1 (Concept(s) of situs).

The problem is how to identify the location in harder cases. The passage gives the example of trading income, the hardest case to locate a source:

> ... When some of the assets or activities generating income are located in more than one State, the source of the income is less clear. For example, business profits derived from the manufacture of goods in State A and their sale in State B have a significant relationship to State A and to State B. In these circumstances, some rules for determining source are needed.

An American scholar makes the same point:

> ... the source of income is difficult to define. In fact, many public finance economists would claim that the concept lacks meaning in the majority of cases... the problem has been partially solved by arbitrary rules. ... Economists argue that defining the true economic source is almost impossible, because income has contributions from many countries.[13]

In cases where 2 or more states are involved, it is correct that there is no "true" location of source of income in *economic* terms. However this is simply one of many cases where economists and tax lawyers reach different conclusions for the purposes of their different disciplines. Tax law must somehow choose connecting factor(s) to link a source to a state. In principle, it does not matter what the rule is, as long as there is some rule and its application is clear. There are many possible connecting factors, and the selection of the determining factor(s) must to some extent be arbitrary.

14.5 Formal v. substantive source rules: the policy background

An American scholar draws an interesting distinction for rules which determine the location of a source of income: formal and substantive. This is helpful in identifying the policy issues which arise in framing of location of source rules:

> Source rules fall into two basic categories. The first category comprises formal rules. These rules do not attempt to trace the economic source of the income, but rather seek to achieve administrative ease and certainty. For example, the source rule for dividends is residence of the payor. Consider the following example demonstrating the formal rule: Suppose a foreign corporation exists and all of its income is earned in the United

13 Avi-Yonah, *International Tax as International Law*, (2007), p.27, 38.

States - it has no other business activity.[14] From an economic perspective, it is clear that a dividend paid by this foreign corporation to its shareholders is US-source. But it is foreign-source under the dividend rule, because the payor is a foreign corporation. Notice also that this means that the source of dividend income is under the control of the taxpayer ... The main reason behind this rule is that it is administratively hard to tax a dividend from a foreign corporation to foreign shareholders, but easy to tax a dividend from a US corporation.

The rule for interest is also a formal rule, and it is the same as the rule for dividends - the residence of the payor. This is fortunate because of the difficulty of distinguishing debt from equity in many cases; at least the source rule is the same. ...

The other kind of source rule is the substantive rule, which attempts to trace the economic source of the income. The first one of these is the rule for royalties ... No universal consensus exists about what the source rule for royalties should be. Many countries have a source rule for royalties that focuses on the residence country; the place of ownership of the underlying copyright or the place of production (research and development). The American rule is a place of use rule, meaning that it focuses on where the copyright or patent is utilised. ...

There are other categories in which a substantive rule applies. In services, for example, the place of delivery of service controls. ...

The basic difference between formal rules and substantive rules is that the formal rules require one single determination (residence of the payor, residence of the seller, or passage of title), whereas substantive rules attempt to trace the economics of the transaction. Formal rules are generally relatively easy to administer, from both the IRS perspective and the taxpayer's perspective, whereas substantive rules may involve much more difficult determinations. For example, in the case of patents and copyrights, the rule requires determination of the location of use, which may be difficult to determine if it is used in many countries: it may be difficult to break up the income into where the service was actually delivered. Not all substantive rules are difficult to administer: real estate is relatively easy because the location of real estate governs residency, and location is simply to determine in real estate. Most of the important applications of substantive rules, however, are difficult to administer and are more difficult for the taxpayer to avoid because the formal rules are much more under the taxpayer's control.[15]

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14 Author's note: A foreign corporation is non-resident for US tax purposes: there is no central management and control test for corporate residence.

15 Avi-Yonah, *International Tax as International Law* (2007), p.42.

14.6 Location of source of income when there is no source

It was once the case that income tax was charged only on income from sources specified in the schedules, so in the absence of a source of income there could be no income tax. This is not always the case:

> Income tax is traditionally a source-based annual tax, liability depending upon the existence of a source of income falling under one of the Schedules during the year of assessment ...
> It is, however, no longer true to say that liability to income tax depends upon the existence during the year of assessment of a source within the charge. There are cases (such as post-cessation receipts) when liability depends upon the existence of income defined by reference to a source which does not exist within the year of assessment. Or liability may depend upon an event, such as a balancing charge on the sale of an asset which has attracted a capital allowance, or the receipt of a capital sum from a particular kind of transaction, which is deemed to be taxable income received in that year of assessment or sometimes spread over several years of assessment.[16]

ITTOIA EN Vol II para 1639 notes that:

> Such chargeable amounts [capital receipts subject to income tax] could not therefore be said to derive from a "source" in the traditional sense.

ITTOIA EN was concerned that this might cause difficulty in finding the location of the source:

> 1640. Although the definition [of RFI] uses "income which arises from a source" in respect of all income within the definition, specific rules have been added, in view of Lord Hoffmann's remarks, in sections 428(3) ITTOIA (deeply discounted securities) and 658(2) ITTOIA (beneficiaries' income from estates in administration), to attribute a foreign source to the income in question to ensure that there is no doubt that the definition applies to these provisions.

Accordingly, there is a statutory provision to cover the point. For Part 4 ITTOIA (savings & investment income) s.368(3) ITTOIA provides:

> References in this section to income which is from a source in the UK include, in the case of any income which does not have a source, references to income which has a comparable connection to the UK.

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16 *Walker v Centaur Clothes Group* 72 TC 379 at p.416.

For Part 5 ITTOIA (miscellaneous income) s.577(3) repeats the same point verbatim.

ITTOIA EN Vol II expands on this:

> 34. However, while the term "source" may apply to the majority of receipts chargeable to income tax it does not apply to all such receipts. "Source" is something from which income arises and not all sums charged to income tax are by nature income. "Source" may not be the appropriate term where the amount charged to tax represents a profit on a transaction which is not by nature income and would not be charged to income tax without a specific charge. Indeed, the chargeable profit may arise on the disposal of an income source.....
> 35. It has therefore been necessary to consider how to express the territorial scope in cases where there is no natural source of income.
> 36. [Section 368(3)] is broadly worded to catch such income. Where the connection such income has to the UK is comparable to the connection that income with a source in the UK has to the UK, then it is treated for the purposes of this section as income from a source in the UK.

It is hard to see that this concern was justified, but the statutory provision does no harm.

14.7 Non-UK tax cases on the source of income

There are many Commonwealth cases, which ought to be helpful. It is of course necessary to consider whether the relevant Commonwealth legislation is differently worded from the relevant UK provision. This arises particularly for cases on the source of trading income.

The Southern Rhodesia statute imposed a charge on the amount:

> received by ... any person ... *from any source within the Territory* ...

In *Rhodesia Metals v CT*, the Privy Council said of this provision:

> ... numerous cases founded on the various Income Tax Acts, English, Australian, New Zealand and South African, were cited ...
> Their Lordships have no criticisms to make of any of those decisions, but they desire to point out that
> [1] decisions on the words of one statute are seldom of value in deciding on different words in another statute, and that
> [2] different business operations may give rise to different taxing results.

Point [2] is obviously correct but we are here concerned with point [1]. The Privy Council continue:

> [3] If the charging words of the English statute are looked at,
>
> "annual profits or gains arising to any person ... (ii.) residing in the UK from any trade wherever carried on, and (iii.) whether resident in the UK from any trade exercised within the UK";[17]
>
> they are obviously different from the Southern Rhodesian charging words,
>
> total amount [other than capital] received by ... any person ... from any source within the Territory.
>
> [4] It is desirable, also, to point out that, at any rate for different taxing systems, income can quite plainly be derived from more than one source even where the source is business. For instance, in the case of the business of a railway company whose railway is situate abroad, as in *San Paulo (Brazilian) Railway v Carter*,[18] while the English company may be assessed in England on the whole of its profits because it carries on part of its business there, yet it could not be doubted that so much of the profits of the business as were in fact earned from running the railway in Brazil were derived from exercising a business in Brazil; and still less could it be doubted that the sums received by the company in Brazil were received from a source in Brazil.[19]

Lord Atkin correctly states at [4] that the Commonwealth legalisation and case law has no relevance to the (artificially wide) test of location of source of trading income for UK residents.[20] It is considered that the Commonwealth legislation does apply the same test as s.6(2) ITTOIA (trading income of non-resident). For this purpose the Commonwealth cases *are* persuasive authorities in the UK. For the object of the rules for non-residents is to avoid double taxation and ensure that income is taxed in one and only one jurisdiction. That object can only be achieved if there is an international "common law" on the subject. In practice this is the view taken. For instance, the former International Tax Handbook referred to *Kirk*.[21]

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17 I have corrected a slight misprint in the law report. This is only a rough summary of the statutory wording, later s.18 ICTA, now rewritten in ITTOIA.

18 3 TC 407.

19 [1940] AC 774 at p.788–9.

20 See 15.3 (Trading income of UK resident).

21 See ITH826.

The same applies to Hong Kong, where the charge is on profits "arising in or derived from Hong Kong".[22] *Smidth* is the basis of the Hong Kong case law.[23] The Hong Kong Revenue have issued useful guidance **"the Hong Kong guidance note"**. It is suggested that its status in an English court should be the same as that of a textbook. The Hong Kong guidance note provides:

> 4. Though the word "source" is not used in section 14, it has always been accepted by the courts that the words "arising in or derived from" raised the concept of source. Cases from other common law jurisdictions with legislation using the specific word "source" are therefore relevant and have been used in assisting the interpretation of the words used in section 14. In *IRC v Philips Gloeilampenfabrieken* [1955] NZLR 868, Barrowclough CJ at 874 said that the concept of derivation seems necessarily to imply the concept of a source.[24]

In an Indian statute, the charge was on profits "accruing or arising in British India". This was held to be substantially the same as in Hong Kong.[25]

> This authority can only be distinguished from the instant case if the words in s 14 'derived from' are given a much wider meaning that the words 'arising in'. Whilst it may be that there is some marginal difference in the shades of meaning conveyed by the two phrases, their Lordships do not accept that it can possibly be sufficient to bear the weight sought to be put on it in distinguishing *Mehta's* case.

14.8 Source of alimony and maintenance income

I deal with this topic here as it does not fit anywhere else.

Before 2000, the source of alimony income was important for the payer and the recipient, because foreign source income was outside the scope of UK withholding tax and a remittance basis taxpayer who received it qualified for the remittance basis. Since 2000, alimony income is not

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22 Section 14 Hong Kong Inland Revenue Ordinance.

23 *IRC v HK-TVB* [1992] STC 723 at p.728.

24 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No. 21 (Revised) Locality of Profits December 2012, accessible *http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf.* See 14.2 (Location of source of income).

25 *IRC v Hang Seng Bank* [1990] STC 733 at p.739 though "it may be that there is some marginal difference in the shades of meaning conveyed by the two phrases".

generally taxable,[26] so the question of source does not usually arise.

Where the question does arise, the source of alimony income is the country whose court ordered the payment.[27]

Foreign tax may be payable if alimony income has a foreign source under the foreign law (ie if it is paid by the foreign state). However if:

(1) there is a DTA with an "other income" article in OECD model form, and
(2) the recipient is treaty-resident in the UK,

the DTA will in principle provide exemption from the foreign tax (even though the alimony income is not taxable in the UK). This is of course a matter for the foreign law.

14.9 Split years: savings & investment & miscellaneous income

For Part 4 ITTOIA (savings & investment income) s.368(2A) ITTOIA provides the usual split year rule:

> If income arising to an individual who is UK resident arises in the overseas part of a split year, it is to be treated for the purposes of this section as arising to a non-UK resident.

For Part 5 ITTOIA (miscellaneous income) s.577(2A) repeats the same point verbatim.

14.10 Capital/income distinctions

"Income tax is a tax on income." This slogan is less true now than when it was formulated in 1900; but the question whether a receipt is "income" in the hands of the recipient is often important. References to "income" in tax legislation do not include capital receipts unless statute so provides (which it often does). The issue arises in various contexts; those discussed in this book are:

20.5 (Receipt from a non-resident company: Income or capital?)
25.8 (Payment from discretionary trust: Income or capital receipt?).

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26 See sections 727 and 730 ITTOIA.

27 See *Bingham v IRC* 36 TC 254 where a UK resident made maintenance payments to his ex-wife who was resident in the Netherlands. The payments had been ordered by a Dutch court and so were not UK source income. HMRC agreed. The former ESC A12 provided: "Where alimony or maintenance payments are paid under a UK court order or agreement, the income arises from a UK source regardless of the country of residence of the payer."

CHAPTER FIFTEEN

TRADING INCOME

15.1 Trading income: Introduction

A full discussion of the taxation of trading income would require many volumes. In this chapter I focus on matters closest to the themes of this book.

15.1.1 *Cross references*

The following matters are discussed elsewhere:
16.5 (Border between trading income and property income)
21.6 (Trade royalties)
44.11 (When is there a trade in financial assets?)
43.2 (Collection of tax from UK representatives)

15.2 Charge on trading income

Section 5 ITTOIA provides:

> Income tax is charged on the profits of a trade, profession or vocation.

Section 5 applies to all trading[1] income, but s.6 ITTOIA distinguishes between trading income of residents and of non-residents; these need to be considered separately.

15.3 Trading income of UK resident

Section 6(1) ITTOIA provides:

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1 In this chapter, reference to a "trade" includes a profession or vocation as there is no relevant distinction between them. Section 6(3) ITTOIA provides:
"This section applies to professions and vocations as it applies to trades."
It is suggested that uniform rules should apply to trades, professions and vocations: that would be a worthwhile simplification; no-one knows what is meant by "vocation" if it actually mattered.

> Profits of a trade arising to a UK resident are chargeable to tax under this Chapter wherever the trade is carried on.

Section 7 ITTOIA provides:

> (1) Tax is charged under this Chapter on the full amount of the profits of the tax year. …
> (4) This section is subject to Part 8 (foreign income: special rules).

This brings in the remittance basis rules if the trading income arises from a source outside the UK. It is therefore necessary to identify the source. Section 7(5) ITTOIA states the test of source of trading income:

> And, for the purposes of section 830 (meaning of "relevant foreign income"), the profits of a trade, profession or vocation arise from a source outside the UK only if the trade, profession or vocation is carried on *wholly* outside the UK.

This is a statutory statement of the pre-ITTOIA case law.[2] It is a wide and strange test of source. Applying this test, if a trade is carried on partly in country A and partly in country B, the source of the income is in country A *and* country B. For the same income to have a source in two different countries is contrary to the natural meaning of "source" and contrary to the purpose of the concept which is to locate a source in one jurisdiction in order to identify one state with jurisdiction to tax. (Similarly an individual can have only one domicile.)

The explanation is that s.7(5) ITTOIA does not provide the natural meaning of "source"; it is an artificial or deeming definition. It is fortunate (but not surprising) that commonwealth countries which adopted a UK style income tax did not adopt this rule. Thus Commonwealth cases on the source of trading income are not relevant here.

If any part of the trade is carried on in the UK then the entire trade has a UK source and does not qualify for the remittance basis. There is not even a *de minimis* rule; contrast the incidental duties disregard which applies to employment income.[3]

The former International Tax Handbook discussed the old case law, which still holds good under ITTOIA:

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2 See John Avery Jones, "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", *Studies in the History of Tax Law* (Vol 1 2004) p.26 accessible *http://www.kessler.co.uk/tfd-archive*.

3 See 22.14 (Incidental duties in UK).

209. San Paulo case

[The San Paulo Railway Company (*San Paulo (Brazilian) Railway Company v Carter* 3 TC 407)] ... was a UK incorporated company with its board meetings in London. The whole of its physical undertaking was in South America and while it accepted that it was resident here it argued that its business was carried on wholly abroad where its railway was. The Courts held that the head and brain of the trading venture was here and that the profits were those of a trade partly carried on here and that, accordingly, Case I applied. ...

210. Trade partly in UK

The principle underlying the San Paulo decision is that a trade carried on partly in the UK is within Case I. The factors which decide whether a company is resident in the UK by reason of central management and control are, as will be seen, similar to those which decide whether its trade should be within Case I or Case V and the result is that for many years in the corporate sector the only examples seen of Case V trades were those in which a company is a partner in an overseas trade. ...

211. *Ogilvie v Kitton*

But other cases were to show how difficult it was going to be, except on very exceptional facts, to establish that any trade of a resident person was carried on wholly abroad. There was, for example, Mr Ogilvie in *Ogilvie v Kitton* (5 TC 338). He lived in Aberdeen and ran a shop in Canada. To say that he ran the shop really begs the question because he simply received reports from his manager in Canada and did not in fact intervene actively in the business at all, merely taking a tacit interest in things from the information in the reports. It was held that the head and brain of the trading venture was in Aberdeen and that the profits were assessable under Case 1.

In short, if a sole trader is UK resident it is in practice impossible to arrange that their trading income has a foreign source. Section 7(4)(5) ITTOIA is dead letter law. The former International Tax Handbook recognised this at para 209:

> That decision [*San Paulo*] suited the Revenue very well. We no longer had to worry about remittances which after all, though very sensible for an extractive activity which had to send its produce home, did not apply well at all to the more modern industries which did not need to remit their profit and which indeed probably wanted to keep as much profit abroad as possible for the expansion of their business. And so we effectively got on to a statutory arising basis for trades which, in everyday language, were wholly overseas and we reached that position purely through the interpretation of the statute by the Courts. ...

For completeness: s.95 ITA restricts loss relief for trades carried on wholly outside the UK, but since it is almost impossible to arrange that, the section is dead letter law.

15.3.1 *Planning for UK resident sole trader*

If a remittance basis taxpayer carries on a trade partly in and partly out of the UK, the individual will be taxed on the arising basis and not under the remittance basis. In these circumstances the individual may be able to divide up their activities into two spheres – those in and those out of the UK. The individual will then be carrying on two separate activities, of which at least one will yield foreign source income and qualify for remittance basis treatment.

How is this division to be achieved? Overseas activities could be carried on by a partnership controlled abroad. The offshore partner may be a company. This was the route successfully adopted by Sir David Frost: see *Newstead v Frost* 53 TC 525. Alternatively the activities could be carried on by a company or trust. In this way foreign trading income may be converted into foreign employment or dividend income which would enjoy a more beneficial tax treatment

15.4 To whom does trading income arise?

Since different rules apply depending on whether trading income arises to a UK or non-UK resident, it is necessary to identify the person to whom the income arises.

Suppose a non-resident trust is carrying on a trade. If the trading income accrues to the trustees, they are taxed in accordance with the rules relating to *non*-residents, discussed below, so the trustees would only be subject to UK income tax if the trade was carried on partly in the UK, and then only on the profits (if any) attributable to that part.

However if the life tenant of a transparent (*Baker*-style) trust was resident in the UK, then the profits of the trade arise to a UK resident, and the life tenant is taxed in accordance with the rules relating to UK residents: ie on an arising basis unless the strict condition is satisfied that the trade is carried on wholly outside the UK.

Suppose a non-resident settlor-interested trust with a settlor who is a remittance basis taxpayer. One might think that the settlor would be taxable on an arising basis only on the part (if any) of the trading income attributable to carrying on the trade in the UK. The balance of the profits one might think taxable only (if at all) under the s.624 remittance basis. But this is not the case. Since the trust income is deemed to be that of the UK resident settlor, the settlor is taxed in accordance with the rules relating to UK residents: ie theirs are taxed on an arising basis unless the

strict condition is satisfied that the trade is carried on wholly outside the UK.

What if the trade is carried on by a non-resident company within s.720 ITA? The transferor is treated as receiving s.720 income which is not trading income. However, the s.720 remittance basis applies only to income which would be RFI if it were the individual's.[4] So for the purpose of the s.720 remittance basis one must apply the rules relating to UK residents: ie the transferor is taxed on an arising basis unless the strict condition is satisfied that the trade is carried on wholly outside the UK.

In practice there will often be some UK element which would be sufficient to make the entire trade taxable.

15.5 Trading income of non-resident

An entirely different rule applies to trading income arising to a *non*-resident person. Section 6(2) ITTOIA provides:

> Profits of a trade arising to a non-UK resident are chargeable to tax under this Chapter only if they arise—
>
> (a) from a trade carried on wholly in the UK, or
>
> (b) in the case of a trade carried on partly in the UK and partly elsewhere, from the part of the trade carried on in the UK.

The pre-ITTOIA wording imposed a charge on non-residents on income arising:

> from any trade, profession or vocation exercised within the UK.[5]

The meaning was the same so pre-ITTOIA case law is still relevant.

Section 6(2) raises two issues: (1) When is a trade carried on wholly or partly in the UK? and (2) If a trade is carried on partly in the UK, how does one identify the profits from that part?

This is sometimes paraphrased by asking the question whether (or to what extent) the source of the trading income is in the UK. There seems nothing wrong with that; it is the correct and natural meaning of the word "source". Since s.7(5) ITTOIA uses the word "source" in an artificial sense in the rules relating to trading income UK residents, I have

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4 See 29.14 (Section 720 remittance basis).

5 Section 18 ICTA 1988 (repealed). It was accepted (though not stated in statute) that where a trade was exercised partly in the UK, income was apportioned and only the UK part was taxable.

wondered whether it would aid clarity to avoid the word "source" in the context of the rules for non-residents. But in practice it is not possible to avoid the use of the word "source" here[6] so one simply needs to remember that source has two distinct meanings.

15.6 Trading income of split year

Section 6(2A) ITTOIA provides for the usual split year rule:

> If the tax year is a split year as respects a UK resident individual, this section has effect as if, for the overseas part of that year, the individual were non-UK resident.

15.7 Trading income of non-resident companies

Section 5 CTA 2009 provides:

> (1) A UK resident company is chargeable to corporation tax on all its profits wherever arising...
> (2) A non-UK resident company is within the charge to corporation tax only if it carries on a trade in the UK through a permanent establishment in the UK.[7]

15.7.1 *Extent of profits chargeable through PE*

Section 5(3) CTA 2009 identifies the amount on which CT is charged:

> A non-UK resident company which carries on a trade in the UK through a permanent establishment in the UK is chargeable to corporation tax on all its profits wherever arising that are chargeable profits as defined in section 19 (profits attributable to its permanent establishment in the UK)...

Section 19 CTA 2009 defines "chargeable profits":

> (1) This section applies if a non-UK resident company carries on a trade in the UK through a permanent establishment in the UK.
> (2) The company's chargeable profits are its profits that are—
> (a) of a type mentioned in subsection (3), and
> (b) attributable to the permanent establishment in accordance with sections 20 to 32.
> (3) The types of profits referred to in subsection (2)(a) are—

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6 Since relevant case law and foreign statutes regularly use the word "source".

7 The drafting is based on article 7 of the OECD Model Convention.

(a) trading income arising directly or indirectly through or from the establishment,
(b) income from property or rights used by, or held by or for, the establishment, and
(c) chargeable gains falling within section 10B of TCGA 1992 (non-resident company with UK permanent establishment)—
  (i) as a result of assets being used in or for the purposes of the trade carried on by the company through the establishment, or
  (ii) as a result of assets being used or held for the purposes of the establishment or being acquired for use by or for the purposes of the establishment.

The topic of how profits are attributed to a PE needs a long book to itself; it is not discussed here.

15.8 Where is the source of trading income?

The UK case law is mostly antique, because in practice double taxation treaties often apply and then the issues may not arise. But of course that is not always the case. The former International Tax Handbook is erudite and still helpful.[8] Commonwealth cases on the source of trading income can be helpful[9] though unfortunately these cases are less than wholly consistent.[10]

15.8.1 *Foreign tax credit cases*

Cases on foreign tax credit may also help. Section 9 TIOPA provides foreign tax credit relief where the foreign tax is:

> calculated by reference to income arising ... in the territory.[11]

Thus for the purposes of foreign tax credit it is similarly necessary to

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8 Tax Bulletin 18 provides a brief summary, not set out here.

9 See 14.7 (Non-UK tax cases on the source of income).

10 See Littlewood's scholarly article "The Privy Council, the Source of Income and *Stare Decisis*" [2004] BTR 121; Venables, "The Territorial Source of Income" OTPR, Vol 7, p.177, accessible *http://www.khpplc.co.uk/reviews*; Wong, "A comparative study of the taxation of business profits - especially 'online' profits - in Australia and the Hong Kong Special Administrative Region of the People's Republic of China" (2009) *http://arrow.monash.edu.au/vital/access/manager/Repository/monash:7770*

11 See 58.1 (Foreign tax credit relief).

identify the locality of the source. The issue arose in *Yates v GCA International*[12] where *Smidth* principles (ie the rules for trading income of non-residents) were applied. The former International Tax Handbook para 827 provided:

> The *Gaffney Cline* case [*Yates v GCA International* 64 TC 37], ... The point there was what part, if any, of the income from services arose in Venezuela when the contract was made in Venezuela but the services were performed partly in Venezuela but mainly in the UK. That is not necessarily the same as asking whether the trade was exercised in only one or in both of the countries – that was made clear in the judgement. But the judge looked for guidance to the criterion of Atkin LJ in the *Smidth* case 'where do the operations take place from which the profits in substance arise' when deciding that the income arose partly in Venezuela and partly in the UK.

15.9 Place where contract made

The former International Tax Handbook provided:

> **813. *Erichsen v Last***
> Another very early case was *Erichsen v Last* [4 TC 422] which was heard in the Court of Appeal in 1881. It is a highly important case and, curiously, was not published in Tax Cases until some twenty years after the decision. It is perhaps a pity that *Erichsen v Last* was concerned with a very special sort of trade – the relaying of telegraph messages. The application of the ideas which emerge from *Erichsen v Last* to other trades is, because of its special facts, rather difficult.
> The facts are simple enough. Erichsen was the UK representative of the Great Northern Telegraph Company of Copenhagen. The company was not resident here but it had three cables running across the North Sea to bases in Scotland and it had a staff of operators here. Messages were collected through an arrangement with the Postmaster General. The Post Office collected the money and deducted its agreed remuneration before handing over the messages to the company's operators here. The company's own staff then transmitted the messages across the North Sea. Thereafter, depending on their destination, they passed through cables owned by the Danish and Russian governments to their destinations which might have been as far off as Japan. The company made a weak sort of claim that it was not trading here but it went on to say that if it was, it ought to be taxed only on the profit arising from the relaying of the messages along the main cable to Denmark. It was making the point that some of the profit arose from the transmission along other cables which had absolutely nothing to do with the UK.
> The first thing the judgments in the Court of Appeal make clear is that the matter is wholly one of fact. The judgments then separate two questions for decision. First, is there trading in the UK? Brett LJ says this on page 425. His words are important because it is here that the significance of contract – place of contract

12 64 TC 37.

– begins.

> "Now, I think it would be first of all nearly impossible and second wholly unwise to attempt to give an exhaustive definition of when a trade can be said to be exercised in this country. The only thing that we have to decide is whether upon the facts of this case it can be said that this company is carrying on a profit earning trade in this country. Now I should say that wherever profitable contracts are habitually made in England by or for a foreigner with persons in England, because those persons are in England, to do something for or supply something to those persons, such foreigners are exercising a profitable trade in England, although everything done by or supplied by them in order to fulfil their part of the contract is done abroad. The profit arises to them from the contract which they make. The profit which they derive can only be derived from the payment which is to be made to them by the person with whom they contract. In the given case they would not have any such contract as they are in the habit of making unless it was a contract made in England with a person who is in England because he is in England. Observe, if the person or someone acting for him were not in England he would not be wanting to send a telegraph message from England".

The language is now over 100 years old and while it may perhaps look a little old fashioned today its meaning seems plain. The Court was saying: "You, the customer, are in England and because you are here you want goods here (or in the case in point, you want a message sent from here). The profit comes from the contract, the contract is here and there is trading in England and it is nonetheless trading in England even though the goods come from abroad or the service is provided through electric cables which are partly abroad". ...

815. First champagne cases

Erichsen v Last was followed by the so-called champagne cases. There were three leading champagne cases. In the first two, the Revenue succeeded in a claim that the French champagne houses concerned were trading in the UK through agents in London. In the Pommery case [*Pommery and Greno v Apthorpe* 2 TC 182] there was no express finding as to where contracts were made but most orders were met from stock held in the UK. In the Werle case [*Werle v Colquhoun* 2 TC 402] the Court of Appeal made it clear that they considered the contracts to be made by the agents here on behalf of their principal.

These two houses were producers of champagne as well as sellers of champagne and it is reasonably clear that the Revenue did not claim to tax the producer's profit. In the Pommery case at page 189, the Judge specifically referred to the difficulty of calculating the profit; he said that there might be some difficulty as to the manner of calculation in deciding what amount of expenditure to put against the profits and wondered whether it would be proper to look at the goods sent over to England and to put a fair valuation upon them as they arrived. That he said was a matter of quantum, a matter for the consideration of persons skilled in such things.

In the Werle case on page 413 Fry LJ had a similar approach, he said

> "A small shopkeeper... is plainly carrying on a trade in the place where the shop is ... The question, however, becomes more difficult when the trade is carried on, as in the present case, in a far more complicated manner ... when the contract may be in one place, the goods in another, the principal in another and the goods may be delivered in some other place. We have, however, simply to do this, to take all the relevant facts and the mode in which the business is carried on, and to ask ourselves whether that business be or be not carried on within the UK. It appears to me that the same business may in some sense be carried on in many places. The Head Office of a firm, the place where the goods are manufactured, the place where the contracts are made, may all of them be places in which the business or parts of the business is or are carried on. Now, in the present case what we find is this, that the appellants reside in France, carrying on there the business of vineyard proprietors, champagne makers and champagne merchants, no doubt a large portion of that business is carried on within France, but a portion of that business is that of champagne merchants. Now, that means, as I understand, the selling of champagne and that business they carry into effect in England through the intervention of a firm of agents in this country."

816. Contracts abroad

The last of the champagne cases is *Grainger v Gough* [3 TC 311 and 462] and it is a very significant case. The Court of Appeal made no distinction between this and the earlier cases and found that the champagne house was liable on its trading here. ...

But Lord Esher and his fellow judges were overruled by the House of Lords on the question of whether there was liability at all. That was on the basis that in this particular case, contracts were not made in the UK. Although to the customer there may have been little difference between buying through the agents in the first two cases and buying through the agents in the third, there was a difference in the arrangements which the House of Lords saw as vital in determining the non-resident's liability to UK tax. In finding that the contracts were not made in the UK the House of Lords drew the now classic distinction between trading in the UK which involves liability and trading with the UK which does not. Non-residents with customers here commonly rely on this distinction.

The House of Lords may well have had it in mind that if we sought too strenuously to tax foreigners who sold goods here, we might be faced with hostility by countries to which we were exporters and which might seek to tax those exporters in parallel circumstances. The thought is not directly expressed but there is a hint of it at the end of Lord Herschell's judgment on page 468.

15.10 Rejection of place of contract test

The former International Tax Handbook provided:

817. Place of contract not decisive

There are later judgments and very important judgments which tend to water down a little the great emphasis on place of contract. Lord Atkin

> speaking in the Smidth case [*Smidth & Co v Greenwood* 8 TC 193] in 1921 said this
>
> > "It (the place of contract) is obviously a very important element in the enquiry and if it is the only element the assessments are clearly bad. The contracts in this case were made abroad. But I am not prepared to hold that this test is decisive. I can imagine cases where a contract of resale is made abroad, and yet the manufacture of the goods, some negotiation of the terms, and complete execution of the contract take place here under such circumstances that the trade was in truth exercised here. I think that the question is, where do the operations take place from which the profits in substance arise?"

This is sometimes called "the operations test". It is not in fact a "test" as such, because further guidance is needed to identify where the profits in substance arise. It is however a rejection of the place of contract test. The former International Tax Handbook gave one further quote to drive the point home:

> In one of the few fairly modern[13] cases on this subject, the Firestone case [*Firestone Tyre & Rubber v Lewellin* 37 TC 111 at p.142] in 1957, Lord Radcliffe said this
>
> > "But he (Counsel for the Appellants) rightly reminded us that more than once the place where the contract is made has been spoken of as the 'crucial' test or, again, as the 'most vital' element. Speaking for myself, I do not find great assistance in the use of a descriptive adjective such as 'crucial' in this connection. It cannot be intended to mean that the place of contract is itself conclusive. That would be to re-write the words of the Taxing Act, and could only be justified if there was nothing more in trading than the act of sale itself. There is of course much more. But if 'crucial' does not mean as much as this, it cannot mean more than that the law requires that great importance should be attached to the circumstance of the place of sale. It follows, then, that the place of sale will not be the determining factor if there are other circumstances present that outweigh its importance or unless there are no other circumstances that can."

This approach is adopted in the Privy Council. The Hong Kong Revenue

13 I guess that this passage in the former International Tax Handbook was written in the 1980s.

have issued useful guidance (**"the Hong Kong guidance note"**[14]) which provides:

> 7. Lord Bridge explained the "broad guiding principle" in *Hang Seng Bank* at 322H to 323A in the following terms: "But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question."
>
> 8. The "operations test" was further elaborated by Lord Jauncey in *HKTVBI* at 407C-D:
>
> > "*F. L. Smidth &v Greenwood* [1921] 3 K.B. 583 was cited in Hang Seng Bank case and their Lordships do not doubt that Lord Bridge has in mind the judgment of Atkin L. J. in that case and in particular the passage when he said, at p. 593: 'I think that the question is, where do the operations take place from which the profits in substance arise?' Thus Lord Bridge's guiding principle could properly be expanded to read 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it.'"[15] ...
>
> 21. When Lord Bridge said in *Hang Seng Bank* that profits from buying and reselling of commodities were derived from the place where "the contracts of purchase and sale were effected", he could not merely mean legally executed (as this would depend on formal legal rules of offer and acceptance). The Department agrees with the approach in *Magna* and will contemplate all the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts.
>
> 22. The Department does not merely look at the place of contract to determine the geographical source of profits. Where the contract is made by exchange of letters, by fax, or by e-mail, the application of contract law and of private international law as to where the contract is made may result in conclusions that are entirely fortuitous. In *Firestone Tyre and*

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14 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

15 Similarly Lord Jauncey in *HK-TVBI* at 409D-E:
"The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place."

Rubber Co v Lewellin [1957] 1 WLR 464 (HL) at 471, Lord Radcliffe said such an approach under the conditions of international business and modern facilities of communication was capable of proving a somewhat ingenuous one. Hunter J shared the same view in *Sinolink Overseas v IRC* 2 HKTC 126 at 131.[16]

15.11 Where profits in substance arise

So we turn to the question of where profits in substance arise. The short answer is that there is no short answer. The former International Tax Handbook provided:

> **820. NRs: profits in substance**
> It is consistent with the words of Brett LJ at the start of the quotation in ITH813 to say that no neat formula to decide what is, and what is not, trading in the UK can be devised. ...

Circumstances vary so widely that it is not possible to devise a single test that fits all cases.[17] The Hong Kong guidance[18] note provides:

> 11. The broad guiding principle has been followed in subsequent cases before the Court of Final Appeal. In *Kwong Mile*, Bokhary PJ summarised the broad guiding principle at 174I to 175E:
>
> "The ascertainment of the source of a profit is not hindered by technical rules, but is helped by the broad guiding principle that one looks to see what the taxpayer has done to earn the profit and where he has done it. ... In *IRC v Orion Caribbean* [1997] HKLRD 5 924, Lord Nolan emphasised (at p.931F) that '[n]o simple, single, legal test can be employed' when ascertaining the source of a profit. ... The situations in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters."[19]

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16 *IRC v Hang Seng Bank* [1990] STC 733 at p.739 though "it may be that there is some marginal difference in the shades of meaning conveyed by the two phrases".

17 "No simple legal test can be employed"; see *IRC v Orion Carribean.*

18 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

19 *IRC v Hang Seng Bank* [1990] STC 733 at p.739 though "it may be that there is some marginal difference in the shades of meaning conveyed by the two phrases".

It is not, of course, an answer to say that the question is just a question of fact. The comments made at 18.8 (Objection to multi-factorial approach) apply here too.

15.12 Trading in UK: Preparatory and auxiliary activities

The former International Tax Handbook Manual para 849 provided that activities within OECD Model Convention para 5(4) do not amount to trading in the UK. This states (in short) that preparatory and auxiliary activities do not constitute a PE.[20] That includes in particular

(1) storage, display or delivery of goods
(2) purchasing goods[21]
(3) collecting information

The Hong Kong guidance note provides:

> ANTECEDENT OR INCIDENTAL ACTIVITIES
> 14. In *ING Baring* at 428, Ribeiro PJ when discussing the legal principle also emphasised the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters. The focus is on establishing the geographical location of the taxpayer's profit-producing transactions as distinct from activities antecedent or incidental to those transactions.
> 15. Whether an act is an antecedent or incidental activity is a question of fact and would depend on the nature of the transaction. In *IRC v The Hong Kong & Whampoa Dock Co* [1960] 1 HKTC 85, the initial business contact in Hong Kong which set in motion a chain of operations that ultimately led to the salvaging of the vessel was rejected as the relevant operation.[22]
> 16. Comments in a similar vein can be found in *Hang Seng Bank* at 320F-G:
>
> > "The activities of the bank from which the income arose was the buying and selling of this property in overseas market places and not the decision making process in Hong Kong or any other activities in Hong Kong. Likewise the income arose from the trading in property situate outside of Hong Kong and not the moneys of customers

20 See 86.9 (PE: preparatory and auxiliary activities).

21 See 15.13 (Buying from UK sellers).

22 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

situate in Hong Kong."[23]

15.13 Buying from UK sellers

The former International Tax Handbook provided:

> **812. Purchasing is not trading in**
> The mere buying of goods here does not amount to trading here. That was decided in the very first case in these matters, *Sulley v AG* [2 TC 149], in 1860. A New York firm purchased goods in England for sale in America. It had an office here where the English resident partner saw to the purchasing and shipping of the goods. The Court of Exchequer (a Court of Appeal) found that "The profits of the firm in America do not accrue in respect of any trade carried on in this country, but in respect of the trade carried on in New York, where the main business is conducted".

Maintaining a purchasing office is also included in the list of auxiliary activities which do not amount to trading in the UK.[24]

The Hong Kong guidance note provides:

> BUYING OFFICE
> 29. A trading company, carrying on business outside Hong Kong, may set up a branch in Hong Kong to act as a buying office for the purpose of purchasing goods or merchandise or of collecting information. The activities of the branch are confined to the purchase of goods or merchandise or of collecting information in Hong Kong and it is not involved in their sale, either in Hong Kong or elsewhere. In such a situation, a liability to Hong Kong profits tax would not arise. The functions of a buying office may also be carried out by a subsidiary company or by an agent (either related or unrelated). However, as for a branch, the subsidiary company or agent must not be involved in the sale of the goods. On the other hand, any commission or other remuneration earned by the subsidiary company or agent for performing its services in Hong Kong will be fully taxable.[25]

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23 *IRC v Hang Seng Bank* [1990] STC 733 at p.738.

24 Model convention para 5(4)(d); see 15.12 (Trading in UK: preparatory and auxiliary activities).

25 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

15.14 Buying and selling to UK purchasers

The former International Tax Handbook para 820 provided:

> But we do attach much importance to Lord Atkin's approach to the question of "trading in" in the *Smidth v Greenwood* case quoted in ITH817 above – "where do the operations take place from which the profits in substance arise".
> We have come to adopt this test as the principal criterion for determining whether there is "trading in". But it should be borne in mind that the Smidth company was found not to be trading in the UK. Although it had an agent in the UK to advise prospective purchasers and assist with the installation of machinery, the profits in substance arose from the sale of that machinery under contracts made abroad. ...
>
> **821. Merchanting: Place of sale**
>
> The decision in the *Smidth* case supports the conclusion that in the case of merchanting business (buying and selling goods for profit), the trade is normally exercised at the place where the contracts for sale are made – that is where the operations take place from which the profits in substance arise.
> It may help, in considering why that should be the relevant place, to put the decided cases aside and to ask what sort of facts could possibly be significant in leading to an answer to the question of whether there is trading in the UK. Where merchanting is concerned – buying and selling – there will often be a central office where questions of policy are considered and finance is arranged. There is the buying of the goods and perhaps the holding of a stock of goods. Then there is the search for customers and there is the actual contract for sale. That contract may be at a price laid down in a distant Head Office or it may be for a price negotiated with some skill on the spot. Finally there is delivery involving the question where does the lawful property in the goods pass from seller to buyer.
> Few if any of the elements described above necessarily call for a presence in this country and the functions involved can be located where the trader wishes. Most countries take the same view as we do about buying. The Court in *Sulley's* case simply said "It would be most impolitic thus to tax those who come here as customers." The place of sale, as identified by the place of contract for sale, is a reasonable means of determining the location of trading; trading profit becomes measurable only when there is a sale and without a sale there can be no profit.
>
> **822. Place of sale unreliable**
>
> But the place of sale, like other elements, can be moved. Even where the trade is that of buying and selling some qualification is needed to the assertion that there is trading in the UK if the contracts for sale are made here. It is generally taken for granted that it must be so if the sales are to people who are here. But, as is apparent from ITH830–ITH834 below which look at the place of contract, just when and where a contract is concluded can depend on fine distinctions and may even be a matter of chance. If, for example, a non-resident advertises goods for sale in a newspaper here and the customer responds by a telephone call to the non-resident during which agreement is reached or there is an exchange of

telexes, the contract may technically be made in the UK even though the non-resident does very little here at all. We do not know what view the Courts would take of that though they have certainly not ruled out the possibility that while there may be contracts here there may nevertheless be no trading here [See *Belfour v Mace* 13 TC 558].

There may be similar doubt when sales are to people who are not resident here. The problem can be illustrated by a simple example. A New York art dealer has a picture which a Frenchman is interested in. The American and the Frenchman happen to meet in London which both are visiting for a few days holiday. In their hotel they agree on a price for the picture and conclude the deal. The contract is made here. Is the American trading in the UK? The matter is considered further on in chapter 9 (ITH947).

One may devise improbable examples of this kind without doing more than to highlight the difficulties which absolute reliance on the place of contract as a test would involve. Other cases of difficulty are those where there is reason to believe that, although contracts are formally made abroad, everything is really done here short of signing a piece of paper. In such cases we would say that there is trading here. The problem in such a case is largely one of proof. See, for example, the comments in chapters 9 (ITH914) and 10 (ITH1017).

The Hong Kong guidance note provides:

18. In *IRC v Magna Industrial Co* [1997] HKLRD 171 at 178, Litton VP recognised that in case of a trading profit the purchase and the sale were the important factors. He further included in his deliberation all of the relevant operations and not just the purchase and sale of the products. When applying the operations test, Litton VP said at 176G:

> "In other words, one looks to see what the taxpayer has done to earn the profits and where he has done it. Obviously the question where the goods were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?"

19. The obtaining of the buyer's order in Hong Kong and the placing of the order with the seller from Hong Kong are the foundations of a trading transaction since the differential between the selling price and the buying price (i.e. the mark-up) generates the profit. In *Exxon Chemical International Supply SA v IRC* 3 HKTC 57, having decided that the obtaining of the order from the buyer and the placing of the order with the seller, took place respectively in and from Hong Kong, Godfrey J concluded that the profit arose in or was derived from Hong Kong.

20. In *IRC v Euro Tech (Far East) Limited* 4 HKTC 30, Barnett J doubted that there should be some particular level or threshold of activity on the part of the taxpayer in Hong Kong, such as by bringing the products into Hong Kong and re-exporting them. He observed that in many trading companies the taxpayer was doing no more than bringing together the complementary needs of sellers and buyers. He said if the bringing together was done in Hong Kong the trading profit was sourced in Hong Kong....

23. On the basis of the various court judgments discussed in paragraphs 18 to 22 above, the Department's views which are reflected in its assessing practice on the locality of profits derived from trading in commodities or goods by a business carried on in Hong Kong can be summarised as follows:
(a) Where both the contract of purchase and contract of sale are effected in Hong Kong, the profits are fully taxable.
(b) Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits are taxable.
(c) Where either the contract of purchase or contract of sale is effected in Hong Kong, the initial presumption will be that the profits are fully taxable. Matters, such as those mentioned in paragraph 18 above, will be examined to determine the issue.
(d) Where the sale is made to a Hong Kong customer (including the Hong Kong buying office of an overseas customer), the sale contract will usually be taken as having been effected in Hong Kong.
(e) Where the commodities or goods are purchased from either a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.
(f) Where the effecting of the purchase and sale contracts does not require travel outside Hong Kong but is carried out in Hong Kong by telephone, fax, etc., the contracts will be considered as having been effected in Hong Kong.
(g) The purchase and sale contracts are important factors but all the relevant operations that produce the trading profits must be looked at to determine the locality of the profits. Persons who are merely trading with Hong Kong by either selling goods to customers in Hong Kong or buying goods from suppliers in Hong Kong will not fall within the ambit of this paragraph. Nor will this paragraph applies to a buying office referred to in paragraph 29 below.
24. Having regard to the points expressed above, it will be apparent that, in the Department's view, the question of apportionment does not arise in relation to trading profits. Trading profits will be either wholly taxable or wholly non-taxable. There is no room to substitute a mixed source for a Hong Kong source even though there might be some overseas activities.[26]

15.14.1 *Situs of assets sold*

In *IRC v HK-TVB* the Privy Council said:

> profits accruing to a resident taxpayer from the sale of foreign immovable property are likely to arise in the country where that property is situated although both the contracts of purchase and sale thereof are

26 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

made in the country of residence of the taxpayer.[27]

The Hong Kong guidance note provides:

> 45. Subject to specific provisions, the Department regards the locality of the following types of profits to be as follows:
>
> (a) Rental income from real property. *Locality:* Location of the property.
>
> (b) Profits derived by an owner from the sale of real estate. *Locality:* Location of the property.
>
> (c) Profits from the purchase and sale of listed shares and other listed securities. *Locality:* Location of the stock exchange where the shares or securities in question are traded. Where the purchase and sale took place over-the-counter, the place where the contracts of purchase and sale are effected.
>
> (d) Profits from the purchase and sale of unlisted shares and other unlisted securities. *Locality:* Place where the contracts of purchase and sale are effected, except financial institutions in instances where section 15(1)(l) applies.

15.14.2 *Buying and selling through an agent*

SP 1/01 provides:

> 22. If a non-resident carries on a financial trade outside the UK, any transactions carried out through a UK investment manager are likely to amount to trading in the UK. That is so whether there is a discretionary agreement or whether the manager acts on the instructions of the non-resident.

Whether or not this is right does not much matter as in most cases the investment manager exemptions apply, but (even allowing for the qualification in the use of the word "likely") it is too widely expressed. The Hong Kong guidance note provides:

> 25. Cases may arise where it is claimed that contracts of purchase and of sale have been effected wholly outside Hong Kong by employees of the Hong Kong business travelling abroad or by overseas agents. In this context, no operations are carried out in Hong Kong to give effect to the trading transaction; and the employee or overseas agent habitually exercises a general authority to negotiate and conclude contracts on

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27 [1992] STC 723 at p.729 citing *Liquidator, Rhodesia Metals v Commissioner of Taxes* [1940] AC 774.

behalf of his principal.

26. Normally the activities of an agent and an employee are accorded the same weight if it can be shown that the employee has full authority to conclude contracts without reference to the business in Hong Kong. In considering claims that contracts have been wholly effected outside Hong Kong by employees, Assessors will, in addition to facts in paragraph 18 above, require details of travelling, hotel and subsistence expenses in respect of each individual transaction. Where it is claimed that contracts are effected by overseas agents, it will be necessary to provide agency agreements or other evidence to support the claim.[28]

15.15 Services

The former International Tax Handbook continued:

826. Where work is done

Many trades are not limited to merchanting. Where services are concerned, we tend to give greater weight to the place where the service is provided.[29]

The Hong Kong Guidance Note adopts the same approach:

45. The Department regards the locality of the following types of profits to be as follows -

...(e) Service fee income. *Locality*: place where the services are performed[30] which give rise to the fees.[31]

This is consistent with the statutory rule for foreign tax credit relief. Section 9(1) TIOPA provides relief where foreign tax is

(b) calculated by reference to income arising ... in the territory, and

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28 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

29 The former International Tax Handbook para 826 continued:
There are particular difficulties with transmission services with which the approach is to say that the service is given where the act of transmission begins, following the case of *Erichsen v Last* already quoted in ITH813.

30 The International Tax Handbook refers to the place where services are *provided* and the HK guidance refers to the place where services are *performed* but the meaning is the same.

31 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

Section 9(3) TIOPA provides:

> For the purposes of subsection (1), profits from, or remuneration for, personal or professional services performed in the territory are to be treated as income arising in the territory.

This raises the question of where the services are provided or performed. Where the services involve physical work, the answer is obvious. In *Brackett v Chater*[32] a surveyor contracted himself to a Jersey company (owned by a Jersey trust that he had made although this was not material). He became its employee. Clients contracted with the Jersey company but the surveyor did all the work in the UK using facilities available to them at the offices of the firm in which they were previously partners. The Jersey company was held to be trading in the UK.

The Hong Kong guidance note provides:

> It should be noted that in the case of an investment adviser whose organisation and operations are located only in Hong Kong, profits derived in respect of the management of the clients' funds are considered to have a Hong Kong source. Included in chargeable sums are not only management fees and performance fees but also rebates, commissions and discounts received by the adviser from brokers located in Hong Kong or elsewhere in respect of securities transactions executed on behalf of clients.[33]

In *Yates v GCA International*[34] a UK resident company provided services (an investigation into oil fields in Venezuela). Some of the work was done in Venezuela and some in the UK. The company (being UK resident) was in principle taxable on all trading income, but subject to foreign tax credit relief for Venezuela tax on income arising in Venezuela.[35] The *Smidth* principles were applied and so (unsurprisingly) part of the profits were held to arise in Venezuela.

15.15.1 *Commissions*

The Hong Kong Revenue guidance provides:

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32 60 TC 134 & 639.

33 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

34 64 TC 37.

35 See 15.8.1 (Foreign tax credit cases).

RE-INVOICING CENTRE

27. The Department's view is that if a profit is derived from services rendered in Hong Kong, the profit is clearly taxable. Commission income or profit that accrues to a "re-invoicing centre" for services rendered is chargeable to profits tax. Profits derived from the buying and selling of goods are not service income. The transaction involves the taking of commercial risks (e.g. product risks, inventory risks, credit risks, exchange risks, capital risks, etc.) different from those attached to a service. Confirmation of sales and issue of purchase orders are indications that it is a trading transaction. The source of trading profits depends on the locality of the trading operations. Paragraphs 18 to 26 are relevant.

28. It is not possible to categorise the circumstances under which income or profit derived by a "re-invoicing centre" would be regarded as a service income and not as a trading profit. In each case, the Department would examine the nature of the operations and the type of risks in question to determine whether they constitute the provision of services or trading. The label "re-invoicing centre" clearly does not in itself provide the answer as it can mean different business structures.

Example 1

Company A, incorporated in Hong Kong, is a re-invoicing centre of a group of companies with a holding company incorporated in the United States, as more particularly described below. It manages in Hong Kong all foreign currency exposures from intra-company trade, guarantees the exchange rates for future orders and manages intra-affiliate cash flows, including lead and lags of payments. Manufacturing affiliates in Mainland China sell goods to Company A, which in turns resells to the distribution affiliates in North America and Europe. Company A resells at cost plus a mark-up for its services. The mark-up covers the cost of the re-invoicing centre and a reasonable return on the services provided. The profits accrue to Company A are service income derived from Hong Kong. The mark-up earned by Company A, which acts as a re-invoicing centre, is chargeable to profits tax.[36]

15.16 Construction and engineering works

The former International Tax Handbook para 826 continued:

> Where construction and engineering works are concerned we say that the construction works are the essential operations and it is normally immaterial where the contract is signed – there is support for this in the Muller case [*WH Muller & Co (London) v Lethem* 13 TC 151].

36 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf

15.17 Manufacturing

The former International Tax Handbook para 826 continued:

> There may be more than one part of the trade which can be identified as the profit producing part. There can be the case where there is manufacture abroad and selling here or manufacture here, and selling abroad. To look at the first situation, manufacture abroad and selling here, it is reasonably clear from the champagne cases that the Revenue only claimed to tax the selling profit and there is nothing in the judgments to suggest that it was entitled to more. The question is considered more fully in chapter 9 (ITH920). As to the second situation, manufacture on its own is certainly trading, even though there may be no sales here, and the old judgments tend to support the view that we should in such circumstances seek, on some sensible basis, to tax only the manufacturing profit. There was a Privy Council [*Commissioners of Taxation v Kirk* [1900] AC 588] case in the early part of the century, an Australian case, which supports that idea and it is what we have in fact always done.

See too *IRC v Hang Seng Bank*:

> If he has … engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where ... the profit making activity carried on. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.[37]

The Hong Kong Revenue guidance note provides:

> MANUFACTURING PROFITS
>
> 30. Lord Jauncey in *HK-TVBI* at 410F has commented on the source of manufacturing profits. He explained:
>
> > "If a manufacturer in Hong Kong sells his goods to a merchant in Manila the payment which he receives is no doubt sourced in Manila but his profit

37 [1990] STC 733 at p.740. The *dictum* to the contrary in *IRC v HK-TVB* [1992] STC 723 at p.730h can be disregarded.

on the transaction arises in and is derived from his manufacturing operation in Hong Kong."

Where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit making activities are considered to be the manufacturing operations carried out in Hong Kong, which should include the procurement of raw materials, the employment of labour, the design of products and the use of machinery and plant, etc.

31. The following examples illustrate the Department's views on this subject:

Example 2

Company B manufactures goods in Hong Kong and sells them to overseas customers. The fact that Company B has sales staff based overseas does not give a part of the profits an overseas source. This is not a case for apportionment. The whole of the profits are liable to profits tax.

Example 3

Company C manufactures in Mainland China and sells the finished goods through a retailing branch in Hong Kong. The retailing branch has sales staff and a fixed place of business, and has registered for business in Hong Kong. Company C is both a manufacturer and a retailer. Profits are derived from the manufacturing operations in Mainland China and the retailing operations in Hong Kong. It is necessary to apportion the profits derived by Company C. Profits attributable to the Hong Kong retailing branch are chargeable to profits tax.

32. In Mainland China, two types of processing trade normally involve Hong Kong companies: contract processing and import processing. They are two different forms of transaction and require an accurate legal analysis.

CONTRACT PROCESSING

33. In contract processing, the document that governs the contractual relationship among the parties is the processing agreement. It sets out the rights and responsibilities of the Hong Kong company and the Mainland processing enterprise. The Hong Kong company is responsible for the supply of raw materials and machinery without consideration and to provide technical and managerial know-how while the Mainland processing enterprise is responsible for the provision of factory premises, utilities and labour force. 34. In return for the processing service, the Hong Kong company pays a subcontracting charge to the Mainland enterprise. The legal title to the raw materials and finished goods remains with the Hong Kong company. In the Department's view, the Hong Kong company's operations in Mainland China complement its operations in Hong Kong. Recognising the operations of the Hong Kong company in the Mainland, an apportionment of profits on a 50:50 basis is usually accepted.

35. In *D132/99* 15 IRBRD 25, the taxpayer contended that all of its profits were offshore in nature. The Board of Review held that its operations in Mainland China were not dominant operations that overshadowed the activities in Hong Kong and the operations in Hong Kong could not be disregarded.

36. In *D145/99* 15 IRBRD 91, the Board found that the taxpayer was not privy to the processing agreements, which had been entered into by its fellow subsidiaries and the taxpayer should be assessed for profits tax on 100% of its profits for the years of assessment after the processing agreement lapsed. The

Board found that the taxpayer's business was the procurement of toys to satisfy sale and purchase contracts and that important operations took place inside Hong Kong: the reaching of purchase agreements; the determination of price; the issue of invoices; the procurement of raw materials and the shipment of finished products.

37. If the Hong Kong company has restricted involvement in the processing arrangement with the Mainland enterprise, the apportionment of profits could not be appropriate. For example, a Hong Kong company has contracted out the assembly work to various contractors in Hong Kong and the Mainland. The jobs are numerous, small in value and of short duration and the Hong Kong company has minimal involvement in the assembly work. Given that the Hong Kong company does not carry out any manufacturing operations outside Hong Kong, its profits should be fully chargeable to profits tax without any apportionment.

38. The apportionment contemplated in paragraph 34 above will also apply to cases where manufacturing activities are undertaken under a similar arrangement in other places.

IMPORT PROCESSING

39. In import processing, the manufacturing operations are carried out by a foreign investment enterprise (FIE) related to the Hong Kong company. An FIE is often a separate legal entity incorporated in the Mainland. The Hong Kong company sells raw materials to the FIE and buys back the finished goods from the FIE. The Hong Kong company engages in the trading of raw materials and finished goods whilst the FIE manufactures the finished goods. The legal title to the raw materials and the finished goods passes to/from the FIE.

40. In import processing, the gross profits arise from trading transactions whereby the Hong Kong company purchases finished goods from an FIE and sells them for a profit. The manufacturing operations of the FIE in the Mainland are not performed on behalf of, or for the account of, the Hong Kong company even though the Hong Kong company and the Mainland enterprise might be within the same group of companies.

41. In *ING Baring*, Lord Millet NPJ said that the source of profits had to be attributed to the operations of the taxpayer which produced them and not to the operations of other members of the group. In D36/06 21 IRBRD 694 which was a typical import processing case, the Board held that the taxpayer's profits were fully chargeable to profits tax. It was ruled that the FIE was not part of the taxpayer and was not an agent of the taxpayer. Hence the FIE's operations were not relevant in determining the source of profits of the taxpayer. The Board of Review rejected the contention of "substance over form" and disagreed with the suggestion that a leasing agreement of production facilities was similar to a contract processing agreement.

42. The Department holds the view that profits which accrued to the Hong Kong company from "trading transactions" carried out in Hong Kong cannot be attributed to the manufacturing operations of the FIE carrying on business in Mainland China. The source of the trading profits must be attributed to the operations of the Hong Kong company which produced them. In *Consco Tradingv IRC* [2004] 2 HKLRD 818, To Deputy J said that it was correct to consider factors such as the finance arrangements, the payment of raw materials

and processing fees, the arrangement for receipt of payment from purchasers for the finished product and pre-contract negotiations and the Board was entitled to conclude that, on the evidence, the preponderance of the activities which earned the profits were performed in Hong Kong. The Court of First Instance said the Board correctly excluded the processing activity of the Mainland Chinese entity as not being relevant to the determining of the taxpayer's source of profits which were derived through the sale of processed goods.

43. In *IRC v Datatronic Limited* [2009] 4 HKLRD 675, where the arrangement between Datatronic and the FIE was an import processing arrangement, the Court of Appeal held that the profit-producing transactions were the purchase of goods from the FIE by Datatronic and subsequent sale and that these activities took place in Hong Kong. Thus, the profits were derived from Hong Kong. The Court of Appeal further held that the fact that the FIE, although a wholly-owned subsidiary of Datatronic, is a separate legal entity and that its dealings with Datatronic were not at arm's length would not detract from the reality of the legal effect of the transactions. It is also worth to note the Court of Appeal's concurrence with the Board's findings that the manufacturing was done by the FIE in the Mainland is substance and not form and that Datatronic's activities (i.e. assisting the FIE in preparing the goods and supplying them to Datatronic) in the Mainland were merely antecedent or incidental to the profit-generating activities.

44. The Department has noticed that a Hong Kong company is sometimes interposed between an overseas company and a Mainland manufacturing enterprise in order to comply with or circumvent the trade barriers imposed by the overseas jurisdiction. In D7/08 23 IRBRD 102, the Board of Review recognised that making the Hong Kong company a customer of the overseas company and of the Mainland enterprise freed the overseas company from the trade barriers. Applying what the Court of Final Appeal held in the Kim Eng case on the effective cause of the production of the profits in question, it was held that the Hong Kong company's relevant activity in Hong Kong however limited was what was done to earn the profits in question and the Hong Kong company did it in Hong Kong.[38]

15.18 Use of UK commodity markets

The former International Tax Handbook provided:

929. Is use of the markets "trading in"?

It is a good thing for this country that these markets exist. There are all sorts of spin-off advantages. Big business has to be financed and insured and there are shipping services and all sorts of peripheral activities which are good both for the people who are involved in them and for the country's balance of payments. Looking at the physical markets the produce concerned may or may not come to

38 Inland Revenue Department Hong Kong, Departmental Interpretation and Practice Notes No.21 (Revised) Locality of Profits (2012), http://www.ird.gov.hk/eng/pdf/e_dipn21.pdf.

this country. A Brazilian plantation owner may sell his cocoa in London although the buyer may be in France. A broker here will sell to another broker acting on behalf of the buyer and the contract will be made here. So the question arises – is the Brazilian producer trading in London and until the end of the last century it never occurred to anybody that this might be so.

Then came clarification by the Courts on the meaning of trading in the UK and the possibility that the fact of a contract being made by an agent in London could involve the principal in UK tax. It appeared open to the Revenue to contend that the principal was carrying on the selling part of his trade in London or even carrying on the whole trade in London. The Revenue had contended neither of those things; to have done so would have frightened off the foreign users of our markets. In any event, in those early days, the non-resident principal could have arranged that his London brokers did not receive the profits or gains.

But in 1915 everything changed because it was then provided that the receipt of the profits or gains would no longer count[39] and the business world was worried. The Revenue said that it had always regarded business done on our markets through brokers as trading with the UK rather than trading in the UK. But the business world was not satisfied. The difficulty was clear enough. If, as some of the early cases might suggest, the bare making of a contract here is such a vital matter, there is a risk that anybody using our markets might be held to be trading here. The Revenue's former view that in normal circumstances that constituted trading with rather than in the UK is not easily defensible.

930. Pt VIII TMA 1970: Trading in: Can there be any profit?

But accepting that a primary producer, a Brazilian plantation owner selling cocoa in London, is trading in the UK, where is the profit? Such commodities have a world market price at any time; it is an essential function of the market to decide exactly what that price is. If it is decided that the Brazilian producer is trading in the UK he must be charged either as a seller of cocoa or as a cocoa grower. If he is not charged as a grower and, to put it no higher it would be stretching things rather to do so, it is hard to see how any profit can be said to arise in London as a seller of cocoa. The position is entirely different from that of the French champagne grower of the type referred to in ITH815 of chapter 8, who may at least be regarded as making a merchanting profit here. In that situation one would look at the market value of the champagne in bulk and then at the price (wholesale or retail) actually realised in this country. But where commodities like bulk tin or rubber or cocoa are concerned, the position is otherwise. These things are traded in our markets precisely to determine what their market value is and to dispose of them at that price.

931. Dealer

In some cases the primary producer may not sell directly in London but sell to an intermediary in the producing country who in turn sells on the London market. The trade here is then clearly that of selling and if the intermediary does not purchase at world prices – there may, for example, be a reserve price – it may be

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39 F(no.2)A 1915 introduced the rules under which UK representative are liable for the tax of non-resident principals.

> possible to identify a profit or a loss. But if the intermediary sells through a broker within the exemption described in the following paragraphs then the exemption runs just the same. But it sometimes happens that, although the contracts are made through a broker, the seller has a presence here – a branch or an agent – which plays some part in the selling process. It may, for example, instruct the brokers. The question then is whether what is done is sufficient to enable us to say that the non-resident is trading also through that branch or agent. The terminal markets may be used by a non-resident dealer in commodities simply to hedge purchases or sales of raw materials which take place outside the UK. The hedging transactions may amount to trading here but, again, the broker exemption may apply unless the non-resident has a presence here, other than the broker, which is involved with the hedging transactions. If the exemption does not apply, there is then the question of the extent, if any, to which the results of the related transactions outside the UK should be taken into account in measuring the taxable profits. This is an area of difficulty and International Division should be consulted in such a case.

In practice the point is not important because the broker exemption applies.[40]

15.19 Leasing and licensing tangible property

The position for property income from land is governed by statute and trading case law is irrelevant for UK tax.[41]

What about leasing[42] chattels (eg pictures)? It is helpful to consider trading and non-trading cases separately.

15.19.1 *Leasing chattels without trading*

If there is a simple lease (without a trade) the source of the income is the chattel (not the contract) and one would expect the source to be where the chattel is situate.

In *IRC v Hang Seng Bank*, the Privy Council said:

> If the profit was earned by the exploitation of property assets as by letting property ... the profit will have arisen in or derived from the place where the property was let ...[43]

But this was tactfully "explained" in *IRC v HK-TVB*:

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40 See 44.1 (Investment Manager exemptions).

41 See 16.1 (Property income).

42 References to leasing in this paragraph include licensing: there is no material distinction for our purposes.

43 [1990] STC 733 at p.740b.

> When Lord Bridge used the words "place where the property was let" he must have been referring to the place where the property was situated and not to the place or places where the lease happened to have been signed.[44]

Although the comment was made in the context of immoveable property, it is considered that the same applies to chattels.

It is true that the chattel may be moved, but most chattels do not move often. If a picture was moved permanently, it is unclear whether the source changes. It is tentatively suggested that the source changes.

If the chattel were a mobile asset (a plane or yacht) then it is suggested that one should not adopt the rule that the source is where the asset is situated. It is rational to have a separate rule for ships and aircraft. The IHT/CGT situs rules are also different for such assets.

15.19.2 *Leasing as part of trade*

If the leasing is a trade, then the income is trading income and the source is the trade not the assets of the trade. The question whether the trade is partly carried on inside the UK can be addressed looking at wider factors than just where the asset is situate. But in practice it is suggested that the situs of the assets will often be determinative (unless the trade involves assets situate in more than one country).[45]

15.19.3 *When is chattel leasing a trade?*

Business Leasing Manual provides:

> **00315. Whether lessor trading** [March 2008]
> In general, where chattels are leased, you should accept that the leasing is by way of trade.
> In exceptional cases, however, where the evidence of trading is extremely slight, for example if only one asset has been acquired for leasing and there is no personal involvement by the taxpayer or any semblance of a trading organisation, the taxpayer's activities may be special leasing within Section 19 CAA 2001.
> You should not seek to deny trading treatment where, although there is no personal involvement by the taxpayer, there is trading activity by a manager as agent for the taxpayer.

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44 [1992] STC 723 at p.729e.

45 See 15.14.1 (Situs of assets sold).

> The same principle applies to special purpose vehicle lessor companies set up by groups that carry out leasing activities. In such cases it is not unusual for the company to own only one (or a few) assets and be managed by a group member.[46]

This is an oversimplification. For instance, when the chattel is acquired by way of gift (not purchase), and when the taxpayer is an individual or trust rather than a commercial company, then trading is much less likely.

A conclusion of trading will usually suit a non-corporate taxpayer and so not be challenged. A conclusion of trading would be a concern to a corporate taxpayer only if it were carrying on that trade in the UK through a permanent establishment, which would move it from income tax to the more onerous corporation tax regime.

15.20 Research division and shop windows

The former International Tax Handbook provided:

> **827. Profit producing activities**
> Early in this chapter (ITH811) an illustration was given of the hypothetical maker of refrigerators making them in various places in the world and selling them in those places. One way of describing the split of that trade is as a vertical split with a vertical slice here and other similar vertical slices in other countries. We would wish to tax only the vertical slice of the trade carried on here. The other way in which a trade may be split may be thought of as horizontal, the sort of situation we have just discussed, one horizontal slice of the trade, manufacturing say, being here and another slice, the selling, abroad.

The horizontal/vertical terminology seems strange. The metaphor is also used in competition law but the other way round.[47] The former International Tax Handbook continued:

> The above cases are straightforward enough but difficulty starts to emerge when what is done here is not clearly identifiable as part of the

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46 Very similar wording is found in BI Manual 61190 [February 2006].

47 "Vertical agreements" are those made between two or more undertakings each of which operates at a different level of the production or distribution chain. "Horizontal agreements" are those made between undertakings operating at the same level of the production or distribution chain, covering for example research and development, production, purchasing or commercialisation. See Regulation (EC) no. 2790/1999.

> whole trade in that way. An example is the non-resident stock-broker with a branch in London which merely puts the goods in the shop window.

"Shop window" is another unhelpful metaphor. What does it mean? The former International Tax Handbook explained:

> There may be a research section here with computers and the other paraphernalia of a modern trade of that sort. The branch gives advice to would be customers and when they decide to buy a particular American stock, it tells its head office in New York and there the actual deal is done. If the London branch really is only a shop window and really does take no part in the contracting process then the conclusion is that that is not trading within the UK; there is only one trade which is providing the service of buying or selling stocks and that is done in New York. It is quite possible for a non-resident trader to have an office here employing a substantial number of people and yet not to be exercising the trade here.
>
> Another example might be the manufacturer on a very large scale in America, which has a research division in this country. The work of the research division may be absolutely vital to the trade but if that trade consisted for example in the making and sale of television sets, one could not say that research on, let us say, conductivity constituted a distinct profit producing part of that trade. That is reasonably clear.

This is right because it is difficult to allocate the profits, so they should be regarded as merely auxiliary.[48]

> More difficult is the position of non-resident banks or insurance companies which use the UK for their investment activities but do not carry on the business of banking or insurance here. The questions in this whole area of "trading in" are mainly those of fact and degree and absolute guidelines are simply not possible. International Division will be glad to help in cases of doubt.

15.21 Where is contract made?

If or to the extent that the place where is the contract made is an important factor, that place has to be identified. The place where a contract is made is, fundamentally, a question of contract law. But the identity of the place where the contract is made is not relevant for the purposes of contract law, so there are no contract law cases discussing the issue. In the reported tax cases the place where the contract was made was fairly obvious, and so the cases do not help us here. We are thrown back to first principles.

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48 See 15.12 (Trading in UK: preparatory and auxiliary activities).

Going back to first principles, a contract in English law[49] is made by acceptance of an offer. The contract takes effect on acceptance and the place where the contract is made is where the acceptance takes place. As a general rule, acceptance takes place when the acceptance is received by the person who makes the offer. There are, however, exceptions to this:

(1) Acceptance by post–acceptance takes place when and where the letter of acceptance is posted, not where received (unless the offer otherwise provides).
(2) When an offer is made, one can specify in the terms of the offer how and when it can be accepted, and this can therefore alter the place where the contract is made.

Offer and acceptance can be difficult to identify. The court will try to impose an offer and acceptance analysis on circumstances which may not lend themselves to that analysis.[50]

There is no case law on email acceptance.[51] The person making the offer can decide how that offer is accepted so if the documentation is correctly drafted a contract can be made abroad by the click of a mouse outside the UK.

The former International Tax Handbook discussed this issue:

> **The making of a contract**
> **830. General**
> There have been many references in this chapter to the making of a contract and to the place where a contract is made. If two people agree specifically on a sale by word of mouth that is the making of a contract and the place of their agreement is the place where the contract is made. A great deal of business is done in that way daily and the place of contract is not changed by the signing of a piece of paper in a tax haven sometime afterwards. The difficulty is one of proof as we have already seen in ITH822. But putting difficulties of that sort on

49 Further consideration is needed if the applicable law is not English law.

50 Some academic writers have suggested abandoning the "offer and acceptance" analysis and replacing it by a contract theory based on reliance. (There is more than a hint of this in Lord Denning's judgment in *Gibson v Manchester City Council*. This decision was reversed by the House of Lords but even Lord Diplock accepted that there would be times when offer and acceptance would be difficult to identify and the "normal analysis of a contract as being constituted by offer and acceptance" might not be appropriate. However that would be exceptional. See [1979] 1 WLR 294 at p.297).

51 The Law Commission paper (Electronic Commerce: Formal requirements in commercial transactions, December 2001) does not deal with the issue of where a contract made by email is made.

one side, if the question where a contract is made becomes of central importance it is one on which we should rely on legal advice – it is pre-eminently a question for the Solicitor and what follows is very general guidance.

831. Acceptance of offer

Offer and acceptance constitute contract. The place of contract is governed by the place of acceptance of the offer and acceptance takes place where it is received. Where acceptance is communicated by letter it is regarded as received at the place of posting rather than at the place of actual receipt. This is because, once a letter has been posted, the Post Office holds it on behalf of the addressee. Where telephone communication is used the place of acceptance is the place where the recipient of the acceptance is. That is the general rule for so-called instantaneous communication. It would apply also to an acceptance sent by telex or fax directly from the acceptor's office to the offeror's office. The general rule may need qualifying when a cable company's services are used. A telegram like a letter is regarded as received when put into the hands of the Post Office.

832. Price lists

The mere sending out of price lists and advertisements does not constitute an offer, it is rather an open invitation for offers to be made. An offer must be quite specific and a price list is not an offer to supply an unlimited amount of goods at the price named. It follows that when a customer buys goods from a supplier the customer makes the offer and the supplier notifies acceptance. That is generally the assumption in cases where place of contract has been decisive in determining a non-resident's liability. But it is not impossible for a price list to amount to an offer, as long as the list details the price, the quantity and gives a definite description of the goods concerned. If in such circumstances the buyer were to put in some amendment not contained in the original offer, then what the buyer does becomes a fresh offer and one which has to be unconditionally accepted before there can be said to be a binding contract. And there may be a series of communications between customer and supplier so that it is a matter of chance as to who makes and who accepts the final offer.

833. Delivery

It is quite common to find that there is no formal acceptance of the offer by the person supplying the goods and, in that situation, delivery itself will normally constitute acceptance; and then it would be important to look at the place of delivery, the place where the lawful property in the goods passes from seller to buyer.

834. Acceptance by agent

There can be widely different circumstances in which contracts are made here. There is the case where the agent or branch in this country really does the job of negotiating the contract. That person settles the deal and terms and makes the contract here and there is no doubt whatever about it. On the other hand, there can be the case where the agent makes the contract in the legal sense, but does so only with the specific authority of the principal. That is to say the agent gets an offer, writes to or rings the principal, obtains approval and then, and only then, accepts the offer. In that case, acceptance would be here and there are at

least two cases [For example, *Wilcock v Pinto & Co* 9 TC 111] on that point.[52]

15.22 Trade partly in UK: Apportionment

I turn to the question of how to apportion where part of the trade is in the UK. Of course this overlaps with the question of whether there is a trade partly in the UK. If there are activities in the UK which do not involve trading in the UK there is nothing to apportion.

Tax Bulletin 18 provides:

> It is perhaps less obvious how the profits from the part of the trade carried on in the UK should be measured. They are required to be measured on the arm's length principle set out in the [OECD model tax convention] where a DTA applies which includes the relevant provisions. It is considered that it also follows from the main rule in Schedule D that the same principle applies even if there is no treaty.
>
> There is support for this principle in the early tax cases on non-residents trading in the UK. For example, in *Pommery & Greno v Apthorpe* at 2 TC 189, Denman J said, with regard to the profits chargeable in the UK from merchanting champagne produced in France, that:
>
> > It may be that there may be some difficulty in some respects as to the manner of calculating the amount of expenditure to be put against the profits, whether it would be a proper course to look at the goods sent over to England and then to consider what profit they make, putting a fair valuation on them as they arrive, and as the money is transmitted, or whether it would be necessary in such a case to look more minutely into the profits and losses upon the whole trade carried on partly in France and partly in England. I do not think it is necessary at all at this stage of the case to decide that. That is a matter of quantum, a matter for the consideration of persons skilled in dealing with such matters as assessing profits of trade.
>
> This can be seen as an early description of the arm's length principle and as a recognition of the need to develop methods to apply that principle in practice. Such methods were developed in the OECD 1979 Report on "Transfer Pricing and Multinational Enterprises" and have been reaffirmed and clarified in the recently published 1995 revision of that report by OECD "Transfer Pricing Guidelines for Multinational

52 There is also a brief comment (not worth setting out here) in NI Manual 29013 [February 2006].

Enterprises and Tax Administrations".[53]

The former International Tax Handbook also touched on this issue:

> **814. Measure of profit in *Erichsen v Last*[54]**
> The second point the case deals with is – what is the chargeable profit? That is a rather special point where the transmission of messages is concerned. What the company claimed was that a great deal of the profit arose from the transmission over cables which were not here at all. The Master of the Rolls gave a simple parallel example of a foreign company running a steam packet between Dover and Calais. He said that as far as carrying passengers from Dover to Calais was concerned that was trading in Dover. There was no need to look at the three mile limit or anything of that sort. One simply had to take the receipts and deduct the expenses. The journey started here and the service was here. That is an idea limited in its application to trades involving the transmission of passengers, goods and information.

15.23 Income from contracts (casual income)

This section considers the source of casual income. Casual income is not, strictly, trading income but it is convenient to deal with it here.

The BI Manual provides:

> **BIM100130 Miscellaneous income: Scope of the provisions: Sweep-up - judicial comment** [Dec 2013]
> **...Income from "property"**
> The case of *Alloway v Phillips* [1980] 53 TC 372 involved the wife of one of the Great Train Robbers. Whilst living in Canada, she received £39,000 from a newspaper. It was not in dispute that she had provided information to the newspaper which led to the newspaper publishing a series of articles. It was found that she had entered into an agreement, governed by English law, to assist the newspaper.
> The Court of Appeal held that the £39,000 was taxable in the UK under the miscellaneous income sweep-up provisions as it arose from 'property' in the UK. Lord Denning MR said at page 387D:
> 'The truth is that she had a chose in action in England. It was

53 [Author's Note] For a more up-to-date discussion, see Russo (ed), "The Attribution of Profit to Permanent Establishments" (2005) and OECD Report on the Attribution of Profits to Permanent Establishments (July 2008) accessible *http://www.oecd.org/dataoecd/20/36/41031455.pdf*.

54 [Author's Note] For facts of *Erichsen v Last* 4 TC 422 see 15.9 (Place where contract made).

> property in England: but she had no property at all in Canada. She had no copyright there. She only had the information in her head which she told to the newspaper reporter. That is not a species of property known to the law of England.'
>
> Under the agreement that she had entered with the newspaper, she had a valuable right enforceable in law. The valuable right was property and it was situated in the UK. As she was receiving income under that agreement she was taxable under the miscellaneous income sweep-up provisions.

In *Alloway v Phillips* the location of the source of income was held to be the place that the benefit of the contract (the chose in action) was situate, and the contract being enforceable in the UK the income was taxable. This is not a suitable test, as taxpayers can in principle choose the place where the contractual right is situate. *Alloway v Phillips* is one of those cases where the Court decided the result first and the reasoning second.[55] It is considered that the correct test for casual income is the place where the work is done. But until such time as the Courts say so, a taxpayer is entitled, indeed strictly required, to proceed on the basis that the reasoning of the Court of Appeal is correct in law.

Bayfine v HMRC concerned the profit from a forward contract between a US and a UK company. The contract was executed in the US, partly negotiated in the US, related to assets situated in the US, and was governed by New York law. Thus all the factors were all weighed in favour of a foreign source except for the residence of the recipient. This was held to be foreign source income.[56] That must be right, for if residence was the decisive test of source in this case, then the profit would be UK source if the market moved one way and the UK company took the profit, and US source if the market moved the other way and the US company took the profit; which would be an odd result.

15.24 DT relief for trading income

A full discussion of this topic requires several volumes, and (apart from a chapter on the definition of PE) that is not attempted here. See

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55 "If the criminals or their wives get money by relating their stories to newspapers, they ought to pay tax on their profits and gains. That is this very case. The wife is now in England. She is outside the jurisdiction of the Canadian courts. She received the money here and ought to pay tax here ..."; 53 TC 372 at p.387.

56 *Bayfine v HMRC* [2011] STC 717 at [54].

Kobetsky, *International Taxation of Permanent Establishments* (2011).

15.24.1 *Treaty relief for trading income*

Article 7(1) OECD model treaty provides:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

Article 7(4) OECD model treaty deals with overlap between this and other articles in the treaty:

> Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

15.24.2 *"Business"*

"Business" is defined in article 1(h) OECD model treaty:

> the term "business" includes the performance of professional services and of other activities of an independent character.

One point of this is to exclude the business of being an employee.

In the usual UK tax sense "business" is very wide. No-one doubts that a profession involves a "business" in that sense. The reference is there for historical reasons. The OECD commentary provides:

> 8. Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, i.e. Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character

is now dealt with under Article 7 as business profits. This was confirmed by the addition of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character.

15.24.3 *"Enterprise"*

The term "enterprise" is used in two ways:
(1) to refer to the business activity,
(2) to refer to the person who carries on that activity.
Usage (2) seems erroneous, but it does not matter as the meaning is clear enough.

"Enterprise" is defined in article 1 OECD model treaty:

> 1. For the purposes of this Convention, unless the context otherwise requires...
> c) the term "enterprise" applies to the carrying on of any business;
> d) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State ...

The OECD commentary provides:

> 4. The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No exhaustive definition of the term "enterprise" has therefore been attempted in this Article. However, it is provided that the term "enterprise" applies to the carrying on of any business. Since the term "business" is expressly defined to include the performance of professional services and of other activities of an independent character, this clarifies that the performance of professional services or other activities of an independent character must be considered to constitute an enterprise, regardless of the meaning of that term under domestic law.

15.24.4 *Treaty override for trading income*

Section 130 TIOPA provides:

> (1) Subsection (4) applies if double taxation arrangements make the provision, however expressed, mentioned in subsection (2).
> (2) The provision is that the profits of an enterprise within subsection (3) are not to be subject to UK tax except so far as they are attributable to

a permanent establishment of the enterprise in the UK.

(3) An enterprise is within this subsection if the enterprise—

(a) is resident outside the UK, or

(b) carries on a trade, or profession or business, the control or management of which is situated outside the UK.

The reference to "enterprise" here means the person who carries on the enterprise, which seems an erroneous usage, but it is one which is found the OECD model and the meaning is clear enough.

Assuming we have such an enterprise we move on to s.130(4) which disallows treaty relief:

> The provision does not prevent income of a person resident in the UK being chargeable to income tax or corporation tax.

Treaty relief is only allowed for a person resident outside the UK. Section 130(6) TIOPA defines residence:

> A person is resident in the UK for the purposes of this section if the person is resident in[57] the UK for the purposes of the double taxation arrangements.

Section 130 is headed: *Interpreting provision about UK taxation of profits of foreign enterprises.* This rule is however not interpretation or even misinterpretation: it is a treaty override. This section simply disapplies treaty relief for business profits. Breach of treaty agreements has ceased to concern HMRC when on the tax avoidance warpath.

Section 130 applies where an enterprise is carried on by a trust or company which is a resident in a treaty state with a standard business income article; and a UK resident is taxable on the income as life tenant of the trust, or under s.624, or under s.720 (at least in its pre-2013 form). The UK resident person does not qualify for DT relief.

For completeness: s.130(5) TIOPA provides an exception:

> Subsection (4)—
>
> (a) does not apply in relation to income of a person resident in the UK if section 858 of ITTOIA 2005 (UK resident partner is taxable on share of firm's income despite any double taxation arrangements) applies to the income, and

57 The wording in the definition of treaty-residence is: "a resident *of* the UK", but the preposition does not matter; see 6.1 (Three concepts of residence).

(b) does not apply in relation to income of a company resident in the UK if section 1266(2) of CTA 2009 (UK resident company that is partner in a firm is taxable on share of firm's income despite any double taxation arrangements) applies to the income.

Section 130 is not needed here as s.858 ITTOIA does the same job; see 41.10 (DT relief for partnership).

15.25 Commentary: Multinational trading income tax reform?

This topic has risen to prominence in connection with the current debate on tax avoidance.

An OUCBT paper provides:

> There are various ways to try to reform the taxation of business, especially international business. One route would be to reform existing rules, including those on transfer pricing, royalties, interest deductibility and the CFC rules. There are, however, constraints on a country's ability to undertake these international changes unilaterally. The desire to maintain or improve the country's competitive position is one powerful constraint. European Law is another. ... Further it may be difficult, though not impossible, to change established international norms on such matters as transfer pricing even though these norms were developed in a former era and are not always suitable for current economic and technological conditions.
>
> For this reason some would argue that tinkering with such rules can never produce a satisfactory result – a more radical change is required. We could move away from a corporate level tax on profits altogether and tax business activity on a different basis instead. This would raise other issues. Another popular radical solution would be to keep a corporate profits tax but to adopt a unitary system of taxation. Under this system multi-national companies would be treated as a single entity for tax purposes. Their profits would be determined on a world-wide basis and then allocated to different jurisdictions in accordance with a pre-established formula based on factors such as assets, labour and sales. Whilst clearly providing a number of benefits, it is equally clear that this system raises a number of problems, including difficulties surrounding the design of the all-important formula that will suit all the relevant jurisdictions and not be open to manipulation by taxpayers.
>
> One of the authors of this report has proposed a different radical

solution: a destination based cash flow tax.[58] This solution has many desirable properties; however further work is required to turn it into a workable proposal.

This is not to say that radical change is not possible. However there is unlikely to be a system which effortlessly solves all current difficulties without creating others. Claiming that there is a simple alternative to the current system as a silver bullet is unhelpful to real progress. A good deal of hard work, international co-operation and serious dialogue will be necessary to find the best practical way forward. ...[59]

58 [Footnote original] Michael P. Devereux, "Issues in the Design of Taxes on Corporate Profit", 65 National Tax Journal 709-30 (September 2012).

59 "Tax avoidance" (December 2012) accessible *http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/TA_3_12_12.pdf*

CHAPTER SIXTEEN

PROPERTY INCOME

16.1 Property income: Introduction

ITTOIA uses the term "**property income**" to mean income from land.[1] The taxation of property income is governed by Part 3 ITTOIA. A full discussion requires a book to itself. This chapter focuses on matters closest to the themes of this book.

I do not consider the position of UK resident companies (subject to CT rather than to IT).

I do not consider deduction of tax at source, the Taxation of Income from Land (Non-residents) Regulations 1995 on which HMRC have written 88 pages of guidance notes; though I hope to cover this in a future edition.

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1 A note on terminology. The commentary to TLR Exposure Draft No. 13 provides: "*Finding a suitable name*

223. Letting income has long been referred to as 'Schedule A income' by tax professionals. But that is not an informative label for the non-specialist and we are removing references to the Schedules.

224. We considered several possible new names for this type of income including 'land income', 'letting income', 'rental income', 'property business income' and 'property income'. We concluded that 'property income' offered the best compromise because:

- it matches the names that are proposed for the other types of income: 'trading income', 'employment income' and 'savings and investment income';
- for most people, it is likely to appear the most appropriate name; and
- it links directly with what we think is the most appropriate name for the business activity ('property business'): 'land business' and 'rental business' might be particularly misleading.

225. The disadvantage is that it might appear to go wider than income just from land; that is, strictly, 'property' means more than just land and buildings. But we do not think that most people will find this confusing as the proposed use corresponds broadly to the popular use."

16.1.1 *Cross references*

See 58.2 (Foreign tax credit relief: property income).

16.2 "Property business": terminology

The definitions are in s.263, 264 ITTOIA.

CT has equivalent definitions in Chapter 2 Part 4 of CTA 2009. CT itself is outside the scope of this work, but the definition is relevant as it is applied (with modifications) in the ATED rental business relief.[2]

16.2.1 *"UK property business"*

Section 264 ITTOIA provides:

> A person's UK property business consists of—
> (a) every business which the person carries on for generating income from land[3] in the UK, and
> (b) every transaction which the person enters into for that purpose[4] otherwise than in the course of such a business.

The CT equivalent is s.205 CTA 2009.

At first sight para (b) is puzzling. ITTOIA EN explains:

> 1049. … the concept of the "property business" is, to a certain extent, an artificial one. Unlike the term "trade" it may not always correspond to an activity organised in a way that the proprietor would necessarily describe as a business. As such, the term has to cover:
> - "real" businesses where the lettings are organised in a professional way;
> - lettings which are not so organised; and
> - casual and one-off transactions which may have very little of the qualities normally associated with a business.
>
> Then all of these lettings of different types must be treated as part of the same, single business.

16.2.2 *"Overseas property business"*

Section 265 ITTOIA provides:

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2 See 75.26 (Property rental business).

3 The expression "generating income from land in the UK" is defined in ss.266, 267 ITTOIA.

4 ie for the purpose of generating income from land.

A person's overseas property business consists of—

(a) every business which the person carries on for generating income from land outside the UK, and

(b) every transaction which the person enters into for that purpose otherwise than in the course of such a business.

ITTOIA EN explains:

1056. The definition is identical to that of "UK property business" except that the land from which the income arises is outside the UK. That is the only difference between a UK and an overseas property business: income from land outside the UK can arise only in an overseas property business; income from land in the UK can arise only in a UK property business.

1057. For the purpose of deciding whether there is an overseas property business, overseas land law is interpreted in accordance with section 363.

See 16.4 (Losses of overseas property business) for a refinement to this definition.

16.2.3 *"Property business"*

Section 263(6) provides a commonsense definition:

In this Act "property business" means a UK property business or an overseas property business.

The CT equivalent is s.204 CTA 2009.

16.3 Taxation of income from property business

The charging provisions are in Chapter 3 Part 3 ITTOIA. Sections 268–270 provide:

268 Charge to tax on profits of a property business

Income tax is charged on the profits of a property business.

269 Territorial scope of charge to tax

(1) Profits of a UK property business are chargeable to tax under this Chapter whether the business is carried on by a UK resident or a non-UK resident.

(2) Profits of an overseas property business are chargeable to tax under this Chapter only if the business is carried on by a UK resident.

270 Income charged

(1) Tax is charged under this Chapter on the full amount of the profits arising in the tax year.

(2) Subsection (1) is subject to Part 8 (foreign income: special rules).

Section 270(2) ITTOIA feeds into s.832 which incorporates the remittance basis rules.

16.3.1 *Split year*

Section 270(3) ITTOIA provides the usual split year rule:

> If, as respects an individual carrying on an overseas property business, the tax year is a split year—
> (a) tax is charged under this Chapter on so much of the profits referred to in subsection (1) as arise in the UK part of the tax year, and
> (b) the portion of the profits arising in the overseas part of the tax year is, accordingly, not chargeable to tax under this Chapter.

Section 270(4) (not discussed here) deals with capital allowances.

16.4 Losses of overseas property business

16.4.1 *Losses from 2008/09*

Chapter 4 Part 4 ITA provides loss relief for a property business. There are three classes of loss relief:

(1) Carry forward against subsequent property business profits: ss.118–119 ITA.
(2) (a) Capital allowance losses and
(b) agricultural estate losses.
Sections 120–124 ITA.
(3) Post-cessation property relief: ss.125–126 ITA.

In this chapter I consider only the first of these reliefs. Section 118 ITA provides:

> **Carry forward against subsequent property business profits**
> (1) Relief is given to a person under this section if the person—
> (a) carries on a UK property business or overseas property business (alone or in partnership) in a tax year, and
> (b) makes a loss in the business in the tax year.
> (2) The relief is given by deducting the loss in calculating the person's net income for subsequent tax years (see Step 2 of the calculation in section 23).
> (3) But a deduction for that purpose is to be made only from profits of

the business.[5]

The Property Income Manual correctly summarises:

> **4705 CT** [February 2006]
> *Losses*
> As part of the changes made by FA 1995, the taxable profits and losses of overseas let property were ring fenced for IT purposes. The effect was that:
> - losses of an overseas property business cannot, for IT purposes, be set against profits of a UK property business carried on by the same individual,
> - similarly, losses of UK property business cannot for IT purposes be set against profits of an overseas property business carried on by the same individual.

The definitions of UK property business and overseas property business in ITTOIA were only ITTOIA-wide definitions (they do not apply for all the income tax Acts) so the drafter of the ITA had to repeat them. Section 989 ITA extends them to the income tax acts:

> The following definitions apply for the purposes of the Income Tax Acts—
> "overseas property business" has the meaning given by Chapter 2 of Part 3 of ITTOIA 2005,
> "UK property business" has the meaning given by Chapter 2 of Part 3 of ITTOIA 2005

At this point we need to consider s.263(4)(5) ITTOIA which restricts the meaning of "overseas property business":

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5 For completeness, the ITA continues:
"(4) In calculating a person's net income for a tax year, deductions under this section from the profits of a business are to be made before deductions of any other reliefs from those profits.
(5) No relief is to be given under this section so far as relief for the loss is given under section 120.
(6) This section needs to be read with section 119 (how relief works).
119 How relief works
This section explains how the deductions are to be made.
The amount of the loss to be deducted at any step is limited in accordance with section 25(4) and (5).
Step 1 Deduct the loss from the profits of the business for the next tax year.
Step 2 Deduct from the profits of the business for the following tax year the amount of the loss not previously deducted.
Step 3 Continue to apply Step 2 in relation to the profits of the business for subsequent tax years until all the loss is deducted."

> (4) References in this Act to an overseas property business are to an overseas property business so far as any profits of the business are chargeable to tax under Chapter 3 (as to which see, in particular, section 269).
> (5) Accordingly, nothing in Chapter 4 or 5 is to be read as treating an amount as a receipt of an overseas property business if the profits concerned would not be chargeable to tax under Chapter 3.

I refer to this provision as **"the non-chargeable overseas property business rule".** This rule applies for the purposes of "this Act" (ITTOIA). However it is suggested that this applies for the purposes of loss relief in the ITA, s.989 ITA incorporates the s.263 rule, because it incorporates the definition of Chapter 2 Part 3 ITTOIA, and s.263 is in Chapter 2.
Suppose T carries on an overseas property business and:
(1) Year 1: T is non-resident and realises losses;
(2) Year 2: T is UK resident and realises profits.
The losses of Year 1 are disallowed since the profits of that year are not chargeable under Chapter 3 (or at all) so there is no overseas property business. In short, losses of non-residents are not relievable. *Quaere* whether this would apply if T were resident in an EU member state.

What about an overseas property business carried on by a remittance basis taxpayer? An overseas property business which is taxed under the remittance basis is (from 2008/09) taxed under Chapter 3 (even though the amount of income taxed is determined by s.832 ITTOIA which is not in chapter 3.) So the non-chargeable overseas property business rule does not disallow loss relief. Presumably this change was intentional as it was not desired to introduce an equivalent of the incomprehensible CGT loss rules into this context.[6]

16.4.2 *Losses before 2008/09*

The position was different before 2008/09. This is still relevant in relation to the question of whether pre-2008 losses can be carried forward and set against post 2008 profits. The relevant legislation in ITTOIA provided:

> **268 Charge to tax on profits of a property business**
> Income tax is charged on the profits of a property business.
> **269 Territorial scope of charge to tax**
> (1) Profits of a UK property business are chargeable to tax under this

6 See 54.9 (Loss accruing to remittance basis taxpayer).

> Chapter whether the business is carried on by a UK resident or a non-UK resident.
> (2) Profits of an overseas property business are chargeable to tax under this Chapter only if the business is carried on by a UK resident.
> *(3) But, in the case of an overseas property business carried on by a UK resident to whom the remittance basis applies, the only profits of the business chargeable to tax under this Chapter are those in respect of land in the Republic of Ireland.*
> *(4) For a UK resident to whom the remittance basis applies, see also Chapter 11 (charge to tax on overseas property income other than income arising in Republic of Ireland).*

(Words in italics repealed by the FA 2008.) Thus for a remittance basis taxpayer, and ignoring the special case of land in Ireland,[7] the charge was not under Chapter 3. Instead it was in Chapter 11 (also repealed in the FA 2008). This provided:

> ***357 Charge to tax on overseas property income***
> *Income tax is charged on the overseas property income of a person to whom the remittance basis applies.*
> ***358 Meaning of "overseas property income"***
> *In this Chapter "overseas property income", in relation to a person to whom the remittance basis applies, means amounts which*
> *(a) are not brought into account in calculating the profits of any overseas property business of the person, but*
> *(b) would be if section 269(3) (charge to tax on profits of an overseas property business of a person to whom the remittance basis applies only in respect of land in the Republic of Ireland) were omitted.*
> ***359 Income charged***
> *Tax is charged under this Chapter on the amount specified by section 832 (relevant foreign income charged on the remittance basis).*

So before 2008, the remittance basis taxpayer did not have an "overseas property business" so there could not be loss relief. In the 2007/08 edition of this book I commented:

> This is consistent with the CGT treatment of losses. It may be desirable for a foreign domiciliary not to claim remittance basis treatment in the year that a loss accrues in order to obtain that loss relief. Though the cost of that

7 I do not discuss Irish property income here, but note that the pre-2008 legislation was in breach of EU law; see 10.21 (RFI from Ireland).

claim must be set against the benefit of the remittance basis in that year. Suppose the loss is allowable in the year it accrues but in a subsequent year the owner claims remittance basis treatment. The loss is not allowable in that year. However, it is suggested that the loss can be carried forward and set against profits of other years if the arising basis applies to those years.

It is suggested that a loss which did not qualify for relief in the year that it accrued cannot be carried forward to 2008/09 or subsequently. HMRC may well agree. The Property Income Manual provides:

> **4702. IT cases up to 2004-05** [April 2007]
> No loss can ever arise on income taxed on the remittance basis.

Offshore property business losses from before 1998/99 are allowable under ESC B25, but it seems unlikely that any such losses will still be available to be carried forward to the present time.

16.5 Border between trading income and property income

A receipt may in some cases be both a trading receipt and a receipt of a property business. Sections 4 and 261 ITTOIA deal with the overlap.

Section 4(1) ITTOIA provides:

> Any receipt or other credit item, so far as it falls within—
> (a) Chapter 2 of this Part (receipts of trade, profession or vocation), and
> (b) Chapter 3 of Part 3 so far as it relates to a UK property business,
> is dealt with under Part 3.

Section 261 ITTOIA provides:

> Any receipt or other credit item, so far as it falls within—
> (a) [i] Chapter 3 of this Part so far as it relates to an overseas property business or
> [ii] Chapter 8 or 9 of this Part (rent receivable in connection with a UK section 12(4) concern or for UK electric-line wayleaves), and
> (b) Chapter 2 of Part 2 (receipts of a trade, profession or vocation),
> is dealt with under Part 2.

ITTOIA EN explains:

> 1058. The priority rules in the trading income Part of this Act (section 4) make it clear that a charge under Part 3 of this Act as UK property income has priority over a charge under Part 2 as trading income. This reflects the rule in Schedule D Case I (section 18(3) of ICTA). The sort

> of receipt to which this rule might apply is rent received by a property developer from the temporary letting of land awaiting development. The rent is taxed as property income, even if it could properly be regarded as a trade receipt.
> 1059. In the case of a foreign trade and foreign property, the rule in section 65A(1)(b) of ICTA is the reverse of that in section 18(3) of ICTA. An overseas property business does not include "income to which section 65(3) of ICTA applies (income immediately derived from carrying on a trade ..)". So the priority rule in section 261 preserves this position.

Perhaps the reason for this apparent anomaly is to maximise income classified as UK source. Under these rules, if UK property income is a receipt of a foreign trade, it is classified as UK property income (and so taxable even in circumstances where foreign trading income may not be); whereas if foreign property income is part of a UK trade it is treated as UK trading income (and similarly taxable).

16.6 DT relief for property income

Article 6(1) OECD Model Convention provides:

> Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

The significance of this is that income from immovable property does not fall within article 21 ("other income", which is taxed only in the state of residence). Instead, it is taxed in the source state with credit given in the state of residence.

The OECD Model Commentary provides:

> 1. Paragraph 1 gives the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This is due to the fact that there is always a very close economic connection between the source of this income and the State of source. ... Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 [other income] shall apply to such income.

16.6.1 *"Immovable property"*

The definition of immovable property is important for article 6 and for article 13 (capital gains).

Article 6(2) OECD Model Convention provides:

> The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include
> [1] property accessory to immovable property,
> [2] livestock and equipment used in agriculture and forestry,
> [3] rights to which the provisions of general law respecting landed property apply,
> [4] usufruct of immovable property and
> [5] rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources;
> ships, boats and aircraft shall not be regarded as immovable property.

The OECD Model Commentary provides:

> 2. Defining the concept of immovable property by reference to the law of the State in which the property is situated, as is provided in paragraph 2, will help to avoid difficulties of interpretation over the question whether an asset or a right is to be regarded as immovable property or not. The paragraph, however, specifically mentions the assets and rights which must always be regarded as immovable property. In fact such assets and rights are already treated as immovable property according to the laws or the taxation rules of most OECD member countries. ... No special provision has been included as regards income from indebtedness secured by immovable property, as this question is settled by Article 11.

Article 6(3) elucidates "derived from" immovable property:

> 3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

The OECD Model Commentary provides:

> 3. Paragraph 3 indicates that the general rule applies irrespective of the form of exploitation of the immovable property....

The OECD Model Commentary comments on the border between property income and distribution income:

> 3. ... Income in the form of distributions from Real Estate Investment

Trusts (REITs), however, raises particular issues which are discussed in paragraphs 67.1 to 67.7 of the Commentary on Article 10.

Article 6(4) deals with the border between business income and property income:

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise.

The OECD Model Commentary provides:

3. ... Paragraph 4 makes it clear that the provisions of paragraphs 1 and 3 apply also to income from immovable property of industrial, commercial and other enterprises. ...

4. It should be noted in this connection that the right to tax of the State of source has priority over the right to tax of the other State and applies also where, in the case of an enterprise, income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudge the application of domestic law as regards the manner in which income from immovable property is to be taxed.

CHAPTER SEVENTEEN

DEDUCTION OF INTEREST IN COMPUTING PROPERTY INCOME

17.1 Deduction of interest: Introduction

This chapter considers the deduction of interest for the purposes of income taxation of property income and trading income.

A great deal of tax and tax planning depends on obtaining that deduction.[1] See *Langsam v Beachcroft LLP* [2011] EWHC 1451 (Ch) for an interesting negligence action where a dissatisfied remittance basis taxpayer obtained damages against solicitors who failed to advise on the tax avoidance possibilities dignified with the label of an "equity release arrangement".

The position of UK resident companies (subject to corporation tax and governed by the loan relationship rules) is not discussed.

17.1.1 *Cross references*

For questions of the location of the source of interest, and deduction at source, see 18.1 (interest income).

17.2 Basis for deduction

Section 272(1) ITTOIA is the starting point for property income:

> The profits of a property business are calculated in the same way as the profits of a trade.

Section 272(2) provides a long list of statutory provisions which apply to a property business.

Thus I can deal with property income and trading income in the same chapter, though my focus here is on property income.

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1 See Traversa, "Interest Deductibility and the BEPS Action Plan: *nihil novi sub sole*" [2013] BTR 607.

17.3 Capital expenditure

Section 33 ITTOIA provides:

> In calculating the profits of a trade, no deduction is allowed for items of a capital nature.

In the early days of income tax, the Courts ruled that where a loan was used as capital in a trade, interest on the loan was a capital expense and so disallowed.[2] That seems a strange result, but the Courts wished to avoid the anomaly, which holds today, and is a contributing factor to the current financial crisis,[3] that debt finance gives rise to deductible interest but equity finance does not, as there is no deduction for dividends or the cost of share capital.

The old rule was however reversed by statute and s.29 ITTOIA now provides:

> For the purpose of calculating the profits of a trade, interest is an item of a revenue nature, whatever the nature of the loan.

Interest is in principle a deductible expense if incurred wholly and exclusively for the purpose of the property business.

A premium (if not interest) is not deductible for IT purposes. That rule is preserved by s.58 ITTOIA, which allows relief for incidental costs of loan finance, but s.58(4) ITTOIA provides:

> But the following are not incidental costs of obtaining finance ...
>
> (c) the cost of repaying a loan or loan stock so far as attributable to its being repayable at a premium or having been obtained or issued at a discount...

17.4 Wholly and exclusively

Section 34 ITTOIA provides:

> (1) In calculating the profits of a trade, no deduction is allowed for—
>
> (a) expenses not incurred wholly and exclusively for the purposes of the trade,

---

2 See for instance *European Investment Trust v Jackson* 18 TC 1.

3 The issue is discussed briefly in Report of the Parliamentary Commission on Banking Standards, *Changing banking for good* (2013) Volume II para 185-188 *http://www.parliament.uk/documents/banking-commission/Banking-final-report-vol-ii.pdf*

The Property Income Manual provides:

2105. Introduction [April 2011]

Overview

... For IT, interest payable on loans used to buy land or property which is used in the rental business, or on loans to fund repairs, improvements or alterations, is deductible in computing the profits or losses of the rental business in the same way as other expenses.

Similarly, interest payable under hire purchase agreements or on an overdraft is deductible where the asset is used for business purposes.

The normal rental business rules apply, see PIM2000 onwards, including the "wholly and exclusively" rule and the rules governing the timing of relief (see PIM1100 onwards). A taxpayer cannot, for example, deduct interest on a private loan, such as a loan used to buy their private residence. Where part of the taxpayer's own residence is let see PIM2120.

Similarly, the interest on a loan or overdraft may not be allowable, or only part may be allowable, where the taxpayer, for example, uses the borrowing:

- to buy non-rental business investments (which may be shown in the balance sheet as assets),
- to buy private assets or assets for their family,
- for the provision of private funds to be taken out from the rental business.

Deciding what interest, if any, can be deducted may be difficult, particularly where the taxpayer's account with the business is overdrawn. That is, where the taxpayer has drawn out more money than the profits of the rental business. The loan may have, for example, partly financed the rental business and partly met private living expenses. Interest on a borrowing that is used to fund private living expenses or other non-business expenditure isn't allowable.

For advice regarding the incidental costs of loan finance see PIM2050.

Interest on a partner's capital account with the business isn't deductible. It is merely an allocation of the rental business profit and is taxed as property income.

For more detailed guidance about the deduction of interest see BIM45650 onwards.[4]

Interest payable on property only partly used for rental business

A property may be let for short periods in a tax year or only part of it may be let throughout a tax year (or both); the rest of the time the property is used for private or non-business purposes. Here the interest charged on a qualifying loan on that property has to be split between the rental business use and the private

4 This material is not set out here for reasons of space, but it is well worth reading, particularly where the interest is deducted from trading income rather than property income.

or non-business use. The split is done in whatever way produces a fair and reasonable business deduction, taking account of both the proportion of business use and the length of business use.

You don't have to split the interest if the taxpayer is genuinely trying to let the property but it is empty because they have not been able to find a tenant. In this case the interest will meet the "wholly and exclusively" test. It won't meet this test if they have not been trying to let the property or they have been using it for private or non-business purposes .

[***Interest and rent-a-room relief*** *- passage not printed here*]

Legislation

The profits of a rental business are calculated in the same way as the profits of a trade. Therefore interest may be deducted in computing the profits of a rental business provided that it meets the following criteria.

- It must be payable wholly and exclusively for the purposes of the rental business.

[• If it is paid to a person not resident in the UK, the deductible element must not be at more than a reasonable commercial rate - see PIM2110.][5]

- It must not be within MIRAS - see PIM2120.

Remember that under the rental business rules, relief is given for interest payable on the accruals basis (not interest paid unless, exceptionally, the cash basis is used - see PIM1101).

The guidance on interest as a trade expense at BIM45650 onwards applies equally to interest as a rental business expense.

Interest rate hedging instruments

Where an interest rate hedging contract such as a swap or cap is taken out to hedge interest payments which are deductible in computing the profits or losses of a rental business, then profits or losses on that contract will normally be taxed or relieved as receipts or deductions of that rental business. This is because trading principles are imported into the property income computation rules. Profits and losses on such instruments should normally be computed on an accruals basis so that payments and receipts are allocated to the periods to which they relate, without regard to the periods in which they are made or received or become due and payable, in accordance with normal accounting practice.

For more on the tax treatment of swaps held by IT payers see PIM2140.

2110. Paid abroad [April 2011]

Business deduction and deduction of tax

The residence status of the lender does not affect the taxpayer's right to an interest deduction in computing the profits or losses of their rental business. But where they pay interest to a lender whose usual place of abode is outside the UK, they should normally deduct IT at the basic rate from the payments they

5 This passage is out of date: see 17.4.1 (Interest paid at uncommercial rate).

make and account for it to HMRC, ...

17.4.1 *Interest paid at uncommercial rate*

The Property Income Manual provides:

> **2110. Paid abroad** [April 2011]
>
> **...**
>
> ***Interest paid at uncommercial rates***
>
> Interest paid to a lender not resident in the UK over and above a commercial rate isn't allowable as a deduction even if it would otherwise qualify (perhaps because the loan was used to buy a rental business property). Generally, HMRC will accept the interest charged by the lender as an allowable deduction where it is paid on an arm's length loan made on a normal commercial basis.
>
> ... Take a broad view of what is a reasonable commercial rate. You should not normally seek an adjustment where the payer and recipient are at arm's length. If interest is payable in the UK on an advance from a foreign bank carrying on a bona fide banking business in the UK through a branch, treat it as if it were interest payable to a UK bank...

This is referring to the former s.74(1)(n) ICTA 1988, which disallowed interest paid to a non-resident so far as it was at more than a reasonable commercial rate. The provision was repealed in 2004, so the Manual is almost a decade out of date. However if interest is paid at more than a commercial rate, whether or not to a non-resident, the deduction would in principle be disallowable on transfer pricing or on "wholly and exclusively" principles.

17.4.2 *Non-resident company paying interest*

Lastly, for completeness, the Manual refers to (what is now) 1301A CTA 2009:

> In calculating a company's income from any source for corporation tax purposes, no deduction is allowed for interest otherwise than under Part 5 (loan relationships).

That only applies for CT and does not disallow a deduction for interest for IT. HMRC agree. The PI Manual states:

> **2110. Paid abroad** [April 2011]
>
> **...**
>
> ***Non-resident companies***
>
> ... Section [1301A] does not preclude a deduction for interest for

companies chargeable to IT such as non-resident companies with income from UK property.

17.5 Tax relief schemes and arrangements

Section 809ZG(1) ITA provides the general rule:

> Relief is not to be given under any provision of the Income Tax Acts to a person in respect of a payment of interest if
>
> [a] a tax relief scheme has been effected, or
>
> [b] tax relief arrangements have been made,
>
> in relation to the transaction under which the interest is paid.

Section 809ZG(2) ITA is a small point:

> Subsection (1) applies whether the tax relief scheme is effected, or the tax relief arrangements are made, before or after the transaction.

I do not see how a transaction could take place before the scheme is effected, but it does not matter.

Section 809ZG(3) ITA defines tax relief scheme:

> A scheme is a tax relief scheme in relation to a transaction for the purposes of subsection (1) if it is such that the sole or main benefit that might be expected to accrue to the person from the transaction is the obtaining of a reduction in tax liability by means of relief under the Income Tax Acts.

Section 809ZG(4) ITA defines tax relief arrangements in the same way:

> Arrangements are tax relief arrangements in relation to a transaction for the purposes of subsection (1) if they are such that the sole or main benefit that might be expected to accrue to the person from the transaction is the obtaining of a reduction in tax liability by means of relief under the Income Tax Acts.

Section 809ZG(5) ITA provides a commonsense definition of relief:

> In this section "relief" means relief by way of—
>
> (a) deduction in calculating profits or gains, or
>
> (b) deduction or set off against income.

Corporate Finance Manual provides:

> **39030. Artificial payments of interest: Sole or main benefit** [October 2009]
>
> [The Manual summarises the legislation and continues:] The sole or main benefit test is an objective, rather than a subjective test: the

> subsection focuses on the result to be expected from the transaction rather than its purpose. (See *The Crown Bedding Co v IRC* 34 TC 107 at pp 115, 118-120, followed in *Ackland & Pratten v IRC* 39 TC 649 at p662, and approved in *IRC v Brebner* 43 TC 705 at p718).
> Ordinary borrowings involving funds, which are genuinely invested or re-lent, are not affected because the tax relief on the interest paid is incidental to the transaction.

The International Manual formerly provided:

> **509120. Section 787 ICTA 1988** [February 2006]
> '*Part XVII ICTA 1988 includes various anti-avoidance provisions including Section 787. This restricts relief for interest paid under a scheme from which the sole or main benefit which might be expected to accrue is the reduction of tax resulting from the relief, including group relief. Although this appears to be a far reaching section which could be used against many avoidance schemes, its usefulness is somewhat restricted.*
> *The provision was introduced to counteract a specific domestic avoidance scheme to get relief on 'manufactured' interest by paying interest in advance on a borrowing which was effectively immediately repaid. It is necessary to distinguish between an out-and-out avoidance scheme and a judiciously arranged borrowing scheme. The section is not, therefore, easily invoked but it may still be legitimate to use it in some cases involving intra-group funding transactions.*'

The entry has been deleted but there seems to be no reason to believe that HMRC practice has changed. HMRC's reluctance to use the section goes back to an assurance given in Parliament:

> **Mr. Robert Sheldon (financial secretary to the Treasury)**: The hon. Member for Guildford (Mr. Howell) rightly asked for some assurance that there would be no problems for innocent parties seeking arrangements whereby they undertook to pay interest for genuine business purposes. I can give the hon. Gentleman the assurance that those paying true interest for genuine business purposes will not be caught by this scheme. To give him the definition, which I think also deals with the question put by the hon. Member for Cirencester and Tewkesbury (Mr. Ridley), in a genuine commercial scheme the main benefit is to secure finance. If that is applicable, those people will not be caught by the main benefit test and they will be perfectly free to go about seeking and undertaking any transactions which fall within that definition.
> The natural anxiety of the hon. Member for Guildford is that these

> matters are closely watched. I can give him that assurance. That is to the advantage of the kind of people mentioned in this debate so that we do not entrap those perfectly legitimate and proper cases where people are prepared to pay the interest and get it allowable against tax. We are concerned about people who resort to some of those very peculiar devices of the kind which show an immense amount of ingenuity and, as the hon. Member for Guildford said, with such unfortunate results.[6]

17.6 Transfer pricing and thin capitalisation

The transfer pricing rules are in part 4 TIOPA, supplemented by the OECD transfer pricing guidelines which is nearly 400 pages. This is a vast topic, and a full discussion would need many volumes. I focus on matters closest to the themes of this book.

Assuming interest is paid at market rates, one would not expect any transfer pricing issues to arise. However the effect of some deft deeming provisions is that transfer pricing rules also serve as thin capitalisation rules, ie rules which restrict the deduction of interest by companies funded primarily by borrowing, having limited share capital or net value. It is therefore necessary to consider these rules in some detail.

The International Manual explains the background as it appears to HMRC:

> **413010. Definition of thin capitalisation** [August 2012]
> In the commercial world, a company is said to be thinly capitalised when it has more debt than equity, and many thin cap cases boil down to a company with more debt than it could and would have borrowed on its own resources, because it is borrowing either from or with the support of connected persons.
> However, the amount of interest payable may be excessive for one or more reasons - interest rate, excessive duration of lending, restrictions on repayment, etc - so all terms and conditions should be considered in a thin capitalisation review. Other less obvious issues of possible interest are the appropriateness of the currency of the loan (e.g. forex risk) and the presence of guarantees. For HMRC, thin cap means looking at every aspect of lending and borrowing from a transfer pricing angle.
> **Other legislation on finance**
> There is other legislation - and this is not an exhaustive list - which may result in a restriction of the interest deduction, including:
> • Arbitrage provisions - see INTM590000

6 Hansard, 13 July 1976.

- Unallowable purpose legislation - Section 441–442 CTA 2009 - see CFM38010
- Remaining provisions of pre-2004 legislation [Section 209 ICTA 1988] - now around Section 1000 CTA 2010 - such as interest in excess of a commercial rate of return - see below and CTM15502
- World-wide debt cap - Part 7 TIOPA 2010 - see CFM90100 onwards

The first two represent anti-avoidance legislation, so the choice depends on the facts and circumstances of the particular case, and transfer pricing concerns may sit alongside avoidance concerns. Section 155(6) TIOPA 2010 says that the Section 1000 CTA 2010 list and the world-wide debt cap legislation shall be disregarded when calculating the transfer pricing tax advantage. The debt cap applies after any transfer pricing adjustment has been made.

These provisions concern corporation tax only and are not discussed here. The Manual provides:

How thin capitalisation arises

When a company operates at arm's length from its sources of funding, commercial considerations drive the decision to raise funds either through debt, equity, or a mixture of the two. There is a marked difference in tax treatment between debt finance and equity, in that interest on debt is deductible from profits, whereas dividends on shares are not. This is explored in more detail in the Practical Thin Cap Guidance from INTM570000 onwards.

When a company borrows from or with the support of other group companies, funding decisions may not be driven by commercial considerations alone. The connection between the parties involved might allow them to change the way in which the funding is obtained in ways unavailable or unattractive to the borrower at arm's length, or to take on funding risks which an independent borrower would avoid. Factors such as group policy, strategy, and tax planning will sit alongside commercial considerations.

As a result of the differences in tax treatment between interest and dividends, a company which increases its indebtedness, and thereby increases its interest payments, reduces the tax it has to pay.

Thin capitalisation is just a form of transfer pricing, and is not limited to companies, except where the legislation says so, but this guidance concentrates largely on corporate relationships.

Thin capitalisation and tax planning

As with transfer pricing more generally, thin capitalisation does not require a tax avoidance motive. The aim of applying transfer pricing legislation is to ensure that arm's length prices are recognised for goods,

services, etc, for tax purposes. However, company finance is an easy and attractive way for groups to change the jurisdiction within which profits arise, and tax planning will be an aspect of the financing plans for any major corporate acquisition.

Corporate thin capitalisation is usually seen in a group context, since it would be counter-productive (though not unheard of) for a company to increase its interest costs payable to a third party, just to reduce its tax liability. Besides, a borrower cannot borrow more (or pay more interest) than an arm's length lender is willing to lend, unless that money is guaranteed, usually by group members. Where the borrowing is intra-group, the interest remains within the group; the group as a whole is no less profitable, but the borrower has paid less tax, and, where the lender is in a country with a lower corporation tax rate than the borrower or has losses to absorb interest received, the group can end up far better off overall. At the same time, there may be arbitrage (INTM590000) or other opportunities to further reduce tax.

With third party borrowing supported by a group guarantee, interest is paid to a third party and value leaves the group, but in that case the issue may be a matter of where it is most tax efficient for the group's interest costs to arise. The inference is that the world-wide group has capacity to borrow but not necessarily within the UK entity, which is where it wishes to place the debt. However, guarantees, including less formal support such as a letter of comfort, can enable a company to borrow more cheaply than would be possible on a standalone basis.

The EC comment on the EU law aspects of thin capitalisation:

Thin capitalisation rules. There are many different approaches to the design of thin cap rules which reflect the different views and legal traditions of MSs. However, the background to these rules is similar. Debt and equity financing attract different tax consequences. Financing a company by means of equity will normally result in a distribution of profits to the shareholder in the form of dividends, but only after taxation of such profits at the level of the subsidiary. Debt financing will result in a payment of interest to the creditors (who can also be the shareholders), but such payments generally reduce the taxable profits of the subsidiary. Dividend and interest may also attract different withholding tax consequences. The difference in treatment between debt and equity financing under national tax law (and at bilateral level), as a result of which the source state's taxing rights on interest are generally more limited than those on dividends, make debt financing considerably more attractive in a cross-border context and can therefore lead to the erosion of the tax base in the state of the subsidiary.

By abolishing their thin cap rules altogether or by carving out dealings with lenders resident in other MSs and EEA States from their scope, the difference in treatment between resident subsidiaries according to the seat of their parent company within the EU/EEA would be removed. The Commission is of the opinion that MSs should, however, be able to protect their tax bases from artificial erosion through structured debt

financing, also within the EU/EEA. Following *Lankhorst*, some MSs have tried to avoid the charge of discrimination by extending the application of their thin cap rules to cover also purely national relations. As discussed above, this is not desirable development.

In *Thin Cap* the ECJ acknowledged that measures to prevent thin capitalisation are not per se impermissible. Their application must however be confined to purely artificial arrangements. This may be achieved by ensuring that the terms of the debt financing arrangements between related companies remain within the limits of what would have been agreed upon between unrelated parties or that they are based on otherwise valid commercial reasons. The Commission considers that the principles laid down by the ECJ in relation to thin cap rules also apply to transfer pricing rules, which are essential to the continued existence of individual national tax systems. MSs cannot operate effective tax systems unless they are able to ensure that their tax bases are not eroded through non-commercial arrangements between associated companies.

4. APPLICATION OF ANTI-ABUSE RULES IN RELATION TO THIRD COUNTRIES

CFC rules determine the tax treatment of the profits of a foreign company controlled by a resident. As such rules are directed at, and thus only affect resident shareholders with definite influence over a foreign company (usually a parent in a corporate group) their centre of gravity lies with the ability of companies (and as the case may be, individuals) to establish themselves, through subsidiaries, in other countries. Similarly, MSs' thin cap rules are directed exclusively at group debt financing arrangements, i.e. they are only applied in situations where a foreign shareholder holds a substantial participation in the resident subsidiary. Thus, the centre of gravity in respect of thin cap rules also lies clearly with the freedom of establishment and as in the case of CFC rules their application is therefore to be examined solely from the perspective of Article 43 of the EC Treaty[7].

As Community law does not require MSs to avoid discrimination in relation to the establishment of their nationals outside the Community, or the establishment of third-country nationals in a MS[8] the issue of discrimination does not arise in the cases of a controlled company or a creditor/shareholder resident in a third country. MSs should therefore not be precluded from applying CFC and thin cap rules in relation to third countries. Community law does not impose any particular requirements on the legitimacy of the application of such legislation to transactions outside the EU[9].

However, should the application of those rules not be confined to situations and transactions between companies in a corporate group (or otherwise related parties where one has definite influence over the other) and to the extent that this was the case, they would need to comply with Article 56 of the EC Treaty, and also in relation to third countries, be applied to wholly artificial arrangements only (with the exception of situations where there is no adequate information exchange relationship with the third country concerned).

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7 Lasertec, C-492/04, #20.

8 As the ECJ noted in *ICI*: " (…), when deciding an issue concerning a situation which lies outside the scope of Community law, the national court is not required, under Community law, either to interpret its legislation in a way conforming with Community law or to disapply that legislation (…)" #34.

9 Their application may however be precluded by the relevant Double Tax Convention.

The corporate tax directives only apply to companies incorporated in the MSs and their overall objective is to create *within the Community* conditions analogous to those of an internal market by removing tax obstacles to cross-border reorganisations and to payments of dividends, interest and royalties. It would therefore not appear to fall within their ambit to, for instance, facilitate arrangements intended to avoid withholding taxes on payments to non-European entities, if such structuring does not serve any commercial purpose.[10]

17.6.1 "*The basic pre-condition*"

Section 147 TIOPA provides:

> (1) For the purposes of this section "the basic pre-condition" is that—
> (a) provision ("the actual provision") has been made or imposed as between any two persons ("the affected persons") by means of a transaction or series of transactions,
> (b) the participation condition is met (see section 148),
> (c) the actual provision is not within subsection (7) (oil transactions), and
> (d) the actual provision differs from the provision ("the arm's length provision") which would have been made as between independent enterprises.

Thus the "basic pre-condition" actually consists of four conditions or sets of conditions.

Section 151(1) TIOPA defines **"arm's length provision"** in line with the commonsense usage above:

> In this Part "the arm's length provision" has the meaning given by section 147(1).

17.6.2 "*Transaction of series of transactions*"

Section 150 TIOPA defines transaction:

> (1) In this Part "transaction" includes arrangements,[11] understandings and mutual practices (whether or not they are, or are intended to be, legally enforceable).
> (2) References in this Part to a series of transactions include references

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10 EC Communication "The application of anti-abuse measures in the area of direct taxation" COM(2007) 785 *http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52007DC0785*

11 Section 150(5) TIOPA provides the standard, unnecessary definition of "arrangement": "In this section "arrangement" means any scheme or arrangement of any kind (whether or not it is, or is intended to be, legally enforceable)."

to a number of transactions each entered into (whether or not one after the other) in pursuance of, or in relation to, the same arrangement.
(3) A series of transactions is not prevented by reason only of one or more of the matters mentioned in subsection (4) from being regarded for the purposes of this Part as a series of transactions by means of which provision has been made or imposed as between any two persons.
(4) Those matters are—

(a) that there is no transaction in the series to which both those persons are parties,
(b) that the parties to any arrangement in pursuance of which the transactions in the series are entered into do not include one or both of those persons, and
(c) that there is one or more transactions in the series to which neither of those persons is a party.

The International Manual provides:

413060. Transaction or series of transactions [August 2012]
Transactions within a series do not have to occur in a recognisable sequence. They may be simultaneous or removed in time from one another, but they have to be part of an overall arrangement or scheme.
The meaning of series of transactions is further widened by Section 150(4) TIOPA 2010 [the Manual sets out s.150(4) and continues:]
By recognising a series of transactions, the transfer pricing legislation can apply to more complex and indirect financial structures in the same way that it does to the most straightforward borrower/lender situation. However, irrespective of the complexity or number of transactions which make up the "series", it should always be borne in mind that this legislation is still about a provision within Section 147 TIOPA 2010 between two persons that results in a tax advantage. (INTM412020 and INTM413050)
A simple example of indirect finance which would fall within the definition of a series of transactions is a UK borrower being lent money by an entirely unconnected third party bank, with a party connected to the borrower guaranteeing the loan.
A more complex example is where a company in the same group as the UK borrower has provided a guarantee to one bank, which then provides a guarantee to a second bank, and the second bank then lends money to the UK borrower. Here there is a step - between the first and second banks - which does not involve either the parent or the borrower. This is still a series of transactions, and one which, though difficult to detect, would fall within the scope of the thin capitalisation legislation. Apart from the provision of a guarantee, the most likely situations where the provision might consist of a series of transactions would be where an

intermediary is acting in a nominee or agency capacity in providing finance cross border between group companies.

In guarantee cases of this nature, the questions to ask in considering the provision are:

- Without the guarantee(s) would the borrower have been able and willing to borrow on these terms?
- Had the borrower and the guarantor been at arm's length from one another, would they have entered into the guarantee?

17.7 The participation condition

Section 148 TIOPA provides:

> (1) For the purposes of section 147(1)(b), the participation condition is met if—
>
> (a) condition A is met in relation to the actual provision so far as the actual provision is provision relating to financing arrangements, and
>
> (b) condition B is met in relation to the actual provision so far as the actual provision is not provision relating to financing arrangements.

I refer to **"participation conditions A and B"**. It is helpful to consider condition B first.

17.7.1 *Participation condition B*

Section 148(3) TIOPA provides:

> Condition B is that, at the time of the making or imposition of the actual provision—
>
> (a) one of the affected persons was directly or indirectly participating in the management, control or capital of the other, or
>
> (b) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons.

17.7.2 *Participation condition A*

Section 148(2) TIOPA provides:

> Condition A is that, at the time of the making or imposition of the actual provision or within the period of six months beginning with the day on which the actual provision was made or imposed—
>
> (a) one of the affected persons was directly or indirectly

participating in the management, control or capital of the other, or

(b) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons.

Participation condition A is the same as B, except that the participation test can be satisfied at the time of the arrangement in the following 6 months. This wider tests applies to financing arrangements. That term is given a commonsense definition in s.148(4) TIOPA:

> In this section "financing arrangements" means arrangements made for providing or guaranteeing, or otherwise in connection with, any debt, capital or other form of finance.

17.8 Participation in the management control or capital of another person

This expression is elaborately defined.

17.8.1 *Direct participation*

Section 157 TIOPA provides:

> (1) Subsection (2) applies for the purposes of—
> (a) this Part,
> (b) in Part 2, section 132(7), and
> (c) in Part 5, section 219(2).
> (2) A person is directly participating in the management, control or capital of another person at a particular time if (and only if) that other person is at that time—
> (a) a body corporate or a firm, and
> (b) controlled by the first person.

17.8.2 *Indirect participation: Potential direct participant*

Section 159 TIOPA provides:

> (1) Subsection (2) applies for the purposes of—
> (a) sections 148(2) and (3), 154(5), 175(2) and 204(4),
> (b) in Part 2, section 132(7), and
> (c) in Part 5, section 219(2).
> (2) A person ("P") is indirectly participating in the management, control or capital of another person ("A") at a particular time if
> [a] P would be directly participating in the management, control or capital of A at that time
> [b] if the rights and powers attributed to P included all the rights

and powers mentioned in subsection (3) that are not already attributed to P for the purpose of deciding under section 157 whether P is directly participating in the management, control or capital of A.

(3) The rights and powers referred to in subsection (2) are—

(a) rights and powers which P is entitled to acquire at a future date,

(b) rights and powers which P will, at a future date, become entitled to acquire,

(c) rights and powers of persons other than P so far as they are rights or powers falling within subsection (4),

(d) rights and powers of any person with whom P is connected (see section 163), and

(e) rights and powers which would be attributed by subsection (2) to a person with whom P is connected were it being decided under that subsection whether that connected person is indirectly participating in the management, control or capital of A.

(4) Rights and powers fall within this subsection so far as they—

(a) are required, or may be required, to be exercised in any one or more of the following ways—

(i) on behalf of P,

(ii) under the direction of P, or

(iii) for the benefit of P, and

(b) are not confined, in a case where a loan has been made by one person to another, to rights and powers conferred in relation to property of the borrower by the terms of any security relating to the loan.

(5) In subsections (3)(c) to (e) and (4), the references to a person's rights and powers include references to any rights or powers which the person either—

(a) is entitled to acquire at a future date, or

(b) will, at a future date, become entitled to acquire.

(6) In paragraph (e) of subsection (3), the reference to rights and powers which would be attributed to a connected person includes a reference to rights and powers which, by applying that paragraph wherever one person is connected with another, would be so attributed to the connected person through a number of persons each of whom is connected with at least one of the others.

(7) References in this section—

(a) to rights and powers of a person, or

(b) to rights and powers which a person is or will become entitled to acquire,

include references to rights or powers which are exercisable by that person, or (when acquired by that person) will be exercisable, only jointly with one or more other persons.

17.8.3 "*Connected*"

Section 163 TIOPA defines "connected":

(1) Subsections (2) and (3) apply for the purposes of section 159 and this section.
(2) Two persons are connected with each other if one of them is an individual and the other is—
(a) the individual's spouse or civil partner,
(b) a relative of the individual,
(c) a relative of the individual's spouse or civil partner, or
(d) the spouse, or civil partner, of a person within paragraph (b) or (c).
(3) Two persons are connected with each other if one of them is a trustee of a settlement and the other is—
(a) a person who in relation to that settlement is a settlor, or
(b) a person who is connected with a person within paragraph (a).
(4) In this section—
"relative" means brother, sister, ancestor or lineal descendant, and
"settlement" and "settlor" have the same meaning as in section 620 of ITTOIA 2005.

17.8.4 *Indirect participation: One of several major participants*

Section 160 TIOPA provides:

(1) Subsection (2) applies for the purposes of—
(a) sections 148(2) and (3), 154(5), 175(2) and 204(4),
(b) in Part 2, section 132(7), and
(c) in Part 5, section 219(2).
(2) A person is indirectly participating in the management, control or capital of another person at a particular time if the first person is, at that time, one of a number of major participants in that other person's enterprise.

17.8.5 "*Major participant*"

(3) For the purposes of this section, a person ("A") is a major participant in another person's enterprise at a particular time if at that time—
(a) that other person ("the subordinate") is a body corporate or firm, and

(b) the 40% test is met in the case of each of two persons—
(i) who, taken together, control the subordinate, and
(ii) of whom one is A.

(4) For the purposes of this section, the 40% test is met in the case of each of two persons wherever each of them has interests, rights and powers representing at least 40% of the holdings, rights and powers in respect of which the pair of them fall to be taken as controlling the subordinate.

(5) For the purposes of this section—

(a) the question whether a person is controlled by any two or more persons taken together, and

(b) any question whether the 40% test is met in the case of a person who is one of two persons,

is to be determined after attributing to each of the persons all the rights and powers which would be attributed by section 159(2) to a person were it being decided under section 159(2) whether that person is indirectly participating in the management, control or capital of another person.

(6) References in this section—

(a) to rights and powers of a person, or

(b) to rights and powers which a person is or will become entitled to acquire,

include references to rights or powers which are exercisable by that person, or (when acquired by that person) will be exercisable, only jointly with one or more other persons.

17.8.6 *Indirect participation: Sections 148 and 175: financing cases*

Section 161 TIOPA provides:

(1) Subsection (2) applies for the purposes of sections 148(2)(a) and (3)(a) and 175(2)(a).

(2) A person ("P") is indirectly participating in the management, control or capital of another ("A") at the time of the making or imposition of the actual provision if—

(a) the actual provision relates, to any extent, to financing arrangements for A,

(b) A is a body corporate or firm,

(c) P and other persons acted together in relation to the financing arrangements, and

(d) P would be taken to have control of A if, at any relevant time, there were attributed to P the rights and powers of each of the other persons mentioned in paragraph (c).

(3) It is immaterial for the purposes of subsection (2)(c) whether P and the other persons acting together in relation to the financing arrangements did so at the time of the making or imposition of the actual provision or at some earlier time.

(4) In subsection (2)(d) "relevant time" means—

(a) a time when P and the other persons were acting together in relation to the financing arrangements, or

(b) a time in the period of six months beginning with the day on which they ceased so to act.

(5) In determining for the purposes of subsection (2)(d) whether P would be taken to have control of another person ("A"), the rights and powers of any person (and not just P) are to be taken to include those that would be attributed to that person by section 159(2) were it being decided under section 159(2) whether that person is indirectly participating in the management, control or capital of A.

(6) In this section "financing arrangements" means arrangements made for providing or guaranteeing, or otherwise in connection with, any debt, capital or other form of finance.

17.8.7 *Indirect participation: Sections 148 and 175: further financing cases*

Section 162 TIOPA provides:

(1) Subsection (2) applies for the purposes of sections 148(2)(b) and (3)(b) and 175(2)(b).

(2) A person ("Q") is indirectly participating in the management, control or capital of each of the affected persons at the time of the making or imposition of the actual provision if—

(a) the actual provision relates, to any extent, to financing arrangements for one of the affected persons ("B"),

(b) B is a body corporate or firm,

(c) Q and other persons acted together in relation to the financing arrangements, and

(d) Q would be taken to have control of both B and the other affected person if, at any relevant time, there were attributed to Q the rights and powers of each of the other persons mentioned in paragraph (c).

(3) It is immaterial for the purposes of subsection (2)(c) whether Q and the other persons acting together in relation to the financing arrangements did so at the time of the making or imposition of the actual provision or at some earlier time.

(4) In subsection (2)(d) "relevant time" means—

(a) a time when Q and the other persons were acting together in

relation to the financing arrangements, or

(b) a time in the period of six months beginning with the day on which they ceased so to act.

(5) In determining for the purposes of subsection (2)(d) whether Q would be taken to have control of another person ("A"), the rights and powers of any person (and not just Q) are to be taken to include those that would be attributed to that person by section 159(2) were it being decided under section 159(2) whether that person is indirectly participating in the management, control or capital of A.

(6) In this section "financing arrangements" means arrangements made for providing or guaranteeing, or otherwise in connection with, any debt, capital or other form of finance.

17.9 The general rule

If the "basic pre-condition" is met, we move on. Section 147 TIOPA provides:

(2) Subsection (3) applies if—

(a) the basic pre-condition is met, and

(b) the actual provision confers a potential advantage in relation to UK taxation on one of the affected persons.

If that is the case we come to the general rule:

(3) The profits and losses of the potentially advantaged person are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

Similarly if there are several affected persons:

(4) Subsection (5) applies if—

(a) the basic pre-condition is met, and

(b) the actual provision confers a potential advantage in relation to UK taxation (whether or not the same advantage) on each of the affected persons.

(5) The profits and losses of each of the affected persons are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

The International Manual provides:

413020. Introduction [August 2012]

...Paragraph 1.65 of the OECD Transfer Pricing Guidelines is particularly helpful in finding the appropriate approach towards the arm's length provision in thin capitalisation cases. This says that the

basic transfer pricing approach considers economic substance versus form in thin capitalisation cases:

> "[In cases] where the economic substance of a transaction differs from its form... the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital."[12]

This means that where a borrower obtains an actual loan of £100m from a non-arm's length source, but would only be able to borrow £60m at arm's length, the tax deduction for the interest costs should be restricted to those accruing on £60m of the £100m actually borrowed. The balance would have had to be provided in some other form, most likely as equity. This is an explanation, not a literal recharacterisation in the way that excessive interest was once reclassified as a distribution for tax purposes (see INTM413260). Debt which is found to be excessive may be treated as equity for the purposes of a thin cap analysis, but the interest on the £40m excess remains interest for tax purposes; it is simply disallowed in the computation.

There will be variations in the way debt is treated as equity. There may be negotiations which result in an amount of debt being recognised as serving an equity function, as if that debt had actually been permanently converted into equity, but there will be other instances, for example the application of a debt: equity ratio in an advance agreement, where equity will in effect vary from year to year.

This sort of "recharacterisation" should be uncontroversial, assuming the level of disallowance is agreed. It is a case of finding an explanation, should one be needed, for the presence and treatment of funds that have been deemed "excessive" as debt in thin cap terms. However, if the argument goes further, for example towards saying that the loan transaction would not have taken place at all and something different would have happened at arm's length, it is recommended that the matter be discussed with Business International before the case is developed,

It is important to remember that thin capitalisation considerations are not

12 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and tax Administration* (July 2010).

limited to determining simply the amount which would have been borrowed at arm's length, but also extend to the other terms attached to the actual provision, such as the interest rate, duration and repayment terms. Any of these is capable of creating or extending a tax advantage for the UK borrower.

17.9.1 *Separate entity basis*

The International Manual provides:

> **413070. Separate entity basis for determining borrowing capacity** [September 2012]
> The separate entity principle is part of the basic precondition in TIOPA10/S147(1)(d). This defines the arm's length provision as that "which would have been made as between independent enterprises". The arm's length borrowing capacity of the borrower is therefore the debt which it could and would, as a stand-alone entity, have taken on from an independent lender. To establish this, it is necessary to consider the borrower separately from other members of the same group of companies This is the "separate entity" or stand-alone basis for determining borrowing capacity.
> This approach is derived from OECD Transfer Pricing Guidelines, as expressed in paragraph 1.6 of the Guidelines:
>
> > By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focussed on the nature of the dealings between those members.
>
> The main impact of the "separate entity" basis for determining borrowing capacity is that no account is taken of any guarantees, explicit or implicit, from connected companies (INTM413130). However, it is recognised that, without offending the "separate entity" principle, negotiations with a third party lender would include an assessment of the financial strength of the borrower. This would take into account the income, assets and liabilities of the company, but also of its subsidiaries. In broad terms, this will be based on the strength (or otherwise) of the borrower's consolidated balance sheet and profit and loss account, subject to some analysis of what underlies the figures on the face of the accounts. This grouping is known as the "borrowing unit".
> HMRC follows a practical approach and, if consolidated accounts are

not drawn up as a matter of course, will request a consolidated presentation of the relevant figures. The borrower is not obliged to produce audited consolidated accounts purely for HMRC, so properly drawn up schedules reflecting the consolidated position will be acceptable. This may not be a straightforward task if the exercise embraces companies resident in a number of countries and using a variety of accounting conventions. In such cases it may be helpful to discuss how HMRC may be satisfied without creating major expense and difficulty.

There may be companies that need to be excluded from the consolidation and dealt with according to their own characteristics e.g. finance companies which are likely to have higher proportions of debt to equity than ordinary trading companies. Some subsidiaries may need to be excluded altogether e.g. companies with a dividend block, which a lender might not recognise as assets against which they would be willing to lend. This whole question must be viewed pragmatically.

Further practical guidance on the separate entity measure of borrowing capacity is at INTM542050. The next page gives some background on the pre-2004 treatment; this shows the contrast between the previous statutory approach to the borrowing unit with the practical, analytical approach which has been adopted to deal with the separate entity basis. UK companies under common ownership with the borrowing unit may be able to make a compensating adjustment claim if they have spare borrowing capacity...

17.10 "Differ from the provision that would have been made"

Section 151(2) TIOPA provides:

> For the purposes of this Part, the cases in which provision made or imposed as between any two persons is to be taken to differ from the provision that would have been made as between independent enterprises include the case in which
>
> [a] provision is made or imposed as between two persons but
>
> [b] no provision would have been made as between independent enterprises;
>
> and references in this Part to the arm's length provision are to be read accordingly.

The International Manual provides:

> **413030. The "would" and "could" arguments** [September 2012]
>
> The test of thin capitalisation is to test the actual borrowing position against the arm's length borrowing position.
>
> The arm's length principle recognises that connected parties may enter

into transactions with each other on terms which differ from those which would be found in the open market between entirely unconnected persons. Where profits arise and the extent to which those profits are taxed may also differ from the arm's length position.

The application of the arm's length principle requires a judgement on the merit of each individual case to establish what would have happened at arm's length; the terms on which the company in question could have borrowed and would have borrowed (if anything),

- as a separate entity
- from a third party lender unconnected with the borrower, and
- without guarantees or other forms of comfort from any party connected with the borrower.

There are two main ways of looking at the borrowing: what the lender would do and what the borrower would do if the circumstances were as outlined above, and these are expressed as:

- the "could" argument - what a lender would have lent and therefore what a borrower could have borrowed - and
- the "would" argument - what a borrower acting in the best interests of their own business would have borrowed.

The "could" argument

This is generally the less subjective issue. The could argument focuses on what a lender would be prepared to lend to the company and on what terms, taking into account the borrower's capacity to borrow, the risk of default, assets (as security) and liabilities (additional drains on the borrower's resources), and its ability to service the debt: in short, how much and on what terms a lender would lend.

Risk elements will include amount, duration of lending, purpose, security, currency and the economic climate at a sector, national and international level.

The "would" argument

This issue is more subjective, since it can involve the whole basis on which the business is run. The "would" argument considers the borrower's perspective: whether the borrower would have entered into the actual transaction in the absence of a special relationship (INTM412020) with the lender. Therefore, when trying to establish the amount and terms of arm's length debt, the "would" argument relates to how much, and on what terms, the borrower would have borrowed at arm's length bearing in mind the sort of issues mentioned below.

So, the "would" argument requires consideration as to what terms a borrower would have agreed at arm's length, such as

- the amount of debt, and whether that leaves headroom to allow the borrower to absorb cyclical or seasonal variations, an unforeseen event or a fluctuation in interest rates or profits, and ultimately repay

the principal;

- the costs of borrowing, and whether forecasts indicate that the borrower is likely to be able to service the debt fully and still have sufficient cash to operate as a profitable going concern;
- whether the other terms, such as the interest rate or provision for early repayment are ones to which the borrower would have agreed in the absence of a special relationship;
- whether the borrower would have taken out the loan at all.

Consideration of all aspects of the "could" and "would" arguments should highlight situations such as where

- an arm's length interest rate is being applied, but the amount of debt is more than the borrower could have borrowed from an independent lender, or
- an arm's length interest rate is applied to an arm's length amount of debt, but the borrower appears to have no purpose of its own for borrowing the money (and therefore no reason to borrow other than the group relationship).

Debt is not necessarily paid down to nil. A certain level of debt is acceptable, even desirable in most companies, and while higher levels of acquisition debt tend to be reduced in the years following the transaction, there is likely to be a level of debt appropriate to the needs of the business, year on year, appropriate to achieving the right balance between debt, equity and profitability...

17.11 Securities (loans)

Section 152 TIOPA provides:

(1) This section applies where—
  (a) both of the affected persons are companies, and
  (b) the actual provision is provision in relation to a security issued by one of those companies ("the issuing company").

(2) Section 147(1)(d) [the actual provision differs from the arm's length provision] is to be read as requiring account to be taken of all factors, including—
  (a) the question whether the loan would have been made at all in the absence of the special relationship,
  (b) the amount which the loan would have been in the absence of the special relationship, and
  (c) the rate of interest and other terms which would have been agreed in the absence of the special relationship.

The International Manual provides:

413040. Summary of sections specific to thin capitalisation [August

2012]

There are specific sections within Part 4 TIOPA 2010 that apply only to loans between two companies:

- Section 152 TIOPA 2010 requires that in the case of lending between companies certain factors to be considered when comparing the arm's length provision with the actual provisions in Section 147(1)(d) TIOPA 2010. See INTM413100
- Section 181 TIOPA 2010 to Section 184 TIOPA 2010 sets out the conditions required for a lender to make a valid compensating adjustment claim where a disallowance has been made in the borrower's computations. See INTM413140
- Section 153 TIOPA 2010 deals with the factors that are taken into account when a loan is supported by a guarantee, and the borrower and the guarantor have a special relationship. See INTM413160
- Section 191 TIOPA 2010 to Section 194 TIOPA 2010 sets out the conditions required for a guarantor to make a valid compensating adjustment claim. See INTM413150

Non-corporates

Part 4 TIOPA 2010 applies to loans made to companies by non-corporates where the participation condition in Section 148 TIOPA 2010 is met. However, the explicit instructions regarding factors to be considered as part of evaluating the arm's length provision in Section 152 TIOPA 2010 and Section 153 TIOPA 2010 do not apply directly as legislation to loans by non-corporates. Even so, the factors that are set out in Section 152 TIOPA 2010 and Section 153 TIOPA 2010 are generally those which are taken into account by lenders and borrowers acting at arm's length, so in practice the nature of the lender, corporate or non-corporate will have little if any impact on how the arm's length provision is determined.

Claims for compensating adjustments by non-corporates can be made under the conditions in Section 174 TIOPA 2010 to Section 178 TIOPA 2010 (Para 6 of Sch 28AA).

17.11.1 *Disregard: Non-business loans*

Section 152(3) TIOPA introduces two disregards:

Subsection (2) has effect subject to subsections (4) and (5).

Section 152(4) TIOPA provides:

(4) If—

(a) a company ("L") makes a loan to another company with which it has a special relationship, and

(b) it is not part of L's business to make loans generally,

the fact that it is not part of L's business to make loans generally is to be disregarded in applying subsection (2).

Why is this needed? The International Manual explains:

> **413100. Special rules for lending between companies** [September 2012]
> Section 152(4) TIOPA 2010 ensures that the fact that the lender is not generally in the business of making loans cannot be taken into account when evaluating the terms.

17.11.2 *Disregard: Guarantee*

Section 152(5) TIOPA provides:

> (5) Section 147(1)(d) [the actual provision differs from the arm's length provision] is to be read as requiring that, in the determination of any of the matters mentioned in subsection (6), no account is to be taken of (or of any inference capable of being drawn from) any guarantee provided by a company with which the issuing company has a participatory relationship.
> (6) The matters are—
> (a) the appropriate level or extent of the issuing company's overall indebtedness,
> (b) whether it might be expected that the issuing company and a particular person would have become parties to a transaction involving—
> (i) the issue of a security by the issuing company, or
> (ii) the making of a loan, or a loan of a particular amount, to the issuing company, and
> (c) the rate of interest and other terms that might be expected to be applicable in any particular case to such a transaction.

Section 153 TIOPA repeats the same material:

> (1) This section applies where the actual provision is made or imposed by means of a series of transactions which include—
> (a) the issuing of a security by a company which is one of the affected persons ("the issuing company"), and
> (b) the provision of a guarantee by a company which is the other affected person.
> (2) Section 147(1)(d) [the actual provision differs from the arm's length provision] is to be read as requiring account to be taken of all factors, including—
> (a) the question whether the guarantee would have been provided at all in the absence of the special relationship,

(b) the amount that would have been guaranteed in the absence of the special relationship, and

(c) the consideration for the guarantee and other terms which would have been agreed in the absence of the special relationship.

(3) Subsection (2) has effect subject to subsections (4) and (5).

(4) If—

(a) a company ("G") provides a guarantee in respect of another company with which it has a special relationship, and

(b) it is not part of G's business to provide guarantees generally,

the fact that it is not part of G's business to provide guarantees generally is to be disregarded in applying subsection (2).

(5) Section 147(1)(d) [the actual provision differs from the arm's length provision] is to be read as requiring that, in the determination of any of the matters mentioned in subsection (6), no account is to be taken of (or of any inference capable of being drawn from) any guarantee provided by a company with which the issuing company has a participatory relationship.

(6) The matters are—

(a) the appropriate level or extent of the issuing company's overall indebtedness,

(b) whether it might be expected that the issuing company and a particular person would have become parties to a transaction involving—

(i) the issue of a security by the issuing company, or

(ii) the making of a loan, or a loan of a particular amount, to the issuing company, and

(c) the rate of interest and other terms that might be expected to be applicable in any particular case to such a transaction.

The International Manual provides:

413110. Guarantees - what they do and what they are [August 2012]
As explained in INTM413060, a provision may arise from a series of transactions rather than just a single transaction between two connected companies. A loan from a third party which is guaranteed by a connected person constitutes a provision consisting of a series of transactions. The same would apply to a loan from a connected party which is guaranteed by another connected party. The most common instance will be a single loan supported by a single guarantee but the provision could consist of any number and combinations of loans and cross guarantees.

The effect of a guarantee

Guarantees most commonly support third party borrowing, but can be used to support loans between group companies: for example, a European group treasury company might provide finance to a fellow

group company resident in the UK, but under guarantee from the UK borrower's parent company.

With the additional comfort offered to the lender by a guarantor, the lender might provide a loan on more advantageous terms than the borrower could have obtained otherwise, because the guarantee will reduce the risk to the lender. In the event of a failing borrower and no guarantee, a third party lender's prospects of recovering its outlay would be at risk. However, with a guarantee in place, the lender should have greater and more immediate success in recovering debt and interest, simply by exercising its rights under the guarantee and seeking payment from the guarantors, than it would by waiting for a distribution of assets in a liquidation, or having to write off all or part of the loan. The guarantor would of course have to demonstrate that it could make good its pledge, and probably provide security in relation to its commitment.

The effect of a guarantee on loan terms is varied. Guarantees may help secure:

- A larger loan
- A lower rate of interest
- An increase in duration
- Less demanding covenants on the borrower

Any of these may have implications for the transfer pricing of the transaction e.g. a larger loan may be obtainable, but it may be more than the borrower would be able or willing to take on at arm's length. Also, the guarantee may secure preferable terms as compared to what would be otherwise on offer. A lower interest rate on a larger amount of debt might be regarded as a more attractive and not a more expensive deal. See INTM413120.

The presence of a guarantee does not necessarily signify a change in lending terms, and in any case larger, longer, etc, do not mean "better" for the borrower; a larger loan may be more than the borrower would or could borrow without this help, and therefore more than the borrower could or would borrow at arm's length. Lenders may seek guarantees as part of a "belt and braces" approach: not crucial factor, but better to have than not have. A typical example being the cross guarantees required by lenders when they lend to a group of companies.

413120. Evaluating guarantees: starting with the arm's length cost of debt [August 2012]

Section 153 TIOPA 2010 (Paragraph 1B Schedule 28AA) is about considering the effect of, and consequently the issue of allowing the costs of pricing guarantees between connected companies. It adopts a similar approach to the way transfer pricing of securities between companies operates - see Section 152 TIOPA 2010 (INTM413100). However to understand how the section works it is better to start by

looking at the factors that have to be disregarded before looking at the factors that are specifically to be taken into account.

Section 153(4) TIOPA 2010 has the same effect for guarantees as Section 152(4) TIOPA 2010 has for loans. It ensures that where the guarantor is not generally in the business of making guarantees, that circumstance cannot be taken into account when evaluating what the guarantee fee would be at arm's length.

Section 153(5) and (6) TIOPA 2010 ensure that guarantees from connected companies are ignored, so that the borrower's borrowing capacity is evaluated on a separate entity basis (INTM413070). These subsections repeat what was said at Section 152(5) and (6) TIOPA 2010, except with different intent. Section 152 is about how the arm's length provision is calculated for the borrower, for the purposes of testing whether a security is on arm's length terms. Section 153 repeats the same test, but as a precursor to working out whether a guarantee has an arm's length value to the borrower. The exercise should isolate and exclude the effect of the guarantee to identify what would have been achieved without it.

Looking at the loan whilst ignoring the effect of any guarantees establishes the amount the borrower would have been able to borrow in its own right, and the terms on which it would have done so. The legislation specifically states that guarantees should be disregarded in considering the following specific issues:

- the level or extent of overall debt
- whether a loan would have been entered into
- the rate of interest or other terms

Once this is established, the legislation considers the transfer pricing of the guarantee fee itself - see INTM413110.

413130. Establishing the arm's length value of a guarantee [August 2012]

This is about guarantee fees and their worth to the borrower: where the borrower is actually charged for the provision of a guarantee. This is therefore about:

- what value the guarantee brings to the borrower, compared to what it could and would obtain without it
- what is the appropriate level for the guarantee fee which the borrower pays

Section 153 (Paragraph 1B) first establishes the arm's length price of the loan without guarantees. This does not necessarily mean that guarantees will be ignored in pricing the debt. In considering what guarantee, if any, would have been provided at arm's length. Section 153(2) TIOPA 2010 (Paragraph 1B(2)) asks that "all factors" be taken into account in working this out, and particularly asks what would have happened in the

absence of the special relationship between the borrower and the provider of the guarantee (i.e. at arm's length):

- would the guarantee have been provided at all
- what amount would have been guaranteed
- what consideration (fee, etc) and other terms would have been agreed

This is simply a matter of applying a transfer pricing test to guarantee costs.

At arm's length, a company will not take on the extra cost of a guarantee unless that guarantee makes the overall cost of finance cheaper than it would be on a stand-alone basis. If the cost of the guarantee itself is greater than the saving it brings, it will be disallowed to the extent that it causes the total finance costs relating to the guaranteed debt to exceed the stand-alone arm's length price.

The scenarios below set out how Section 153 TIOPA 2010 operates for the borrowing company. The "cost of loan" in the headings below refers to actual costs of borrowing excluding guarantee fees and not adjusted by transfer pricing provisions. These scenarios do not demonstrate the arm's length price of a guarantee, but will show whether the guarantee has brought a benefit when the borrowing is considered on an arm's length basis.

1.Guarantee fee charged and cost of loan exceeds arm's length

The borrower is already paying more than it would if borrowing on a separate entity basis. Considered at arm's length, the value of the guarantee is nil and it simply represents an additional cost. The terms of the loan are adjusted for transfer pricing purposes to the arm's length amount, the non-arm's length element of the loan costs is disallowed, and the guarantee fee is disallowed.

There is no apparent benefit from this guarantee, so any claim that there is value meriting a guarantee fee should be subject to a thorough analysis to identify whether the guarantee provides any other, less obvious commercial benefit that would justify the payment of a fee. A guarantee might enable a borrower to spread its finance costs over a longer period, which might be advantageous in certain circumstances.

2.Guarantee fee charged and cost of loan is equal to the arm's length

The cost of the loan is arm's length so no adjustment is required with respect to the loan itself, but as in 1 above, it would be difficult to justify a guarantee fee. It appears to provide no benefit by way of cheaper financing and is likely to be disallowed unless some less obvious benefit can be demonstrated.

3.Guarantee fee charged and cost of loan is less than arm's length

This situation may arise where the guarantee is taken into account in setting the terms of the loan. For example, the presence of the guarantee may have the effect of improving the credit rating of the borrower and

achieve a lower interest rate. As the guarantee has reduced the cost of the loan to below the stand-alone cost, there is a clear benefit to the borrower in entering into the guarantee. It is therefore likely that at arm's length a fee would be paid, as there is a genuine benefit to the borrower. However, the borrower would only agree to pay a fee at arm's length if there was an overall saving, and the level of the fee should reflect this.

4.No guarantee fee charged and cost of loan is less than arm's length

Where there is a guarantee in place but no fees have been charged, the guarantee may still provide the borrower with beneficial terms, such as a reduced interest rate. The arm's length cost of the loan will exceed the actual cost of the loan, because the guarantee reduces finance costs without itself costing anything. It might be argued that, at arm's length, a fee would be charged for such an effective guarantee, but one cannot be imputed in the computations of the borrower, because transfer pricing legislation operates as a one way street. This scenario creates no tax advantage, so the basic transfer pricing conditions are absent. Of course if the guarantor negotiated a fee, that would be considered on its merits.

Evaluating the arm's length value of a guarantee fee should be more than a simple mathematical comparison of actual and arm's length costs. It is worth emphasising that all relevant factors should be considered:

- the obligations of the guarantor
- its ability to fulfil them
- an analysis of the improvement to the borrower's credit worthiness
- consideration as to whether the guarantee brings the borrower something beyond the implicit parental or group support provided by passive association with fellow group members.

It may be that the benefits provided by a guarantee, particularly informal understandings, are such that a guarantee fee would not normally be justified. Furthermore, where the guarantor is unable to honour its commitments under the guarantee because of the state of its own finances, the guarantee will in practice have no value.

17.12 Definitions

17.12.1 *Special relationship*

Section 154 TIOPA provides some definitions introduced by s.154(1)

> Subsections (3) to (7) apply for the purposes of sections 152 and 153....

Section 154(3) TIOPA provides:

> "Special relationship" means any relationship by virtue of which the participation condition is met (see section 148) in the case of the affected persons concerned.

The term "special relationship" is used in the OECD model treaty without definition (though discussed in the commentary) but the definition here is narrower.

17.12.2 *Guarantee*

Section 154(4) TIOPA provides:

> Any reference to a guarantee includes—
> (a) a reference to a surety, and
> (b) a reference to any other relationship, arrangements, connection or understanding (whether formal or informal) such that the person making the loan to the issuing company has a reasonable expectation that in the event of a default by the issuing company the person will be paid by, or out of the assets of, one or more companies.

The International Manual has an interesting passage on implicit guarantees which is not set out here as it is not relevant to the themes of this book.

17.12.3 *Participatory relationship*

Section 154(5) TIOPA provides:

> One company ("A") has a "participatory relationship" with another ("B") if—
> (a) one of A and B is directly or indirectly participating in the management, control or capital of the other, or
> (b) the same person or persons is or are directly or indirectly participating in the management, control or capital of each of A and B.

17.12.4 *Security*

Section 154 TIOPA provides:

> (6) "Security" includes securities not creating or evidencing a charge on assets.
> (7) Any—
> (a) interest payable by a company on money advanced without the issue of a security for the advance, or
> (b) other consideration given by a company for the use of money so advanced,
> is to be treated as if payable or given in respect of a security issued for the advance by the company, and references to a security are to be read accordingly.

Subsection (6) is standard form. However subsection (7) means that all loans are "securities." It would have been clearer to use the word "loan" rather than to (mis)use the word "securities", but there it is.

17.13 `Potential advantage in relation to UK taxation

Section 155 TIOPA provides:

> (1) Subsection (2) applies for the purposes of this Part.
> (2) The actual provision confers a potential advantage on a person in relation to UK taxation wherever, disregarding this Part, the effect of making or imposing the actual provision, instead of the arm's length provision, would be one or both of Effects A and B.
> (3) Effect A is that a smaller amount (which may be nil) would be taken for tax purposes to be the amount of the person's profits for any chargeable period.
> (4) Effect B is that a larger amount (or, if there would not otherwise have been losses, any amount of more than nil) would be taken for tax purposes to be the amount for any chargeable period of any losses of the person.

17.13.1 *Disregarded income*

Section 155(5) provides a disregard for disregarded income:

> In determining for the purposes of subsection (3) or (4) the amount that would be taken for tax purposes to be the amount of the profits or losses for a year of assessment in the case of a non-UK resident, there is to be left out of account any income of that person which is—
> (a) disregarded income within the meaning given by section 813 of ITA 2007 (limits on liability to income tax of non-UK residents), or
> (b) disregarded company income within the meaning given by section 816 of that Act.

Subsection (6) provides two more disregards:

> For the purposes of subsections (2) to (4)—
> (a) Part 7 (tax treatment of financing costs and income), and
> (b) paragraph E of the list in section 1000(1) of CTA 2010 (excessive interest etc treated as a distribution),
> are to be disregarded.

17.14 Exemption for small companies

Section 166 TIOPA provides what appears to be a general exemption,

which is then restricted by significant exceptions.

> (1) Section 147(3) and (5) do not apply in calculating for any chargeable period the profits and losses of a potentially advantaged person if that person is a small or medium-sized enterprise for that chargeable period (see section 172).

Section 166(2) provides the signposts in accordance with the dictates of plain English drafting:

> Exceptions to subsection (1) are provided—
> (a) in the case of a small enterprise, by section 167, and
> (b) in the case of a medium-sized enterprise, by sections 167 and 168.

17.15 Election into transfer pricing regime

I mention the first exception only for completeness. Section 167(1) TIOPA provides:

> (1) Subsections (2) and (3) set out exceptions to section 166(1).
> (2) The first exception is if the small or medium-sized enterprise elects for section 166(1) not to apply in relation to the chargeable period. Any such election is irrevocable.

Why would anyone would want to elect into the regime?

17.16 Resident of non-qualifying territory

The next exception is more important. Section 167 TIOPA provides:

> (3) The second exception is if—
> (a) the other affected person, or
> (b) a party to a relevant transaction,
> is, at the time when the actual provision is or was made or imposed, a resident of a non-qualifying territory (whether or not that person is also a resident of a qualifying territory).

Section 167(4) TIOPA provides some general definitions:

> For the purposes of subsection (3)—
> (a) a "party to a relevant transaction" is a person who, if the actual provision is or was imposed by means of a series of transactions, is or was a party to one or more of those transactions, and
> (b) "qualifying territory" and "non-qualifying territory" are defined in section 173.

Resident is based on the OECD model definition. Section 167(5) TIOPA provides:

> In subsection (3) "resident", in relation to a territory—
> (a) means a person who, under the law of that territory, is liable to tax there by reason of the person's domicile, residence or place of management, but
> (b) does not include a person who is liable to tax in that territory in respect only of income from sources in that territory or capital situated there.

17.17 Qualifying Territory

Section 173 TIOPA provides:

> (1) In section 167(3)—
> "non-qualifying territory" means any territory which is not a qualifying territory, and
> "qualifying territory" means—
> (a) the UK, or
> (b) any territory in relation to which condition A or condition B is met.

I refer to **"qualifying territory conditions A and B"** to avoid confusion with the myriad conditions in TIOPA.

17.17.1 *Qualifying territory conditions A and B*

Section 173 TIOPA provides:

> (2) Condition A is that—
> (a) double taxation arrangements have been made in relation to the territory,
> (b) the arrangements include a non-discrimination provision, and
> (c) the territory is not designated as a non-qualifying territory for the purposes of this subsection in regulations made by the Treasury.
> (3) Condition B is that—
> (a) double taxation arrangements have been made in relation to the territory, and
> (b) the territory is designated as a qualifying territory for the purposes of this subsection in regulations made by the Treasury.

Non-discrimination provision has a commonsense definition:

> (4) For the purposes of subsection (2)(b) a "non-discrimination

provision", in relation to any double taxation arrangements, is a provision to the effect that nationals of a state which is a party to those arrangements (a "contracting state") are not to be subject in any other contracting state to—

(a) any taxation, or

(b) any requirement connected with taxation,

which is other or more burdensome than the taxation and connected requirements to which nationals of that other state in the same circumstances (in particular with respect to residence) are or may be subjected.

(5) In subsection (4) "national", in relation to a state, includes—

(a) any individual possessing the nationality or citizenship of the state, and

(b) any legal person, partnership or association deriving its status as such from the law in force in that state.

(6) In this section "double taxation arrangements" means arrangements that have effect under section 2(1) (double taxation relief by agreement with territories outside the UK).

CHAPTER EIGHTEEN

INTEREST INCOME

18.1 Interest: Introduction

This chapter considers:
(1) The taxation of interest income
(2) Withholding tax on payment of interest to non-residents
(3) Withholding tax on payment of interest by deposit-takers (banks)
(4) The EU Interest and Savings Directive

Each topic requires a book to itself, except the EU directive which requires several volumes. I focus on matters closest to the themes of this book. I do not consider:
(1) Corporation taxation of interest (the loan relationship rules)
(2) The EU interest and royalties directive 2003/49/EC of 3rd June 2003 which applies to interest and royalty payments made between associated companies of different member states.

Each of those would also require long books to themselves.

18.1.1 *Cross references*

The following topics are considered elsewhere:
17.1 (Deduction for payment of interest
14.2 (Location of source of income: Territorial scope of IT)
14.9 (Split years: savings & investment & miscellaneous income)
19.1 (Exempt interest: Introduction).

18.2 Definition of interest

The SAI Manual provides:

> **SAIM2030 - Interest: meaning of interest** [July 2007]
> **The legal concept of interest**
> Interest is not defined in the Taxes Acts. It is a concept of common and contract law. Halsbury's Laws of England defines it as follows.
> "Interest is the return or compensation for the use or retention by

one person of a sum of money belonging to or owed to another..."[1]

While there can be no such thing as interest without the requisite principal (a sum of money advanced or a debt incurred) there is no requirement that such principal has to carry interest. In common law the general rule is that interest is not payable on a debt or a loan; except where

- there is an express agreement to pay interest,
- an agreement to pay interest can be implied from a course of dealing between the parties, or from the nature of the transaction, or custom or usage of the trade or the profession concerned, or
- in certain cases by way of damages for breach of a contract (other than a contract merely to pay money) where the contract, if performed, would to the knowledge of the parties have entitled the parties to receive interest.

SAIM2040 - Interest: when does interest run? [July 2007]

Interest cannot be back-dated

Since interest on a loan or debt can normally only run where there is an agreement to pay interest (SAIM2030), it follows that interest cannot be back-dated.

Example (Deborah)

D is a controlling shareholder in Deb's Fashions Ltd. When the company started in 2001, she made a loan of £10,000 to the company. There was no agreement in 2001 that the loan should pay interest. In preparing the company accounts for year ended 31 December 2005, the company's accountant advises that the company can now afford to pay interest, and accordingly it is agreed on 4 February 2006 that the loan will carry interest at 3% per annum.

The agreement will have effect only from 4 February 2006. The company may make a payment to D to compensate her for the period when she received no interest on the £10,000. Such a payment is not interest, even if it calculated on a time basis, or if it is described in the company accounts as 'interest'. The tax treatment of such a payment will depend on the exact nature of the arrangements between D and the company.

SAIM2050 - Interest: voluntary payments [July 2007]

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1 [Author's footnote] See *Halsbury's Laws of England* (5th ed., 2008),Vol 50, para 1303 (Interest in general). Halsbury's footnote at this point refers to: *Re Farm Security Act 1944* [1947] SCR 394 at 411; *Dunn Trust Ltd v Feetham* [1936] 1 KB 22; *Bennett v Ogston* 15 TC 374; *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353; *Westminster Bank v Riches* (28 TC 159); and adds: Money paid in lieu of interest is not itself interest: *Tomkins v Tomkins* (1978) Times, 24 May.

Voluntary payments are not interest

Since interest can only accrue by virtue of some right, a voluntary or gratuitous payment cannot be interest, even if it is expressed as in lieu of or 'equivalent to half the interest', as in the case of *Seaham Harbour Company v. Crook* (16 TC 333). J Rowlatt's comment that

> "interest or an annual sum which is paid really benevolently each time is merely an allowance, and not taxable at all"

is a reflection of that common-law principle.

Truly voluntary payments are likely to be rare. For instance where compensation is paid, labels such as 'ex gratia' may only mean that the payer settled out of court, or 'without admitting liability'. Such a payment is not voluntary or gratuitous if made in consideration of the claimant giving up the right to take proceedings for the damage suffered. See SAIM2330 for more on compensation or damages generally.

SAIM2060 - Interest: case law [May 2012]

Case law on the meaning of interest

The definition of interest has been the subject of much judicial interpretation over the years. In *Westminster Bank v. Riches* (28 TC 159), Lord Wright observed

> "...the essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had had the use of the money, or, conversely the loss he suffered because he had not had that use. The general idea is that he is entitled to compensation for the deprivation."

The leading case on the meaning of 'interest of money' is now *Re Euro Hotel (Belgravia)* (51TC293). In that case, Megarry J considered that in general the case-law showed there were two requirements which had to be satisfied for a payment to amount to interest

- there must be a sum of money by reference to which the payment which is said to be interest is to be ascertained - a payment cannot be 'interest of money' unless there is the requisite 'money' for the payment to be said to be 'interest of';
- those sums of money must be due to the person entitled to the alleged interest.

He did not suggest that the two requirements are exhaustive or inescapable but that in the ordinary case they sufficed.

What is interest is a question of substance

What constitutes interest is a question of legal substance, not terminology. In the Westminster Bank case Lord Wright said its 'essential quality…depends on substance not on the mere name'. Lord

Simonds, with Lord Porter concurring, said that what needed to be considered was 'what is its intrinsic character'.

That substantive test was reaffirmed in *Re Euro Hotel (Belgravia),* in which by Megarry J said

> "It has, quite rightly, not been suggested that the language used by the parties to an instrument in describing payments to be made under it can bind the Inland Revenue, or affect the operation of a statute. The question must always be one of the true nature of the payment."

The contract in that case was one in which it was provided that one party would 'pay to the Bank interest'. It was held that what was paid was not 'interest of money' despite the wording of the contract quoted above, because the Bank in question had not advanced money as a loan, but instead as out and out non-returnable payments for building works. The 'interest' was not 'interest of money'.

'Single indivisible sums'

Another important case on the nature of interest is *Chevron Petroleum (UK) v BP Petroleum Development* (57 TC 137). Payments between the companies included 'an interest factor' and were calculated in accordance with a complex formula. BP made the payments to Chevron after deducting income tax from the interest factors. The point at issue was whether the payments were true interest. Lord Justice Megarry's view was that the 'interest factor' was, in law, 'interest of money' and that because of the substantive nature of the test the Court would, if necessary, dissect lump-sum payments into interest of money and other sums. He said

"If in its nature a sum is 'interest of money', I think it retains that nature even if the parties to a contract provide for it to be wrapped up with some other sum and the whole paid in the form of a single indivisible sum. The wrappings may conceal the nature of the contents but they do not alter them. Were the law otherwise, strong contractual wrappings might become remarkably popular."

The Corporate Finance Manual para 33030 also discusses this issue; omitting the parts which repeat the SAI manual, the other parts of this passage provide:

CFM33030 - Loan relationships: computational rules: what is interest? [October 2009]

...

What is interest: case law

The question of what constitutes interest has been the subject of much case law over the years. Perhaps the best known quotation on what

> interest is comes from Rowlatt J in *Bennett v Ogston* (15 TC 374). He described interest as 'payment by time for the use of money'.
> ... The concept that interest is something that accrues over time is supported by the cases of *Wigmore v Thomas Summerson* (9 TC 577) and *Willingale v International Commercial Bank* (52 TC 242). These cases indicated that true interest accrues from day to day or at periodic intervals.

18.2.1 *Discounts*

Section 381(1) ITTOIA provides:

> All discounts, other than discounts in deeply discounted securities, are treated as interest for the purposes of this Act.

18.3 Part payment: attributable to interest or capital?

If a debtor owes both interest and capital, the question may arise as to whether any particular payment made is interest or capital.

A solvent debtor can[2] direct that any payment is to be treated as a payment of the interest, or a payment of the capital. That is, if the debtor chooses to pay interest, the receipt is interest; if the debtor chooses to repay capital due, the receipt is not interest. (If the creditor does not like that, they can sue for the remaining sums due.)

If the debtor is bankrupt, the same applies if the payment is made with the consent of the creditor and the debtor. That is, if the creditor waives the interest, what is then received will be capital.

There is a complication if the debt is owned by an interest in possession trust. If the debtor is bankrupt, and the trustee-creditor does not expressly agree to attribute the payment to income or to capital, the position[3] is governed by the rule in *Re Atkinson* [1904] 2 Ch 16. The rule is summarised by Gregory Hill:

> ... the rules in *Re Atkinson* and *Re Bird*, ... prescribe apportionments between trust capital and income where the realisation of a fixed interest security, such as a mortgage debt or debenture stock, produces a sum which is less than the total amount owing for principal and arrears of interest.
> ... *Re Atkinson* applies where the deficient security was an authorised investment, [this will be usual the case] and requires the amount

2 Unless the contract otherwise provides.

3 Unless the trust otherwise provides.

> actually realised (A) to be divided between capital and income in the proportion which the amount due for capital (B) and that due for arrears of interest (c) bear to one another, but the income beneficiary's entitlement to the interest actually received is not in any way affected. The relevant formulae, where the investment was authorised, are thus:
> Capital = A × B÷(B + C)
> Income = A × C÷(B + C)[4]

The rule in *re Atkinson* was applied in a case where under a scheme approved by the Court, interest on debentures was cancelled and what was paid was regarded as capital (not interest) for tax purposes.[5] But that was a case where the trustees did not consent to treating the payment in that way (they had no choice in the matter as they held only a small holding of the debenture stock concerned). So the application of the rule was necessary if one was to be fair to the life tenant. But the fairness is not tax-efficient. The life tenant's receipt is not interest but it is subject to income tax under the category of "annual payment".

18.4 Interest: charge to tax

Section 369(1) ITTOIA imposes the charge on interest:

> Income tax is charged on interest.

Section 370 ITTOIA provides:

> (1) Tax is charged under this Chapter on the full amount of the interest arising in the tax year.
> (2) Subsection (1) is subject to Part 8 (foreign income: special rules).

Section 370(2) incorporates the remittance basis for foreign source interest.

18.5 Interest: location of source

I refer to the person paying interest as "**the debtor**" and the recipient as "**the creditor**".

Foreign source interest is outside the scope of withholding tax and qualifies for the remittance basis, so the question of source matters to both creditor and debtor.

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4 Hill, "Successive Interests and Deficient Fixed-Interest Securities" [2012] TQR *http://www.step.org/successive-interests-and-deficient-fixed-interest-securities*.

5 *Re Morris* [1960] 1 WLR 1210.

Statute provides virtually no guidance on the location of a source of interest, so one falls back on principle and case law. There are three rival tests, or approaches, to the source of interest:

(1) **The situs approach**: the source of interest is in principle the situs of the debt as determined by the IHT/international law situs rules[6] (**"the situs rules"**). I say "in principle" as a situs approach may allow for points of detail where the rules for the location of the source differ slightly from the debt situs rules.
(2) **The multi-factorial approach**: the source is identified by weighing up all relevant factors.
(3) **The place of credit test**: the source is the place that credit was provided.

The correct approach is currently disputed. In short:

(1) The situs approach was universally accepted until 1993.
(2) HMRC adopted one multi-factorial approach in 1993, and a different multi-factorial approach in 2007, but there is (in short) no UK case law supporting this.
(3) International case law supports the place of credit test but there is no UK case law supporting this.

18.6 The situs approach

18.6.1 *The consensus until 1993*

The situs approach is readily understandable when one recalls the terms of the legislation in force before the ITTOIA rewrite. Section 18 ICTA 1988 provided (so far as relevant):

> *Case III: tax in respect of... any interest of money...*[7]
> *Case IV: tax in respect of income arising from securities out of the UK... ;*
> *Case V: tax in respect of income arising from possessions out of the UK;*

What was the test to determine whether income was from securities or possessions "outside the UK" and so taxed under case IV or V (now,

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6 See 18.7 (Rejection of the situs approach).

7 Case III was not expressed to have any territorial limitation at all! That had to be read in: interest arising from securities or possessions "outside the UK" was taxed under case IVor case V and did not fall within case III.

relevant foreign income)? The natural reading of the phrase "out of the UK" was *situate* outside the UK, ie, the situs test.

The pre-rewrite legislation did not refer to interest arising from a *source* inside/outside the UK. The word *source* was used as a paraphrase of the statutory words, and I do so here, but it is important to remember it is only a paraphrase.

From the earliest times, up to about 1993, the situs approach was universally adopted. In argument and in the decisions, the textbooks cited were private international law textbooks on situs; and case law cited was situs case law.

The IR consultative document "Tax Treatment of Interest paid by Companies to Non-residents"[8] confirmed a situs approach to location of a source of interest was applied up to 1979:

> In the case of a simple contract debt it is settled law that the source is where the debtor is resident. Before the ending of exchange control, the Revenue was normally able to accept that interest paid abroad in a foreign currency[9] under a specialty contract (ie a contract under seal governed by foreign law) to a non-resident could have a foreign source, even though the payer was a UK resident company.

The situs approach still survives in the Double Taxation Relief Manual (which has not been properly updated since the publication of RI 55 in 1993):

> **1730. Interest** [February 2006]
> There is sometimes some difficulty in deciding whether interest is treated as having a UK source where the borrowing is made by a UK branch. ...
> The leading case on this subject is a Privy Council decision on a Hong Kong estate duty matter (*Kwok Chi Leung Karl*[10] [1988] STC 728). The Privy Council decided that where a debtor company has two places of residence where a debt may be enforced, the locality of the debt *(and its source for tax purposes* in the absence of statutory provision to the contrary) falls to be determined by reference to the place of residence where under the contract creating the debt the primary obligation is

8 January 1983 accessible *http://www.kessler.co.uk/tfd-archive*.

9 The currency is not relevant for situs; but it was relevant for exchange control, as a UK resident needed Bank of England consent to buy, or issue, foreign currency securities.

10 Author's footnote: *Kwok* is a situs case, see 82.13.1 (Meaning of "residence").

expressed to be performed (that is where the creditor would apply first for his money).

A (slightly) refined version of the situs approach to the source of interest is recorded in Revenue/Treasury correspondence in 1969. According to the Revenue, interest has a foreign source if:

(a) the loan contract is made abroad
(b) the loan contract is governed by foreign law
(c) the interest is payable abroad, and there is no UK paying agent and
(d) the loan is not secured on any specific assets or revenue in the UK.[11]

The same (more or less) is recorded in *Whiteman & Sherry on Income Tax:*

> Consistently with the decision in the *National Bank of Greece* case, the Inland Revenue accepted, prior to the suspension of exchange controls in October 1979, that interest payable by a debtor in the UK fell outside Case III (and within Case IV) provided that the debt was constituted by what came to be known as a foreign security. To be a foreign security, the obligation had to be either a bearer document or executed under seal, and had to be governed by a foreign law, executed and kept outside the UK and to provide for interest, in a currency other than sterling, to be payable and paid outside the UK.
>
> The Inland Revenue apparently took the view that, since exchange controls would normally prevent such an obligation being owned by a UK resident, it was sufficiently foreign to constitute a source of income outside the UK. Such foreign securities were commonly employed by UK companies wishing to issue bonds the income on which could be paid gross and in practice confirmation that Case III would not apply could be obtained from the Inland Revenue. Following the suspension of exchange controls, the Inland Revenue ceased to give confirmations that such loan arrangements did not give rise to interest taxable under Case III.[12]

The IR consultative document "Tax Treatment of Interest paid by

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11 Note by the Inland Revenue to the Working Party on Balance of Payments Aspects of Tax Questions 20 November 1968; Letter HM Treasury to Inland Revenue 10 January 1969; both accessible *http://www.kessler.co.uk/tfd-archive*.
These conditions are reflected in s.338(4)(c) and s.340 ICTA 1988 (repealed) (circumstances in which interest not subject to deduction at source is a charge on income).

12 4th ed., (looseleaf), para 18-050.

Companies to Non-residents"[13] set out the HMRC view from 1979:

> The abolition of exchange control has meant that a transaction in the form of a foreign specialty contract can now take place entirely between UK residents. The Revenue therefore now generally has to regard interest paid by a UK borrower as having a UK source, whatever the nature of the contract ...

This (more or less) equates source with residence of the debtor. It is a step from the situs approach, though not a large one: it differs only in the (non-standard) case of a specialty debt. It appears that this change of practice was made for pragmatic reasons and without reference to tax law. In the circumstances it is not altogether surprising that their view could not be maintained. The consultation paper gives the impression that this practice lasted for 15 years but I doubt if the view was strictly enforced. There was no support for this view in the case law, though in practice a residence test will often lead to the same result as other better established tests.

18.6.2 *Bank of Greece*

Against that background, we can consider the *Bank of Greece* case.[14] The key facts were straightforward:

(1) A Greek bank issued bearer bonds.

(2) The bank defaulted and the guarantor[15] paid the interest.[16]

The Revenue took the situs approach: the "basic test" for the source of interest was the IHT/private international law situs test:[17]

> The basic test for determining whether the payments are income arising in the UK is to be found in *Dicey and Morris on The Conflict of Laws*, 8th ed. (1967), p. 508, rule 79, on the determination of the situs of

13 January 1983 accessible *http://www.kessler.co.uk/tfd-archive*.

14 *Westminster Bank Executor and Trustee Co v National Bank of Greece* 46 TC 472.

15 For completeness: the payments were made by a company which succeeded to the original guarantor, following an amalgamation, and which was subject to the same obligations as the original guarantor; but that made no difference.

16 For completeness: it was not completely clear that guarantee payments should be classified as "interest". However even if it was not interest it is sensible that location of the source of guarantee income should be determined on principles similar to those which apply to interest income, and the House of Lords proceeded on the basis that there is no difference.

17 [1970] 1 QB 256, at p.266; the Revenue were not called on to argue the point in the House of Lords but there is no reason to think they changed their view.

things.[18]

The Revenue argued that although the debt was originally situate in Greece, it had moved and become situate in the UK:

> Applying that rule here, the debt is enforceable only in England where it is situate and this is the place where the income arises.

The difficulty which the Revenue argument faced was that the usual test of situs is residence, and the guarantor was not UK resident! The Revenue answer was that where residence and enforceability differed, situs was in the place of enforceability, not residence:[19]

> Residence is important because in most cases it is where the debtor is resident that the debt can be enforced. But the true test is: in what country is the obligation primarily enforceable? The answer to the question: ... this was an English contract governed by English law; and under English law the Income Tax Act, 1952, requires tax to be deducted before payment. *New York Life Insurance Co. v. Public Trustee*[20] shows that if the test of residence leaves one with a choice between an English and a Greek situs, the English situs must be preferred because the proper law of the contract is English. It would be patently absurd to attribute a Greek situs to the obligation when Greece is the one country where it has been abolished....

The House of Lords held that the interest had a foreign source. First they summarised the facts:

> [1] I have come to the conclusion that the source of the obligation in question was situated outside the United Kingdom.
>
> [a] This obligation was undertaken by a principal debtor which was a foreign corporation.
>
> [b] That obligation was guaranteed by another foreign corporation which, as was conceded before us, had at no time any place of business within the UK.

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18 Now Dicey, Morris & Collins, (15th ed., 2012), rule 129; see 82.13.4 (Place-of-enforceability as synonym of place-of-debtor rule). The text has not materially changed.

19 The better view of the law of situs is that where residence and enforceability differ, situs is in the place of *residence*, not enforceability; but the point was arguable.

20 [1924] 2 Ch 101; See Cheshire, North, and Fawcett, *Private International Law* (14th ed., 2008), p.1226; *New York Life Insurance* is a situs case; see 82.13 (Simple contract debt).

[c] It was secured by lands[21] and public[22] revenues in Greece.

[d] Payment by the principal debtor of principal or interest to residents outside Greece was to be made in sterling[23] and either at the offices of [UK banks in London] or (at the option of the holder) at the National Bank of Greece in Athens, Greece, by cheque on London. Whichever method of payment was selected, ... discharge of the principal debtor's obligation would have involved in the ordinary course either a remittance from Greece to the paying agents specified in the bond or, at the option of the holder, a cheque issued within Greece though drawn on London, and presumably payable there out of funds remitted by the debtors from abroad.[24]

[e] ... the bond contained no provision for payment by the guarantor at any particular place or in any particular country.

This is a straightforward case of a foreign company raising funds by issuing debentures. Why was it argued the interest had a UK source?

[2] The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the United Kingdom were as follows.

[a] Although the original guarantor had no branch in the United Kingdom, the present Appellants had acquired one on their universal succession in London.[25]

[b] Moreover, it was urged that, since discharge of the obligations under the bond in Greece had been caught by the moratorium enacted by the Greek Government, it followed that the only place at which the obligation could have been discharged or enforced was in London.

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21 For completeness. The debt was originally secured on land in Greece but these properties were taken over or destroyed following the German and Italian occupation of Greece in 1941. But nothing turns on that.

22 For completeness: The interest was payable out of income of the Bank of Greece. That is only "public" revenues in a loose sense, as the National Bank of Greece was publically owned. The bonds were bank bonds and not government bonds.

23 For completeness: in 1935 this changed so that Greek residents could only be paid in drachmas: see *National Bank of Greece v Metliss* [1958] AC 509 at p.510. But nothing turns on that.

24 The point is that payment would in the ordinary course have ultimately derived from funds situate in Greece.

25 That is, the guarantors who succeeded to the original guarantor acquired a branch in London on their succession to the original guarantor.

That is, circumstances had changed, and

(1) The guarantor (who originally had no branch in the UK) now had a branch in the UK.

(2) The bonds (which were originally enforceable in Greece) were now enforceable in the UK.[26]

These changes (though seemingly fundamental) did not change the location of the source of the interest:

> [3] Speaking for myself, I do not see how an obligation originally situated in Greece for the purposes of British income tax could change its location either by reason of the fact that
>
> [a] one guarantor had been substituted for another, or
>
> [b] ... the second guarantor so substituted subsequently acquired a London place of business, or
>
> [c] ... the Government of Greece had by retrospective legislation altered by moratorium and substitution of a new guarantor for the purposes of Greek law the obligations imposed upon the principal debtor and the guarantor.
>
> The Appellants acquired no obligation different from that of the original guarantors, and that was the obligation imposed on the original guarantors by the terms of the bonds.
>
> [4] In my view, the bond itself is a foreign document, and the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document.

Only one (quite narrow) proposition of law can be inferred from this. *Bank of Greece* is authority for the (sensible) proposition that the location of a source of interest is fixed and does not move with changes of circumstances.[27]

It was clear, and all sides accepted, that interest paid by the principal debtor (the Bank of Greece, which issued the bonds) had a Greek source.[28] The question whether the interest on the bonds originally had a

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26 *National Bank of Greece v Metliss* [1958] AC 509.

27 More accurately, the case is authority for the proposition that the changes which occurred in the *Bank of Greece* case did not change the location of the source. However the changes which occurred there were so fundamental that there will be few if any cases where the location of a source of interest will move.

28 In the Court of Appeal at p.487 "it has been common ground both in this Court and at first instance that if the payments of the coupons had been made by the principal debtors (the Mortgage Bank) they would have fallen within Case IV as being in respect of foreign securities." Likewise the case for the respondents in the House of

UK source was not raised, not argued, and not answered. The practice at the time that interest paid by a non-resident was in principle within case IV or V was applied without need for consideration. In any event, almost[29] all the features of the debt pointed to Greece.

A statement of a proposition of law in a judgement on a matter that was not the subject of argument is not binding authority, even in the House of Lords.[30] But it seems to me that no general propositions on locating the source of interest are to be found anywhere in the case.

HMRC argue that paragraph [1] of the quoted passage supports the multi-factorial approach: all the features listed in the paragraph were relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise. This is a misreading. *Bank of Greece* provides no support for that approach. That is not surprising, as the House of Lords had no need to say anything about the location of source of interest paid by the Bank of Greece. The court heard no argument about the principles of identifying the location of the source of interest. The relevant cases were not cited. In my view *Bank of Greece* gives no general guidance at all on what is the test for the location of the source of interest. That is what one would expect as the courts do not usually lay down the law on points which did not arise for decision and were not argued.

In short: the passage sets out a list of *facts*, not *factors.*

The short sentence at [4] ("the bond is a foreign document") was a paraphrase of the then statutory phrase, *securities out of the UK*). It was not intended to be a test for location of the source of interest. It is not an statement of the law: it is the conclusion.

If (contrary to that view) that half sentence did lay down a test, it raises

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Lords states at para 6: "It is common ground that if payment of the interest due on presentation of the coupons had been made by the principal debtor, those payments would have fallen within case IV of Schedule D as being in respect of foreign securities."

29 The following features in *Bank of Greece* did not cause the interest to have a UK source:

(1) payment made in sterling
(2) English proper law
(3) interest paid in England.
(4) The loan was "raised in London": 46 TC at p.489.

30 This is basic, but if authority is needed, see *Scrivens v Ethical Standards Officer* [2005] All ER (D) 78 (Apr) at [52] citing long established authorities.

more questions than it answers:

(1) How does one decide if a bond is a "foreign document"? If one identifies a test for that (presumably multi-factorial) one can apply that test without the concept or label of a "foreign document".
(2) What happens if the interest does not arise on a bond: does a "foreign document" test apply also apply to simple contracts?

18.6.3 *Hafton Properties*

Hafton Properties v McHugh (a decision at Special Commissioner level) was another case where the location of the source of interest was straightforward until the circumstances of the debt changed:

(1) Under the original loan agreement, a US company borrowed from a US bank, the loan being secured on US property.
(2) Hafton (UK resident) acquired the property subject to the mortgage. It paid the interest due under the original loan agreement.

At the time of *Hafton Properties* (1986) the Revenue still maintained the situs approach. They argued that IHT/international law situs was the test of source:

> [The Revenue] maintained that, notwithstanding the arrangements made for the servicing of the debt, the residence of the debtor fixed the situs of the debt. See the citation from Atkin LJ's judgment in *New York Life Insurance Company v Public Trustee* [1924] 2 Ch 101 at page 119[31] in Cheshire and North, Private and International Law (10th Edn.) at page 537.

The difficulty for the Revenue was that the debtor (the US company) was not UK resident, so the interest should have been foreign source! the Revenue answer was that the US company was not the debtor:

> [The Revenue] submitted, ... there was a novation of the personal debt: so that Hafton became ... the debtor under the Note. [The Revenue] accordingly submitted that Hafton is the ultimate debtor, that Hafton is resident in the UK, and therefore that the debt is located in the UK. The situs of the debt locates, in her submission, the source of income, and therefore the source of income is a UK source.[32]

Interest under the original loan was not UK source, and the Special

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31 *New York Life Insurance* is a situs case, see 82.13 (Simple contract debt).

32 59 TC 420 at 426.

Commissioner held it did not acquire a UK source when the payor changed:

> In one respect the Greek Bank case is different from this one, in that in that case the debtors (both original and substituted) were at all times essentially Greek in character. Nevertheless I collect from Lord Hailsham's speech a clear disinclination to regard sources of income as being peripatetic.[33]

This correctly identifies the *ratio* of *Bank of Greece*: the location of a source of interest does not change. One started here with foreign source interest. The change (a change to the identity of the debtor) did not change the source.

It is important to note that there is *nothing* in the judgment about balancing relevant factors, and *Hafton* offers no support for a multi-factorial approach. It was (once again) not necessary to consider how one *does* determine the source of interest, because the circumstances of the original US debt were clear.

This point will not often arise because the facts of *Hafton Properties* (purchase of property subject to mortgage) are unusual. A mortgage is usually paid off at the time of the purchase.

A more common situation is that an individual who has borrowed funds later changes his or her residence, and continues to pay interest. *Hafton* supports the view that (whatever the test for location) interest does not become UK source merely because the debtor becomes UK resident. Conversely interest does not cease to be UK source just because a debtor becomes non-resident.

The Special Commissioner added that the Revenue argument failed even if Hafton was the debtor, because the situs was still outside the UK:

> That is fortified, of course, by the fact that the debt was a mortgage debt. Such a debt is regarded for private international law purposes (at any rate) as a speciality debt, the situs of which is to be found where the mortgage deed is to be found. The mortgage deed is, and so far as I know always has been, in the United States.[34]

18.6.4 *Broome*

For completeness, I should mention *IRC v Viscount Broomes Executors*

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33 59 TC 420 at p.426.

34 59 TC 420 at p.426.

19 TC 667. This was another case where the circumstances of the loan had changed:

(1) The original debtor was (primarily) resident in Kenya (also UK resident, but that does not matter).
(2) The original debtor died. His executors were UK resident.
(3) The loan was enforceable in Kenya. The UK executors who became liable for the debt paid the interest in the UK out of funds in the UK.

Both sides agreed, and the judge accepted, that the situs approach was the test of source:

> There was really very little dispute between the Solicitor - General and [Counsel for the taxpayer] as to the law (particularly perhaps as to the Income Tax law) which is applicable. There is no doubt at all that if a payment is made by a person here out of a source which is here, then that payment attracts tax. ... This also seems to me to be clear, and it is elaborately explained in the case of the *English, Scottish and Australian Bank, Limited v IRC*,[35]; this, I say, was not questioned, that the locality of a simple contract debt is the place where the debtor is to be found. That is laid down with the utmost clearness in numerous speeches in the House of Lords, and there is no doubt about it at all.[36]

The dispute concerned where the situs actually was. Since the executors were resident in the UK, one would expect that the situs of the debt would also be in the UK. The taxpayer's argument to the contrary was curtly dismissed:

> I think the executors were resident in this country. Mr. Latter [Counsel for the taxpayer] contended that it was not the question of the executors; it was a question of the executorship. I hardly ever fail to understand Mr. Latter, but I am not perfectly certain that I did exactly understand what he meant by the residence of the executorship.[37]

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35 *English, Scottish and Australian Bank* is a situs case, see 82.13 (Simple contract debt).

36 at p.678.

37 at p.679.

For completeness: The judge added (at p.680):

"There is no doubt at all that if a payment is made by a person here out of a source which is here, then that payment attracts tax. ... I think it was payment out of a source here. The first two payments are perhaps a little more clear, because there the payment was actually made to [the creditor] personally in this country. He happened to be here; he was resident abroad, but he happened to be here, and he was actually paid by the executors in London; and equally [the other payments] were made in

More analytically, an executorship is not a person and does not have a residence. Only executors do.

The result in *Broome* would be different after *Bank of Greece*. Accepting (as the judge did) that interest on the original debt was not UK source, it should not have changed following the death of the debtor, as interest sources are not peripatetic.

18.6.5 *UK cases: conclusion*

The older UK cases all accept a situs approach.

18.7 Rejection of the situs approach

It should always have been apparent that there were some difficulties in applying the situs approach to the source of interest:

(1) The situs rules did not always give what a policy approach would identify as the most sensible answer to the location of the source of interest. That is not surprising, as the rules were not devised for that purpose, or indeed for any tax purpose. This is self-evident, but if authority is needed, see *Philips*:

> If the location of the debt were to be selected as the test, the source would be located differently according as whether the contract was a simple contract or a specialty; and, in the latter case, its location would arbitrarily change with the actual situation of the deed itself. Such a test would, indeed, be far from the practical commonsense test prescribed by the authorities; and I cannot think it proper to apply it here if some other is available.[38]

The High Court of Australia rejected the situs approach for similar reasons in *Studebaker Corporation of Australasia v Commissioner of Taxation*.[39]

(2) There were always some discrepancies between a strict situs approach and HMRC practice, which perhaps mattered more after the abolition of exchange control in 1979.

London, were sent to a bank in London, and were remitted by the bank in London to Kenya to be paid there. In these circumstances I am of opinion that this was a payment made by persons resident in London out of sources in London."

This passage adopts uncritically the view that the funds used to pay interest constitute the source of interest. It is suggested that no guidance should be taken from *Broome* on this point, and in practice it has been ignored.

38 See 18.9.1 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR 868 at p.898.

39 See 18.9.1 (*IRC v Philips' Gloeilampenfabrieken*).

(3) *Bank of Greece* could be taken as inconsistent with a situs approach. If the basis, or a basis, of the decision is that the House of Lords was that the source of interest does not move, there is already one inconsistency.[40]

If it is accepted that the situs approach is to be abandoned, the question arises as to what should be the new test for the source of interest.

18.7.1 *HMRC view 1993–2008: Multi-factorial test*

HMRC finally made the break from the situs approach in RI 58 (1993):

> **Schedule D Case III—meaning of "source"**
> ...The current [HMRC] view on the location of the source for interest is based on ... the Greek Bank case. The factors considered relevant in that case (leading to the conclusion that the income involved did not have a UK source) were—
> [1] there was an obligation undertaken by a principal debtor which was a foreign corporation;
> [2] the obligation was guaranteed by another foreign corporation with no place of business in the UK;
> [3] the obligation was secured on lands and public revenues outside the UK;
> [4] funds for payments by the principal debtor of principal or interest to residents outside Greece would have been provided
> [i] either by a remittance from Greece or
> [ii] funds remitted by debtors from abroad[41]
> (even though a cheque might be drawn in London).
> Although the Greek Bank case was concerned with income which turned out not to have a UK source, inferences can be drawn from that case about the factors which would support the existence of a UK source and [HMRC] regard the most important as—
> [a] the residence of the debtor, that is the place in which the debt will be enforced;
> [b] the source[42] from which interest is paid;

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40 The security in that case was a bearer security, and under the situs test should have been regarded as situate wherever the document was held. It would obviously be impractical to apply that rule for the source of interest, though I do find it puzzling that the case discloses no mention at all of this difficulty.

41 I am not sure what is meant by this.

42 [Author's Note] I think this means the situs (on IHT/international law principles) of the funds used to pay the interest. It does not mean the location on IT principles of the source of the income used to pay the interest (which could of course be different).

> [c] where the interest is paid; and
> [d] the nature and location of the security for the debt.
> If all of these are located in the UK then it is *likely* that the interest will have a UK source.
> (Emphasis added)

This adopted a multi-factorial approach. This is not supported by *Bank of Greece*. *Spotless* does support this approach, but it does not select these four factors as the most important.

Assuming one does adopt that approach, "likely" was a timid word to use when all four of what HMRC identified as the "most important" connecting factors point the same way. The RI acknowledged the problem that different connecting factors may point different ways, but did not offer an answer:

> It is not possible for [HMRC] to comment individually in advance on the many cases in which the location of the source of interest may be relevant since the precise tax treatment depends on all the factors and on exactly how the transactions are in fact carried out.[43]

18.7.2 *Changes made by the tax law rewrite*

If the situs test is rejected, it followed that the old legislation (which seemed to suggest a situs test) was not appropriate. The tax law rewrite recognised this. ITTOIA EN cited s.18(3) ICTA set out above, and explained why they replaced the expression securities/possessions "out of the UK" with the expression "*source* outside the UK":

> 3079.Section 18(1) and (3) of ICTA require that, for an amount to fall within the charge under those Cases, [cases IV and V] as opposed to another charging provision, it has to be (a) income, (b) which arises from, (c) securities or possessions, (d) out of the United Kingdom ....
> 3080.Case law establishes that "securities" are a sub-set of "possessions". The definition of "relevant foreign income"[44] does not maintain any distinction between income which, in the source legislation, is within Schedule D Case IV and income which is within

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43 RI 58 ended with wishful thinking:
"[HMRC] hope that this summary of [their] views will assist practitioners and their clients in determining for themselves where the source of interest with which they may be concerned is located."

44 The EN is considering the definition of relevant income in s.830 ITTOIA, but the comments on source apply to the source of interest generally.

Schedule D Case V.

3081.The definition [in the rewrite legislation, ITTOIA] uses "source" rather than "possessions" (the expression in Schedule D Case V). "Possessions", in the context of Schedule D Cases IV and V, appeared in the first income tax Act of 1799 when the word carried associations with, in particular, colonial property that it no longer has. The definition employs the more widely used term "source".

3082.The meaning of "possessions" [out of the UK] in Schedule D Case V has been interpreted by case law. It covers any and every source of income arising outside the United Kingdom. Income charged to tax under Schedule D Cases IV and V by virtue only of section 18(3) of ICTA (that is, excluding amounts treated as income by another provision in the source legislation and charged under Schedule D Case IV or V) has an identifiable source.

3083.In *Colquhoun v Brooks* (1889), 2 TC 490 HL (where the subject was how to tax a partner's share of a foreign trade), Lord Macnaghten dealt with the meaning of "possessions" in terms of a source of income (page 508):

> ...The word "possessions" is not a technical word. It seems to me that it is the widest and most comprehensive word that could be used. Why, for instance, should not possessions in Ireland mean everything, every source of income that the person chargeable has in Ireland, whatever it may be? Why should not "profits from possessions out of Great Britain," which is to be found in [Income Tax Act 1842] Schedule G., No. XI., ... mean profits from every source of income abroad? I use the expression "source of income" because it is as a source of income that the Act contemplates and deals with property and everything else that a person chargeable under the Act may have, and the [Income Tax Act 1842] itself, in section 52, uses the expressions "sources chargeable under [this] Act" and "all the sources contained in the said several schedules" as describing everything in respect of which the tax is imposed.

The current wording, referring to the source of income, removes the inference of the former wording, that the situs test should be the test for the source of interest. But it sheds no light on what the test for source is or ought to be.

18.7.3 *HMRC view from 2009: Multi-factorial test with different factors*

HMRC did not announce a change of view, but from 2008 the SAI Manual adopts a different version of the multi-factorial test, and RI 58 is

now described as "superseded by SAIM 9090 onwards".[45] I take that to be notice that HMRC have withdrawn from it.[46] This version of the multi-factorial approach expands the list of relevant factors from four to eight, and give an inkling of priority:

> **9090. Yearly[47] interest: UK source: The general rule** [August 2013]
> ... Whether or not interest has a UK source depends on all the facts and on exactly how the transactions are carried out. HMRC consider the most important of factor in deciding whether or not interest has a UK source to be
> [1] the residence of the debtor and
> [2] the location of his/her assets.
> Other factors to take into account are
> [3] the place of performance of the contract and
> [4] the method of payment;
> [5] the competent jurisdiction for legal action and
> [6] the proper law of contract;
> [7] the residence of the guarantor and
> [8] the location of the security for the debt.
> This list of factors is derived from the leading case on the source of interest, *Westminster Bank Executor and Trustee Co v National Bank of Greece* (46 TC 472).

Bank of Greece provides no support for a multi-factorial approach or for this particular selection of eight factors.[48]

> HMRC consider the residence of the debtor to be most important because this, along with the location of the debtor's assets, will influence where the creditor will sue for payment of the interest and repayment of the loan.

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45 See the HMRC online version of Tax Bulletin 9 *webarchive.nationalarchives.gov.uk/20101006151632/http:/www.hmrc.gov.uk/bulletins/tb9.htm* also recorded in Tolley's Yellow Tax Handbook.

46 However INT Manual still supports RI 58:
> **342030 UK source** [January 2010]
> The onus is on the payer to decide whether tax is properly to be deducted having regard to settled case law principles [!] and all the facts surrounding the loan. In particular, the payer should refer to the approach and criteria endorsed by the House of Lords in the *National Bank of Greece* case (46 TC 472). HMRC's position in that case is outlined in Tax Bulletin 9 of November 1993 [RI 58].

47 [Author's note] Although the Manual heading refers to yearly interest, the same rules should apply to the source of short interest.

48 See 18.6.2 (*Bank of Greece*).

The SAI Manual then defines "residence":

> 'Residence' in these circumstances is not the same as tax residence. Residence of the debtor is residence for the purposes of jurisdiction.

I refer to the concept as "**jurisdiction-residence**" to distinguish it from tax-residence. It seems surprising to use the term residence in a non-tax sense but this arises for historic reasons: the concept comes from common law/IHT debt situs rules which in the past governed the rules for the source of interest.[49]

What is the test of jurisdiction-residence? In the case of an individual it is the same as tax-residence (or as near as makes no difference); but in the case of a company, it is place of business, which is quite different from tax-residence.

The SAI Manual provides:

> **9095. Yearly[50] interest: UK source: Companies** [July 2007]
> *Interest paid by companies*
> In deciding whether or not interest has a UK source, in addition to the factors described in SAIM9090, there are other matters to be taken into account for companies.
> **Companies and branches**
> Where the debtor is a company it may of course have more than one residence – for example it may be registered in a US state but managed and controlled from the UK.[51] Jurisdiction in relation to a corporation will in general depend on where the corporation does business (except where the EU Regulation or the 1968 Convention apply – see SAIM9090). So for these purposes it will be resident where it carries on business. If a debtor company has a number of places of residence/business then to decide the location of the debt you have to look at the terms of the loan agreement. The loan agreement should say where the interest and loan are payable, which (if the company is also resident in that place) will determine whether or not the interest has a UK source.
> When it comes to considering loans made to a branch of a UK company the source of the interest is overseas if all the following factors apply:

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49 See 82.13.1 (Meaning of "residence").

50 [Author's note] Although the Manual heading refers to yearly interest, the same rules should apply to short interest.

51 The example given is muddled, or using "Residence" in an idiosyncratic way, but it does not matter.

[1] an overseas branch of a UK resident company has entered into a loan agreement overseas;
[2] the loan is for the business of the overseas branch;
[3] the overseas branch pays the interest from its income;
[4] the loan agreement obligations are enforceable in the jurisdiction in which the branch is situated.

The paragraph does indicate a "safe haven" situation where one can be confident that the interest paid by a person who is UK tax-resident does not have a UK source.

The SAI Manual continues:

> Conversely, where a branch of a non-UK resident company enters into a loan agreement in the UK for the business of its UK branch and the UK branch pays the interest then the interest is regarded as having a UK source.

18.7.4 *Impact of changes in private international law*

The background law (that is, private international law) has changed since the date of the situs cases which underlie the HMRC view, such as *New York Life Insurance* decided in 1924. Jurisdiction is now largely governed by international conventions, under which it is only approximately correct to say that residence of the debtor is the test of jurisdiction, (even though in most cases the end result will be the same). In short, it is not the case that the residence or place of business of the debtor is the place the debt will be enforced.[52] So if jurisdiction-residence is the test, or a factor in the test, there is a choice. Does interest arise:

(1) in the place where the debtor has jurisdiction-residence; or
(2) in the place where the debt is actually enforceable.

The author of the SAI Manual is aware of the question, but does not give the answer:

> **9090. Yearly interest: UK source: The general rule** [August 2013]
> *Duty to deduct tax from interest with a UK source*
> **EU rules**
> If the debtor is resident within the EU, the Council Regulation (EC) 44/2001 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial matters, ["the Judgments

52 See 82.13 (Simple contract debt). In *Bank of Greece* the debt was enforceable in the UK but the interest was not UK source.

Regulation"] and the 1968 'Brussels Convention',[53] may have an impact on the general rule described above.

There are different rules for individuals, corporations, and trusts.

The usual rule is that where an individual is domiciled in a contracting state, then they should be sued in the courts of that state (Article 2 of the Regulation/Convention).[54] Domicile is defined according to the rules of that contracting state but for these purposes only, it is, in the UK, linked to the individual's residence. Under these rules an individual is domiciled in England for example if he is resident there and the nature and circumstances of his residence indicate that he has a substantial connection with England.[55] So an individual resident in England would in general terms only be sued in the courts in that country. However this is a complex area and there are exceptions. For example it may be argued that:

[1] the case does not fall within the Regulation;
[2] another convention or international agreement gives jurisdiction to another state's courts
[3] proceedings have already begun in another state's courts; or
[4] it has been agreed under Article 22 of the Brussels Convention[56]

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53 [Author's footnote] The Judgments Regulation applies in EU Member States. It supersedes the 1968 Brussels Convention except for some territories which fall within the scope of the Convention and which are excluded from the Regulation pursuant to Article 349 TFEU.

54 [Author's footnote] Article 2 Judgments Regulation provides: "Subject to this Regulation, persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that Member State."

55 [Author's footnote] Article 59 Judgments Regulation provides:
"1. In order to determine whether a party is domiciled in the Member State whose courts are seised of a matter, the court shall apply its internal law.
2. If a party is not domiciled in the Member State whose courts are seised of the matter, then, in order to determine whether the party is domiciled in another Member State, the court shall apply the law of that Member State."
In England, s.41(3) Civil Jurisdiction and Judgments Act 1982 provides:
"... an individual is domiciled in a particular part of the UK if and only if—
(a) he is resident in that part; and
(b) the nature and circumstances of his residence indicate that he has a substantial connection with that part."

56 [Author's footnote] I think the reference should be Article 23 Judgments Regulation, which provides:
"1. If the parties, one or more of whom is domiciled in a Member State, have agreed that a court or the courts of a Member State are to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a

that the courts of a particular state have exclusive jurisdiction.

Point [4] is common, as the parties may agree any jurisdiction which suits them. What happens then? The Manual does not say:

> In any case in which it is argued that a UK resident debtor can be sued in a Member State in precedence to the UK courts please refer the case to CT&VAT (Financial and Insurance Team).

The SAI Manual then turns to consider the impact of modern private international law on companies:

> **9095. Yearly interest: UK source: Companies** [July 2007]
> *Interest paid by companies*
> **Companies within the EU**
> Under both the EU Regulation and 1968 Convention, domicile is the main ground of jurisdiction and will, at first sight, determine the rules for the recoverability of debts. EU regulation 44/2001 provides for a definition of domicile for corporations so that the company is domiciled where it has its statutory seat (in the UK its registered office), central administration or its principal place of business.[57] However it is important to note that a corporation is not domiciled in a country for these purposes merely because it does business there.

The Manual does express a view on the location of a source in a case where the debtor is jurisdiction-resident in one place but domiciled (in the sense of the Regulation) in another:

> If an EU based company carries on business in a country in which it is not domiciled you have to consider the terms of the loan agreement to

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particular legal relationship, that court or those courts shall have jurisdiction..."

57 [Author's footnote] Article 60 Judgments Regulation provides:

"1. For the purposes of this Regulation, a company or other legal person or association of natural or legal persons is domiciled at the place where it has its:

(a) statutory seat, or

(b) central administration, or

(c) principal place of business.

2. For the purposes of the UK and Ireland 'statutory seat' means the registered office or, where there is no such office anywhere, the place of incorporation or, where there is no such place anywhere, the place under the law of which the formation took place."

Thus the Judgments Regulation provides *three* places where a company is domiciled and may be sued. There is no single place where the debt can be enforced which would serve as a test for the location of a source.

> determine the situation of the debt. For example, if a company which has its principal place of business in the UK also carries on business in another Member state, where the interest and loan are payable in that other Member state and that member state's courts have jurisdiction then the interest will be non-UK source.
> For branches of EU companies the position is as described above for branches generally.[58]

Thus in the Manual's view, the place of jurisdiction-residence has priority.

For the reasons given in 82.13.3 (Place-of-debtor rule v. jurisdiction where debt enforced) it is suggested that the better approach is to pay no regard to modern conflicts law in determining the source of interest, even if the place where the debt is enforceable is not the place where the debtor resides. But if one adopts a place of credit test, as is suggested, the problem does not arise.

18.7.5 *Interest from securities*

If one does adopt a multi-factorial test, slightly different considerations apply in the case of securities issued by a company as (particularly in the case of publicly issued securities, held by many investors) many of the other connecting factors do not work so well. In these cases the residence of the company should play a more significant role.

The RDR Manual provides:

> **33550 - Remittance Basis: Identifying Remittances: Specific Topics: Accrued Income Scheme** [July 2010]
> ... Securities are "foreign" where income (in practice, interest) from them would be relevant foreign income. This will include, for example, a security issued in registered form by a non UK company, which maintains the register of note-holders outside the UK.[59]

The rule that the source of interest on registered bonds of a foreign company is the location of the register seems a sensible rule but that will

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58 [Author's footnote] Article 5(5) Judgments Regulation provides:
"A person domiciled in a Member State may, in another Member State, be sued:
... 5. as regards a dispute arising out of the operations of a branch, agency or other establishment, in the courts for the place in which the branch, agency or other establishment is situated;"

59 The comment is made in relation to the AIS remittance basis, but the point made here relating to the source of interest has a more general application. The text is also found in EN FB 2008.

normally be the same as the place of residence.

The same applies to bearer securities: that is consistent with *Bank of Greece*.

18.7.6 *Tribunal and Special Commissioner decisions*

There have been three decisions since HMRC announced their change of view in 1993.

The first is an unreported Special Commissioners decision, *Poldi (UK) Ltd v IRC* (25 November 1985). Unreported decisions cannot properly be cited as precedents, so this decision is not relevant. That is just as well, as HMRC practice is (rightly) to refuse to provide copies of unreported cases.

The second is a tribunal decision, *Perrin v HMRC* [2014] UKFTT 223 (TC). Unfortunately *Poldi* was cited and relied on by the Tribunal, a serious procedural irregularity, with the result that the case cannot be relied on as a precedent.

The third is *Ardmore Construction v HMRC* T [2014] UKFTT 453 (TC). I do not discuss that case here, as a full discussion must wait until the case is final.

18.8 Objection to multi-factorial approach

There are two objections to the multi-factorial approach.

(1) As a matter of principle: it does not provide a clear test.

(2) As a matter of precedent, it has no support in the case law and the rival place of credit test is well supported.

Some interest cases cite the familiar dictum:

> The Legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact.[60]

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60 *Nathan v FCT* [1918] HCA 45; [1918] 25 CLR 183 at p.189-190 cited for instance in *Rhodesia Metals v CT* [1940] AC 774 at p.789. The adjectives "practical, hard" are meaningless. The point is made discreetly by Lockhart J at first instance in *Spotless* ("... a little opaque..."); the Court of Appeal said the principle that the source is a matter of fact "did not mean that the question is one for a jury". But if it did not mean that, it does not mean anything.

The most unsatisfactory approach of all is to say that source is a question of fact. The meaning and identification of "source" are questions of law given the basic background facts (which will usually be simple). It is the task of the courts to provide an answer to that question.

Equally unsatisfactory is to say that the answer is whatever a "practical man" would regard as the "real source". The only way in which a man, practical or otherwise, can locate a source of interest (other than tossing a coin) is to apply a theory as to the priority of rival connecting factors.[61] The exhortation to adopt a "practical approach" is unobjectionable. It is just not helpful. No-one advocates that the law should adopt an impractical approach. Those who stress the practical approach should bear in mind that the one thing that a practical man will ask of the law is that it will provide a clear *answer* to the question of where is a source. There is nothing more impractical than uncertainty. What Kurt Lewin said of psychology is also true of tax: there is nothing so practical as a good theory.

It is not satisfactory to say that all the features listed are relevant, and if different features point in different ways, it is a matter of carrying out a balancing exercise. We need rules on which factors have priority or there is no law on the subject at all.[62]

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61 See 18.9.1 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR 868 at p.895–6:

"What sort of thing is to be looked for when it is sought to discover a *source of income*? This is a question less simple than it seems at first sight, and its difficulty does not seem to me to be greatly lessened by taking the 'practical' approach to it first put forward in *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183. ... I am attracted by an approach by which an attempt is made to state lucidly what must be meant by the word 'source' in the phrase 'source of income' in given circumstances."

Similarly, though in a different context, *IRC v Pratt* 57 TC 1 at p.52:

"It is very simple to say that something is a question of fact, or mixed fact and law, and leave it at that, but this does not solve anything at all."

Contrast Keynes' *dictum* that "practical men who believe themselves exempt from intellectual influence are the slaves of some defunct economist".

62 The difficulty is acknowledged in *Spotless* (which adopted a multi-factorial approach) at [52]: "Where ... the transaction is complex in terms of its background, its nature and its execution, and where ... important aspects of the transaction have their origin in locations in several different countries, it will usually be difficult to identify the real source of income so generated." 71 ALJR 81; 34 ATR 183; 141 ALR 92 *http://www.uniset.ca/other/css/96ATC5201.html*.

It is considered that a test which will "usually be difficult" to apply is not a satisfactory one for something as basic as identifying the source of interest.

This formulation derives from Commonwealth cases on the source of *trading* income. There it seems more apt as the circumstances in which trading income arises differ very widely indeed. But even in that context experience has shown that it has not worked well, because no consistent pattern has developed as to which factors have the greatest weight.[63] However that may be, the questions of the source of *interest* and the source of *trading* income are different. There is no reason why the test should be the same. The point is made correctly in *Philips*:

> The location of the source of profits of a business, for instance furnishes a kind of investigation quite different from that of the source of interest on moneys lent, and decisions on sources of one kind of income may be of little assistance when considering sources of a different kind of income.[64]

18.9 Foreign case law

In the absence of UK cases, the UK courts should pay regard to decisions in other common law jurisdictions, especially appellate courts. These are not binding of course, but they should be regarded as persuasive:

(1) The issue of source discussed in those cases is the same issue, and the wording of the foreign statutes is the same as in the UK (this is clearer after the tax law rewrite).

(2) One the point of the source rules is to avoid double taxation (two states regard the source as situate in their territory, and double non-taxation (no state regards the source as situate in its territory) so it is desirable that courts should so far as possible agree on the principles: the IT source rules form a part of international tax law (like situs for IHT).

18.9.1 *IRC v Philips' Gloeilampenfabrieken*

Philips[65] is a case where money was borrowed to pay an existing debt:

(1) The debtor (a New Zealand company) owed a trading debt to the creditor (a Dutch company) ("the old debt").

(2) The debtor borrowed to pay the old debt. So the old debt was paid off and a new debt ("the new debt") came into existence: in technical terms there was a novation.

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63 See 15.5 (Trading income of non-resident).

64 See 18.9.1 (*IRC v Philips' Gloeilampenfabrieken*) [1955] NZLR 868 at p.896.

65 10 ATD 435 [1955] NZLR 868 accessible *http://www.kessler.co.uk/tfd-archive*.

(3) The new debt arose under a loan agreement made in Holland and governed by Dutch law. The money was not received in New Zealand: it was set against the old debt.[66]

The New Zealand Revenue sought to tax the non-resident company on the grounds that the interest was income from a source in New Zealand.

Philips does what *Bank of Greece* does not do: it considers what should be the test to determine the source of interest. It rejects the situs rules. It rejects the location of funds used to pay the interest.[67] It adopts the place of credit test.

> The lender … gives credit to the borrower and this supply of credit is the service which the lender performs for the borrower, in return for which the borrower pays him interest. Consequently this provision of credit is the originating cause or source of the interest received by the lender
>
> ... the source is located where the transaction from which the debt took its origin took place...

On the facts of Philips the credit was not provided in New Zealand, so the source of the interest was not in New Zealand. It did not matter that the interest was paid out of trading profits in New Zealand.

In reaching this conclusion the Court of Appeal of New Zealand followed other Commonwealth case law. The origin of the place of credit

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66 This was done in a convoluted way:
(1) The Dutch company creditor drew a cheque and sent it to the New Zealand company.
(2) The New Zealand company debtor endorsed it and returned it to the Dutch company in satisfaction of the old debt.
I do not think anything turns on those mechanics.

67 See *IRC v Philips Gloeilampenfabrieken* [1955] NZLR 868 at p.898: "It is not sufficient to ascertain the fund out of which the income was in fact paid, which is no more than the reservoir from which it was drawn. It is not whence it was paid, but why it was paid, that is the determining factor. The emphasis is not upon the receipt, but upon the derivation of the income. Consequently, it does not constitute the source within the meaning of the section that the money [used to pay the interest] was drawn from or provided by the trading profits in New Zealand. The New Zealand company [the debtor] was free to obtain the funds with which to perform its obligation anywhere it chose, from deposits in England, if it had any, or from borrowing in England, or from the profits of its trading in New Zealand. That was a domestic matter. The money could "come from" any of these "sources", but none of them would be the source from which the [creditor] derived what it received as income."

test is *IRC v Lever Bros*.[68] This was a case where a new debtor replaced the original debtor. The key facts were:

(1) An English company sold assets to a Dutch company. The purchase price remained outstanding ("the old debt"). Clearly, interest on the old debt would not have a South African source.

(2) A South African resident company purchased assets from the Dutch company and as consideration undertook to pay the old debt and the interest on it.

The High Court of Australia applied the same test in *Studebaker Corporation of Australasia v Commissioner of Taxation* where the facts were more straightforward: an Australian debtor paid interest on a trade debt arising on the purchase of cars from America. The interest did not have a source in Australia.[69]

The High Court of Singapore has adopted the same test.[70]

A particular attraction of this test is that it is fixed at the time the loan is made and does not change. On the facts of *Philips* the credit was not provided in New Zealand, so the source of the interest was not in New Zealand.

18.9.2 *Hong Kong cases and practice*

In *IRC v Hang Seng Bank* [1990] STC 733 at p.740 the Privy Council state the position quite clearly:

> If the profit was earned by ... lending money ... the profit will have arisen in or derived from the place where ... the money was lent ...[71]

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68 [1946] AD 441; see in particular at p.455 (last paragraph) - 456 (Appeal Division of South Africa).

69 (1921) 29 CLR 225 accessible *http://www.austlii.org* at p.233: "...when we find that the interest arises from business transacted and wholly carried out in America the conclusion must be that it was not derived from any source within new South Wales." Similarly *Commissioner of Taxes v Dunn* [1918] AD 607, in which interest earned by an English company on advances for the purchase of goods in the UK for despatch to a South African company was held to be derived from a source in the UK. (In the UK the issue would not have arisen as the interest was short interest not subject to UK tax regardless of source.)

70 *CH Pte v Comptroller of Income Tax* (1988) 1 MSTC 7022 accessible *http://www.kessler.co.uk/tfd-archive*. In this case a loan agreement was made in Malaysia, but (which is considered to be the key fact) the money lent was received in Singapore. (A cheque received outside Singapore but paid into a Singapore account was regarded as a receipt in Singapore.)

71 [1990] STC 733 at p.740.

In *IRC v Orion Caribbean* [1997] STC 923 at p.930 the court made (I think) the same point, slightly more cautiously:

> If [a company] lent its own money to a borrower in, say, New York, then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York.[72]

This sentence is ambiguous; it could mean that interest has a New York source if the money is lent in New York, ie the credit was provided there. It could mean that interest has a New York source if the borrower is in New York, ie resident in New York. But the context, and reference to the comment from *Hang Seng Bank*, shows that the former is the correct reading.

Both Hong Kong cases were trading cases, ie the issue was the source of trading income. Since different principles apply to trades[73] the comments are *obiter*. However, there is much to be said for the *Hang Seng* approach and it represents the generally held view in Hong Kong. The Hong Kong Revenue explain:[74]

> 2. Only interest arising in or derived from Hong Kong is liable to profits tax. For many years,[75] the Department has taken the view that for the purpose of determining the place where interest arises or is derived from, it is the location of the originating cause that almost invariably determines the source. In essence, the place of derivation of interest is the place where the credit was provided to the borrower, i.e. *the place where the funds from which the interest is derived were provided to the borrower*, commonly known as the "provision of credit" test. This view is based on the decisions in *IRC v Philips Gloeilampenfabrieken,* and *IRC v Lever Brothers & Unilever*.
>
> 3. If the originating cause is situated in Hong Kong, the source of the interest is in Hong Kong, irrespective of the currency in which the loan is denominated, the place of residence of the debtor or the place where

72 [1997] STC 923 at p.930.

73 See 18.8 (Objection to multi-factorial approach).

74 Departmental Interpretation and Practice Notes No. 13 (Revised) Profits Tax: Taxation of Interest Received, December 2004, accessible *http://www.ird.gov.hk/eng/pdf/e_dipn13.pdf*.

75 Author's footnote: The practice goes back at least to 1973: see Willoughby, 'Hong Kong: Source of Interest Profits' (1997) 25 World Tax Report 192.

the debtor employs the capital.[76]

18.9.3 *South Africa cases and practice*

The origin of the place of credit test is in *IRC v Lever Bros.*[77] This was a case where a new debtor replace the original debtor. The key facts were:

(1) An English company sold assets to a Dutch company. The purchase price remained outstanding ("the old debt"). Clearly, interest would not have a South African source.

(2) A South African resident company purchased assets from the Dutch company and as consideration undertook to pay the old debt and the interest on it.

The interest did not have a source in South Africa. One could have reached that conclusion on *Bank of Greece/Hafton* grounds, that changing

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76 Emphasis added. The statement continues with three exceptional cases:

"[1] Whilst the emphasis is generally placed on the provision of the credit, in some situations, such as mortgages, the originating cause may well be the mortgage itself.

[2] In addition, interest has a Hong Kong source where it forms an integral part of a trading transaction carried out in Hong Kong, e.g. where a Hong Kong manufacturer sells his goods to an overseas buyer on extended credit terms. In such situations, the interest is just as much a part of the profit as the trading profit itself and also arises in Hong Kong, e.g. BR 20/75, IRBRD, vol. 1, 184 and *Studebaker Corporation of Australasia v C of T*, 29 CLR 225.

[3] It should also be noted that the 'provision of credit test' is not applicable where the loans are not simple loans of money. The Privy Council held in the case of *IRC v Orion Caribbean* 4 HKTC 432 [1997] STC 923 that where the taxpayer earned its profits by borrowing and lending of money, the proper test to determine the source of the profits was the operation test, i.e. "one looks to see what the taxpayer has done to earn the profit in question and where he has done it". In the case of a money lending business, the taxpayer's business would normally encompass a broader range of activity, including the borrowing and/or lending of money. For this type of business, the Department will apply the operation test instead of the provision of credit test in determining the source of the interest income."

Cases [2] and [3] are both trading cases and not governed by the location test for interest.

Whether case [1] should be an exception is more doubtful, though it has a little support from *obiter* in *Philips* at p.898: "Where the debt is a secured one, it is possible that the application of the practical test may, in some cases, make it arguable that the source is where the security is; or where the registry is wherein the mortgage deed is registered..."

77 [1946] AD 441, 14 SATC 1 accessible *http://www.kessler.co.uk/tfd-archive*.

the payor does not alter the source. But the Court reached the conclusion by applying a place of credit test.

The Katz commission record the position in South Africa, though they express some dissatisfaction:

> 6.2.2.2 ... Currently there is no statutory definition of the primary source of interest and both Revenue practice and our courts have been relying for many years on the unclear ratio from the decision in the *Lever Brothers* case.[78] Essentially, it was held that the source of interest was the making available of the credit. However, to determine the location of the source, the court considered various factors particular to that case. Over the years, the application of the test applied in the *Lever Brothers* case has become highly over-simplified, and the credit was generally held to be sourced where the agreement was concluded and the funds "physically" made available to the debtor. This simplification not only fails to consider the many other circumstances the majority of the court relied on for their decision, but has led to a damaging formalism in the sourcing of interest. It has become very simple to locate the source of interest tax advantageously, without affecting the economic substance in any way.
>
> 6.2.2.3 The Commission is of the view that the arguments stated by Schreiner JA in his minority judgment in the *Lever Brothers* case have both practical and theoretical merit... Judge Schreiner concluded that the source of interest on a loan should be considered to be where the capital is used and therefore where the debtor is located.[79]

The problem identified by the Katz commission consists of the misapplication of the place of credit test rather than the test itself.

18.9.4 *Spotless*

Commissioner of Taxation v Spotless Services[80] was essentially a bank

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78 *IRC v Lever Brothers* 1946 AD 441; 14 SATC 1 accessible *http://www.kessler.co.uk/tfd-archive*.

79 5th Report - Basing the South African Income Tax System on the Source or Residence Principle - Options and Recommendations (March 2007) *http://www.polity.org.za/polity/govdocs/commissions/katz-5.html#6.2.1*. The Katz commission go on to recommend a statutory definition for the source of interest.

80 71 ALJR 81; 34 ATR 183; 141 ALR 92. I could not find the case on *http://www.austlii.org* so have put it on *http://www.kessler.co.uk/tfd-archive*.. *Spotless* went on to the High Court of Australia but the Revenue wisely abandoned their appeal on the source issue.

deposit (that is, in law, a loan) from an Australian creditor (Spotless) to a Cook Islands bank.[81]

Instead of a simple transfer of funds from the creditor's Australian account to the Cook Islands bank account:

(1) the creditor deposited its funds in a bank in Singapore

(2) the creditor drew a cheque on that account and delivered the cheque to the borrower in the Cook Islands.

The Australian elements in the arrangement were insignificant:

(1) Pre-contract negotiations

(2) Australian creditor

(3) The security (a letter of credit from Midland Bank, London) was received in Australia

The Court considered that the test of source of interest was a multi-factorial test:

> 52. ... To attribute "source" is a matter of judgment, and of assessment, of the relative weight of all of the relevant surrounding circumstances.

However, the Court applied the multi-factorial test in a completely different manner from the way that HMRC currently formulate their multi-factorial test, and without any stress on residence of the debtor. It is relevant to note the factors which the Court held were the most significant.

Beaumont J said:

> It is true that not all factors point in this direction, and that the case is, as a consequence, on the borderline. Certainly, the origin of the dealings between the parties was to be found in activities undertaken in Australia. Likewise, the provision of the Midland' Bank's letter of credit (with its origins elsewhere than the Cook Islands), to back up the transactions was essential from the taxpayer's standpoint. But, in my view, Lockhart J [the judge at first instance] was correct to identify the

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81 The deposit was guaranteed by a UK bank, and made in a slightly complex way, but nothing turns on that:

Instead of a simple transfer of funds from the creditor's Australian account to the Cook Islands bank account:

(1) the creditor deposited its funds in a bank in Singapore

(2) the creditor drew a cheque on that account and delivered the cheque to the borrower in the Cook Islands.

I infer that the (rather complex) arrangements were designed to strengthen the argument that Cook Islands was the source.

certificate of deposit as the "critical" document for present purposes. As his Honour observed, it was this certificate which gave rise to rights vested in the taxpayers against [the Cook Islands bank] … (See also *Commissioner of Inland Revenue (NZ) v NV Philips Gloeilampenfabrieken* (1954) 10 ATD 435 at 443, per North J.)[82]

Cooper J said (Northrop J agreeing):

In weighing the factors to be taken into account when reaching a conclusion as to the source of the income, his Honour gave considerable weight to the place where the contract was made and where the money was lent. These events, his Honour found, occurred in the Cook Islands. His Honour continued:-

> "There are other facts and circumstances that in my view point strongly in the direction of the conclusions that the interest was derived by the taxpayers in the Cook Islands.
>
> [1] The borrower, [the Cook Islands bank], was incorporated in the Cook Islands and carried on business there. It did not carry on business in Australia.
>
> [2] The deposit was repaid, together with interest, less withholding tax, from the Cook Islands.
>
> [3] It is impossible to ignore the legal effect of the arrangements entered into by the parties with respect to the lending of the money. Until the cheque for $40m was handed over on 11 December in the Cook Islands (10 December CI time) and the certificate of deposit received in return there was no contract between the lender (the taxpayer) and the borrower. If [the borrower] failed to honour the certificate of deposit on the due date the taxpayers could have sued on the certificate and there would have been no answer in law to their right to judgment."

Once the contention that the contract was in reality made in Australia and that what occurred in the Cook Islands was a mere "formal step designed to screen the reality" is rejected and the banker's letter of credit issued by Midland is seen for what it was, a security to secure performance by [the borrower] of repayment of the loan with interest, and not as an investment in itself, the matters contended for by the Commissioner as matters of practical substance sourcing the interest in Australia are either not factually correct or not sufficient to outweigh the Cook Islands elements.[83]

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82 At p.262 B-D.

83 At p. 275G - 276.

There is no guidance here as to how to deal with less clear cut cases but the stress on *where the money was lent* takes us close to the place of credit test. It is a pity that the commonwealth cases were not cited, so the Court did not have the opportunity to consider them.

I doubt if other courts will pay much attention to where the contract was made.

18.10 Source of interest: conclusion

There are two rival solutions to the question of where is the source of interest: the place of credit test and the multi-factorial approach. It is submitted that the courts ought to adopt the place of credit test, ie the source of interest is where the credit is provided, or where money is lent, ie where the money lent is received (the two phrases being understood to come to the same thing). This is consistent with case law, principle, international practice[84] and provides a reasonable element of certainty.

Two objections have been raised:

(1) The place of lending can be manipulated and allows scope for tax avoidance.

(2) Other circumstances should be taken into account.

But as to (1) the test (properly applied) cannot so easily be manipulated; and as to (2) avoidance may better be dealt with by other provisions than by using the concept of source. Indeed, an avoidance motive should not be a factor relevant to source at all; and if it did influence decisions, ie the courts emphasise whatever factors happen to defeat the taxpayer's appeal, the result is bound to lead to an incoherent case law.

The rival multi-factorial approach is supported by *Spotless* and (after dithering) HMRC practice. However it would need at least half a dozen reported cases before one could have much idea of the relevant factors and their relative priority, and in practice it is unlikely that the law would ever be clear. In particular, *Spotless* is not consistent with HMRC's view that the residence of the debtor is the most important factor.

If (contrary to my view) such an approach were adopted, it is suggested that the position should be as follows:

(1) Suppose a debt were wholly non-UK connected but secured on UK land; that is, the UK situate security is the only UK aspect of the debt. For instance, a debt from one non-resident to another non-resident, which

84 I would be grateful to readers who could direct me to statements of practice from other common law jurisdictions.

arises under a contract governed by a foreign proper law. It is suggested that interest on such a debt has a foreign source. It would be wiser to avoid the issue.

By contrast, suppose a debt was made unsecured (or secured on non-UK assets) and later became secured on UK land. It is considered that this would not turn a non-UK source into a UK source.

(2) Suppose a debt were wholly non-UK connected but paid out of funds derived from UK source income (eg rents of UK land). This cannot be enough to make the interest UK source. The origin of funds used to pay interest is a weak connecting factor. (I would submit it should not be a connecting factor at all.)

(3) Suppose a debt were wholly non-UK connected but had a UK resident debtor. It is suggested that this alone does not give the source of interest a UK location.

18.10.1 *Source of interest: Commentary*

After reading 30 pages on this issue, the reader will agree with HMRC who say:

> The current tests in UK law of whether, for the purposes of deduction of tax, payment of interest is made from a UK source are unclear and cause confusion.[85]

It is surprising that the question of the source of interest has not given rise to more litigation or to clearer principles. The reason may be that HMRC have in the past taken a relaxed view on source (which no doubt encourages taxpayers to take a relaxed view on disclosure). The enactment of s.874(6A) ITA and the recent case law suggests that HMRC attitudes have changed and the final outcome of *Perrin* and *Ardmore* may lead to greater clarity. Sometimes the point is irrelevant because of a DTA[86] or non-residents income tax relief.[87]

The test in the OECD Model Treaty is superior to both the place of credit test and any multi-factorial approach.[88] However legislation (with

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85 Inland Revenue, "Income tax: Meaning of UK Source for Payments of Interest and Royalties" Consultation document (December 2003), para 1.1.

86 See 18.17 (DTA relief for interest income).

87 See 42.1 (Non-residents IT relief).

88 See 18.17.1 (OECD Model). If we adopted the OECD model treaty test one modification might be desirable: that where a debtor changes residence, the source of interest does not change (ie the source is determined and fixed at the time the debt

appropriate transitional provisions) would be needed to make this reform.

A HMRC consultation document in 2003 proposed this sensible reform but the proposal was quietly dropped. The reason why was never announced. Tax reforms generally have winners and losers. The losers cry louder than the winners, and that is an obstacle for many tax reforms. It is not clear that this was the case here since at first sight it is hard to identify obvious "losers", ie persons who could say with any confidence that they were not taxable under the present law. But there may have been a lobby on behalf of taxpayers who could argue in favour of foreign source at present, and who would lose under a clearer set of rules.

The gap between the existing case law and this solution is too great to be bridged by the courts, except by the Supreme Court, but the Supreme Court ought to follow the international case law rather than adopting a new solution.

18.11 Source of building society income

In practice, building society income will have a UK source. ITTOIA EN Vol II explains:

> 48. Under section 66 FA 1988 a society incorporated under the Building Societies Act 1986 will be resident in the UK through incorporation. As long as dividends are paid by a UK resident company they have a UK source under the principle in *Bradbury v The English Sewing Cotton Company* 8 TC 481.
> 49. But a society may be non-resident where it satisfies a residence test in the territory of a treaty partner and the treaty awards residence to that other territory. Section 249 FA 1994 will then apply to treat the society as non-resident. Theoretically dividends paid by a building society may therefore arise from a source outside the UK. This would be most unlikely, however, since a building society may only be incorporated under the Building Societies Act 1986 if its principal office is in the UK. With the place of incorporation and the principal office in the UK a residence test is unlikely to be satisfied in another territory.

18.12 Source of Industrial and provident society income

ITTOIA EN Vol 2 explains the source of income from an industrial and provident society:

> 52. Under section 66 of FA 1988 a society registered under the Industrial and Provident Societies Acts will be resident in the UK through incorporation. A society may, however, be non-resident where it also satisfies a residence test in the territory of a treaty partner of the

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arises). But that point could be argued both ways.

UK and the treaty awards residence to that other territory. Section 249 of FA 1994 will then apply to treat the society as non-resident.

53. Section 486(4) of ICTA provides that share or loan interest is chargeable under Schedule D Case III. Theoretically therefore payments by a registered society may arise outside the UK but be charged under Schedule D Case III and not able to benefit from treatment specific to Schedule D Cases IV and V. For the sake of consistency this section[89] treats such income arising outside the UK as relevant foreign income and therefore able to benefit from the special rules in Part 8 of this Act.

18.13 Non-resident's withholding tax

Section 874 ITA provides:

> (1) This section applies if a payment of yearly interest arising in the UK is made—
>
> (a) by a company,
>
> (b) by a local authority,
>
> (c) by or on behalf of a partnership of which a company is a member, or
>
> (d) by any person to another person whose usual place of abode is outside the UK.
>
> (2) The person by or through whom the payment is made must, on making the payment, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which it is made.

For interest paid by individuals, trustees and PRs the obligation to withhold arises under s.874(1)(d) when the following conditions are satisfied:

(1) A payment of yearly interest.

(2) The interest arises in the UK.

(3) The payment is made to a person whose "usual place of abode" is outside the UK. In the following discussion a person whose usual place of abode is outside the UK is described (for brevity) as "**outside the UK**".

Deduction of interest at source is particularly important if the recipient is not UK resident, as non-residents IT relief provides effective exemption if interest is not deducted at source.[90]

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89 [Author's Note] See ss.379 and 83D(2) ITTOIA.

90 See 42.1 (Non-residents IT relief – Introduction).

18.13.1 *Collection of tax deducted and interest on late payment of tax*

The rules for the collection of tax deducted are in chapters 15-17 ITA 2007, s.945-964 ITA. I do not address them here, though I hope to do so in a future edition.

INT Manual provides:

> **413220. Consequences of failing to deduct withholding tax** [August 2012]
>
> ...
>
> ***Assessing the unpaid income tax***
>
> Chapter 15, Part 15 of Income Tax Act 2007 (formerly Schedule 16 ICTA 1988) provides for returns and collection of income tax in respect of payments falling within s.946 ITA 2007, which specifically includes payments of yearly interest where a deduction is required under s.874.
>
> The rules, under s.951 ITA 2007 are that:
>
> - the income tax at the basic rate on the interest is due on the same date as the return reporting the payment
> - both the return and tax are due within 14 days of the end of the quarter within which the payment of interest was made
> - no assessment is required for collection of this tax.
>
> This means that withholding tax, and where applicable, late payment interest, are due and payable even if HMRC does not raise an assessment.
>
> Section 957 ITA 2007 sets out what should happen if it appears that a s.946 payment (which this is) has not been included in a return, and the tax arising on the payment has not been paid:
>
> (1) This section applies if an officer of Revenue and Customs thinks—
>
> (a) that there is a section 946 payment which should have been included in a return under this Chapter and which has not been so included, or
>
> (b) that a return under this Chapter is otherwise incorrect.
>
> (2) An officer of Revenue and Customs may make an assessment, to the best of the officer's judgement, on the person who made the return, or who should have made one.
>
> Note that the onus is on the payer to fulfil their obligation, and to rectify the position if they do not.

18.14 To whom is interest paid?

Since the duty to withhold arises on a payment to a person who is not in the UK, it is necessary for non-residents' withholding tax to identify the

person to whom the payment is made.[91]

Suppose interest is paid to a transparent (*Baker*-style) interest in possession trust which is not a settlor-interested trust. It is suggested that the interest is paid "to" the trustees (who have a lien). So if the trustees are in the UK but the life tenant is outside the UK the person paying the interest to the trustees need not deduct; but the trustees must do so when they pay the interest to the life tenant. But if the trustees mandate the income to the life tenant, the payer has an obligation to deduct.

Suppose:

(1) interest is paid to a settlor-interested trust; and

(2) the trustees are outside the UK and the settlor is in the UK.

At first sight there is no obligation to deduct as the interest is treated as income of the settlor "and of the settlor alone". Following the deeming, the payment should be treated as paid to the settlor. Conversely, if the settlor is outside the UK, there is an obligation to deduct even if the trustees are in the UK. It is suggested that that is the correct view. This is consistent with the position for deposit-takers. HMRC agree. TDSI Guidance Notes (October 2012)[92] para 2.3 provide:

> [2] The current HMRC view is that Stiftungs are Trusts for UK tax purposes. For TDSI purposes, the deposit should be considered to belong to the settlor[93] and the TDSI treatment depends on the nature of the settlor – so if the settlor is an individual, BRT [basic rate of tax] must be deducted.
>
> [3] If the settlor can show that they have not retained an interest, the Financial Institution can treat the Stiftung as an interest in possession trust ... and the TDSI position will depend on the nature of the beneficiary. If the beneficiary is an individual, BRT must be deducted.

But this result is surprising: the payer is expected to know whether the payee is outside the UK, but they cannot be expected to know if the recipient is a settlor-interested trust, and if so, who is the settlor and is the settlor outside the UK.

Section 646(8) ITTOIA provides:

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91 Similar issues arise elsewhere: see 15.4 (To whom does trading income arise?). Somewhat different issues arise for deposit-takers withholding tax: see 18.18(Withholding tax on interest from deposit-takers)

92 *http://www.hmrc.gov.uk/taxon/guidance-notes.pdf.* For TDSI (tax deduction scheme for interest) see 18.18 (Withholding tax on interest from deposit-takers).

93 [Author's footnote] It is assumed that the Stiftung is a settlor-interested trust.

> Nothing in sections 624 to 632 is to be read as excluding a charge to tax on the trustees as persons by whom any income is received.

This is not entirely to the point but it illustrates the view that the deeming of s.624 does not apply in all cases.

Suppose:

(1) interest is paid to a non-resident company within s.720; and
(2) the transferor is in the UK.

The transferor is taxable under s.720 on income treated as arising to them, but the interest is still the income of the company. So there is an obligation to deduct.

18.15 Usual place of abode

18.15.1 *Introduction*

The expression "usual place of abode" occurs in the context of withholding tax on rent and copyright royalties, as well as in the context of withholding tax on interest. The meaning in all cases is the same.[94]

The expression is discussed in a variety of HMRC Manuals. I set out all relevant passages whether or not the Manual has interest specifically in mind.

The phrase "settled or usual abode" was often used as an explanation or paraphrase of the concept of residence before the SRT[95] so one might think that there is no difference between residence and "usual place of abode". However in the HMRC view there is a difference, though the concepts overlap. The PI Manual provides:

> **4800 Overseas landlords** [September 2013]
> Meaning of ‹usual place of abode"'
> ‹Usual place of abode' is not identical in meaning to residence, or ordinary residence, but a person who is not resident in the UK should normally be treated as having their usual place of abode outside the UK.

Likewise the SAI Manual para 9080:

> **9080. Yearly interest: 'place of abode' of recipient** [July 2007]
> *Meaning of 'place of abode'*

94 This view is adopted by ITA EN para 2648: "The term 'usual place of abode' is consciously retained, *because it is a technical term*, distinct from residence" (emphasis added).

95 See the 2012/13 edition of this work para 3.8.

Section 874(1)(d) ITA 2007 requires deduction of tax from a payment to a person "whose usual place of abode is outside the UK". This phrase is distinguishable from the concept of "residence"...

18.15.2 *Individuals*

The PI Manual provides:

4800 Overseas landlords [September 2013]

- Individuals have a usual place of abode outside the UK if they usually live outside the UK. You should still regard the term as applying to them even if in a particular year they are resident in the UK for tax purposes, as long as the usual place of abode is outside the UK.

(For example the individual may count as resident in the UK in a particular year because of
[1] a six months' visit, or
[2] a visit of a shorter time when he has a place of abode available in the UK.)[96]
Do not treat someone as having their usual place of abode outside the UK if they are only temporarily living outside the UK, say for six months or less.

The SAI Manual makes the same point more tersely:

9080. Yearly interest: 'place of abode' of recipient [July 2007]
An individual's usual place of abode is outside the UK if he or she usually lives abroad, unless that arrangement is temporary.

This roughly equates "usual place of abode" with ordinary residence, but the analogy does not help, as the concept of ordinary residence was abolished for tax purposes by the SRT in 2013, and even before then its meaning was vague and sometimes contested.

The former Inspectors Manual made some comments which are not in the current Manuals.

18.15.3 *Companies*

The PI Manual continues:

96 Author's note: Para [2] refers to the supposed "available accommodation rule" which was an aspect of the pre-SRT residence test abolished in 1993. The passage was no doubt written before 1993 and has not been updated since.

4800 Overseas landlords [September 2013]

- Companies that have their main office or other place of business outside the UK, and companies incorporated outside the UK, will normally have a usual place of abode outside the UK. However if the company is treated as resident in the UK for tax purposes, do not treat it as having a usual place of abode outside the UK.

The SAI Manual addresses the question of UK branches of non-resident companies:

> **9080 Yearly interest: 'place of abode' of recipient** [July 2007]
> *Companies*
> A non-UK resident company that has a UK permanent establishment that is within the charge to corporation tax does not have a usual place of abode abroad.[97]

This practice seems surprising, but it favours the taxpayer so it will not be challenged.

18.15.4 *Trustees and PRs*

The SAI Manual 9080 provides:

> **9080 Yearly interest: 'place of abode' of recipient** [July 2007]
> *Trustees*
> Trustees, including personal representatives, have a usual place of abode abroad if each trustee, considered as an individual or a company as the case may be, has a usual place of abode there. So if one trustee does not have a usual place of abode abroad, neither does the trust.[98]

This text was probably composed before the statutory residence rules for trustees and PRs. One might have thought that the usual place of abode for trustees and PRs is where they are resident under those rules. But the HMRC practice favours the taxpayer so it will not be challenged. It is also satisfactory for HMRC; as long as one trustee is here, HMRC can collect

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97 Accessible *http://www.hmrc.gov.uk/cnr/nrl_guide_notes.pdf*. The HMRC guidance notes on the Non-resident Landlords Scheme likewise provides:
"2.5 The UK branch of a non-resident company, where that branch is within the charge to Corporation Tax, does not have a usual place of abode outside the UK for the purposes of the NRL Scheme."

98 The PI Manual similarly provides:
"c. Trustees have a usual place of abode outside the UK if all the trustees have a usual place of abode outside the UK."

tax from that trustee and do not need the assistance of a withholding tax.

18.15.5 *Miscellaneous*

The HMRC guidance notes on the Non-resident Landlords Scheme makes further comments which are also relevant to deduction of interest:

> **Jointly owned property**
> 2.7 Where a property is jointly owned and one or more of the joint owners has a usual place of abode outside the UK, the share of rental income applicable to those joint owners falls within the NRL Scheme. The share applicable to joint owners who do not have a usual place of abode outside the UK does not fall within the Scheme. For husband and wife joint-ownership cases, see para 2.8 below.
> **Husband and wife joint-ownership cases**
> 2.8 Where a husband and wife jointly own a UK property and both have their usual place of abode outside the UK, the NRL Scheme applies to both spouses and each is treated as a separate landlord in their own right. If the husband and wife both wish to receive the rental income with no tax deducted they must each complete a separate application form and send it to the Inland Revenue (see Chapter 11 below). In such cases, letting agents and tenants should pay rental income with no tax deducted only to the spouse(s) named on Inland Revenue authorities they hold. Under no circumstances should they pay with no tax deducted to a husband and wife where they hold an authority to do so for only one spouse. But if only one of the spouses has a usual place of abode outside the UK, the NRL Scheme applies only to that spouse's share of the rental income. The rental income belonging to the UK resident spouse is not within the Scheme and no Inland Revenue approval is required to pay the income with no tax deducted.
> **Members of HM Armed Forces and other Crown Servants**
> 2.9 Members of HM Armed Forces and other Crown Servants, including diplomats, are treated no differently from any other non-resident landlords. So if they receive UK rental income and have a usual place of abode outside the UK (see para 2.3 above) the NRL Scheme applies to them.
> 2.10 If members of HM Armed Forces and other Crown Servants whose usual place of abode is outside the UK wish to receive rental income with no tax deducted, they should apply to HMIT Public Department 1 or South Wales Area tax office, as appropriate, for approval (see Chapter 11.1 below).
> **How do letting agents and tenants know whether a landlord has a "usual place of abode" outside the UK?**

2.11 A landlord's usual place of abode (see paras 2.3 to 2.6 above) will usually be evident without the need for special enquiries. If it is outside the UK, letting agents or tenants should operate the NRL Scheme. If the usual place of abode is in doubt, letting agents and tenants should get more information from the landlord to satisfy themselves on the point. In particular, PO Box numbers and "care of" addresses alone should *not* be relied on as evidence that the Scheme does not apply. In cases of difficulty letting agents can get advice from the Centre for Non-Residents (see para 1.15 above).

2.12 Where letting agents and tenants have no reason to believe that a landlord has a usual place of abode outside the UK they are not required to make any special enquiries. In these circumstances they do not have to operate the Scheme.[99]

18.15.6 *Place of abode: Commentary*

Do we need a concept of "usual place of abode" in addition to concepts of residence? The statutory residence test provides a proper definition of "residence" which should be the starting point here and "place of abode" should be abolished. (There would need to be some provision for cases where at the time of payment of the interest it is not clear whether the payee is resident or not.)

18.16 Exceptions to obligation to deduct

Sections 875–888 ITA set out 14 exceptions to the duty to deduct. In outline:

Section	Exemption
875	Interest paid by building societies
876	Interest paid by deposit-takers
877	UK public revenue dividends[100]
878	Interest paid by banks
879	Interest paid on advances from banks
880	Interest paid on advances from building societies
881	National Savings Bank interest
882	Quoted Eurobond interest
883	Interest on loan to buy life annuity
884	Relevant foreign income
885	Authorised persons dealing in financial instruments

99 Accessible *http://www.hmrc.gov.uk/cnr/nrl_guide_notes.pdf*.

100 See 19.3 (Deduction at source).

886 Interest paid by recognised clearing houses etc
887 Industrial and provident society payments
888 Statutory interest

The exemptions for interest in advances from banks, and for RFI, are considered below.

18.16.1 *Foreign source interest*

Section 874 ITA imposes the obligation to deduction on making:

> a payment of yearly interest arising in the UK[101]

Foreign source interest is not subject too the obligation to deduct at source, as one would expect.

Section 884(1) ITA provides:

> The duty to deduct a sum representing income tax under section 874 does not apply to a payment of interest which is chargeable to income tax as relevant foreign income.

This makes the mistake of thinking that relevant foreign income means the same as income arising outside the UK. The drafter has overlooked the definition of RFI, which means (in short) foreign income of a UK-resident. Foreign source income of non-residents is not RFI.[102] But fortunately this defect does not matter, as under s.874 ITA the obligation to deduct applies only to interest arising in the UK; s.884(1) ITA is otiose.

The SAI Manual provides:

> **9090 Yearly interest: UK source: The general rule** [August 2013]
> ... whether or not tax should be deducted from interest paid on an overseas loan depends on the source of the interest. If the interest has a UK source tax must be deducted, if it does not then tax should not be deducted.

18.16.2 *Source of interest for deduction at source purposes*

Section 874(6A) ITA provides:

> In determining for the purposes of subsection (1) whether a payment of interest arises in the United Kingdom no account is to be taken of the location of any deed which records the obligation to pay the interest

101 See 18.13 (Non-resident's withholding tax).
102 See 10.3.1 ("Relevant foreign income").

For the purposes of s.874(1) (only) the location of a deed is disregarded; for other purposes it is not. Thus there are two definitions of the source of interest.

The disregard does not apply for the purposes of s.884(1). So if one took the provision literally, the location of the deed is taken into account in determining whether the interest is RFI, and if it is RFI, there is no obligation to deduct.

Fortunately this defect does not matter, as the location of a deed is not relevant to the location of the source of interest.[103] Section 874(6A) is otiose. What a mess!

The reason for the provision is found in a shallow HMRC consultation paper:

> 4.11 For 'debts under seal' or 'specialty debt' it is sometimes argued that case law supports the view that interest paid on such debts does not have a UK source where the loan agreement is physically held outside the UK, and hence that income tax is not required to be deducted at source.
> 4.12 HMRC does not accept this argument. However, to put the matter beyond doubt, the Government proposes to amend the relevant provisions of Chapter 3 of Part 15 of ITA so that the question of whether or not interest arises in the UK is established without reference to the location of the agreement or deed evidencing the debt.[104]

The need for a statutory definition of source remains unmet.

18.16.3 *Interest paid to UK bank*

Section 879(1) ITA provides:

> The duty to deduct a sum representing income tax under section 874 does not apply to a payment of interest on an advance from a bank if, at the time when the payment is made, the person beneficially entitled to the interest is within the charge to corporation tax as respects the interest

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103 See 18.7 (Rejection of the situs approach).

104 HMRC, "Possible changes to income tax rules on interest" *http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_031986*

> The consultation paper omitted to point out that HMRC formerly adopted the view which they now reject, as did at least one Special Commissioner's decision. It contained no discussion of the relevant law (beyond a cursory reference to *Bank of Greece*) and does not mention the 2003 consultation.

> [or is a bank that would be within the charge to corporation tax as respects the interest apart from section 18A of CTA 2009].[105]

This would apply on payment of interest to a UK branch of a non-resident bank, though it may be that such companies do not have their usual place of abode abroad.

18.16.4 *Short interest*

Tax law distinguishes between:
(1) "yearly" or "annual" interest (the terms are synonymous); and
(2) other interest (known as "short" interest).
The duty to deduct tax does not apply to short interest. The SAI Manual explains the distinction:

> **9075. Yearly interest: Case law on short and yearly interest** [January 2009]
> *When is interest "short" or "yearly"?*
> Although tax law has made a distinction between yearly and short interest since 1806, there is no statutory definition of yearly interest. The distinction rests wholly on case law.
> The classic example of short interest is interest payable on a bank loan for less than a year. In the early case of *Goslings and Sharpe v Blake* (2 TC 450), the Court of Appeal confirmed that interest on such a loan, where there was no provision to extend the borrowing for more than a year, could not be yearly interest, notwithstanding the use of an annual percentage rate.
> It is therefore a useful starting point to say that where a loan or debt is for less than a year, there is a presumption that it gives rise to short interest. Conversely, interest on a loan or debt that exists for more than a year is likely to be yearly interest.
> But you cannot just apply this as a mechanical rule, with the benefit of hindsight. Particular difficulties may occur where, at the time when a loan or debt comes into existence, it is not clear how long it is going to last.
> For example, the case of *Bebb v Bunny* (1854) 1 K&J 216 concerned the payment into court of the purchase price of a property, with interest on the delayed payment. It would have been possible for the interest to have run for more than a year if the purchaser had been particularly late in paying. The judge held that the interest was yearly. On the other hand, the Court of Appeal held, in *Gateshead Corporation v Lumsden* [1914] 2 KB 883, that certain interest which

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105 For completeness, s.879 continues:
"(2) Section 991 (meaning of 'bank') applies for the purposes of this section.
(3) Subsection (1) applies to the European Investment Bank as if the words from 'if' to the end were omitted.
(4) An order under subsection (2)(e) of section 991 designating an international organisation as a bank may provide that subsection (1) applies to the organisation with the modification mentioned in subsection (3)."

had run for more than a year was nevertheless short interest. The interest in question was statutory interest due to Gateshead Corporation on late-paid contributions towards the cost of making up roads. The court took the view that the mere failure by the Corporation to enforce the debt within a year did not make the interest "yearly interest".

To distinguish interest arising on long-term loans from that arising on apparently short-term debts, the courts began to lay stress on the debt having "a measure of permanence" or being "in the nature of an investment" as opposed to being merely "temporary accommodation". Thus in *Corinthian Securities v Cato* (46 TC 93) the Court of Appeal decided that interest on a bank loan, repayable on demand, was yearly interest because the loan had the quality of investment – even though, in the event, the loan was called in after 6 months.

However, the leading case on yearly interest is now considered to be *Cairns v MacDiarmid* (56 TC 556). In this case, the Court of Appeal saw the intention of the parties as the determining factor. If the debtor and creditor intend that the debt should subsist for more than a year, or where there is mutual acceptance that the interest may have to be paid from year to year, the interest will be yearly. This principle was applied in *Minsham Properties v Price* (63 TC 570), where a loan from a parent company, repayable on demand, gave rise to yearly interest because it was regarded by both parties as permanent finance.

It was felt in *Cairns v MacDiarmid* that merely asking whether a loan had the character of an investment was a less useful test – even an overnight deposit of money might be regarded as an "investment".

9076. Practical application [January 2009]

Applying case law principles

It is always a question of fact whether, in any particular case, interest is yearly or short. The intention of the parties will be the most important factor in deciding the question (see SAIM9075).

The question of whether interest is short interest, from which the payer has no obligation to deduct tax, is most likely to arise in the context of payments made by a UK resident to a person whose usual place of abode is outside the UK. If the interest is short, there is no need for the recipient to apply under a relevant Double Taxation Agreement to receive the interest gross (or with tax withheld at a reduced rate). There is guidance at INTM505010 onwards.

A UK resident may make a series of loans, each of less than a year, to a non-resident, and claim that the interest is short. HMRC staff should refer to the guidance at INTM542010 in such cases.

Uncertainty may also arise as to whether there is a duty to deduct tax from interest in circumstances comparable to that in *Bebb v Bunny* (SAIM9075) – where a sum of money remains outstanding for a period that may, or may not, be longer than a year. For example, a manufacturer might guarantee to refund the purchase price, with interest from the date of claim, if a product proves faulty: such claims may normally be processed speedily but, in disputed cases, may drag on for over a year.

Where the parties intend at the outset that monies due will not be left outstanding longer than 12 months, the interest will be short – even if, in a few cases, there are delays which prolong the period over which interest accrues. If however the

parties anticipate at the beginning that the debt will exist for more than a year, or appear to be indifferent as to whether it will or not, the interest is likely to be yearly.

Where the payer of the interest is uncertain about whether it is short or yearly, they may in practice "play safe" by deducting tax. If the recipient of such interest objects to the tax deduction, HMRC staff should advise him or her to take up the matter with the payer, see SAIM9180.

If, conversely, the payer decides that interest is short and pays it gross, HMRC staff should not challenge that view unless

- the decision appears to be completely unjustified on the facts and in the light of relevant case law, or there is reason to suspect a definite intention of avoiding the payment of withholding tax; and
- material sums of tax are at risk.

Overdraft interest is usually short interest.

The INT Manual formerly provided:

542010. Provisions of Section [s.874 ITA] [March 2007]

'*In some circumstances, an overseas lender may seek to circumvent the provisions of [what is now s.874 ITA] by advancing a series of short-term consecutive loans, each for a period of less than one year. It may then be argued that the interest is not annual interest but short interest, to which the provisions of [s.874 ITA] do not apply. This argument is open to challenge unless the UK borrower can show that there was no need for long term funding or that alternative sources of funding were readily available to replace that which was argued to be short term.*

Where Inspectors meet a situation in which a long-term funding requirement is being met via a series of short-term loans, they should refer for advice to CT & VAT, Business Profits & Relief.'

This was deleted when the Manual was rewritten in March 2011. Perhaps HMRC now accept these arrangements. Challenge would be harder if the short-term loans are each from separate lenders.

The interest consultation paper proposes to extend the deduction at source rules to short interest (and so to abolish the yearly/short interest distinction):

4.4 The distinction between yearly (or 'annual') interest, and interest that is not yearly (usually referred to as 'short' interest), goes back to the origins of the income tax system. There is a substantial body of case law on what constitutes yearly interest. HMRC's Savings and Investment Manual has more details on this.

4.5 This case law is not always straightforward in its application to the facts of a particular case. Whether or not interest is 'yearly interest' is

> not simply determined by the duration of the loan. More recent cases emphasise the importance of the intentions of the parties when making the arrangement under which the interest is paid. However, these intentions are not always easy to determine, for example in cases where interest is paid under a statutory obligation.
>
> 4.6 It is often observed that the concept of yearly interest is now somewhat archaic[106] and of relevance only to the question of whether tax should be deducted at source. There is no distinction between yearly and short interest for the purposes of the TDSI scheme under which most bank and building society interest is paid.
>
> 4.7 In view of this, views are invited on the removal of references to 'yearly' interest throughout Chapter 3 of Part 15 ITA so that deduction of income tax would be required in all cases where interest is not otherwise covered by the rules in Part 15 of ITA. Such a changes would eliminate the need for payers of interest to consider whether it amounts to 'yearly interest' and would remove the cliff edge that may lead to contractual terms being inserted into a loan agreement merely in order avoid it being treated as 'yearly'.[107]

The paper did not consider the need for the rule, or whether any modification of the rule would be better suited for its purpose. It is in fact a form of de minimis rule and as such serves an important purpose. The paper also did not consider international practice. Do other countries require deduction at source for interest on transient or short term loans?

18.16.5 *Discounts and premiums*

The duty to deduct tax does not apply to:

(1) profits on discounts (which are normally treated as interest but which are expressly taken out of the duty to deduct);

(2) premiums even though premiums may be charged to income tax.

SAI Manual rightly provides:

> **3070 Taxation: Profit on disposal** [July 2011]
>
> *Deduction of tax*
>
> Discounts or premiums payable on the redemption of relevant

106 The author does not give any reference to support this; I have not been able to trace any instance where the distinction has been described as archaic, nor can I see any reason why it should be.

107 HMRC, "Possible changes to income tax rules on interest" *http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_031986*

discounted securities[108] are not payments of interest. Consequently the payments are made without deduction of tax.

However, the distinction between interest and premiums can be fraught.

18.17 DT relief for interest income

18.17.1 *OECD Model*

Article 11 OECD Model provides:

> 1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
> 2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

The OECD Commentary provides:

> 5. Paragraph 1 lays down the principle that interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in the latter. In doing so, it does not stipulate an exclusive right to tax in favour of the State of residence. The term "paid" has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom.
> 6. The Article deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to interest arising in a third State or to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State (for these cases, see paragraphs 4 to 6 of the Commentary on Article 21).

On the beneficial ownership requirement, see 25.12 (Are discretionary trusts "beneficial owners" for DTA purposes?).

Article 11(4) and (6) provides the usual exceptions for where the interest

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108 Discounts and premiums on securities which are not "relevant discounted securities" are also not "interest".

arises through a permanent establishment and for special relationships:

> 4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
> 6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

18.17.2 *Definition of interest for DTA purposes*

Article 11(3) OECD model defines "interest":

> The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

The OECD Commentary provides:

> 18. Paragraph 3 specifies the meaning to be attached to the term "interest" for the application of the taxation treatment defined by the Article. The term designates, in general, income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits. The term "debt-claims of every kind" obviously embraces cash deposits and security in the form of money, as well as government securities, and bonds and debentures, although the three latter are specially mentioned because of their importance and of certain peculiarities that they may present. It is recognised, on the one hand, that mortgage interest comes within the category of income from movable capital (revenus de capitaux mobiliers), even though certain countries assimilate it to income from

immovable property. On the other hand, debt-claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest.

19. Interest on participating bonds should not normally be considered as a dividend, and neither should interest on convertible bonds until such time as the bonds are actually converted into shares. However, the interest on such bonds should be considered as a dividend if the loan effectively shares the risks run by the debtor company (see inter alia paragraph 25 of the Commentary on Article 10). In situations of presumed thin capitalisation, it is sometimes difficult to distinguish between dividends and interest and in order to avoid any possibility of overlap between the categories of income dealt with in Article 10 and Article 11 respectively, it should be noted that the term "interest" as used in Article 11 does not include items of income which are dealt with under Article 10.

20. As regards, more particularly, government securities, and bonds and debentures, the text specifies that premiums or prizes attaching thereto constitute interest. Generally speaking, what constitutes interest yielded by a loan security, and may properly be taxed as such in the State of source, is all that the institution issuing the loan pays over and above the amount paid by the subscriber, that is to say, the interest accruing plus any premium paid at redemption or at issue. It follows that when a bond or debenture has been issued at a premium, the excess of the amount paid by the subscriber over that repaid to him may constitute negative interest which should be deducted from the interest that is taxable. On the other hand, any profit or loss which a holder of such a security realises by the sale thereof to another person does not enter into the concept of interest. Such profit or loss may, depending on the case, constitute either a business profit or a loss, a capital gain or a loss, or income falling under Article 21.

21. Moreover, the definition of interest in the first sentence of paragraph 3 is, in principle, exhaustive. It has seemed preferable not to include a subsidiary reference to domestic laws in the text; this is justified by the following considerations:

a) the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws;
b) the formula employed offers greater security from the legal point of view and ensures that conventions would be unaffected by future changes in any country's domestic laws;
c) in the Model Convention references to domestic laws should as far as possible be avoided.

It nevertheless remains understood that in a bilateral convention two Contracting States may widen the formula employed so as to include in it any income which is taxed as interest under either of their domestic laws but which is not covered by the definition and in these circumstances may find it preferable to make reference to their domestic laws.

21.1 The definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kinds of nontraditional financial instruments where there is no underlying debt (for example, interest rate swaps). However, the definition will apply to the extent that a loan is considered to exist under a "substance over form" rule, an "abuse of rights" principle, or any similar doctrine.

22. The second sentence of paragraph 3 excludes from the definition of interest penalty charges for late payment but Contracting States are free to omit this sentence and treat penalty charges as interest in their bilateral conventions. Penalty charges, which may be payable under the contract, or by customs or by virtue of a judgement, consist either of payments calculated pro rata temporis or else of fixed sums; in certain cases they may combine both forms of payment. Even if they are determined pro rata temporis they constitute not so much income from capital as a special form of compensation for the loss suffered by the creditor through the debtor's delay in meeting his obligations. Moreover, considerations of legal security and practical convenience make it advisable to place all penalty charges of this kind, in whatever form they be paid, on the same footing for the purposes of their taxation treatment. On the other hand, two Contracting States may exclude from the application of Article 11 any kinds of interest which they intend to be treated as dividends.

23. Finally, the question arises whether annuities ought to be assimilated to interest; it is considered that they ought not to be. On the one hand, annuities granted in consideration of past employment are referred to in Article 18 and are subject to the rules governing pensions. On the other hand, although it is true that instalments of purchased annuities include an interest element on the purchase capital as well as return of capital, such instalments thus constituting "fruits civils" which accrue from day to day, it would be difficult for many countries to make a distinction between the element representing income from capital and the element representing a return of capital in order merely to tax the income element under the same category as income from movable capital. Taxation laws often contain special provisions classifying annuities in the category of salaries, wages and pensions, and taxing them accordingly.

18.17.3 *Definition of source for DTA purposes*

Article 11(5) OECD Model provides:

> [1] Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State.
> [2] Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

Interest arising in a third country (not in either state) is not within this article. Such interest falls within article 21 ("other income") and is taxed only in the state where the recipient is residence.

The OECD Commentary provides:

> 26. This paragraph lays down the principle that the State of source of the interest is the State of which the payer of the interest is a resident. It provides, however, for an exception to this rule in the case of interest-bearing loans which have an obvious economic link with a permanent establishment owned in the other Contracting State by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, the paragraph determines that the source of the interest is in the Contracting State in which the permanent establishment is situated, leaving aside the place of residence of the owner of the permanent establishment, even when he resides in a third State.
> 27. In the absence of an economic link between the loan on which the interest arises and the permanent establishment, the State where the latter is situated cannot on that account be regarded as the State where the interest arises; it is not entitled to tax such interest, not even within the limits of a "taxable quota" proportional to the importance of the permanent establishment. Such a practice would be incompatible with paragraph 5. Moreover, any departure from the rule fixed in the first sentence of paragraph 5 is justified only where the economic link between the loan and the permanent establishment is sufficiently clear-cut. In this connection, a number of possible cases may be distinguished:
>
> a) The management of the permanent establishment has contracted a loan which it uses for the specific requirements of the permanent establishment; it shows it among its liabilities and

pays the interest thereon directly to the creditor.

b) The head office of the enterprise has contracted a loan the proceeds of which are used solely for the purposes of a permanent establishment situated in another country. The interest is serviced by the head office but is ultimately borne by the permanent establishment.

c) The loan is contracted by the head office of the enterprise and its proceeds are used for several permanent establishments situated in different countries.

In cases a) and b) the conditions laid down in the second sentence of paragraph 5 are fulfilled, and the State where the permanent establishment is situated is to be regarded as the State where the interest arises. Case c), however, falls outside the provisions of paragraph 5, the text of which precludes the attribution of more than one source to the same loan. Such a solution, moreover, would give rise to considerable administrative complications and make it impossible for lenders to calculate in advance the taxation that interest would attract. It is, however, open to two Contracting States to restrict the application of the final provision in paragraph 5 to case a) or to extend it to case c).

28. Paragraph 5 provides no solution for the case, which it excludes from its provisions, where both the beneficiary and the payer are indeed residents of the Contracting States, but the loan was borrowed for the requirements of a permanent establishment owned by the payer in a third State and the interest is borne by that establishment. As paragraph 5 now stands, therefore, only its first sentence will apply in such a case. The interest will be deemed to arise in the Contracting State of which the payer is a resident and not in the third State in whose territory is situated the permanent establishment for the account of which the loan was effected and by which the interest is payable. Thus the interest will be taxed both in the Contracting State of which the payer is a resident and in the Contracting State of which the beneficiary is a resident. But, although double taxation will be avoided between these two States by the arrangements provided in the Article, it will not be avoided between them and the third State if the latter taxes the interest on the loan at the source when it is borne by the permanent establishment in its territory.

29. It has been decided not to deal with that case in the Convention. The Contracting State of the payer's residence does not, therefore, have to relinquish its tax at the source in favour of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne. If this were not the case and the third State did not subject the interest borne by the permanent establishment to source taxation, there could be attempts to avoid source

taxation in the Contracting State through the use of a permanent establishment situated in such a third State. States for which this is not a concern and that wish to address the issue described in the paragraph above may do so by agreeing to use, in their bilateral convention, the alternative formulation of paragraph 5 suggested in paragraph 30 below. The risk of double taxation just referred to could also be avoided through a multilateral convention. Also, if in the case described in paragraph 28, the State of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States together with, where appropriate, the State of the beneficiary's residence, from concerting measures to avoid the double taxation that would result from such claims using, where necessary, the mutual agreement procedure (as envisaged in paragraph 3 of Article 25).

30. As mentioned in paragraph 29, any such double taxation could be avoided either through a multilateral convention or if the State of the beneficiary's residence and the State of the payer's residence agreed to word the second sentence of paragraph 5 in the following way, which would have the effect of ensuring that paragraphs 1 and 2 of the Article did not apply to the interest, which would then typically fall under Article 7 or 21: Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

31. If two Contracting States agree in bilateral negotiations to reserve to the State where the beneficiary of the income resides the exclusive right to tax such income, then ipso facto there is no value in inserting in the convention which fixes their relations that provision in paragraph 5 which defines the State of source of such income. But it is equally obvious that double taxation would not be fully avoided in such a case if the payer of the interest owned, in a third State which charged its tax at the source on the interest, a permanent establishment for the account of which the loan had been borrowed and which bore the interest payable on it. The case would then be just the same as is contemplated in paragraphs 28 to 30 above.

18.17.4 *Which treaties provide full relief?*

The OECD Model Convention does not provide exemption but only a

partial relief. However about one third of UK DTAs provide full relief, ie UK interest received by a person who is treaty-resident in the foreign state is not taxed at all in the UK; this includes France, Ireland, Luxembourg, Switzerland and USA.[109] HMRC publish a convenient digest of DTAs.[110]

The Katz commission discuss some of the policy issues here:

> 6.2.2.1 Most worldwide or residence based systems of taxation subject non-residents to taxation on income derived from a source within their jurisdiction, and, in principle, there should be no objection against doing the same as regards interest accruing to or being received by a non-resident from a South African source. However, in this instance, the high mobility of capital militates against the adoption of a pure approach. Most countries refrain from so taxing interest, at least as regards interest on debts with unrelated parties (so-called portfolio interest). At the same time, most of those systems tax interest flowing between related parties. The reason is that in the latter situations interest merely represents another form of extracting profits from the jurisdiction where they were earned, and of course would enjoy a deduction in appropriate circumstances. In following these tendencies South Africa will ensure that it remains competitive in international capital markets, while still, like most other countries, protecting the tax base on income arising from South African operations.[111]

18.17.5 *Colonial model DTAs*

The Jersey, Guernsey and Isle of Man DTAs do not provide exemption for interest. They do however provide an exemption for industrial or commercial profits. The treaties are in similar form based on the colonial model, so I take the Jersey DTA as an example. Art 3(2) Jersey DTA provides:

> The industrial or commercial profits of a Jersey enterprise shall not be subject to UK tax unless the enterprise is engaged in trade or business in the UK through a permanent establishment situated therein. If it is so engaged, tax may be imposed on those profits by the UK, but only on so

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109 UK/France Art.11; UK/Ireland DTA Art.12; UK/Luxembourg DTA Art.11; UK/Switzerland DTA Art.11; UK/USA DTA Art. 11.

110 *http://www.hmrc.gov.uk/taxtreaties/dtdigest.pdf*

111 5th Report - Basing the South African Income Tax System on the Source or Residence Principle - Options and Recommendations (March 1997) *http://www.polity.org.za/polity/govdocs/commissions/katz-5.html#6.2.1.*

much of them as is attributable to that permanent establishment.

This confers relief on interest, provided:

(1) The recipient is a Jersey enterprise, defined as "an industrial or commercial enterprise or undertaking carried on by a resident of Jersey"[112] (eg a Jersey bank).
(2) The recipient is not engaged in trade or business in the UK through a PE in the UK (or if it is so engaged, the interest is not profits attributable to that PE).
(3) The interest is or is part of the "industrial or commercial profits".

A person who makes a simple loan by way of investment does not carry on an industrial or commercial enterprise, and interest on such a loan does not constitute industrial or commercial profits. However a business (such as a bank) which includes lending does constitute an industrial or commercial enterprise and the interest is part of its profits.[113] HMRC agree. The International Manual provides:

> **355225. Industrial or commercial profits paragraph** [Jun 2011]
> Para 3 provides for the relief from UK tax of "the industrial or commercial profits of a Jersey enterprise".
> In practical terms, this means that we can allow relief on UK interest paid to a bona fide bank in Jersey, since it can be held that interest represents part of the bank's profits as defined by para 3.
> So if you get a claim from a bank in Jersey you will need to;
> - be certain that it is a recognised bank – the Banker's Almanac will help you [here][114] or HMRC users may ref to the **(This text has been withheld because of exemptions of the Freedom of Information Act 2000)**
> - consider if you should have the loan agreement reviewed by the inspector of taxes who deals with the accounts of the UK borrower – the guidance at INTM342010 will help you here
>
> If these checks are satisfactory, you can allow **full** relief.
> **But** if you receive a claim from a Jersey enterprise in respect of any other category of income, please refer to CAR Technical Advice Group before taking any action.

The International Manual provides:

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112 Jersey/UK DTA art.2(1)(h).

113 The issue was discussed in more detail in the 6th edition of this work, but the Manual passages cited makes this academic.

114 [Author's footnote]: see *http://www.bankersalmanac.com*.

337310. Background to claims by foreign financial concerns [December 2011]

Under a long-standing practice approved by the Board a claim by an overseas financial concern for interest which bears the character of income arising from their trading activities or forms part of their trading income may be relieved under the Business Profits Article (provided the Business Profits Article doesn't clearly exclude interest for example Kenya) in either of the following circumstances

- there is no interest article, or
- the conditions of the interest article are not satisfied.

337320. Claims by Channel Islands and Isle of Man Banks [December 2011]

HMRC is authorised to consider claims and applications for relief at source by banks in the Channel Islands and the Isle of Man in respect of interest under paragraph 3(2) of the Double Taxation Arrangements with those countries. The basis for this is that the interest forms part of the 'industrial and commercial profits' of the banks.

Relief in respect of interest is available only to a bona fide bank. If you receive a claim or correspondence about relief under paragraph 3(2) from any other concern in the Channel Islands or Isle of Man you should refer the case to Specialist Personal Tax, PT International Advisory.

337330. How to deal with claims from foreign financial concerns [December 2011]

If you receive a claim or correspondence for income which can be considered under the Business Profits Article as outlined in INTM337310 you should deal with it as follows:

Where there is no interest article in the relevant Double Taxation Agreement (DTA) and the claimant is not trading in the UK through a permanent establishment, exemption may be authorised under the business profits article on form 241(Int-Roys).

Where in such circumstances the claimant is trading in the UK through a permanent establishment, necessitating restriction of relief under that article, and in cases where there is an interest article but claims under it are automatically restricted because the claimant is trading in the UK through a permanent establishment, you will need to consult the Officer dealing with the permanent establishment and arrange for any interest attributable to the permanent establishment to be included in his computation of liability. Form 502 should be used for this purpose. Provided the Officer has no objections the interest can then be exempted under the business profits article using form 241(Int-Roys). You should issue form 501 (amended as necessary) with the Officer's copy of the exemption notice where relief is authorised under the business profits

article and there is trading in the UK through a permanent establishment. Where there is no trading through a permanent establishment you need to send a memo with the exemption notice explaining the circumstances in which relief has been authorised.

Note: These provisions do not apply where the rate of relief under the business profits article is more favourable than under the interest article and relief is available under the latter.

337340. Requests to extend the provisions to other income [December 2011]

If the claimant asks you to extend the concession to dividends or other distributions you should ask the HMRC office for the permanent establishment (PE) to confirm that

- the payments represent trading income; and
- they are not attributable to the PE.

The reason for doing this is because dividends/distributions, unlike interest and royalties, cannot be brought into the charge to corporation tax on the PE (Section 19 CTA 2009).

18.17.6 *Relief from withholding tax when DT relief applies*

Regulation 2(1) Double Taxation Relief (Taxes on Income) (General) Regulations 1970 provides:

> The following provisions of these Regulations shall have effect where, under arrangements having effect under section 497 ICTA 1970 [now s.2 TIOPA], persons resident in the territory with the government of which the arrangements are made are entitled to exemption or partial relief from UK income tax in respect of any income from which deduction of tax is authorised or required by the Income Tax Acts.

This applies where interest qualifies for relief under a DTA. Regulation (2) provides the exemption from withholding tax:

> Any person who pays any such income (referred to in these Regulations as "the UK payer") to a person in the said territory who is beneficially entitled to the income (such person being referred to in these Regulations as "the non-resident") may be directed by a notice in writing given by or on behalf of the Board that in paying any such income specified in the notice to the non-resident he shall—
>
> (a) not deduct tax, or
>
> (b) not deduct tax at a higher rate than is specified in the notice, or
>
> (c) deduct tax at a rate specified in the notice instead of at the

> lower[115] or basic rate otherwise appropriate;
>
> and where such notice is given, any income to which the notice refers, being income for a year for which the arrangements have effect, which the UK payer pays after the date of the notice to the non-resident named therein shall, subject to the following provisions of these regulations, be paid as directed in the notice...

18.17.7 *Procedure for claiming relief*

For the procedure see RI 79, Tax Bulletin 41, and the HMRC booklet "Double Taxation Relief Provisional Treaty Relief Scheme".

The application forms are available online.[116]

The International Manual provides:

> **413230. The interaction between UK taxing rights and double taxation agreements** [August 2012]
>
> Where UK-source interest is paid to a person taxable in another state, the same income might be taxable both in the source state (the UK) and in the recipient's country. If the person [being subjected] to double taxation (the recipient of the interest) makes a certified application to HMRC's treaty team, fulfilling the relevant requirements, the double taxation can be reduced or eliminated [so far as] the relevant double taxation agreement (DTA) and domestic legislation allows. This is achieved by the source state yielding some or all of its taxing rights.
>
> Chapter 1 of Part 2 of TIOPA 2010 (formerly Section 788 ICTA 1988) gives effect to the arrangements contained in DTAs, since domestic legislation is necessary to either remove or reduce the requirement to deduct tax in Section 874 ITA 2007, or to give entitlement to repayment of tax previously deducted.
>
> To obtain treaty benefits, the lender must demonstrate eligibility, in which case HMRC will give up its prospective taxing rights and issue a notice under SI 1970/488 directing the borrower to begin paying the interest on the loan in question in accordance with the DTA...

18.17.8 *Relief when borrower is a partnership*

HMRC say:

> In deciding whether or not HMRC Residency should exercise its discretion in meeting an application for relief at source [ie an application to pay interest

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115 The rate "otherwise appropriate" is always the basic rate, never the lower rate; the drafter has failed to amend the wording of the regulation to keep up with the changes to the rates of tax in 2008. But no harm arises from this error.

116 Accessible *http://www.hmrc.gov.uk/cnr/app_dtt.htm#5*.

without deduction], it must primarily have regard to the risk that the underlying conditions for relief might change over the lifetime of a Direction (which will normally last no longer than five years). Such changes might remove the basis for relief altogether, or in some other way prejudice the amount of tax that the UK is otherwise properly entitled to receive in that period.

Given its duty of care to the UK Exchequer and taxpayer, HMRC Residency have to give particular consideration to the desirability of giving DT treaty relief where transparent concerns such as partnerships and LLCs are concerned. This is because, more often than not, there is a much higher risk that the beneficial owners of such concerns will change. Or that there will be fluctuations in income or profit apportionment that might erode the amount of UK-source income that is attributable to the DT treaty-resident beneficial owners who were identified at the time the application for relief at source was made.

Attention is drawn to the undertaking sought from claimants in the Declaration (Part F of the US/Company 2002) that they will notify HMRC Residency of any changes in the information given on the form. (A similar warning to notify any material changes is given to a UK payer when a Direction is issued to it.)

Without calling into question the good faith of partnership or LLC claimants who give these undertakings, HMRC Residency considers that the problem of monitoring this aspect is particularly acute where there are a very large number of investors, or there is an unfeasible number of layers of participation - partners who are themselves partnerships, which contain yet more transparent partners.

For these reasons, although HMRC Residency is willing to entertain any application for relief at source from partnerships or LLCs, it should be understood that it is likely to give relief in this way chiefly where:

* HMRC Residency are able to accept satisfactory assurances about the monitoring and notification of membership from the claimant concern.
* The number and type of the concern's membership is not a problem in the first place - for example, a small and fixed number of participators, such as US corporations engaged in a joint venture. Or where the concern is the business arm of a small number of joint intellectual property owners such as a band or similar collaborative venture.
* In response to a successful representation of special considerations or factors that would allow us to decide that relief may safely be given in this form.

Each case will be considered on its merits.

Otherwise, HMRC Residency will consider giving relief only by meeting discrete repayment claims.[117]

Although this comment is made in relation to the USA DTA, it should apply to partnerships generally. On the other hand, it applies only to American LLCs (which are treated as transparent under the US DTA).

If interest is paid before a notice of non-deduction is obtained, tax deducted at source can be reclaimed by the creditor. If the loan agreement

117 "HMRC Residency Double Taxation Guidance Note 3 partnerships and LLCs claiming relief under the 2002 UK/USA DTC."

provided for grossing up where tax is deducted at source, the creditor may compensate the debtor for over-payment).

18.17.9 *Relief when borrower is outside the UK*

HMRC Residency Double Taxation Guidance Note 1 deals with applications for relief at source on interest payments where the borrower is outside the UK:

> This Guidance Note explains how HM Revenue & Customs (HMRC) Residency Nottingham handles applications for relief at source from UK income tax under a double taxation treaty in respect of interest payments where both lender and borrower are outside the UK.
> [After some general comments on the law the note continues]
> In its consideration of an application for relief at source in such circumstances, HMRC Residency must be satisfied that all the elements necessary to give relief are present. In the circumstance where the payer of the interest is not situated in the UK, HMRC Residency will need satisfactory evidence that the payer has concluded that the payments are to be considered as UK-source and has formed the intention of deducting and accounting for tax accordingly.
> HMRC Residency's claim forms ask claimants to attach copies of relevant loan documentation as part of the normal process. In cases such as those discussed in the previous paragraph, HMRC Residency would also ask claimants to enclose supporting evidence confirming the payers' intentions. This could, for example, be copies of pertinent correspondence with the borrower or other relevant documentation.
> Without the comfort afforded by such supporting documentation, HMRC Residency may well take the view that it should not exercise its discretion under SI 1970/488 to authorise relief at source.
> However, it would then be open to the non-resident payee to make a repayment claim to HMRC Residency once the interest payments have commenced and tax has been deducted. HMRC Residency will be prepared to keep the application for relief at source open and on file pending this eventuality. If the non-resident payee is then able to forward a certificate of tax deducted completed by the payer, HMRC Residency may then be able to accept that the UK source categorisation of the payments has been established. Assuming that all the other conditions for Double Taxation treaty relief are present, HMRC Residency should then be in a better position both to repay the tax deducted and consider in a more positive light the appropriateness of issuing a Direction under SI 1970/488 for future payments.

This is quite the most absurd procedure which could possibly be imagined,

for in many cases the payor will want to argue that the interest is not UK source but (since one can rarely[118] be sure) will want a direction to pay gross as a safeguard. Perhaps no-one takes any notice of it in practice.

18.17.10 *Interest paid before HMRC notice to pay gross*

The INT Manual provides:

> **413220. Consequences of failing to deduct withholding tax** [August 2012]
> ...
> An application by the overseas lender under a DTA or under the EU Interest & Royalties Directive (INTM400000), is likely to be made up of two elements, depending largely on how promptly the claim follows the making of the loan. These are:
> - A clearance application - for Section 874 no longer to apply (or only to apply to a lower rate of withholding specified in the relevant tax treaty) to a specific loan. If the application is successful, the payer will receive a notice issued under SI488/1970 advising them that they may henceforth, for a specified period, pay interest gross or at the lower rate on the income named in the notice;
> - A repayment claim - for the lender to have paid to them tax which the payer of the interest has accounted for to HMRC in compliance with their Section 874 obligation, prior to the notice being issued.
>
> Forms available on the HMRC website cater for both aspects on a single form.
> It is vital to understand that until the payer receives a clearance notice directing them to do otherwise, the payer must continue to withhold and account for the income tax on interest payments made to an overseas lender. The UK payer is not entitled to anticipate either the lender making an application or the outcome of them doing so. It is immaterial whether the lender is a fellow group company to the borrower, or a vast European lending institution for which the borrower is just another customer.
> If the payer fails to observe the obligation to withhold and pay, or only does so late, HMRC can assess and recover the tax, and charge late

118 The guidance note states complacently that "The meaning of UK-source in this context will not normally give rise to difficulties." The author has not read the HMRC consultation paper on interest:
"The current tests in UK law of whether … payment of interest is made from a UK source are unclear and cause confusion."
See 18.10.1 (Source of interest: commentary).

payment interest under Section 87 TMA 1970 on the outstanding income tax, running from the tax due date to the date of payment. See INTM413240 for what may happen in circumstances where a valid clearance/repayment claim is received.

Grossing up clauses

"Grossing up clauses" appear in loan agreements, requiring borrowers to pay over interest without withholding income tax, irrespective of the clearance position, so that domestic withholding obligations are at the expense of the borrower and the lender gets 100% of their interest. From a loan relationships point of view HMRC accepts that any additional amount paid under a grossing up clause is a loan relationship expense, but it is not interest. If the borrower received the grossing up amount back from the lender, possible after the lender had made a successful treaty claim, the repayment would be treated as a loan relationship credit.

If £100 of interest is paid over, representing the full amount of interest due, the withholding tax is £20, assuming the rate to be 20%. The payment itself should not "grossed up" to £125 and the tax is not £25.

The existence of a grossing-up clause is not an excuse not to withhold income tax.

The International Manual provides:

413230. The interaction between UK taxing rights and double taxation agreements [August 2012]

...If the lender obtains clearance before any interest has been paid, then for the period of the clearance all the interest accruing on the loan can be paid without deduction, or paid subject to a lower rate of income tax, depending on the DTA. However, a problem arises when the benefits set out in the DTA have not yet been obtained and the company paying the yearly interest does so - for whatever reason - without withholding and accounting for the income tax.

Once treaty clearance has been granted (following a successful certified DTA application), income tax will either no longer be withheld or may be withheld at a lower rate, it must also be recognised that clearance applies only to arm's length interest payments made after the clearance is granted. The obligation to deduct income tax from yearly interest paid prior to clearance will not have been removed, and therefore remains enforceable. For payments of interest made before clearance is notified, double taxation is relieved by the lender making a claim for repayment of the income tax withheld. Forms available on the HMRC website allow repayment claims to be made at the same time as the certified application for treaty benefits, although the repayment relief can only go back 5 years after the 31st January next following the year of assessment to

which it relates (TMA70/S43(1)).

Section 87 TMA 1970 - late payment interest

In addition to the unpaid income tax remaining due and payable on payments of yearly interest not covered by a treaty clearance notice, late payment interest will accrue under Section 87 TMA 1970 on any unpaid tax, from the due date (normally 14 days after the quarter in which the yearly interest was paid) until payment. It will accrue whether or not the income tax has been assessed, and while any income tax paid can be repaid if it is subject to a valid repayment claim from the lender, there is no relief or discharge from the Section 87 TMA 1970 interest charge on the payer.

The Section 87 TMA 1970 late payment interest charge is both mechanical and neutral, and accrues at the same rate irrespective of the reason for late payment. While it is not a penalty (though penalties are available for failure to make a return under Part X of TMA70), it stands to reason that if the loan is large, and the tax is outstanding for a long time, the interest charge will be correspondingly greater than in other circumstances.

This is the position for pre-clearance interest payments made gross, even after a DTA clearance application has been made, and clearance granted. While the UK may give up its taxing rights, HMRC does not give up its right to recompense for the late payment of the income tax from the time when it was due. UK taxing rights do not simply disappear following a DTA clearance application, taking with them all associated obligations. HMRC surrenders primary taxing rights to the tax authority of the claimant's country of residence, but retains the power to assess income tax which has not been accounted for and which has not been paid gross under a notice giving permission to do so. Interest payments made before the date on which clearance takes effect are not subject to the clearance. This is the statutory position, unaffected by the fact that assessment and collection of the tax might take place after a certified DTA clearance application has been lodged, in circumstances where it would be immediately repayable to the applicant (assuming a successful claim).

However, in circumstances where there is an established entitlement to repayment, HMRC will by concession, circumvent the assessment and repayment process, and if assessments are raised, they will be "interest only" assessments to collect the Section 87 TMA 1970 interest.

Assessing only the Section 87 TMA 1970 late payment interest - concession

Despite the existence of the powers mentioned above to recover tax which is owing, HMRC considers that in circumstances where it is clear that

- the overseas recipient of the interest has applied for, and has been

granted, clearance to receive future interest payments from the source in question without deduction of income tax under SI 1970/488; and

- the lender would be entitled to repayment of the tax for the period for which income tax should have been withheld, so that it is clear that if tax had been accounted for each period concerned, ultimately HMRC would not have retained it

the right to assess and collect the tax will be set aside and only the Section 87 TMA 1970 interest will be sought. This will of course be limited to tax which is at the time of the concession both collectible and repayable. For more detail, see the Thin Cap Practical guidance from INTM570000 onwards.

The notion that tax collected from the payer will inevitably be repayable to the overseas recipient is not one that may be assumed. It must be established as a fact and a legal right. It is not a reason for not withholding.

18.17.11 *Improvement of procedures: Commentary*

The EU has issued a recommendation to encourage relief from withholding tax where treaty relief applies. Where "in exceptional cases" tax relief at source is not feasible, member states are invited to set up standardised and quick refund procedures.[119] The recommendation is not binding but hopefully it will lead to a review of the UK law and practice.

The deduction scheme for royalties allows self-certification. It is suggested that a similar system should be introduced here.

18.18 Withholding tax on interest from deposit-takers

The legislation is in chapter 2 part 15 ITA. HMRC refer to this as the tax deduction scheme for interest ("TDSI") but I prefer not to use that label as this is only one of the three tax deduction schemes for interest discussed in this chapter. HMRC have issued 139 pages of guidance notes.[120] This contains much interesting material which is not set out here for reasons of space.

Section 851 ITA provides:

(1) This section applies if—

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119 EU recommendation 19 Oct 2009 on withholding tax relief procedures C(2009)7924 final.

120 February 2009, *http://www.hmrc.gov.uk/taxon/guidance-notes.pdf.*

(a) a deposit-taker or building society makes a payment of interest on an investment (see section 855(1)), and
(b) when the payment is made, the investment is a relevant investment (see section 856).

(2) The deposit-taker or building society must, on making the payment, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which it is made.

Section 852 ITA authorises exceptions to be made by statutory instrument. Sections 853 and 854 ITA provide an elaborate definition of "deposit-taker" but for present purposes it is sufficient to note that the expression includes banks.

18.18.1 *Investment and deposit*

Section 855 ITA provides commonsense definitions of these terms:

(1) In this Chapter "investment" means—
(a) a deposit with a deposit-taker,
(b) a deposit with a building society,
(c) shares in a building society, or
(d) a loan to a building society.

(2) In this Chapter "deposit" means a sum of money paid on terms which mean that it will be repaid (with or without interest)—
(a) on demand, or
(b) at a time or in circumstances agreed by or on behalf of the person who pays it and the person who receives it.

18.19 Relevant investment

The expression "relevant investment" is a label which brings in a number of rules. Section 856 ITA provides:

(1) An investment is a relevant investment for the purposes of this Chapter if it meets—
(a) the individual interest condition (see subsection (3)),
(b) the Scottish partnership condition (see subsection (4)),
(c) the personal representative condition (see subsection (5)), or
(d) the settlement condition (see subsection (6)).

(2) But an investment is not a relevant investment if any of sections 858 to 870 prevent it from being a relevant investment.

18.19.1 *Individual interest condition*

Section 856(3) ITA provides:

> An investment meets the individual interest condition if the only persons beneficially entitled to interest on the investment are individuals.

An investment held by a Baker IIP trust meets this condition as the life tenant (assume, an individual) is beneficially entitled to the interest.

In the case of a settlor-interested trust within s.624, the income is deemed to accrue to the settlor and the settlor alone. If the settlor is an individual, the individual interest condition is satisfied.[121] HMRC appear to agree. TDSI Guidance Notes (October 2012)[122] para 2.3 provide:

> **Anstalts & Stiftungs**
> [1] Anstalts and Stiftungs are Liechtenstein business entities which are fiscally opaque. ...
> [2] The current HMRC view is that Stiftungs are Trusts for UK tax purposes. For TDSI purposes, the deposit[123] should be considered to belong to the settlor[124] and the TDSI treatment depends on the nature of the settlor – so if the settlor is an individual, BRT [basic rate of tax] must be deducted.
> [3] If the settlor can show that they have not retained an interest, the Financial Institution can treat the Stiftung as an interest in possession trust (see paragraph 2.9) and the TDSI position will depend on the nature of the beneficiary. If the beneficiary is an individual, BRT must be deducted.

18.19.2 *Scottish partnership condition*

Section 856(4) ITA provides:

> An investment meets the Scottish partnership condition if—
> (a) a Scottish partnership is beneficially entitled to all interest on the investment, and
> (b) that partnership consists only of individuals.

It is difficult to see the need for this since a Scottish partnership is

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121 If the settlor is non-resident, the NR exemption applies.

122 Accessible *http://www.hmrc.gov.uk/taxon/guidance-notes.pdf*. For TDSI (tax deduction scheme for interest) see 18.18 (Withholding tax on interest from deposit-takers).

123 [Author's footnote] More accurately, the *interest on* the deposit should be considered to belong to the settlor.

124 [Author's footnote] It is assumed that the Stiftung is a settlor-interested trust and that the settlor is UK resident.

transparent for IT purposes. However, it does no harm.

18.19.3 *PR condition*

Section 856(5) ITA provides:

> An investment meets the personal representative condition if
> [a] personal representatives are entitled to any interest on the investment and
> [b] they receive it in that capacity.

Section 856(5)[b] seems to me otiose, though it does no harm.

18.19.4 *Settlement condition*

Section 856(6) ITA provides:

> An investment meets the settlement condition if
> [a] all interest on the investment is income arising to the trustees of a discretionary or accumulation settlement and
> [b] they receive it in that capacity.

Section 856(6)[b] seems to me otiose, though it does no harm.

The key term here is "discretionary or accumulation settlement". Section 873(1) ITA provides a referential definition:

> A settlement is a discretionary or accumulation settlement for the purposes of this Chapter if any income arising to the trustees would (unless treated as income of the settlor) be to any extent income within subsection (2) for the tax year in which it arises.

So we need to turn to s.873(2):

> Income is within this subsection so far as it is—
> (a) accumulated or discretionary income as defined in section 480 (other than income arising under a charitable trust or an unauthorised unit trust in relation to which section 504 applies), or ...[125]

So to follow s.873(2)(a) we need to turn to s.480 ITA. This is discussed elsewhere; see 25.2.1 (Accumulated or discretionary income).

Having dealt with s.873(2)(a), we turn to s.873(2)(b). This is somewhat more confusing:

> (2) Income is within this subsection so far as it is—

125 I consider s.873(2)(b) separately below.

(b) an amount of a type set out in section 482 (unless the trust is a unit trust scheme or the amount is income arising under a charitable trust or is excluded by section 481(5)).

So to follow s.873(2)(b) we need to turn to s.482 ITA. This is discussed elsewhere; see 25.2.3 (Other income taxed at top rates). If one reviews the 11 types set out in s.482 one emerges somewhat confused as these types are not interest. This does not make sense, and I would be grateful to any reader who could explain.

18.20 Exceptions for *non-residents*

18.20.1 *Non-resident individual*

Section 858 ITA provides:

> **858 Declarations of non-UK residence: individuals**
> (1) This section applies to an investment with a deposit-taker or building society which meets the individual interest condition in section 856(3).
> (2) The investment is not a relevant investment if—
> (a) an appropriate person[126] has made the declaration set out in subsection (3) to the deposit-taker or building society,
> (b) the declaration contains the undertaking set out in subsection (4),[127]
> (c) the declaration contains the name and principal residential address of the individual or (as the case may be) each of the individuals entitled to the interest,
> (d) the declaration contains such other information as the Commissioners for HMRC may reasonably require, and
> (e) the declaration is in such form as the Commissioners may prescribe or authorise.

Section 858(3) then sets out the terms of the declaration:

> The declaration is that, at the time when the declaration is made—
> (a) the person who is beneficially entitled to the interest is non-UK

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126 Section 857(5) provides:
"In this section 'appropriate person' means—
(a) a person who is beneficially entitled to interest on the investment, or
(b) a person to whom any such interest is payable."

127 Section 858(4) provides:
"The undertaking is an undertaking by the person making it to notify the person to whom it is made if any individual in respect of whom it is made becomes UK resident."

resident, or

(b) (as the case may be) all the persons who are so entitled are not non-UK resident.

The form is R105. I refer to this (adopting the terminology of the TDSI guidance note) as "**NR declaration**".

In short, the requirement for exemption from deposit takers withholding is non-residence. Curiously, "usual place of abode" (which is more or less the same) is the requirement for the *imposition* of non-resident's withholding.[128] Some irreconcilable policy choices are at play here, on one hand to facilitate collection of UK tax from non-residents and on the other to facilitate investment in the UK by non-residents.

18.20.2 *Interest in possession trusts*

The person beneficially entitled to the interest is the life tenant and if that person is NOR, the NOR exemption applies.

18.20.3 *Non-resident discretionary trust*

Section 861 ITA provides:

> **861 Declarations of non-UK residence: settlements**
> (1) This section applies to an investment with a deposit-taker or building society which meets the settlement condition in section 856(6).
> (2) The investment is not a relevant investment if—
> (a) an appropriate person[129] has made the declaration set out in subsection (3) to the deposit-taker or building society,
> (b) the declaration contains the undertaking set out in subsection (4),[130]

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128 See 18.13 (Non-resident's withholding tax).

129 Defined s.861(5): "In this section 'appropriate person' means—
(a) any person who is a trustee entitled to receive interest on the investment, or
(b) a person to whom any such interest is payable."

130 S.861(4) provides:
"The undertaking is an undertaking by the person making it to notify the person to whom it is made if—
(a) the trustees become UK resident,
(b) an individual in respect of whom it is made becomes UK resident,
(c) a company in respect of which it is made becomes UK resident,
(d) an individual partner in any Scottish partnership in respect of which it is made becomes UK resident,
(e) a company partner in any Scottish partnership in respect of which it is made becomes UK resident,
(f) a partner who is a UK resident individual or a UK resident company joins any Scottish partnership in respect of which it is made, or

(c) the declaration contains such information as the Commissioners for Her Majesty's Revenue and Customs may reasonably require, and
(d) the declaration is in such form as the Commissioners may prescribe or authorise.

(3) The declaration is that, at the time when the declaration is made—
(a) the trustees who are entitled to the interest are non-UK resident (see section 475), and
(b) no person who is a trustee has reasonable grounds for believing that any beneficiary under the settlement is—
(i) an individual who is UK resident,
(ii) a company which is UK resident, or
(iii) a Scottish partnership any of the partners of which is an individual who is UK resident or a company which is UK resident.

The term "beneficiary" is defined in s.873 ITA:

(3) A person is a beneficiary under a discretionary or accumulation settlement for the purposes of this Chapter if—
(a) the person is an actual or potential beneficiary under the settlement, and
(b) condition A or B is met in relation to the person.

(4) Condition A is that the person is, or will or may become, entitled under the settlement to receive some or all of any income under the settlement.

(5) Condition B is that some or all of any income under the settlement may be paid to or used for the benefit of the person in the exercise of a discretion conferred under the settlement.

(6) The references in subsections (4) and (5) to any income under the settlement include a reference to any capital under the settlement so far as it represents amounts originally received by the trustees as income.

The definition is the same as in 42.5.1 ("Beneficiary").

The form is Form R105 (DAT).

The TDSI Guidance Notes (October 2012) provide:

R105 (DAT) – change of trustees or beneficiaries

4.33 Where the Financial Institution becomes aware that there has been a change of trustee or beneficiary, it may continue to pay interest without deduction of BRT if it has no reason to believe

- that the trustees are or may be resident, or
- a beneficiary is or may be ordinarily resident/resident in the

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(g) a person within any of sub-paras (i) to (iii) of subsection (3)(b) becomes or is found to be a beneficiary under the settlement to which the declaration relates."

UK, or

- a new beneficiary is or may be ordinarily resident/resident in the UK.

18.20.4 *Non-resident Scottish partnership*

Section 859 ITA contains an exception for non-resident Scottish partnerships, which is not discussed here.

18.20.5 *Non-resident PRs*

Section 860 ITA provides:

> **860 Declarations of non-UK residence: personal representatives**
> (1) This section applies to an investment with a deposit-taker or building society which meets the personal representative condition in section 856(5).
> (2) The investment is not a relevant investment if—
> (a) an appropriate person[131] has made the declaration set out in subsection (3) to the deposit-taker or building society,
> (b) the declaration contains such information as the Commissioners for Her Majesty's Revenue and Customs may reasonably require, and
> (c) the declaration is in such form as the Commissioners may prescribe or authorise.
> (3) The declaration is that the deceased was non-UK resident immediately before the deceased's death.

One would expect the rule to require withholding where the PRs were subject to tax and not where they were not subject to tax. But the actual residence of the PRs for IT purposes is not relevant. I suspect the reason may lie deep in the history of the provisions, and would be grateful to any reader who could elucidate the puzzle.

The TDSI Guidance Notes (October 2012) provide:

> **R105(PR) – personal representatives**
> 4.21 Form R105 completed by an investor before his or her death will remain in force after the date of death during the winding up of the estate. But if the personal representatives open an account in their own

131 Defined in s.860(4): "In this section 'appropriate person' means—
(a) any of the personal representatives who are entitled to receive interest on the investment, or
(b) a person to whom any such interest is payable."

names, or transfer funds into an account in their own names, that account will not be an NOR account, unless and until the personal representatives make a NOR declaration. Personal representatives must make their declaration on

- a photocopy of the R105(PR) (see Appendix 6), or
- a downloaded copy of the R105(PR) from the HMRC website
- a substitute form which has been approved by the HMRC.

R105(PR) – who can sign?

4.22 In the case of an investment forming part of a deceased person's estate the form can be signed by either

- the personal representative of the deceased (or legal equivalent in the country where they live), or
- the person to whom the interest is paid.

The person signing the declaration should tick the relevant box above the signature to show whether or not he or she is the personal representative (or legal equivalent in that country).

It is the NOR status of the deceased which is important, and not that of the personal representative. Therefore, it is acceptable for a personal representative who is ordinarily resident in the UK to complete the declaration in respect of a deceased NOR investor.

18.20.6 *Policy and practical use of non-resident exceptions*

The former International Tax Handbook para 876 explained the policy reason behind the exemption:

> There were moreover compelling policy considerations. An attempt to tax the interest could have harmed the balance of payments by discouraging foreigners from putting their money into the UK. For the same reason no attempt has been made to require banks to deduct tax from interest paid to non-residents and interest belonging to persons not ordinarily resident[132] is now excluded from the arrangements for deduction of tax from bank interest.

Since the conditions of all these non-resident exceptions could be onerous, I would have thought that the easier course would be to deposit funds with a non resident deposit-taker and not to use a UK bank. IHT may also be a reason for avoiding UK bank deposits. The remittance basis (and the temporary non-residence rules) may be another reason.

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132 From 2013 the references to ordinary residence in the tax code have been replaced by references to residence. But that change does not affect the point made here.

18.20.7 *Other exceptions*

The following exceptions to deposit takers withholding are mentioned for completeness and not discussed here:

- Client accounts: s.863 ITA
- Qualifying uncertificated eligible debt security units: s.864 ITA
- Qualifying certificates of deposit: s.865 ITA
- Qualifying time deposits: s.866 ITA
- Lloyds premium trust funds: s.867 ITA
- Sale and repurchase of securities: s.869 ITA
- Loans made by deposit takers: s.870(1)(a) ITA
- Debt on a security listed on a recognised stock exchange: s.870(1)(b) ITA
- Debt on a debenture issued by the deposit-taker: s.870(1)(c) ITA

18.21 Duty on deposit-taker

Section 857 ITA provides:

> **857 Investments to be treated as being or as not being relevant investments**
> (1) A deposit-taker or building society must treat every investment with it as a relevant investment unless satisfied that the investment is not a relevant investment.
> (2) If a deposit-taker or building society is satisfied that an investment is not a relevant investment, it may continue to treat the investment as not being a relevant investment until subsection (3) applies.
> (3) This subsection applies when the deposit-taker or building society has information which can reasonably be taken to indicate that the investment is or may be a relevant investment.

The TDSI Guidance Notes (October 2012) provide:

> **UK address**
> 4.9 Where the declaration shows a residential address in the UK it should not be regarded as acceptable unless it is known that the investor is temporarily in the UK (for example, as a student) and the address given is for the time being his or her principal residential address.
> **Incompatible evidence**
> 4.10 If there is information which appears incompatible with the investor's status as indicated in his or her NOR declaration (for example, he or she appears to have a business in the UK), the Financial Institution cannot be satisfied that the deposit is a relevant investment and is obliged to seek further clarification from the investor of his status before the NOR declaration can be acted upon. The Financial Institution should contact the investor seeking an explanation of why

he or she considers themselves to be not ordinarily resident. See also paragraph 4.37. If the investor is able to satisfy the Financial Institution that the declaration is valid, the Financial Institution can accept the declaration and need take no further action. Financial Institutions are recommended to retain some note of the enquiry. If the investor is unable to satisfy the Financial Institution that his or her NOR declaration is valid the Financial Institution should deduct BRT from any interest paid on the deposit.

Joint accounts

4.11 Any investor in a joint account may sign the form R105 on behalf of all the other investors. But if that investor ceases to be a party to the account, for example, if he or she dies, a new NOR declaration will be required. Financial Institutions can only pay interest on a joint account without deduction of tax if the investors are eligible to receive interest without deduction of tax for the same reason. For example, where one investor is entitled to register using form R85 and another investor is entitled to sign an NOR declaration on form R105 interest must be paid net. In other words, a mixture of a registration on form R85 [income within personal allowances] and form R105 is not allowed on the same joint account.

Death of an investor

4.12 If one party to a joint account dies or otherwise leaves the account, a new declaration is not required unless that person was the only signatory of the NOR declaration.

Giving effect to the NOR declaration

4.37 When Financial Institutions receive a NOR declaration which is fully completed in the form currently prescribed (or approved) by HMRC, they must satisfy themselves that there are no grounds for believing that the investor is or may be ordinarily resident in the UK or that the trustees are or may be resident in the UK, or that any of the beneficiaries are or may be ordinarily resident/resident, as appropriate. If they are so satisfied they must pay interest without deducting BRT.

If Financial Institutions have any information suggesting that the investor is or may be ordinarily resident in the UK, or that the trustees are or may be resident, or that any of the beneficiaries are or may be ordinarily resident/resident, they must not pay interest without deduction of BRT unless and until they have satisfied themselves that the investor is NOR or that the trustees are not resident and the beneficiaries are NOR/not resident, as appropriate.

The NOR supervisor normally carries out these checks on behalf of the Financial Institution. Financial Institutions must therefore put in place systems (clerical or computer-based) for ensuring that all relevant information is made available to the NOR supervisor. In particular all accounts in the branch to which the investor or trustees/beneficiaries is/are party, whether deposit or loan accounts (including mortgage accounts), and any such other accounts which are known to the branch should be reviewed. Examples of relevant information which could cast doubt on the validity of the declaration are

- a UK business in which the investor/trustees/beneficiaries appear to participate actively,
- a UK address or postal directions,

- an overseas PO Box or "c/o" address,
- a BFPO address, and
- a notification that the account is the subject of a third party mandate in favour of a UK resident or used as security for borrowing by UK residents or for borrowing in respect of the purchase of the UK property.

In making his or her decisions the NOR supervisor must not ignore information which comes to his or her attention by personal knowledge or otherwise. An example of this might be frequent or regular personal visits to the bank, cash transactions etc. The Financial Institution should put procedures in place so that information of a similar nature which comes to the knowledge of an employee who is responsible for handling any NOR accounts should similarly be drawn to the NOR supervisor's attention.

It will be unusual for such information to provide conclusive proof that the NOR declaration is invalid. However, where the information could reasonably be taken to indicate that the investor may be ordinarily resident in the UK, the trustees may be resident or that any of the beneficiaries may be ordinarily resident/resident, the Financial Institution is obliged to satisfy itself that the evidence does not render the NOR declaration invalid. One way of doing this would be by obtaining written confirmation from the investor. A note of any enquiries made should be kept in the investor's records or the trust records.

It may be possible to resolve doubts which arise without reference to the investor or trustees. For example if the investor is known to be a student in the UK it would be reasonable for him or her to make frequent personal visits to the bank. In such circumstances, no further action need be taken by the NOR supervisor and the NOR declaration may be accepted. NOR supervisors are recommended to retain some record of the decisions.

The continuing obligation

4.38 Once an NOR declaration has taken effect, Financial Institutions must continue to pay interest without deducting BRT unless and until they receive information suggesting that the investor is or may be ordinarily resident in the UK, or the trustees are or may be resident, or any of the beneficiaries are or may be ordinarily resident/resident. This is called the "continuing obligation". They must put in place systems so that as far as possible all relevant information which can be readily linked to a NOR account is brought to the attention of the NOR supervisor. Relevant information is that which points to a UK connection, for example

- notification of a UK address,
- change of account title,
- applications for credit cards, loans or mortgages suggesting UK residence,
- use of the deposit as security for borrowing by UK residents or for borrowing in respect of the purchase of UK property,
- the grant of third party mandates in favour of a UK resident,
- the grant of a "lien" on the account,
- information which comes to the NOR supervisor's attention by personal knowledge,
- the existence of a UK business in which the investor has an active interest, and

- frequent or regular personal visits to the Financial Institution, cash transactions in the UK etc.

Where information indicates that the investor is or may be ordinarily resident in the UK or the trustees are or may be resident in the UK, or any of the beneficiaries are or may be ordinarily resident/resident in the UK, as appropriate, strictly the Financial Institution should treat the deposit as a relevant investment immediately and begin to deduct BRT. However, provided the Financial Institution has taken steps to satisfy itself that the investor has remained NOR, and, if necessary, has asked the investor to confirm that he or she has remained NOR (or in the case of trustees or beneficiaries that they are NOR/not resident, as appropriate), the Financial Institution may continue to pay interest without deducting BRT for up to 180 days to enable enquiries to be concluded. In exceptional cases HMRC may allow up to a further 180 days. Any Financial Institutions needing more than 180 days should apply to ...

HMRC recommends that where the matter is resolved without correspondence the NOR Supervisor records why he or she considers that the declaration remains valid.

Where the investor or the trustees is/are unable to satisfy the Financial Institution that a NOR declaration remains valid the Financial Institution should treat the deposit as a relevant investment and deduct BRT. Where the investor has not given all the necessary information within 180 days (or any further period HMRC may allow) the Financial Institution must deduct BRT from any future payments of interest.

Overseas Students

4.39 Students entering the UK for a period of study lasting less than four years are normally treated as not ordinarily resident in the UK. HMRC recommend that institutions make a diary note to review these accounts at the end of 4 years. If, at the end of 4 years, there is still a UK address on the account then you have 180 days to check the position with the investor.

If there is a reply and the investor is now ordinarily resident in the UK the Financial Institution should cancel the form R105 and deduct BRT from future payments of interest. The investor may be eligible to complete a form R85.

If there is no reply and there is still movement on the account. The Financial Institution should cancel the form R105 at the end of 180 days and deduct BRT from future payments of interest.

If there is no reply, no movement on the account and no evidence suggesting the investor is ordinarily resident in the UK interest can continue to be paid gross.

Change of name of investor

4.40 Where the investor changes his or her name, for example by marriage, it is not necessary to replace the NOR declaration but the Financial Institution should ensure there is a clear audit trail. An example of a clear audit trail would be annotating the form with the revised details and endorsing the amendment with date stamp.

Transfer of account between branches

4.41 A new NOR declaration is not required when an account is transferred between branches. But Financial Institutions should ensure that there is a clear audit trail back to the original NOR declaration.

18.22 EU Savings Directive

The relevant law and practice is found in:

(1) European Directive 2003/48/EC on taxation of savings income in the form of interest payments (**"EUSD"**) which applies to EU states.
(2) International agreements made by non-EU states.[133]
(3) Domestic legislation in each state (where the state has chosen to enact domestic legislation to impose the rules agreed in the Directive or agreement).[134]
(4) Guidance notes issued by each state.[135]

A full discussion would require many volumes.

The EUSD has been amended by Council Directive 2014/48/EU of 24 March 2014, which Member States must adopt by 1 January 2016.

In the following discussion, "**an ISD state**" is a state where Directive rules apply.

In short, the rules apply when a "paying agent"[136] established in one ISD state pays "interest"[137] to an individual who is "resident"[138] in another ISD state. The duties of the paying agent depend on the state in which the paying agent is established: they are not identical in every state.

A UK resident will most often be affected where:

(1) they receive interest from a paying agent in Belgium, Luxembourg, Austria, or a tax haven jurisdiction which has agreed to apply Directive rules; or

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133 These are:
(1) UK Crown Dependencies: the Channel Islands and the Isle of Man.
(2) UK Overseas Territories: Anguilla, British Virgin Islands, Cayman Islands, Gibraltar, Montserrat, Turks and Caicos Islands,.
(3) Dependent Territories of the Netherlands: Netherlands Antilles and Aruba.
(4) Other countries: Switzerland, Andorra, Liechtenstein, Monaco and San Marino.
http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/legal_bases/index_en.htm

134 In the UK this has been done by the Reporting of Savings Income Information Regs 2003.

135 In the UK see *http://www.hmrc.gov.uk/esd-guidance/guidance.htm* which is 71 pages long. But UK residents would not be concerned about UK law.

136 This term is elaborately defined: Art.4 EUSD. It includes trustees but not (in short) individual borrowers not carrying on business.

137 This term is also elaborately defined: Art.6 EUSD.

138 This term is defined in Art.3(3) EUSD.

(2) trustees of a transparent *Baker*-type IIP trust[139] in such a jurisdiction pay interest to a life tenant resident in the UK.

The paying agent has two choices:

(1) If the individual gives authority, the trustees may report the interest payments to HMRC in the UK.

(2) Alternatively the trustees must impose a withholding tax (also called a retention tax) on the payment of interest.[140] Statute uses the label "special withholding tax"[141] but I refer to it as **"EUSD withholding tax"**..

Several jurisdictions have taken the view before 2008/09 that the withholding/disclosure requirement does not apply when a payment of interest is made to a remittance basis taxpayer, if the interest is not remitted (and so not subject to UK tax).[142] This is a purposive

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139 Payment from a discretionary trust or non-transparent IIP trust is not "interest" and so it does not require withholding or disclosure. The EUSD will eventually be extended to cover this.

140 The states that operate this tax are: Austria, Belgium, Luxembourg, Jersey, British Virgin Islands, Netherland Antilles, Turks & Caicos, Switzerland, Andorra, San Marino, Liechtenstein and Monaco.

The EU withholding tax is in addition to any foreign tax that is withheld.

141 Section 136(6) TIOPA.

142 The Channel Islands and the Isle of Man take this view. See eg para 32 of the Isle of Man Treasury guidance notes accessible *http://www.gov.im/lib/docs/treasury/incometax/guidance.pdf.*

"32. In deciding to whom the retention tax will need to be applied the focus should be on the ultimate aim of the Directive which is to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State. The emphasis should be on individuals, and also on those individuals who are not only resident in a Member State but are persons subject to effective taxation in accordance with the laws of the Member State. It is therefore consistent with the aims of the Directive, and therefore of the Agreements into which the Crown Dependencies have entered, that the retention tax will not apply to interest payments made to …

- a trust (unless, as in the case of an interest in possession trust, a relevant beneficiary has the immediate and absolute entitlement to an interest payment); …
- an individual where it is known to the paying agent that they benefit in their Member State of residence from an exemption from income tax; or where because no interest is remitted to the individual no liability to income tax arises in their Member State of residence."

Switzerland agrees: see *Eidgenössische Steuerverwaltung: Wegleitung zur EU-*

construction, as the point is not made in the text of the agreements and whether it is correct seems very doubtful. HMRC do not agree, but the point is not within their jurisdiction, and they actually benefit from this practice as they do not have to allow a tax credit. This point ultimately raises questions of EU or international law, but not questions of UK law. However the EU has taken action on this point. An EU press release IP/09/1013, 25 June 2009, provides:

> The European Commission has decided to refer Luxembourg[143] to the European Court of Justice over its incorrect application of certain provisions of the Savings Tax Directive as regards interest payments made to beneficial owners who benefit from so-called "non-domiciled resident" status in their country of residence.
>
> Luxembourg refuses to apply the Directive to beneficial owners who benefit from the so-called "non-domiciled resident" status in their country of residence. Consequently, Luxembourg paying agents do not levy withholding tax on interest payments to such beneficial owners.
>
> According to Luxembourg legislation, beneficial owners are considered to benefit from the "non-domiciled" status, if they are generally exempt from income tax in their State of residence for tax purposes or if the interest payments, as long as they are not transferred to the State of residence ("remittance"), are not subject to tax in that State.
>
> According to the Commission, Luxembourg cannot provide for an exemption from withholding tax in situations other than those expressly provided by article 13 of the Directive (the so-called "voluntary disclosure" procedure which allows the beneficial owner expressly to authorise the paying agent to report information to the tax authorities of his State of residence and the "certificate procedure" which ensures that withholding tax is not levied when the beneficial owner presents to his paying agent a certificate drawn up by his Member State of residence for tax purposes).
>
> The Commission is of the opinion that the paying agent has the obligation to establish the residence of the beneficial owner on the basis of minimum standards, as provided by article 3(3) of the Directive. If the beneficial owner is a resident of another Member State in accordance with these standards, the

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Zinsbesteuerung (Swiss Federal Tax Authority Guidelines) § 37.

The operation of this practice from 2008/09 is a little more difficult, because the remittance basis depends on making a claim and at the time the interest is paid the claim will not yet have been made. But the practice will probably continue to be applied in cases where the individual confirms that they intend to make a remittance basis claim.

143 Belgium had previously taken the same view, see the 7th edition of this work, but it backed down so the proceedings are now against Luxembourg alone. I do not know if there are also proceedings against the tax havens which take the same view, but maybe Luxembourg will be a test case which will determine the point.

> Member State of the paying agent must ensure that the latter applies the Directive and, in the case of Luxembourg, that the paying agent levies a withholding tax on interest payments to such a beneficial owner.
> Consequently, the Commission considers that Luxembourg's legislation, in its current state, is not compatible with articles 2, 3, 10 and 11 of the Directive.
> Given that the above Luxembourg tax rules were not amended following the reasoned opinion sent by the Commission in November 2008 (IP/08/1815), the Commission has decided to refer the case to the European Court of Justice.
> The Commission's reference number for the case at issue is 2007/2178.

In practice, if the paying agent, guided no doubt by the local authorities, takes the view that the duty of withholding/disclosure does apply to unremitted interest, the individual will usually consent to the disclosure. Then there will be no withholding tax. No difficulty will normally arise out of that disclosure. The EUSD is designed to prevent criminal tax evasion, not lawful tax planning of the kind considered in this book.

18.22.1 *Credit for EUSD withholding tax*

If tax is withheld, 75% of it is paid to the Member State where the beneficiary is resident.[144] But the beneficiary is entitled to a tax credit for 100% of the tax withheld.[145]

HMRC now accept that the credit is applicable even if it relates to unremitted income (un)taxed on the remittance basis.[146] Helpsheet 264 (Remittance basis) for 2013/2014 provides:

> Where SWT is deducted you are treated as having paid, in the year of deduction, an equivalent amount of Income Tax in the UK. This can be set against your UK tax liability of that year, including the remittance basis charge, or repaid to you if the amount exceeds that liability.
> This applies to any tax deducted from foreign income or gains under the UK/Swiss Tax Cooperation Agreement that you opt to have treated as a payment on account. You should make a claim to have the withholding tax treated in this way on your return and you should also supply the certificates provided by your Swiss paying agent to confirm the amounts of withholding tax deducted.
>
> If you do not take this option and HMRC deem, the tax paid clears your liability to UK tax in relation to the relevant income or gains, you will not

144 Art.12 EUSD.

145 Art.14 EUSD.

146 HMRC changed their mind in Tax Bulletin 84 (discussed in the 6th edition of this book).

be able to subsequently claim a repayment.

If the remittance basis applies to you, amounts of SWT repaid to you, or set against your Income Tax liability, will be treated as a remittance of income at the time it is set off or repaid.

Example 4 (Grace)
G received £8,000 of interest from a Liechtenstein account after deduction of SWT of £2,000. G is non-domiciled in the UK and claims for her foreign income to be taxed on the remittance basis. G did not remit any of the money from her Liechtenstein account but includes an equivalent amount of Income Tax in her return for the SWT to set against other UK tax liability.

Enter on page F 2/F 3 of the Foreign pages:	
Country or territory code (page F 2 column A)	LIE
Amount of income received (page F 2 column B)	£0
SWT (page F 3 column D)	£2,000

Setting off the SWT against Income Tax liability will mean that part of the interest income is remitted to the UK and will be a taxable amount at that time. Normally the 'set-off' will be regarded as having been at 31 January following the tax year. G will therefore have to enter taxable income of £2,500 on her next tax return (remittance £2,000 increased by the rate of SWT (20%) £500; total £2,500). She will not be entitled to any relief for SWT for that year as the full amount has been relieved in this tax year.

If you use the remittance basis and you remit part of your foreign income after SWT is deducted, then the amount of your income remitted is calculated by including the appropriate proportion of the SWT.
You are still able to claim the whole amount of SWT deducted in the year at column D.
Example 5 (Adam)
A received interest of £800 from Jersey after deduction of SWT of £200. A is non-domiciled in the UK and claims for his foreign income to be taxed on the remittance basis. £400 of the interest was remitted to the UK.

Interest received in UK	£400
SWT	£100
	£500

Enter on page F 2/F 3 of the Foreign pages:	
Country or territory code (page F 2 column A)	JEY
Amount of income received (page F 2 column B)	£500
SWT (page F 3 column D)	£200

As in Example 4, the £200 set-off will be a further remittance at the date it

> is set off and subject to the same calculation until the total of the income, £1,000, is taxed. In this example £250 of income should be included on the tax return of the year when the SWT £200 is set off.

However, if a credit is given against tax, it is considered that the amount credited is not received in the UK and so not remitted.

If the credit takes the form of a refund, received in the UK, it is considered that the amount received is derived from the foreign interest, and so is regarded as remitted.

18.22.2 *EUSD: Commentary*

Has the EUSD given benefits which justify its cost and complexity? Readers may share the doubts of the Law Society:

> There are also examples of EU legislation that has proved complex but of limited effect. One example is the EU Savings Directive (EUSD) , which whilst it has limited "retail" avoidance by taxpayers banking in their next door Member State and not declaring the resulting income, is very straightforward to circumvent for those who can.[147]

It remains to be seen whether the 2014 amendments will resolve this problem.

147 Law Society response to "Review of the Balance of Competences between the United Kingdom and the European Union – Taxation (February 2013) para 22.

CHAPTER NINETEEN

EXEMPT INTEREST OF NON-RESIDENTS

19.1 Exempt interest: Introduction

This chapter considers exemptions for interest on:
(1) FOTRA securities;
(2) foreign currency securities;
(3) international securities

The OECD summarises the policy background for the exemptions:

> 7.5 Where the payer of the interest happens to be the State itself, a political subdivision or a statutory body, the end result may well be that the tax levied at source may actually be borne by that State if the lender increases the interest rate to recoup the tax levied at source. In that case, any benefits for the State taxing the interest at source will be offset by the increase of its borrowing costs. For that reason, many States provide that such interest will be exempt from any tax at source.[1]

19.2 Meaning of "FOTRA Securities"

Section 713(2) ITTOIA provides:

> In this Chapter "FOTRA security" means—
> (a) a security issued with a condition about exemption from taxation authorised by section 22 of F(No.2)A 1931,
> (b) a gilt-edged security which was issued before 6th April 1998 and without any such condition (other than 3½% War Loan 1952 Or After), or
> (c) 3½% War Loan 1952 Or After.

FOTRA stands for 'Free of Tax to Residents Abroad'.

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1 OECD Commentary to article 11 OECD Model Treaty. The OECD are considering exemption provided in a DTA, but the policy points to a general exemption.

19.2.1 *The exemption condition*

Section 713 ITTOIA provides:

> (3) In this Chapter "the exemption condition" has the meaning given by subsections (4) to (6), according to the kind of FOTRA security involved.
> (4) In relation to a security within subsection (2)(a), it means the condition authorised by section 22 of F(No 2)A 1931.
> (5) In relation to a security within subsection (2)(b), it means a condition with which 7.25% Treasury Stock 2007 was first issued, being a condition treated by section 161(1) of FA 1998 (non-FOTRA securities)—
>
> (a) as a condition with which the security within subsection (2)(b) was issued, and
> (b) as a condition authorised in relation to its issue by section 22 of F(No 2)A 1931.
>
> (6) In relation to 31/2% War Loan 1952 Or After, it means a condition of its issue authorised by section 47 of F(No 2)A 1915.

For these provisions see 62.5 (Conditions for FOTRA exemption).

19.3 Deduction at source

Section 893 ITA 2007 provides:

> (1) A payment of a UK public revenue dividend is payable gross if—
>
> (a) it is a payment of interest on gross-paying government securities, and
> (b) no deduction at source application has effect in respect of the securities at the time the payment is made (see section 895).

Thus there are three conditions for gross payment. First the security must be a UK public revenue dividend, defined s.891 ITA:

> In this Chapter "UK public revenue dividend" means any income from securities which—
>
> (a) is paid out of the public revenue of the UK or Northern Ireland, but
> (b) is not interest on local authority stock.

Secondly the security must be a gross-paying government security, defined s.893(2) ITA:

> In this Chapter "gross-paying government securities" means—

(a) gilt-edged securities (see section 1024), or
(b) securities which are the subject of a Treasury direction under section 894(1) or (3).

Thirdly, holders may ask for tax to be deducted at source. It must be rare to want to apply for tax to be deducted, though it might perhaps be convenient for a basic rate taxpayer who does not otherwise have to put in a return.

19.4 FOTRA exemption

Section 714 ITTOIA provides:

> (1) No liability to income tax arises in respect of profits from a FOTRA security if conditions A and B are met. ...
> (3) Condition A is that the profits are stated in the exemption condition to be exempt from income tax.
> (4) Condition B is that any requirements for obtaining the exemption imposed by the security's conditions of issue are met.

A non-resident individual or company would qualify for non-residents IT relief on the interest, so the FOTRA exemption only matters in unusual cases, such as split years (where non-residents income tax relief does not apply).

19.4.1 *Sections 624 and 720*

Section 714 ITTOIA provides:

> (5) Whatever the exemption condition provides, amounts charged under the provisions specified in subsection (6) are not exempted by subsection (1).
> (6) The provisions are—
> Chapter 5 of Part 5 (settlements: amounts treated as income of settlor) so far as it applies to income within section 619(1)(a) or (b), and
> Chapter 2 of Part 13 of ITA 2007 (anti-avoidance provisions: transfer of assets abroad).

These anti-avoidance provisions override FOTRA exemption.

19.4.2 *Restriction on deductions*

For completeness, s.716 ITTOIA provides:

> (1) A person who meets conditions A and B may not bring into account

for income tax purposes—

(a) any amount relating to changes in the value of a FOTRA security, or

(b) expenses related to holding it or to any transaction concerning it.

(2) Condition A is that the person is the beneficial owner of the security.

(3) Condition B is that the person is a person who would be exempt from tax on the security under this Chapter.

This can only apply to traders and is not of general importance.

19.5 Beneficial ownership

For a general discussion of the beneficial ownership requirement, see 62.6 (Beneficial ownership of FOTRA securities). The International Manual provides:

> **368040. The FOTRA condition** [April 2007]
> ...
> *Beneficial ownership of the security*
> To demonstrate beneficial ownership of the security, the claimant must hold the security on the interest date. In strictness a person who has sold a FOTRA security but receives the next interest payment due (an ex-dividend sale) ceases to be the beneficial owner of the security when he sells it.

It would be very strange if an ex-dividend sale caused the interest received post sale to become taxable, and I doubt if that can really be correct. In practice perhaps it does not often happen.[2]

19.6 FOTRA securities held on trust

19.6.1 *Interest in possession trust*

The TSE Manual provides:

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2 For completeness, The INT Manual continues:
"There is a column on the A1 claim form with the heading 'If sold, date of sale or write still held'. Entries in this column will alert you to a sale before the interest date. You should obtain guidance from Technical Advice Group before you take any action if
• a FOTRA security was sold before the interest date
• that column is left blank"
This is more than a decade out of date since from 1998 interest is paid gross and claims for repayment of deducted tax (formerly on form A1) are not needed.

> **3185. FOTRA securities - resident trustees** [March 2013]
> ... From 6 April 1998 all interest on such securities is paid gross. Trustees need to know whether or not to Self-Assess liability. This depends upon the type of trust involved and the Residence status of the beneficiary.
> *Interest in possession trust (see TSEM1564)*
> For any beneficiary who is not ordinarily resident (NOR) in the UK the interest is not taxable. Trustees should not include it on the returns. The authority for this is *Williams v Singer* 7 TC 387 (TSEM7070). In any circumstances the interest is taxable. It must go on the trust returns.

Thus (although not clear from the statute) all that matters is the residence of the life tenant. That is sensible.

19.6.2 *Discretionary trust*

The position has altered by the abolition of ordinary residence in 2013. In order to follow the transitional rules, one needs to know the original and the current versions of s.715 ITTOIA. It is helpful to set them out in track change format:

> (1) This section applies if—
> (a) a FOTRA security is held on trust, and
> (b) apart from this section, interest payable on the security would not be exempt from income tax under section 714 because of the security not being in the beneficial ownership of a ~~person not ordinarily UK resident~~ non-UK resident person.
> (2) For the purposes of determining whether the interest is exempt under section 714 it is to be assumed that the security is in the beneficial ownership of a ~~person not ordinarily UK resident~~ non-UK resident person if none of the beneficiaries of the trust ~~is ordinarily UK resident at the time when~~ is UK resident for the tax year in which the interest arises.
> (3) In subsection (2) "beneficiaries of the trust" includes any person known to the trustees as a person—
> (a) who is, or will or may become, entitled under the terms of the trust to receive income under the trust, or
> (b) to whom or for whose benefit such income may be paid or applied.
> (4) In subsection (3) "income under the trust" includes any property held on the terms of the trust and falling to be treated as capital so far as it is or represents amounts received by the trustees as income.

Para 52 sch 46 FA 2013 provides the transitional relief:

> In relation to a FOTRA security issued before 6 April 2013, the amendments made by this paragraph apply only if the security was acquired by the trust on or after that date.

ITTOIA EN change 116 provides:

> **Change 116: Interest from FOTRA securities held on trust: s.715**
> This change gives statutory effect to a practice relating to interest arising from FOTRA securities held on trust.
> FOTRA exemptions apply where gilt-edged securities are in the beneficial ownership of persons who are not ordinarily resident in the UK. The source legislation, principally section 154 of FA 1996, is rewritten in Chapter 6 of Part 6 of this Act. The beneficial ownership test lies within the definition of "FOTRA security" as it is part of the exemption condition of the securities. (See, in particular, section 22 of F(No 2)A 1931).
> Although in the case of bare trusts and trusts with an interest in possession, it is fairly clear where the beneficial ownership lies, in the case of discretionary or accumulation trusts it can be difficult to apply the beneficial ownership test. In some types of trust the beneficial ownership of an asset is, in effect, in suspense. In others, while it may be clear where the beneficial ownership lies, it may belong to a different person from the person entitled to the income.

The author does not have a sound grasp of the English law concept of beneficial ownership, but it does not matter, as the passage continues:.

> In practice, where interest from FOTRA securities held in trust arises to trustees and none of the beneficiaries of the trust is ordinarily resident in the UK, the beneficial ownership test is regarded as met whatever kind of trust is involved and no account is taken of whether the trustees themselves are resident or ordinarily resident. So if all the potential beneficiaries of a discretionary or accumulation trust (that is, those who have the right, at the discretion of the trustees, to benefit from the trust income or accumulated income) are not ordinarily resident in the UK, the FOTRA beneficial ownership test is treated as having been met.
> Section 715 of this Act gives effect to this practice. So, for the purposes of determining whether interest arising from a FOTRA security held in trust is exempt from income tax under section 714 of this Act, it is to be assumed that the security is in the beneficial ownership of a person who is not ordinarily resident if none of the beneficiaries of the trust is

resident when the interest arises. (See section 715(1) and (2)). Section 715(3) defines "beneficiaries of the trust" widely so as to cover all potential income beneficiaries of discretionary and accumulation trusts. Section 715(4) brings in beneficiaries receiving accumulated income. This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

This applies even to a UK resident trust.

Relief is available under ESC B18 in a case where:

(1) some beneficiaries are UK resident (so the requirements of this relief are not met) but
(2) the trustees distribute income to a non-ordinarily resident beneficiary.

19.7 Interaction of FOTRA exemption and DT relief

DT relief is obviously not needed where FOTRA exemption applies or where non-residents IT relief applies. There are a few gaps where DT relief could be useful, for instance, an individual who is UK-law UK resident but is treaty-resident outside the UK (under the tie-breaker). The International Manual provides:

> **368110. FOTRA and DT claims** [April 2007]
> A person entitled to exemption from UK income tax on interest payments from a FOTRA security may claim repayment of some or all of the tax deducted under the terms of an interest article in a DTA. You should treat any such claim as a claim under the interest article. It follows that the claimant must satisfy the conditions of the DTA rather than the conditions for FOTRA exemption. In effect the payment loses the label of FOTRA and is treated in the same way as any other interest payment.
> In practical terms it makes no difference if the claimant is entitled to full relief under the DTA. However the person who received the FOTRA interest may be able to claim repayment of the tax deducted by meeting the requirements of the DTA without meeting the beneficial ownership condition for FOTRA exemption.
> If the claimant is only entitled to partial repayment of the tax deducted under the DTA he will probably receive credit for the UK tax retained against his liability to tax on the interest in his country of residence. You should therefore make the payment as claimed because to increase the payment may cause the claimant inconvenience when settling his liability to tax in the country of residence. You could explain to the claimant that full repayment would be available if he made a claim on form A1.

This is more than a decade out of date since from 1998 interest is paid gross and claims for repayment of deducted tax (formerly on form A1) are not needed. But the underlying points are still correct.

19.8 Exempt foreign currency securities

19.8.1 *Securities qualifying for relief*

Section 755 ITTOIA provides:

> (1) This section applies to interest on—
> (a) such foreign currency securities issued by a local authority or a statutory corporation as the Treasury direct, and
> (b) such foreign currency loans made to a statutory corporation[3] as the Treasury direct.

I refer to securities within s.755 as **"exempt foreign currency securities"**.

Section 756 ITTOIA defines "foreign currency" security:

> (1) For the purposes of section 755, a security or loan is a foreign currency one if under its terms the currency to be used for repayment is not sterling.
> (2) Subsection (1) is subject to the following qualifications.
> [Subsections (3) and (4) are transitional rules for securities issued before 6 April 1982.]
> (5) If in the case of a security there is an option as to the currency to be used for repayment, the security is only to be treated as a foreign currency one if the option is exercisable only by its holder.
> (6) If in the case of a loan there is an option as to the currency to be used for repayment, the loan is only to be treated as a foreign currency one if the option is exercisable only by the person for the time being entitled

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3 Terms are defined in s.755(4) ITTOIA:
In this section—
"company" means a company, as defined in section 1(1) of the Companies Act 2006 (c 46),
'foreign currency', in relation to loans and securities, has the meaning given by section 756, and
'statutory corporation' means—
(a) a corporation incorporated by an Act (other than a company), or
(b) any other corporation on which functions connected with carrying on an undertaking are conferred by an Act or by an order made under or confirmed by an Act.

to repayment or eventual repayment.

19.8.2 *Exemption from deduction at source*

Section 981 ITA provides:

> Despite the provisions of this Part there is no duty to deduct a sum representing income tax from a payment of interest within section 755(1) of ITTOIA 2005 (interest on foreign currency securities etc owned by non-UK residents).

19.8.3 *Tax exemption*

Section 755(2) ITTOIA provides:

> No liability to income tax arises in respect of interest to which this section applies if—
>
> (a) in the case of interest on a security, its beneficial owner is a non-UK resident, and
>
> (b) in the case of interest on a loan, the person for the time being entitled to repayment or eventual repayment is a non-UK resident.

A non-resident individual or company would qualify for non-residents IT relief on the interest, so the exemption does not matter in practice.

19.8.4 *Section 624 and 720*

Section 755(3) ITTOIA provides:

> But interest is not exempt under subsection (2) because a person is a non-UK resident if it is treated as another person's income under—
>
> Chapter 5 of Part 5 (settlements: amounts treated as income of settlor), or
>
> Chapter 2 of Part 13 of ITA 2007 (anti-avoidance provisions: transfer of assets abroad).

This is the same as the rule for FOTRA securities.[4]

ITTOIA EN provides:

> Subsection (3) of the section is an anti-avoidance provision. Section 581(3) of ICTA is very widely drafted: "where any income of any person is by virtue of any provision of the Income Tax Acts to be deemed to be income of any other person, that income shall not be

4 See 19.4.1 (Sections 624 and 720).

exempt ..". In fact, there are only two sets of provisions under which this type of income could be deemed to be income of another person. The relevant provisions are listed in subsection (3) of the section.

19.8.5 *Commentary*

If the aim is to encourage investment in local authority and similar securities, why should the exemption be limited to foreign currency securities? It seems the object when the rules were introduced in 1969 was to encourage loans from foreign lenders who would not wish to lend in sterling; borrowers fared badly because of the devaluation in the subsequent sterling crisis.

Alignment of the foreign currency security with the FOTRA rules would be a small but worthwhile simplification. However the Treasury when asked for a list of exempt foreign currency securities stated that they did not hold the information and could locate no record of a direction having been given under s.755 ITTOIA! It may well be that no exempt foreign currency securities exist, and the entire legislation is dead letter law. I would be grateful for readers comments on that.

19.9 Securities of international organisations

19.9.1 *Inter-American Development Bank*

Section 773 ITTOIA provides:

> (1) No liability to income tax arises for a non-UK resident in respect of income from a security issued by the Inter-American Development Bank if the liability only arises because one or more of circumstances A to C apply.
> (2) Circumstance A is that the security is issued in the UK or in sterling.
> (3) Circumstance B is that the income is made payable or paid in the UK or in sterling.
> (4) Circumstance C is that the Bank maintains an office or other place of business in the UK.

This reflects Section 9 of the Agreement Establishing the IDB:

> (c) No tax of any kind shall be levied on any obligation or security issued by the Bank, including any dividend or interest thereon, by whomsoever held:
> (i) which discriminates against such obligation or security solely because it is issued by the Bank; or
> (ii) if the sole jurisdictional basis for such taxation is the place or

currency in which it is issued, made payable or paid, or the location of any office or place of business maintained by the Bank.

(d) No tax of any kind shall be levied on any obligation or security guaranteed by the Bank, including any dividend or interest thereon, by whomsoever held:

(i) which discriminates against such obligation or security solely because it is guaranteed by the Bank; or

(ii) if the sole jurisdictional basis for such taxation is the location of any office or place of business maintained by the Bank.[5]

19.9.2 *Designated international organisations*

Section 774 ITTOIA provides:

(1) No liability to income tax arises for a non-UK resident in respect of income from a security issued by an organisation if—

(a) the organisation has been designated by the Treasury for the purposes of this section, and

(b) the liability only arises because one or more of circumstances A to C apply.

(2) Circumstance A is that the security is issued in the UK or in sterling.

(3) Circumstance B is that the income is made payable or paid in the UK or in sterling.

(4) Circumstance C is that the organisation maintains an office or other place of business in the UK.

(5) The Treasury may by order designate for the purposes of this section—

(a) any of the Communities,

(b) the European Investment Bank,

(c) any international organisation that meets conditions A and B.

(6) Condition A is that one of its members is the UK or any of the Communities.

(7) Condition B is that the agreement under which that member became a member provides for the same kind of exemption from tax for income from securities issued by the organisation as this section provides.

See the Bretton Woods Agreement Order in Council, 1946 (SR&O 1946 No 36); International Finance Corporation Order 1955; International Development Association Order 1960; International Monetary Fund (Immunities and Privileges) Order 1977/825; International Organisations

5 *http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=781584*

(Tax Exempt Securities) Order 1984; European Communities (Tax Exempt Securities) Order 1985; International Organisations (Tax Exempt Securities) Order 1991.

CHAPTER TWENTY

DIVIDEND INCOME

20.1 Dividends and distributions: Introduction

A full discussion of the taxation of dividends and distributions needs a book to itself. This chapter focuses on matters closest to the themes of this book.

This chapter considers three sets of provisions:

(1) Dividends/distributions from UK resident companies: Chap 3 Part 4 ITTOIA
(2) Dividends/distributions from non-resident companies:
    (a) Chapter 4 part 4 ITTOIA (Income dividends)
    (b) Chapter 8 part 5 ITTOIA (Income distributions)
(3) Double taxation relief

I do not discuss the corporation tax treatment of dividend/distributions received by UK resident companies.

Unfortunately there (at least) *five* different definitions of dividend/distribution! Each set of provisions discussed here has a distinct definition, with CT (not discussed here) different again. The definition of distribution for company law purposes is different from the tax definitions. I have considered devising distinct terminology, but it is clearest to follow the statutory terminology – as long as one bears in mind that dividend/distribution has distinct meanings in each context.

20.1.1 *Cross references*

The following topics are considered elsewhere:

14.2 (Location of source of income: Territorial scope of IT)
14.9 (Split years: savings & investment & miscellaneous income)

20.2 Income from UK resident company

20.2.1 *The charge to IT*

Section 383(1) ITTOIA imposes the charge:

> Income tax is charged on dividends and other distributions of a UK resident company.

It does not matter whether the receipt is a dividend or "other distribution"; hence I refer to "dividends/distributions".

Section 384(1) ITTOIA provides:

> Tax is charged under this Chapter on the amount or value of the dividends paid and other distributions made in the tax year. ...

There is no reference to the remittance basis rules in part 8 ITTOIA, so dividends and distributions from UK resident companies are taxed on the arising basis (even for remittance basis taxpayers). This is because dividends/distributions from UK resident companies are regarded as UK source income. Thus the legislation adopts or enacts the decision in *Bradbury v English Sewing Cotton* 8 TC 481 that the source of income from shares is located where the company is resident.

20.2.2 *Dividends of a capital nature*

Section 383(2)(3) ITTOIA extends the charge to distributions of a capital nature, for instance, certain bonus issues of shares or securities:

> (2) For income tax purposes such dividends and other distributions are to be treated as income.
> (3) For the purposes of subsection (2), it does not matter that those dividends and other distributions are capital apart from that subsection.

20.2.3 *Definition of dividend/distribution*

Section 989 ITA defines "distribution" by reference to the wide and elaborate definition in CTA 2010:

> The following definitions apply for the purposes of the Income Tax Acts—
> "distribution" has the meaning given by Chapters 2 to 5 of Part 23 of CTA 2010, disregarding section 1027A of that Act.

20.2.4 *Tax credit*

Section 397 ITTOIA provides:

> (1) A UK resident or eligible non-UK resident receiving a qualifying distribution made by a UK resident company is entitled to a tax credit equal to one-ninth of the amount or value of the distribution (but see

subsections (3) and (6)).

(2) Such a person may claim to deduct the tax credit from—

(a) the income tax charged on the person's total income for the tax year in which the distribution is made.

(3) Subsection (1) only applies so far as the distribution is brought into charge to tax, and accordingly if the person's total income is reduced by any deductions which fall to be made from the distribution, the tax credit for the distribution is reduced in the same proportion as the distribution.

Section 397(3) ITTOIA prevents the tax credit being repayable. The SAI Manual provides:

> **5100. Tax credits on qualifying distributions** [November 2011]
> [The Manual paraphrases s.397(3) ITTOIA and continues:] So, for example, if an individual's total income is reduced by deductions (for example, personal allowances) such that the qualifying distributions are not, or are not wholly, brought into charge to tax, the value of the tax credits attaching to those distributions are correspondingly reduced. So a person may be entitled to a tax credit whose value is nil.

20.2.5 *Eligible non-UK resident*

Section 397(4) ITTOIA provides:

> For the purposes of this section "eligible non-UK resident", in relation to a qualifying distribution, means an individual who at any time in the tax year in which it is received is a non-UK resident within
>
> [a] section 278(2) of ICTA or
>
> [b] section 56(3) of ITA 2007 (Commonwealth citizens, EEA nationals etc.).

Subsection (4)[a] has no effect as s.278 ICTA was repealed in 2009 (the drafter forgot to repeal the cross reference here).

There are seven categories of individuals within s.56(3) ITA, of which the only important one is EEA nationals.[1]

The individual has only to fall into the relevant category 'at any time' in the tax year, not necessarily throughout the tax year.

For completeness, s.397(5) ITTOIA provides:

> If a distribution is, or is treated under any provision of the Tax Acts as, the income of a person ("P") other than the recipient ("R"), P (not R) is treated as receiving it for the purposes of this section (and so P (not R)

1 See 47.6.1 (Entitlement to personal allowances: UK residents).

is entitled to a tax credit if P falls within subsection (1)).

20.2.6 *Grossing up*

Section 398(1) ITTOIA[2] provides for grossing up a dividend/distribution by the amount of the tax credit:

> If a person is entitled to a tax credit under section 397 or 397A in respect of a dividend or other distribution, the amount or value of the dividend or other distribution is treated as increased by the amount of the tax credit for all income tax purposes (except sections 397(1) and 397A(1)).

For instance:
Dividend: £1,000 **("net amount")**
Tax credit (one ninth): £111
Dividend plus tax credit: £1,111 **("gross amount")**

20.2.7 *Recipient non-eligible person: effective tax credit*

Section 399 ITTOIA provides:

> (1) This section applies if a person is not entitled to a tax credit under section 397 or 397A for a qualifying distribution included in the person's income for a tax year.
> (2) The person is treated as having paid income tax at the dividend ordinary rate on the amount or value of the distribution (but see subsection (7))...
> (6) The income tax treated as paid under subsection (2) is not repayable.

I call this **"an effective tax credit"** as the legislation uses the expression "tax credit" in the strict sense of a tax credit under s.397 or 397A.

Section 399(7) ITTOIA contains four exceptions concerning specialist topics not discussed here.

20.2.8 *Grossing up income of non-eligible person*

Section 399 ITTOIA provides:

> (3) For the purposes of subsection (2), if the person is non-UK resident the amount or value of the distribution is treated as the grossed up amount, unless the person is a company which is beneficially entitled to the income.

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2 Flagged by s.384(3) ITTOIA.

> (4) If the person is non-UK resident, the amount or value of the distribution is treated for the purposes of Chapters 3, 4 and 6 of Part 9 of ITA 2007 (special rates for trustees' income) as the grossed up amount.
> (5) In this section "the grossed up amount" means the actual amount or value of the distribution, grossed up by reference to the dividend ordinary rate for the tax year.

This is relevant to a non-resident trust because (in the absence of treaty relief or non-residents IT relief) it affect how much tax is paid at the dividend rates.

A non resident individual does not usually care about grossing up, since no tax is due beyond the effective tax credit[3] but grossing up might be relevant to an individual treaty-resident in a state where the treaty allows repayment of the tax credit.

20.3 Income from non-resident company

20.3.1 *Income dividends: the charge to IT*

Section 402(1) ITTOIA imposes a charge to tax on dividends from non-resident companies:

> Income tax is charged on dividends of a non-UK resident company. ...

Section 403 ITTOIA provides:

> (1) Tax is charged under this Chapter on the amount of the dividends arising in the tax year.
> (2) Subsection (1) is subject to ...[4] Part 8 (foreign income: special rules).

Section 403(2) ITTOIA incorporates the remittance basis for foreign source income dividends. When do income dividends have a foreign source? There are many possible connecting factors, but the House of Lords held in *Bradbury v English Sewing Cotton* 8 TC 481 that the source of income from shares is situated in the place where the company is resident – not where it is incorporated or where the share register is kept. (This is a good illustration of how the income tax source rules may differ from the IHT/private international law situs rules.)

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3 See 42.1 (Non-residents IT relief – Introduction).

4 Omitted words relate to SIPs (outside the scope of this book).

20.3.2 *Definition of "dividend"*

Section 402(4) ITTOIA provides:

> In this Chapter "dividends" does not include dividends of a capital nature.

I therefore refer to s.402 as a charge on **"income dividends"**

Apart from that, "dividend" is (sensibly) undefined so it has its ordinary meaning, whatever that is. ITTOIA EN provides:

> 187. The term "dividend" is not defined in this Act. "Dividend" is a widely used and understood term and is defined only in very specific circumstances not applicable in this context ... . It is not thought appropriate to attempt to define "dividend" here. It will usually be a matter of referring to the relevant company law to determine whether or not a payment made by a company is a dividend.

20.3.3 *Income distributions: the charge to IT*

Section 687 ITTOIA provides:

> (1) Income tax is charged under this Chapter on income from any source that is not charged to income tax under or as a result of any other provision of this Act or any other Act. ...
> (4) The definition of "income" in s.878(1) does not apply for the purposes of this section.[5]

This includes a charge on what I call **"income distributions"** from a non-resident company. I use this term (perhaps slightly artificially) to mean distributions (other than dividends) from a non-resident company which are of an income nature (not capital receipts).

Section 688 ITTOIA provides:

> (1) Tax is charged under this Chapter on the amount of the income arising in the tax year.
> (2) Subsection (1) is subject to ...[6]
> (c) Part 8 (foreign income: special rules).

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5 The disapplied definition states:
"'Income' includes amounts treated as income (whether expressly or by implication)."
I would be grateful if any reader could explain what s.687(4) is intended to achieve.

6 The exceptions in (a)(b) are outside the scope of this book.

Section 688(2)(c) ITTOIA incorporates the remittance basis for foreign source income distributions. As for dividends, income distributions have a foreign source if the company is non-UK resident.

Section 689 ITTOIA identifies the person liable:

> The person liable for any tax charged under this Chapter is the person receiving or entitled to the income.

Thus we have two separate charging provisions for receipts from a non-resident company:

(1) Section 402 imposes the charge on income dividends.

(2) Section 687 imposes the charge on income distributions.

ITTOIA EN Vol. II explains why:

> 184. Income which, under the source legislation, is charged to tax under Schedule D Cases IV or V, has, where appropriate, been fully integrated with the equivalent income arising from a UK source. In the case of dividends from non-UK resident companies there is no exact equivalent in terms of UK source income. The closest equivalent is the charge to tax on dividends and other distributions from UK resident companies (section 20 of ICTA, Schedule F in the source legislation). But there is no precise overlap. The UK charge, by the adoption of the definition of "distribution" from Part 6 of ICTA ... can include dividends or distributions of a capital nature and can also operate to convert payments that would otherwise be treated as interest into distributions. Any charge on distributions from non-UK resident companies must be confined to income only. For this reason ... it is not thought appropriate to integrate the charges. So a separate charge is needed to cover dividends from non-UK resident companies. ...
>
> 186. ... It is possible that a non-UK resident company may make a distribution of income which would not fall within Chapter 4 of Part 4 of this Act because it is not a "dividend". But if the distribution comprises income it will fall to be dealt with either under alternative specific charges (eg interest) or within "income not otherwise charged", the charge on which appears in Chapter 8 of Part 5 of this Act.

In practice it does not usually matter whether a receipt from a non-resident company is classified as an income dividend (chargeable under s.402) or as an income distribution (chargeable under s.687). In either case the receipt is only taxable if it is income and not capital in nature.

20.3.4 *Tax credit and grossing up*

The topic of grossing up and tax credits on foreign dividends, in s.397A ITTOIA, needs a chapter to itself. It is not discussed here; though I hope to cover it in a future edition.

20.4 Open-ended investment companies

Corporate residence is important as different rules apply depending on the residence of the company. The topic of corporate residence is not discussed in this book, but some narrow points should be mentioned.

ITTOIA EN Vol II discusses the topic of OEIC income:

> 50. The definition of an open-ended investment company in section 468(10) ICTA carries a limitation that the company should be incorporated in the UK under the OEIC regulations of 1996. Section 468(10) ICTA is inserted in section 468 of ICTA by para 10(4) (Open-ended Investment Companies (Tax) Regulations 1997 SI 1997/1154). All open-ended investment companies within the definition in section 468(10) ICTA are therefore subject to the company residence rule in section 66 FA 1988 ("regarded for the purposes of the Taxes Acts as resident"). Open-ended investment company interest distributions treated as made by a UK resident company will be UK source income. Section 249 FA 1994 could in theory also apply to make such companies non-resident (as explained in connection with industrial and provident societies). In that case interest distributions made will be treated as dividends from non-resident companies.

20.5 Receipt from a non-resident company: Income or capital?

What receipts from non-resident companies are of an income nature and so within the charge under s.403 or s.687? For receipts from UK resident companies the question does not arise. The charge is on "distributions" and the term is defined to include a capital distribution. For receipts from non-resident companies:

(1) The charge on dividends excludes dividends of a capital nature.
(2) The charge on distributions applies only to "income" (which comes to the same thing: it excludes distributions of a capital nature).

There is no guidance in the statute. So the income/capital distinction is one of the general law (eg it applies for trust law purposes) which is adopted by UK tax law. Hence many of the cases are trust cases and not

tax cases.[7]

20.5.1 *General principles*

Courtaulds Investments v Fleming summarises the law as follows:

> The rights and interests of shareholders in the assets and the profits of companies in which they hold shares vary widely in detail, but I think they can all be said to fall under three heads:
> (1) rights to participate in the distributable profits of the company while it is a going concern;
> (2) rights to participate in the division of the assets of the company in a liquidation, and
> (3) rights to participate in any distribution to shareholders on an actual or notional reduction of capital.
>
> Anything received under the first head is treated by English law as income of the recipients for both tax purposes and trust purposes (but subject as to the latter to any special provision of the trust) notwithstanding that the source of the distribution may be a profit not of the company's business but on capital account: see *In re Doughty* [1947] Ch 263 and *IRC v Reid's Trustees* 30 TC 431.
>
> Anything received under the second head is treated by English law as capital both for tax purposes and, subject as aforesaid, for trust purposes. So also is anything received under the third head. That this is so for trust purposes is clear from *In re Duff's Settlements* [1951] Ch 923, where moneys received by trustees on a distribution of part of a share premium account under the Companies Act 1948, s.56, [now s.610 Companies Act 2006] were held to be capital for the purposes of their trust. My attention was not drawn to any case where the same has been held to be so for tax purposes on a distribution of a share premium account under s.56, but in my judgment that must follow.[8]

20.5.2 *Dividend/distribution paid out of capital receipts of company*

In *IRC v Reid's Trustees*, capital profits realised on the sale of properties were distributed to shareholders by way of dividend; the payments were of an income nature. Lord Reid said:

> if a foreign company chooses to distribute its surplus profits as dividend, the nature and origin of those profits does not and cannot be made to

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7 See Law Commission Consultation Paper 175, "Capital and Income in Trusts" (2004) accessible *http://lawcommission.justice.gov.uk/*.

8 46 TC 111 at p.124.

affect the quality of the receipt for the purposes of income tax.[9]

20.5.3 *Dividend/distribution paid out of share premium account*

In *HMRC v First Nationwide*[10] the Court of Appeal said:

> 11. In the UK, prior to 1948, share premium was freely distributable as 'profits'. It was not assimilated to paid-up share capital. It did not fall within the scope of rules designed to protect against reduction of capital.
> In *Drown v Gaumont-British Picture Co* [1937] 2 All ER 609 a shareholder failed to prevent a company from paying a dividend out of share premium; the premium was additional to and was not part of the capital subscribed on the shares. Subject to any inhibition in the articles of association, there was nothing to prevent a company dividing amongst its shareholders the premium obtained on the issue of the shares (617 A-B). It should be noted that, in that case, the premium was carried to a reserve account, to which the premiums made the major contribution (614H and 616H).
> 12. By s.56 Companies Act 1948 [now s.610 Companies Act 2006] share premium was assimilated to a company's subscribed capital and protected as if it were the paid-up capital of the company. The contrasting effect on the categorisation of payments out of share premium, before and after 1948, was clearly identified by both Harman J and the Court of Appeal in *Re Duff's Settlement* [1951] Ch 721 and 923. The importance of that decision, which concerned the question whether payments out of share premium account should be treated as income or capital, lies in the emphasis the courts placed upon the mechanism of payment in order to draw the distinction between capital and income. By virtue of s.56 of the Companies Act 1948, the repayment of share premium, in that case, was made by order of the court on a petition under that section. It followed, the courts agreed, that in contrast to the position before the 1948 Act, as explained in *Drown*, the payments out of share premium account were payments of capital and not income.
> 13. In giving the judgment of the court, Jenkins LJ described s.56 as the essential provision on which the distinction between share capital and divisible profit depends (928).
>
> > "….."the mechanics" are, in our judgment, an essential factor in determining the character as between capital and income of the sum distributed. A company, having (sic) an artificial person, can (as it

9 30 TC 431 at p.450.
10 81 TC 738.

> has been laid down) make a distribution amongst its members (otherwise than in a winding-up) in one of two ways - but only in one of two ways: that is by a distribution of divisible profit, that is, by way of dividend; and by way of a return of capital pursuant to an order of the court upon a petition for reduction of capital in accordance with the Act." (930).

14. The court continued by reflecting upon the nature of share premium. It recognised that it was essentially capital profit and not income (931). But,

> "if distributed in cash before s.56 came into operation (it) would…have been income in the hands of the shareholders, notwithstanding its capital character when considered as a receipt of the company " (932).

15. Harman J's judgment is to like effect. It is of note that he "ranked" the share premium as profits available for distribution (724) because it represented a profit in the sense that the company got more for its shares than the nominal value (727).

The same applies for an Italian company, where the company law is similar to post-1948 UK law:

> 18. The principle that it is the machinery by which the assets are distributed which determines whether they are capital or income finds expression, yet again, in *Courtaulds Investments Ltd. v Fleming* 46 TC 111. Italian law identified the distribution from a share premium reserve as a distribution of capital. It brought share premium within the scope of the rules for protection of capital in a manner similar to s.56 Companies Act 1948. Share premium could not be distributed while the legal reserve fell below 20% of the company's capital. Italian law introduced a new tax on the payment of dividends. To avoid that tax, the Italian company transferred profits of the year, which would have been distributed as dividends, to the legal reserve and thereby freed the share premium for distribution to shareholders. Such a distribution was, under Italian law, a distribution of capital free from the new imposta cedolare. ... Buckley J rejected the Revenue's contention that once the share premium was freely distributable it was, as in the UK before 1948, income. Italian law regarded the distribution as capital, and grafted the share premium onto the paid-up capital of the company (127B-C).

The position is different for a Cayman Island company whose law is similar to pre-1948 UK law:

> 19. Cayman Island Companies Law has followed the reverse route to

that adopted under UK company law. Prior to 1989, the law protected share premium as if it were paid-up share capital, in the same way as it was protected after s.56 of the Companies Act 1948 was introduced in the UK. But by amendment in 1989, share premium was distributable by dividend. ...

20. If, as is clear, prior to 1948 share premium was distributable by way of dividend as income in the UK, it seems equally plain that it was distributable as income in the Cayman Islands following the freedom from restriction in 1989.

...

25. The character of the payment in the hands of First Nationwide is a matter for UK law, the law of the Cayman Islands being relevant, not determinative, (Upjohn LJ in Rae, (q.v. supra [7]). UK law recognises only two species of payment in respect of shares: capital or income payments. Further, the jurisprudence establishes that it is the form by which the payments are made which determines their character. It is true that, under Blueborder's Articles of Association (Art.5.2(b)), had the First and Second Preference Dividends not been paid, the share premium would have been returned as capital on a winding-up or on a redemption. It is also true that, since those dividends were paid, the value of the capital rights which remained, on a winding-up or otherwise, was drastically diminished to £1m. But those features tell one nothing other than, had the mechanism or machinery adopted for distribution of the share premium account been a return of capital on a winding-up or otherwise, the payments would have been capital. Since the payments were made adopting the mechanism of distribution by way of dividend, ... that mechanism dictates the conclusion that the payments were income and not capital. Under the Articles, the owner of the Preference Shares has rights to income, if the premium is distributed as dividends and, if the premium is not distributed as dividends, equivalent capital rights on a winding-up.

HMRC comment in relation to s.1000(1)B CTA 2010, which provides:

(1) In the Corporation Tax Acts "distribution", in relation to any company, means anything falling within any of the following paragraphs.

A Any dividend paid by the company, including a capital dividend.

B Any other distribution out of assets of the company in respect of shares in the company, except however much (if any) of the distribution—

(a) represents repayment of capital on the shares, or

(b) is (when it is made) equal in amount or value to any new

consideration received by the company for the distribution.

For the purposes of this paragraph it does not matter whether the distribution is in cash or not...

This is not quite the same as the charge on income distributions of non-resident companies, but something which would not be not a distribution under s.1000(1)(B) is not an income distribution chargeable to IT under s.687. HMRC say:

[The statement refers to s.1000(1)B CTA 2010 and continues:] Such distributions are likely to comprise redemptions at premium or repurchases of capital.

What is the capital on the shares?

For companies incorporated in the UK under the Companies Act 2006 or its predecessors, this will usually comprise nominal share capital. In addition, where shares are issued at a premium Part 23 CTA 2010 (see section 1025), consistently with section 610(4) Companies Act 2006, makes it clear that share premium is treated as part of the share capital for this purpose. Amounts subscribed for share capital or paid as share premium will be treated as "capital on the shares".

For companies that do not have share capital, for example, companies limited by guarantee, Part 23 CTA 2010 extends the definition of share to include stock or any other interest of a member of the company.

For foreign companies, it may be less clear what capital on the shares consists of. The facts may vary between cases, but HMRC would normally expect to treat as a distribution an amount that:

- is distributable in accordance with the relevant company law, and
- is not made on winding up or as part of a procedure under the relevant company law for reducing share capital.

This is subject to section 1027A CTA 2010 which for the purposes of determining whether an amount is a repayment of capital on the shares, treats a distribution out of a reserve arising from a reduction of share capital as if it were made out of profits available for distribution otherwise than by virtue of the reduction. This will depend on whether section 1027A(4) applies or not to the reduction of share capital.

With regard to application of section 1025 CTA 2010, which treats a repayment of share premium as forming part of the share capital where the premium account was created in respect of new consideration received on the issue of the share capital, HMRC will normally, depending on application of the foreign company law, not treat a payment of out of a share premium account as a repayment of share capital in circumstances where under the foreign company law share

premium is fully distributable and is not treated as forming part of the share capital.

Fiscal and Administrative consolidation (Organschaft)

Some jurisdictions provide for individual entities to enter into arrangements enabling those entities to consolidate their results for tax or administrative purposes. Such arrangements often involve the transfer or payment of amounts between the parties to consolidate results. HMRC takes the view that payments or transfers made as part of such arrangements and under the terms of a contract can be distributions provided that the:

- arrangement is dependent on the existing shareholder relationship for its existence, and
- payments / transfers between the members of the consolidated unit are made in respect of shareholdings (such that transfers or payments are in proportion to shareholdings).[11]

20.5.4 *Partial liquidation*

In *Rae v Lazard Investment Co*, a Maryland company hived off part of its business by a process, unknown to English company law, of partial liquidation; shares in a new company to which the hived off business was sold were distributed to an English investment company which held shares in the Maryland company. The House of Lords held that shares which the English company shareholders received on the partial liquidation were of a capital nature, not income. That conclusion was dictated by the machinery by which the shares were distributed. Lord Reid said:

> In deciding whether a shareholder receives a distribution as capital or income, our law goes by the form in which the distribution is made rather than by the substance of the transaction. Capital in the hands of the company becomes income in the hands of the shareholders if distributed as a dividend, while accumulated income in the hands of the company becomes capital in the hands of the shareholders if distributed in a liquidation. In the present case, the form of the distribution was one unknown to our law - distribution in a partial liquidation. By the law of Maryland, which governs the company and which authorised this distribution, the shares distributed were capital in the hands of the shareholders. Why, then, should we regard them as income? It is said that, if this had been an English company and it had done what

11 *http://www.hmrc.gov.uk/specialist/guidance-payments-uk-companies.pdf* published December 2012.

> Certain-teed did. these shares would have been income in the hands of the shareholders. But an English company could not do what Certain-teed did, for it could not distribute in a partial liquidation.[12]

20.5.5 *Demergers*

Judges have from time to time said that dividends are *prima facie* income, suggesting circumstances in which they will not be of an income nature.[13] But cases where a dividend is not income are exceptional. One example is *Sinclair v Lee* [1993] Ch 497, where a dividend by ICI by the allotment of fully paid-up shares in the new company Zeneca was part of a company reconstruction by way of de-merger, whereby a single company was replaced by two head companies and the trading entity divided into two smaller trading entities.

20.5.6 *Stock option*

The HMRC view was set out in the former Inspectors Manual. The material was deleted from the current SAI Manual, which deals with the issue only cursorily at 5210. I set out the old Inspectors Manual passages, as they no doubt continue to reflect HMRC practice:

> **1611. Distributions/foreign cos: Not in cash: Option cases**
> Published: 9/95
> Where a foreign company declares a cash dividend but offers its shareholders, on their own initiative, the optSAIon of taking up further shares in lieu of the cash dividend, a shareholder who exercises the option to take up the shares is not assessable under Case V of Schedule D in respect of that dividend. If, however, a shareholder does not exercise the option but takes the dividend in cash, he is assessable under Case V of Schedule D on the amount of the cash dividend. See CG51823 regarding the capital gains position.

20.5.7 *Issue of shares or debentures*

The former Inspectors Manual continued:

> **1612. Distributions/foreign cos: Not in cash**
> Published: 9/95
> Where a foreign company capitalises undivided [ie undistributed] profits and —

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12 41 TC 1 at p.26.

13 e.g. *Reid's Trustees per* Lord Normand (374,375) and Lord Morton (380).

a) issues to its shareholders the additional capital so created, in the form of its own shares or debentures, in proportion to the number of shares already held by them or
b) satisfies a dividend out of such profits by the issue of its own stocks or shares (for example, a "stock dividend" by a United States company),

such a distribution does not constitute income for Case V purposes in the hands of the shareholder. This principle applies when the distribution is actually made in shares, whether or not an effective option was given to the shareholder to receive cash in place of shares (*IRC v Blott*, 8 TC 101; *Whitmore v IRC* 10 TC 645; *IRC v Fisher's Executors*, 10 TC 302; *IRC v Wright* 11 TC 181). ...

In cases where the distribution is not actually made in shares and the shareholder accepts cash from the company under an option given to him to receive cash in place of shares, the cash is assessable as income in accordance with IM1610.

1614. Distributions/foreign cos: Certificates of indebtedness

Published: 9/95

As regards liability in respect of dividends received in the form of certificates of indebtedness redeemable at a future date, see *Associated Insulation Products v Golder* 26 TC 231.

See also IM4580 as regards liability on the sale or transfer of such certificates.

20.5.8 *Dividend reinvestment plans*

The former Inspectors Manual continued:

1615. Dividend reinvestment plans

Published: 9/95

Some foreign companies, particularly in North America and Australia, establish dividend reinvestment plans for their shareholders. Such plans can be structured in a number of different ways, some of which result in liability under Case V when a dividend is declared, and others which do not. At one extreme is the pure bonus issue, when a dividend is declared payable in shares with no option for the shareholder to take cash. Alternatively a company may arrange for cash dividends to be paid to a third party, typically a bank, which then applies the dividends in the purchase of additional company shares in the market on behalf of the shareholder. The first situation falls within the principle of *IRC v Blott* (8 TC 107) – see IM1612. The second gives rise to a Case V charge because the reinvestment in the company is regarded as a voluntary application of income which has already arisen to the shareholder.

> Between these two extremes lies a variety of situations, each of which must be considered by reference to their own facts to determine whether a Case V charge arises...

20.6 Distribution to non-shareholder

20.6.1 *Company law background*

A payment from a company to a non-shareholder is not a dividend. The question arises as to whether it might be an income distribution, taxable under s.687 ITTOIA.

It is well established that for company law purposes:

(1) Whether a transaction amounts to a distribution is not simply a matter of form (unlike, say, the question of whether a payment is a dividend, for which certain formalities are required).

(2) The label attached to the transaction by the parties (eg a sale, or remuneration) is not decisive.

(3) A transaction between a company and a non-shareholder may constitute a distribution, if the company and the non-shareholder have the same ultimate beneficial owner.[14]

The classic cases involve a sale at an undervalue from one company to another company where both had the same ultimate beneficial owner. This matters for company law purposes because of the company law rules that a distribution from a UK company can only be made out of distributable profits, and in the absence of distributable profits, there is an unlawful distribution. A fortiori, a gift to or for the benefit of a shareholder or ultimate beneficial owner would in principle constitute a distribution.[15] See *Clydebank Football Club Ltd v Steedman*:

> "Distribution" is not further defined than by [s.829 CA 2006] but it would appear that generally a distribution will be a transfer without consideration given by the recipient. The object of the statutory code is to prohibit the (gratuitous) return to shareholders, other than by specified means, of subscribed capital or assets representing the same. However, ... a transfer involving the passing of some consideration may in certain circumstances give rise to a distribution. That is because a

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14 See Aveling Barford v Perion [1989] BCLC 626: "The fact that the distribution was to Perion rather than to Dr. Lee or his other entities which actually held the shares in Aveling Barford is in my judgment irrelevant."

15 Further consideration is needed in the case of a charitable gift.

> transfer, albeit some consideration is given, may involve in substance a gift of capital to the transferee.[16]

The rule that a sale at an undervalue is a company law distribution has been modified by s.845 CA 2006, to facilitate sales at book value; but that does not affect the rule that a payment from a company to a non-shareholder for no consideration[17] may be classified as a distribution for UK company law purposes, and so unlawful in the absence of distributable profits.

How does one reconcile this with s.829 CA 2006 which provides:

> In this Part [part 23 CA 2006] "distribution" means every description of distribution of a company's assets *to its members*...

The word "to" seems to have been read as "to or at the direction of" or "to or for the benefit of". (Alternatively as there are two sets of company law rules governing distributions, the statutory rules and common law rules, a distribution to a non-shareholder could be said to be at least a "distribution" for the purposes of the latter. But the cases do not make this distinction.)

In practice the tax question arises in relation to foreign companies, whose company law may not impose the same restrictions on distributions as UK law. In Jersey, for instance, a distribution is (in short) permitted as long as the company remains solvent. It might be that some foreign company laws may not classify a gift as a distribution at all. But whether a payment is a distribution within the meaning of a UK tax statute is a matter of UK law and is not determined by the label applied by the foreign law.

20.6.2 *Tax law position*

What is the tax position when a non-resident company makes a distribution to a non-shareholder? Suppose:

(1) the company is owned by A, an individual, and
(2) the company makes a distribution to B.

B cannot be subject to income tax as B has no source of income.

A (if UK resident) will be chargeable to tax on the distribution if A is a

---

16 [2002] SLT 109 at [55] approved in *Progress Property v Moorgarth Group* [2011] 2 All ER 432.

17 or a sale of an asset for consideration which is less than book value.

person receiving or entitled to the income.[18] But there is no reason why A should be such a person.

This is why the rules for UK resident close companies extend the meaning of distribution to include benefits to associates of participators.

What if the company is owned by a discretionary trust, and the company makes a distribution to B, a beneficiary? There are several possible solutions:

(1) The distribution is income of B in the form of a company distribution.
(2) The distribution is income of B in the form of a trust distribution.
(3) The distribution is:
    (a) income of the trustees in the form of a company distribution; and
    (b) income of B in the form of a trust distribution.
(4) The payment is a capital receipt of B.

Solution (1) seems sensible but is inconsistent with two basic principles of tax law:

(a) The source doctrine, which states that one cannot receive income (for tax purposes) unless one has a source of income: B has no interest in the company. (B's interest under the discretionary trust is not an interest in the company.)
(b) The rule that discretionary trusts are not transparent.[19]

So this solution is not available.

Appropriate documentation would of course bring the matter into solution (3) but in the absence of a payment to the trustees, it is wrong to regard them as receiving or entitled to income.

The choice is therefore between solutions (2) and (4). It is clear that a payment from the company to a beneficiary is capable of being a capital payment, as that is assumed in IHT and CGT provisions (which will need separate consideration).[20] It is arguable that such payments are always a capital receipt. However it is considered that the payment may be income (solution (2)) or capital (solution (4)) depending on the circumstances of

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18 See s.404 and s.689 ITTOIA. In the tax avoidance case of *McGuckian v IRC* 69 TC 1 a shareholder-trustee sold the right to a dividend of £400k for £386k (99% of the value) to a third party purchaser. The receipt of the sale price was held to be a receipt of income, but the trustees (and life tenant) were subject to income tax on the amount the trustees (and life tenant) received, ie the sale price; not the (slightly) greater amount of the dividend (which was received by the purchaser).

19 See 25.3.2 (Discretionary trust payment: what is the source?).

20 See 51.8 (Capital payment from close company); 62.16 (Transfer of value by close company). The transactions in securities code may also need to be considered.

the distribution: the same principles apply as a distribution from the trustees: what power are the trustees using when they authorise the company to make the distribution. See 25.8 (Payment from discretionary trust: income or capital receipt?).

The position is different if a company held by a *Baker* trust makes a distribution to a life tenant. The trust is transparent, the life tenant has an interest in the company, and the distribution is taxable under s.687 ITTOIA.

20.7 DT relief for dividend income

It is necessary to consider separately:

(1) A person treaty-resident in the foreign contracting state who receives UK source dividends.

(2) A person treaty-resident in the UK who receives dividends from a company resident in the foreign state; such a person may be entitled to tax relief in the foreign state, but that is not discussed here.

(3) A person who is UK-law UK resident but treaty-resident in a foreign state and who receives dividends from a company resident in a third country.

20.7.1 *OECD model article 10*

Article 10 OECD Model provides:

> 1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
>
> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
>
> a) 5% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividends;
>
> b) 15% of the gross amount of the dividends in all other cases. ...

Actual treaties vary, particularly in the terms of art 10(2).

Persons within art.10(2)(a) are sometimes described as **"direct investors"** and those within art.10(2)(b) as **"portfolio investors"**. The labels aer slightly opaque, but it is difficult to think of better. The effective meaning of those terms in any context varies depending on the

wording of the treaty concerned.

20.7.2 *Person treaty-resident in foreign contracting state*

In practice, non-resident individuals and non-resident companies do not need usually treaty relief. They qualify for non-residents IT relief[21] which restricts the tax on dividends to an amount which is covered by the effective tax credit. Treaty relief is relevant to:

(1) Non-resident trusts (if they do not qualify for non-residents income tax relief, because they have UK resident beneficiaries).[22]
(2) Individuals who are UK-law UK resident, but treaty-resident in the foreign state (under the tie-breaker).
(3) Tax year of arrival and departure.

20.7.3 *Repayment of surplus tax credit*

Section 30(9) F(No.2)A 1997 provides:

> The amendments made by subsections (5) and (6) above and rewritten in section 397(3) of the Income Tax (Trading and Other Income) Act 2005 [tax credit not repayable][23] do not affect the entitlement of a person who is not resident in the UK to payment in respect of a tax credit by virtue of arrangements having effect under section 2(1) TIOPA (relief by agreement with other countries).
>
> (10) Where—
>
> (a) arrangements having effect under section 2(1) TIOPA confer on a person not resident in the UK the right to a tax credit under section 397 ITTOIA in respect of a dividend of a company resident in the UK, and
>
> (b) the arrangements contain provision for permitting—
>
> (i) tax to be charged or deducted, or
>
> (ii) a reduction in the amount of the tax credit that is paid to be made,
>
> by reference to the aggregate of the dividend and the tax credit, and
>
> (c) the amount of that tax or that reduction exceeds the amount of the tax credit,
>
> that provision shall only have the effect of reducing to nil the amount of the payment to which the person is entitled in respect of the tax credit.

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21 See 42.1 (Non-residents IT relief – Introduction).

22 See 42.5 (Trusts: UK beneficiary rule).

23 See 20.2.4 (Tax credit).

Some older treaties give persons who are treaty non-resident in the foreign state the right to be repaid unused tax credit on UK dividends. However:

(1) The number of treaties with a provision of this kind is small, and is diminishing as new treaties replace the older ones.

(2) The reduction in the amount of the tax credit to one ninth usually means that there is nothing to be repaid.

The International Manual provides:

> **343510. Background** [April 2012]
> ...Dividends do not have income tax deducted but have an amount attached to them (not paid to the shareholder at the time of the dividend) called a tax credit. See CTA10/S1109. Some DTAs provide for payment of tax credit. You need to check the details of each DTA. There are two types of investor
> • portfolio investors (someone who owns less than 10% of the total number of issued shares in a UK company) - the dividend article usually provides that the investor is entitled to a tax credit equal to that to which a UK resident individual would be entitled had he received the dividend. Any excess of the tax credit above a deduction of 15% of the aggregate of the dividend and the tax credit is payable.
> • direct investors (where a company controls 10% or more of the voting power of the UK company paying the dividend) - the dividend articles of a small number of DTAs provide that the investor is entitled to a tax credit equal to one-half of that to which a UK resident individual would be entitled had he received the dividend. The relief allowable is a payment of that half tax credit minus 5% or 10% of the aggregate of the dividend plus the half tax credit.
>
> **343520. Portfolio Investors** [April 2012]
> The expression "portfolio investors" describes the great majority of shareholders. They include individual persons, pension funds, companies and others who have invested money in shares issued by the UK company. The number of shares owned by each investor may range from single figures to several million shares. If a shareholder owns 10% or more of the total number of voting shares that have been issued by a UK company they are called a "direct investor".
> Some DTAs contain provisions that allow a portfolio shareholder to claim payment of part of the tax credit. In these treaties the dividend article usually provides that the amount payable is equal to the tax credit minus 15% of the aggregate of the dividend and the tax credit.
> Where the DTA does not provide for payment of tax credits and the shareholder is an individual (a person) see INTM343530.
> The rate of tax credit that is attached to a UK dividend is one ninth of the dividend. The effect of this rate of tax credit is that there is no amount for a portfolio investor to claim (see Section 30(10) F(No2)A 1997).

Example
Dividend £1,000
Tax credit (one ninth) £111.11
Dividend plus tax credit £1,111.11
15% retained in the UK £166.66
Because the amount to be retained in the UK is greater than the original tax credit there is nothing to pay. £111.11 less £166.66 equals nothing.

343540. Direct investors [April 2012]

A "direct investor" may be defined as a company that controls 10% or more of the voting shares of the UK company that is paying the dividend. Many DTAs that provide for payment of tax credits specifically exclude companies that either alone or together with associated companies control 10% or more of the voting power in the company that is paying the dividend. The claim forms contain a question that will allow you to identify these cases.

However, some DTAs contain provisions that specifically allow for payment of part of the tax credit to direct investors. The amount of relief that may be claimed by the non-resident shareholder is one half of the tax credit a UK resident would be entitled to minus 5% or 10% of the aggregate of the dividend plus half the tax credit.

The treaties that contain these special provisions that allow a direct investor to claim payment of part of the tax credit are

• Belgium, see example 1.
• Italy, see example 1.
• Luxembourg, see example 1.
• Netherlands, see example 1, but no amount is payable for dividends paid on or after 6 April 2011.
•Sweden, see example 1.
• Switzerland, see example 1 but no amount is payable for dividends paid on or after 6 April 2009.

Example 1
Rate of tax credit is one ninth of the dividend.
Dividend £1,000,000
Tax credit £111,111.11
Dividend plus half tax credit £1,055,555.55
5% of dividend plus half tax credit £52,777.77
Payment is calculated as half tax credit (£55,555.55) less 5% of dividend plus half tax credit (£52,777.77) equals £2,777.78.

Example 2
(Direct investor company resident in Canada.) Dividend paid on or after 6 April 1999 rate of tax credit is one ninth of the dividend.
Dividend £1,000,000
Tax credit £111,111.11
Dividend plus half tax credit £1,055,555.55
10% of dividend plus half tax credit £105,555.55
Because the amount to be retained in the UK is greater than the original tax credit there is nothing to pay. £55,555.55 less £105,555.55 equals nothing (see Section 30(10) F(No2)A 1997.

20.7.4 *"Dividends"*

Article 10(3) defines dividends:

> The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

See Avery-Jones et al "The Definitions of Dividends & Interest in the OECD Model: Something Lost in Translation?" [2009] BTR 406.

20.7.5 *Dividends paid through PE*

Article 10(4) OECD Model provides:

> The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

20.7.6 *Dividends to company which is treaty resident in foreign state*

Article 10(5) OECD Model provides:

> Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

20.7.7 *Dual resident receives dividends from co resident in third country*

A person who is domestic-law UK resident but treaty-resident in a foreign state may receive dividends from a company which is not a resident of the foreign state.

A person in this category does not qualify for relief under article 10. However relief from UK tax is available under article 21(1) OECD Model (the "other income" article):

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

Dividends from companies in third countries are within this as they are "not dealt with in the foregoing Articles".

CHAPTER TWENTY ONE

ROYALTY INCOME

21.1 Royalties: Introduction

This chapter considers the income taxation of royalties. I use the term **"royalty income"** to mean royalties and other receipts from intellectual property. The topic requires a book to itself, and I focus on matters closest to the themes of this book.

I do not consider corporation taxation of royalties, or the EU interest and royalties directive 2003/49/EC of 3rd June 2003 which concerns interest/royalty payments made between associated companies of different member states. These topics would require long books to themselves.

21.1.1 *Cross references*

The following topics are considered elsewhere:
14.2 (Location of source of income: Territorial scope of IT)
14.9 (Split years: savings & investment & miscellaneous income)

21.2 Classification of royalty income for tax

Royalty income is classified for income tax purposes in one of three ways. Statute does not provide much terminology, so I coin the following terms:
(1) **"Trade royalties"**: royalties which constitute a receipt of a trade (or profession; I use the word "trade" to include a profession).
(2) **"Non-trade royalties"**: royalties which are not trade royalties. These may be:

(a) **"Annual payment royalties"**: royalties which are annual payments
(b) **"Non-annual payment royalties**"

The three categories are recognised in *Noddy Subsidiary Rights v IRC* 43 TC 458 at p.474:

> It seems to me that, where you have this position, that a person owns an asset of any kind, whether physical or not, and grants licences under it,

> the activities which he carries on in connection with the grant of those licences may amount to a trade and then Case I of Schedule D applies. On the other hand, at the other end of the scale, the activities may amount to the mere holding of an investment, so that the receipt of income is in the nature of pure income profit and then Case III of Schedule D applies. There may be intermediate cases in which Case VI of Schedule D might apply.

ITTOIA has changed the terminology but not the underlying categorisation.

21.3 Non-trade royalties

After the (somewhat unnecessary) introduction in accordance with the principles of plain English drafting, s.579(1) ITTOIA provides the charge to tax:

> Income tax is charged on royalties and other income from intellectual property.[1]

Section 580 ITTOIA provides:

> (1) Tax is charged under section 579 on the full amount of the income arising in the tax year.
> (2) Subsection (1) is subject to Part 8 (foreign income: special rules). ...

This incorporates the remittance basis for foreign source royalty income.

Non-trade royalties are taxable under chapter 2 part 5 ITTOIA. This is so whether or not the royalties are annual payments or non-annual payments. The distinction between (non-trade) royalties which are annual payments and those which are not (former DVI income) matters for the following reasons:

(1) Deductibility of expenses: Expenses are only deductible from non-

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1 Section 579(2) ITTOIA defines intellectual property:
"In this section "intellectual property" means—
(a) any patent, trade mark, registered design, copyright, design right, performer's right or plant breeder's right,
(b) any rights under the law of any part of the UK which are similar to rights within paragraph (a),
(c) any rights under the law of any territory outside the UK which correspond or are similar to rights within paragraph (a), and
(d) any idea, information or technique not protected by a right within paragraph (a), (b) or (c)."

annual payment royalties. Section 582 ITTOIA provides:

> (1) This section applies for calculating the amount of income charged under section 579 other than annual payments.
> (2) Expenses wholly and exclusively incurred for the purpose of generating the income are deductible...

(2) Non-residents income tax relief: Annual payment royalties constitute disregarded income and qualify for that relief. Non-annual payment royalties do not qualify.[2]

"Annual payment" is an opaque and unhelpful label for a technical term whose meaning is discussed in a large and rather difficult body of case law,[3] which cannot be discussed here.

21.4 Where is the source of non-trade royalties?

Foreign source royalties are outside the scope of withholding tax and (unless trade royalties) only taxed (if at all) as RFI, so the question of source matters to both payor and recipient.

What is the test to determine the source of non-trade royalties? The INT Manual provides:

> **342520. Copyright royalties** [April 2007]
> If the copyright is exploited in the UK the royalty payment will be regarded as having a UK source and therefore within the provisions of [what is now s.906 ITA]. This is irrespective of the law governing the contract.

The same view is expressed in Hughes & Payne, "Payments for the use of computer software and the deduction of income tax therefrom" [2000] BTR 5 at p.10. It is considered that this is correct.

Another passage in the INT Manual offers a different test:

> **161130. The source rule – concessions** [June 2013]
> ... If the owner of a right such as a patent, trademark or copyright is not engaged in any trade to which the right relates but derives income by exploiting that right, the source of the income may be regarded for the purpose of credit as located in the country where the right is

2 See 42.8 (Disregarded annual payments).

3 Section 582(7) ITTOIA specifies one rule: "The frequency with which payments are made is ignored in determining whether they are annual payments for the purposes of subsection (1)."

enforceable.

But as a result of developments in private international law, the place of enforcement is no longer a useful connecting factor for tax[4] (even though in most cases it will be the same as the place of exploitation).

21.5 Withholding tax

Section 906 ITA provides:

> (1) This section applies to any payment made in a tax year if—
> (a) it is a payment[5] of
> [i] any royalties, or
> [ii] sums payable periodically, in respect of a relevant intellectual property right (see section 907),[6]
> (b) it is one that is charged to income tax or corporation tax, and
> (c) condition A or B is met.

21.5.1 *Withholding tax conditions A and B*

Section 906(2) provides:

> Condition A is that the usual place of abode of the owner of the right is outside the UK.

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4 See 18.7.4 (Impact of changes in private international law).

5 Section 909(3) ITA extends withholding to payments on account:
(3) Section 906—
(a) applies to payments on account of royalties as it applies to payments of royalties, and
(b) applies to payments on account of sums payable periodically as it applies to payments of sums payable periodically.

6 Section 907 ITA defines "relevant intellectual property right":
(1) In section 906 "a relevant intellectual property right" means—
(a) a copyright,
(b) a right in a design, or
(c) the public lending right in respect of a book.
(2) In this section—
"copyright" does not include copyright in—
(a) a cinematographic film or video recording, or
(b) the sound-track of a cinematographic film or video recording, except so far as it is separately exploited,
"a right in a design" means the design right in a design, or the right in a registered design.
This definition takes film royalties outside the deduction of tax at source regime.

See 18.15 (Usual place of abode). Note the test is the place of abode of the owner of the right.

Condition B is an anti-avoidance rule. Section 906(3) ITA provides:

> Condition B is that—
> (a) a person ("the seller") has assigned the right to another person,
> (b) the usual place of abode of the seller is outside the UK,
> (c) the seller is entitled to periodical payments in respect of the right, and
> (d) the payments are in respect of that entitlement.

Section 906(4) ITA provides one exception:

> But this section does not apply if the payment is made in respect of copies of works, or articles, which have been exported from the UK for distribution outside the UK.

Section 906(5) ITA imposes the obligation to withhold tax:

> The person by or through whom the payment is made must, on making it, deduct from it a sum representing income tax on it at the basic rate in force for the tax year. ...

21.5.2 *Miscellaneous*

Section 908 ITA provides a deduction for commissions:

> (1) If—
> (a) a payment to which section 906 applies is made through an agent who is UK resident, and
> (b) the agent is entitled as against the owner of the right to deduct a sum as commission for services provided,
> section 906(5) and Chapters 8 (deduction at special rates), 15 and 16 (collection) apply as if the amount of the payment were the amount net of the sum deductible as commission.
> (2) But if the person by or through whom the payment is made does not know the commission is payable, or does not know its amount—
> (a) the sum representing income tax required to be deducted under section 906 must be calculated in the first instance on the total amount of the payment, and
> (b) the return to be made under Chapter 15 or the account of the payment under Chapter 16, must be based on that total amount.

Section 909(1) ITA is a timing provision:

> A payment to which section 906 applies is treated for all income and

> corporation tax purposes as made when it is made by the first person who makes it, not when it is made by or through any other person.

Section 909(2) ITA prevents contracting out:

> If, under section 906, a sum representing income tax must be deducted from a payment, any agreement to make the payment without deduction of that sum is void.

21.6 Trade royalties

21.6.1 *Trading rules apply*

The recipient of trade royalties has income of a dual character.

(1) The recipient has trading profits

(2) The receipt is also classified as "royalties" in the usual sense of the word.

Although the income has a dual character, there is only one charge to tax. The charge on trading profits under part 2 ITTOIA has priority over the charge on royalty income in part 5 ITTOIA. Section 575(1) ITTOIA provides:

> (1) Any income, so far as it falls within—
>
> (a) any Chapter of this Part, and
>
> (b) Chapter 2 of Part 2 (receipts of a trade, profession or vocation),
>
> is dealt with under Part 2.

21.6.2 *Source of trade royalty income*

The question whether the trading income has a UK source is naturally to be decided according to the rules which apply to trades/professions. Thus a UK resident trader has UK source trading profits even if the royalties come from abroad, since the trade is at least in part carried on in the UK.

What about trading income arising to a non-resident? There is commonwealth authority. In *Millin v IRC* a South African author received royalties from publishers in respect of works which were written by her in South Africa, but printed and published in England and the USA. This was trading income (or more accurately, professional income but the trade/profession distinction does not matter here). The Appellate Division held that the income arose wholly from a source within South Africa:

> ... the source of the whole amount received for royalties was in the

> Union.[7] It is true that in this case no capital in the ordinary sense of that term was employed by Mrs. Millin. It was the exercise of her wits and labour that produced the royalties. They were employed in the Union, and it matters not, on the analogy of the *Overseas Trust* case,[8] that the grant to her publishers of the right to publish her book was contained in a contract made in England. Her faculties were employed in the Union both in writing the book and in dealing with her publishers, and, therefore, on the test applied in the cases cited, the source of the whole of her income would be in the Union.[9]

21.6.3 *Position of payor of trade royalties*

If the royalties have a UK source, and the owner of the royalties is not in the UK, the deduction at source rules in principle apply. This is so even if the royalties are trade royalties, ie are taxable as trading receipt of the recipient. The fact that the recipient of the royalties is trading, in the UK or not, does not prevent the payment from being "royalties".

Similar principles apply to interest, which can also have the dual character of being interest and a trading receipt.

21.6.4 *Professional author exemption*

The International Manual provides:

> **342590. Professional authors** [April 2007]
> Copyright royalties that are payable to an author/originator of a literary, dramatic, musical or artistic work that has been created in the ordinary course of his profession (an "author by profession") fall into the same category as fees for professional services and do not come under [deduction at source rules]. Payments that are made to an author by profession who usually lives overseas are therefore not subject to deduction of UK income tax at source. This follows the decisions in *Carson v Cheyney's Executor* (38 TC 240) and *Hume v Asquith* (45 TC 251) ...
> A Professional Author can be classed as such if he is clearly the originator of the work(s) concerned. If the claimant is not the originator of the work but has acquired the rights from that person they may not be treated as a professional author.

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7 The Union of South Africa (1910-1961) was the predecessor to the present Republic of South Africa.

8 *Overseas Trust Corporation v IRC* [1926] AI 444, 2 SATC 71.

9 [1928] AD 207 at p.216.

This practice goes back to a Parliamentary statement:

> Mr Ashton asked the Chancellor of the Exchequer what steps he takes to recover tax on fees paid to British Nationals living abroad by publishers in this country.
> Mr Roy Jenkins. [The deduction at source rule for royalties] requires any person making such payments to deduct tax at the [basic] rate and to pay it over to the Inland Revenue. I am advised that this does not apply to payments made to those who are authors by profession... [10]

Payments to a professional author are said to be fees for services and not "royalties". This is odd, though the oddity is long-established and based on decisions of high authority. In practice it only matters where the author is resident in a jurisdiction without a DTA conferring relief. That would be fairly unusual, which may why the rule has survived.

The same rule must apply to post-cessation receipts. Payments to the executors of an author which are exempt from deduction at source (because they are not payment of "royalties") continue to be exempt after the death of the author.

21.7 DT relief for royalty income

Art 10.1 OECD model treaty provides:

> Royalties[11] arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

Art 10.3 and 10.4 contain two standard exceptions not discussed here.[12]

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10 Hansard HC debates 10 November 1969 vol 781 col 39.

11 Article 10.2 defines royalties:

> The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

12 "3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

4. Where, by reason of a special relationship between the payer and the beneficial

21.7.1 *Credit for foreign tax on royalties*

Foreign tax may be deducted at source from foreign trade royalties received by a person subject to UK tax on the trading profits. ESC B8 provides:

> **B8 Double taxation relief: income consisting of royalties and "know-how" payments**
> Payments made by a person resident in an overseas country to a person carrying on a trade in the UK as consideration for the use of, or for the privilege of using, in the overseas country any copyright, patent, design, secret process or formula, trademark or other like property
> [1] may in law be payments the source of which is in the UK,
> [2] but are nevertheless treated for the purpose of credit (whether under double taxation agreements or by way of unilateral relief) as income arising outside the UK except to the extent that they represent consideration for services (other than merely incidental services) rendered in this country by the recipient to the payer.

[1] is wrong or poorly expressed. The payments are not "payments the source of which is in the UK". They are receipts of a trade, and the *trading profits* (which are distinct from the payments) is income whose source is in the UK.
[2] is law and not concession, but it does not matter.
INT Manual expands on this:

> **161130. The source rule – concessions** [June 2013]
> *(B) Extra-Statutory concession ESC/B8 - DTR: royalties and 'know how' payments*]
> [The Manual sets out ESC B8 and continues:]
> b) Traders resident in the UK are not entitled to claim credit for any tax which is levied in the foreign country in respect of payments for services which are rendered in the UK and are not merely incidental services. In any such case the net amount of the payment (after deduction of any

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owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."

foreign tax borne by them on the payments) is included in the computation of profits for UK tax purposes.
The prohibition on credit for foreign tax charged on payments for services rendered in the UK may be overruled by the terms of those double taxation agreements which have a royalties Article which includes technical services in the definition of royalties (see INTM153130) or a separate technical fees Article (see INTM153140) and those agreements deem the source of such payments to be in the country of which the payer is a resident. In such cases, even though the services are rendered in the UK, credit is due for the foreign tax charged on these payments.

21.7.2 *Withholding tax when DT relief applies*

The UK operates a self-certification system. Section 911 ITA provides:

(1) This section applies if—
(a) a company pays a royalty from which it is required to deduct a sum representing income tax under Chapter 6 or 7,
(b) the income tax in respect of the payment is collectible under Chapter 15 or 16, and
(c) the company reasonably believes that, at the time the payment is made, the payee is entitled to relief in respect of the payment under double taxation arrangements.
(2) The company may calculate the sum to be deducted from the payment under Chapter 6 or 7 by reference to the treaty rate.[13]
(3) But, if the payee is not at the time entitled to such relief, this Part has effect as if subsection (2) had never applied in relation to the payment.

This only applies to company payors. In other cases, advance clearance is needed under the procedure discussed in the context of interest.[14]
Section 912 ITA allows HMRC to require withholding:

(1) This section applies if an officer of Revenue and Customs is not satisfied that the payee will be entitled to relief under double taxation arrangements in respect of one or more payments of royalties that a company is to make.
(2) The officer may direct the company that section 911 is not to apply to the payment or payments.

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13 Section 911(4) ITA defines "treaty rate": "In this section "the treaty rate" means the rate of income tax appropriate to the payee under the arrangements."

14 See 18.17.6 (Relief from withholding tax when DT relief applies).

(3) A direction under subsection (2) may be varied or revoked by a later direction.

Section 913 provides supplementary definitions:

(1) In sections 911 and 912 "royalty" includes—
(a) a payment received as consideration for the use of, or the right to use, a copyright, patent, trade mark, design, process or information, and
(b) the proceeds of the sale of the whole or part of any patent rights.
(2) In sections 911 and 912 "payee" means the person beneficially entitled to the income in respect of which the payment is made.

21.8 Films and sound recordings

Special rules apply to the exploitation of films and sound recordings. Section 609 ITTOIA provides:

(1) Income tax is charged on income from a business involving the exploitation of films or sound recordings where the activities carried on do not amount to a trade.
Such a business is referred to in this Chapter as a "non-trade business".
(2) Expressions which are used in this Chapter and in Chapter 9 of Part 2 (trade profits: films and sound recordings) have the same meaning in this Chapter as they do in that Chapter.

Section 610 ITTOIA provides:

(1) Tax is charged under this Chapter on the full amount of the income arising in the tax year. ...
(3) This section is subject to Part 8 (foreign income: special rules).

The charge applies to UK and foreign source income, but this incorporates the remittance basis for foreign source income.
Section 612 ITTOIA provides:

(1) This section applies for calculating the amount of income charged under this Chapter.
(2) Expenses wholly and exclusively incurred for the purpose of generating the income are deductible. ...

613 Application of trading income rules to non-trade businesses
The provisions of Chapter 9 of Part 2 apply in relation to non-trade businesses as they apply in relation to trades but as if—
(a) references to a basis period were to a tax year, and

(b) references to anything not constituting trading stock of a trade were omitted.

CHAPTER TWENTY TWO

EMPLOYMENT INCOME

22.1 Employment income: Introduction

The taxation of employment income is mainly governed by ITEPA 2003. Though dwarfed by the CTAs 2009 and 2010, ITEPA was for its day a mammoth Act: the table of contents is 36 pages long. More than two dozen volumes would be required for a full discussion.

The drafter of ITEPA was fond of signpost provisions and repetition, and believed very firmly in the value of dotting *I*'s and crossing *T*'s. That may be useful to a layman reading the statute unmediated by any other assistance: that reader needs all the help they can get! I find this approach makes a textbook exposition of the law rather more difficult, as there is much more statutory text to navigate than need have been. Behind what appear to be stylistic issues lie deeper questions: who are statutes written for? and how best to cater for different classes of readers with different needs? Be that as it may: we must take the text as we find it.

This chapter focuses on matters closest to the themes of this work, but the subject can only be understood in the context of the provisions as a whole, so I begin with a general outline which the more impatient reader may wish to skip.

I do not discuss employment-related securities or the rules for employment income provided through third parties (disguised remuneration), though I hope to do so in a future edition.

22.1.1 *Cross references*

The following topics are considered elsewhere:

23.1 (PAYE – Introduction)
45.5 (Employment-related loans)
48.1 (National insurance contributions)
74.3 (Home owned by company: benefit in kind charge)
74.30 (Chattels held by companies).

22.2 "Employer", "employee" and "employment"

Section 4 ITEPA provides relatively commonsense definitions of these terms.

Section 5 ITEPA extends the concept of "employment" to include offices (because directors need not as a matter of employment law be employees):

> (1) The provisions of the employment income Parts that are expressed to apply to employments apply equally to offices, unless otherwise indicated.
> (2) In those provisions as they apply to an office—
> (a) references to being employed are to being the holder of the office;
> (b) "employee" means the office-holder;
> (c) "employer" means the person under whom the office-holder holds office.

22.3 "Employment income" "general earnings" "specific employment income"

"Employment income" is the general term which is divided into two categories:

(1) general earnings
(2) specific employment income

"General earnings" and "specific employment income" are opaque technical terms.

22.3.1 *"General earnings"*

Section 7 ITEPA provides:

> (1) This section gives the meaning for the purposes of the Tax Acts of "employment income", "general earnings" and "specific employment income"...
> (3) "General earnings" means—
> (a) earnings within Chapter 1 of Part 3, or
> (b) any amount treated as earnings (see subsection (5)),
> excluding in each case any exempt income.
> (5) Subsection (2)(b) or (3)(b) refers to any amount treated as earnings under—
> (a) Chapters 7 to 9 of this Part (agency workers, workers under arrangements made by intermediaries, and workers providing services through managed service companies),

(b) Chapters 2 to 11 of Part 3 (the benefits code),
(c) Chapter 12 of Part 3 (payments treated as earnings), or
(d) section 262 of CAA 2001 (balancing charges to be given effect by treating them as earnings).

22.3.2 *"Specific employment income"*

Section 7 ITEPA provides:

> (1) This section gives the meaning for the purposes of the Tax Acts of "employment income", "general earnings" and "specific employment income"...
> (4) "Specific employment income" means any amount which counts as employment income (see subsection (6)), excluding any exempt income...
> (5) Subsection (2)(c) or (4) refers to any amount which counts as employment income by virtue of—
> (a) Part 6 (income which is not earnings or share-related),
> (b) Part 7 (income and exemptions relating to securities and securities options), or
> (c) any other enactment.

Specific employment income includes payments on termination of employment and employment-related securities.

22.3.3 *"Employment income"*

Section 7 ITEPA provides:

> (1) This section gives the meaning for the purposes of the Tax Acts of "employment income", "general earnings" and "specific employment income".
> (2) "Employment income" means—
> (a) earnings within Chapter 1 of Part 3,
> (b) any amount treated as earnings (see subsection (5)), or
> (c) any amount which counts as employment income (see subsection (6)).

22.4 The charge to tax on employment income

One might expect ITEPA to begin with a provision saying that income tax is charged on employment income. In fact this is implied rather than expressed: s.6 ITEPA provides:

> **Nature of charge to tax on employment income**
> (1) The charge to tax on employment income under this Part is a

charge to tax on—
(a) general earnings, and
(b) specific employment income.

Still, the imposition of the charge is clear enough. Section 6 continues:

(2) The amount of general earnings or specific employment income which is charged to tax in a particular tax year is set out in section 9.

Thus the legislation draws a distinction between what is charged (employment income) and the amount which is charged. This is familiar from other types of income.

22.5 Amount charged to tax (taxable earnings)

So we turn to s.9 ITEPA which provides:

(1) The amount of employment income which is charged to tax under this Part for a particular tax year is as follows.
(2) In the case of general earnings, the amount charged is the net taxable earnings from an employment in the year.

"Net" taxable earnings is a label which brings in rules relating to deductions, not discussed here.

"Taxable" earnings is a label which brings in a large number of rules, for in the various situations where the statute desires to bring earnings into charge in a year it provides that they are "taxable" earnings from the employment in that year.

Section 9(6) ITEPA provides:

Accordingly, no amount of employment income is charged to tax under this Part for a particular tax year unless—
(a) in the case of general earnings, they are taxable earnings from an employment in that year, ...

22.6 Taxable earnings

Section 10 ITEPA provides the starting point of the definition:

(1) This section explains what is meant by "taxable earnings" and "taxable specific income" in the employment income Parts.
(2) "Taxable earnings" from an employment in a tax year are to be determined in accordance with Chapters 4 and 5 of this Part.

So we move on to chapters 4 and 5 part 2 ITEPA. The pace is leisurely.

We eventually find four sections that identify amounts of taxable earnings: ss.15, 22, 26 and 27 ITEPA. There are four bases of taxation of employment income.

(1) The starting point is the arising basis applies to UK residents (unless one of the remittance basis applies).

(2) A remittance basis applies to foreign domiciled UK residents for two types of earnings:
(a) Chargeable overseas earnings **("COE")**
(b) Overseas workday relief earnings **("OWR earnings")**
They might be considered two routes to qualify for the remittance basis, but since the remittance basis rules differ somewhat between the two, they might better be considered as distinct remittance bases, **"the COE remittance basis"** and **"the OWR remittance basis"**.

(3) Non-residents are charged on UK earnings only.

The taxation of general earnings can be summarised in this table:

	UK Resident	UK Domicile	Taxable earnings	ITEPA Section	Part 2 Chap
Arising basis	Yes	n/r	All earnings: AB	15	4
COE Rem. Basis	Yes	No	(1) COE: RB (2) Other earnings: AB	22(2) 15	5
OWR Rem. Basis	Yes	No	(1) OWR earnings: RB (2) Other earnings: AB	26(2) 15	
			(1) Foreign earnings: no tax	27	
Non-resident	No	n/r	(2) UK earnings: AB	–	5

Key
AB: Arising basis
COE: Chargeable Overseas Earnings
OWR: Overseas workday relief
RB: Remittance basis

22.7 Earnings "for" a year, "from the employment in a year" and "received in a year"

ITEPA uses three distinct expressions:
(1) Earnings *"for" a tax year*.
(2) Earnings *from the employment in a tax year*.
(3) Earnings *received in a tax year*.
Earnings which are "for" one year may be earnings from the employment in a different year.

22.8 Earnings "for" a tax year

It is clumsy to refer to the year which earnings are "for". ITEPA sometimes resorts to quotation marks to help the reader grasp the elusive preposition. I adopt the statutory usage as a paraphrase is even more confusing, but sometimes expressions such as earnings "attributable to" or "relating to" or "earned in" a year would be easier to follow.

The concept is fundamental as the taxability of earnings depends on the employee's residence and domicile in the year which the earnings are "for". The policy behind this is that the timing of receipts may be arranged to ensure receipt in a year of non-residence; but one cannot so easily modify the year which earnings are "for".

The concept is (slightly) elucidated in s.16 ITEPA:

> (1) This section applies for determining whether general earnings are general earnings "for" a particular tax year for the purposes of this Chapter.
> (2) General earnings that are earned in, or otherwise in respect of, a particular period are to be regarded as general earnings for that period.
> (3) If that period consists of the whole or part of a single tax year, the earnings are to be regarded as general earnings "for" that tax year.
> (4) If that period consists of the whole or parts of two or more tax years, the part of the earnings that is to be regarded as general earnings "for" each of those tax years is to be determined on a just and reasonable apportionment.
> (5) This section does not apply to any amount which is required by a provision of Part 3 to be treated as earnings for a particular tax year.[1]

Since this section only applies for the purposes of chapter 4, it has to be repeated verbatim in s.29 ITEPA for chapter 5. (If there had been an ITEPA-wide definition the duplication would not have been necessary.)

This is only intended to set out the natural meaning that would have applied in the absence of a definition. EN ITEPA Note 6 provides:

> Sections 16 and 29 of the Act therefore spell out that general earnings are "for" a particular period consisting of the whole or part of a tax year if they are general earnings earned in or otherwise in respect of that period. It is thought that this reflects the meaning that a court would give to "for" if the point ever arose.

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1 This is a reference to s.72(2) ITEPA; see too s.222(2) ITEPA and 223(4) ITEPA for definitions in specialist circumstances.

The EI Manual provides:

40008. The year that earnings are "for" [January 2010]
... This question has no relevance when deciding the tax year in which the tax charge arises. Earnings are assessed to tax in the tax year in which they are "received". The definition of "received" is set out in Section 18 (see EIM42200).
Why is it important to know the tax year that earnings are "for"?
Section 16 establishes the year that earnings are "for". Once this has been done, the next step is to decide which of the rules in Part 2 Chapters 4 and 5 apply to calculate taxable earnings.
For the majority of UK Resident and Ordinarily Resident (R/OR)[2] and domiciled employees, the question of the year earnings are "for" has little consequence. This is because all of their earnings are chargeable to UK income tax in consequence of their residence and domicile status. In addition, most earn and receive their earnings in the same tax year. However, for those employees who are other than R/OR and UK domiciled and who receive earnings in different years from those in which they earn them, the question continues to be relevant.
Principles from case law
The absence of statutory provision in ICTA 1988 and earlier enactments resulted in various cases being litigated through the 20th century.
• *Edwards v Roberts* (19 TC 618)
• *Hunter v Dewhurst*, (*Henry v Foster*) (16 TC 605)
• *Draycup v Radcliffe* (27 TC 188)
• *Heasman v Jordan* (35 TC 518)
• *Board of Inland Revenue v Suite* ([1986] 2 All ER 577)
• *Griffin v Standish* (67 TC 317)
• *Bray v Best* (61 TC 705)
Before 1989, the year that earnings were "for" also dictated the year in which income tax was assessed. "Receipts basis" replaced "earnings basis" in 1989.
The case of *Bray v Best* (61 TC 705), was heard by the House of Lords in 1988. Lord Oliver set out the preferred approach at page 752:

> "The period to which any given payment is attributed is a question to be determined as one of fact in each case, depending upon all of the circumstances, including its source and the intention of the payer so far as it can be gathered either from direct evidence or from the surrounding circumstances."

Lord Oliver's approach to determining the year that earnings are "for" continues to apply. Section 16 simply confirms the recommended approach.
40009. The year that earnings are "for" - arrangement of guidance [March 2009]
In 2007 and 2008, HMRC consulted with professional advisers with particular expertise regarding the treatment of foreign nationals coming to work in the UK and UK residents leaving the UK to work abroad. Many of the advisers' clients have complex remuneration packages. Some are members of Long Term Incentive Plans or participants in other

2 The manual has not yet been revised following the abolition of ordinary residence in 2013, but that does not affect the points made here.

deferred remuneration schemes. The aim of the exercise was to establish principles for determining the tax year that earnings, delivered by these arrangements, are "for".
The guidelines set out on the following pages were adopted by HMRC with effect from 28 February 2008. They are intended to be comprehensive but do not claim to cover every plan and set of circumstances that will arise.
... The guidance sets out general principles and indicates the views HMRC is likely to take in specified circumstances. It is intended to aid and inform fact finding and decision making. It is not a substitute for obtaining all of the relevant information and exercising good judgment by applying the principles to the facts. This is not an easy task as you may be required to balance one set of conditions against others. (This text has been withheld because of exemptions in the Freedom of Information Act 2000)...

40011. The year that earnings are "for" - the approach to take [March 2009]

[The Manual repeats the quote from *Bray v Best* set out in EIM 40008 above, and continues;]

Finding out the facts

An essential starting point is to obtain contemporaneous evidence. This may include all or any of the following:

- An understanding of the intention of the employer in developing the incentive programmes
- Bonus plans
- Award letters
- Notes of meetings
- Correspondence between the parties
- Obtain an analysis of amounts paid out
- An explanation of how awards are treated in the employer-company accounts

These documents may indicate the understanding of the parties regarding the performance period that awards are intended to be "for". The intention of the employer as disclosed to the employee and the understanding of the employee are particularly significant.
Unsubstantiated recollections of the employee regarding intention should be considered but given less weight than contemporaneous documented statements.
If Plan documents and contemporaneous information do not provide clarity, it is reasonable to make inferences from available evidence.
You may ask the Large Business Team or CRM dealing with the Corporation Tax affairs of the employer company how the bonus awards have been treated in the employer company accounts. The company may claim a deduction for a single year or may create provisions to spread the deduction over a longer period. This may indicate the period the employer considers the award to be "for". The accounting treatment is not conclusive, but it is significant. In the absence of clear statements in the Plan documents the accounting treatment may be evidence of the employer's understanding of what the scheme was intended to achieve.
Lump sums may be made up of amounts arising from different bonus periods and different deferred remuneration plans. If component amounts are "for" different tax years, different rules within Part 2 Chapters 4 and 5 may apply, to produce different liabilities to income tax.

40012. Annual bonuses awarded for meeting corporate, team or personal targets [December 2011]

Many employers operate annual bonus schemes for their employees. There are usually

performance criteria. These may require employees to meet corporate, team or individual targets.

Bonuses may be paid out by the employer or through a trust - usually an employee benefit trust (EBT). The identity of the payer is not relevant when determining the year that the award is "for". However, see the guidance below on "discretion".

In some schemes, particularly those referenced to company performance, employees may accrue entitlement to receive bonuses as the performance period passes. In others, entitlement is conditional on remaining in employment until a specified date (see below). The performance period and therefore the period that the bonus is "for" may be set out in the scheme documents.

If the performance period spans more than one tax year, Section 16(4) ITEPA 2003 applies. The bonus should be apportioned to the relevant tax years on the basis of a just and reasonable apportionment.

Section 16 attributes general earnings to one or more tax years. You should not accept that awards can be "for" a shorter period, even a day, to which the rules in Part 2 Chapters 4 and 5 can be applied. Employers may spontaneously award "spot-bonuses" to all employees in post on a particular date, or entitlement to a performance bonus may crystallise when a particular performance factor is satisfied. Even though these events make take place on a particular day, the resultant awards should be treated as general earnings "for" the tax year in which the event occurred.

Unless there is evidence to the contrary, HMRC takes the view that performance bonuses are "for" the performance period. This may be a calendar year or the company accounting period. In the case of specific projects, it may be the period beginning on the date when work started and ending when the specified outcomes were achieved.

Impact of Extra Statutory Concession A11 (ESC A11)[3]

ESC A11 is a non-statutory concession that permits tax years to be split. It is usually relevant to years in which individuals arrive in or depart from the UK. In consequence of arrival or departure, there are discrete periods of non-residence (NR) and ordinary residence (OR) for tax purposes. If the conditions are satisfied, the tax year is split and each part treated as a separate tax year.

Where entitlement to spot bonuses or conditional bonuses arises on a single day the advice set out above indicates that the award is to be treated as earnings "for" the year in which that days falls. In ESC A11 cases this will be that part of the split year in which the relevant day falls.

Evidence suggests spot bonuses and similar payments are relatively unusual and will be seen infrequently. If you suspect that the timing of entitlement has been manipulated to gain a tax advantage from the use of ESC A11, HMRC may decide to set aside the Concession and treat the individual as resident in the UK for the whole tax year.

40013. Bonuses and deferred remuneration plans - the effect of conditionality and employer's discretion [March 2009]

Conditionality

Many bonus schemes are referenced to performance periods, but awards will not be paid unless employees are in employment on the date of payment. For example, a bonus is

3 The Manual has not yet been revised for the 2013 changes which have put the ESC on to a statutory basis, but the general points made here still apply.

referenced to company profits for year ended 31 December but is not paid until the following 30 June. Employees who worked for the employer during the performance year forfeit their entitlement if they leave employment before 30 June.

Up to 28 February 2008, HMRC took the view that the bonus award could only be "for" the year in which unfettered entitlement to receive it arose. The year that the bonus was "for" was the year in which the employment condition was satisfied. Since 28 February 2008, HMRC has adopted the principles set out in EIM40008 and subsequent pages.

Good and bad leavers

Many of the plans with employment conditions identify "good" and "bad" leavers and prescribe different treatments for the two categories. "Good leavers" are employees who cease employment before the bonus payment date through retirement, redundancy or ill-health. "Bad leavers" are those who are dismissed for cause or resign to join a competitor.

It is possible to take various views on the year that such bonus awards are "for" where there is an employment condition:

- The performance period
- The performance period plus the period from the end of the performance period to the date of payment, sometimes referred to as the "vesting period"
- The year in which the date of payment falls

Your decision should take account of what the bonus scheme is intended to achieve. If this is not clear from the documents, you may base judgments on how the employer treats good and bad leavers.

Plans that:

- are designed to provide incentives to employees for performance periods, but,
- do not pay out unless the participants are still in employment at the specified date, but,
- do not specify any additional performance conditions in the period beginning after the original performance period and ending on the payment date,

are likely to pay out awards that are "for" the original performance period. However, if the Plan introduces additional performance conditions for the second period the period that the award is "for" is likely to be the aggregate of both periods.

If "good leavers" are entitled to receive awards; that may indicate that the awards are "for" the original performance period. Entitlement to pro-rated awards may indicate that entitlement is "for" the performance and the vesting periods.

Some schemes provide for deferred bonuses to be paid out when ownership of the company changes hands. This may be an indicator that the bonus is earned by that date and is "for" the relevant performance period.

Even though these contingencies may not occur for all or any of the plan participants, their existence may shed light on the period the bonus is intended to be "for".

It is sometimes argued that the employment condition is never just about being in employment on the specified date; that the intention of the employer in introducing this condition is to obtain satisfactory performance in the period ending on the date of payment. This may well be the case. If evidence can be found to support the contention you should accept that the period the awards from the Plan are "for" is the combined performance and vesting periods.

Employers' discretion

Some bonus schemes give the employer absolute discretion to award or refuse to award bonuses. The discretion may lie with the trustees if an Employee Benefit Trust (EBT)

pays out the awards. The Courts have held that, whatever the Plan says, an employer's discretion in awarding or withholding a bonus is not unfettered. However wide the discretion appears to be, the employer is required to exercise his discretion rationally and in good faith, and not irrationally or perversely.

There may be a pattern of awards that may indicate the year the awards are "for". Employees may also have an understanding of how the bonus scheme works, and the period awards are referenced to, while accepting the employer's discretion.

A discretionary bonus may therefore be "for" the performance period, the combined performance and "vesting" period or the year in which discretion is exercised and payment is made. It is important to consider all of the relevant information.

40014. Long Term Incentive Plans and Deferred Remuneration [March 2009]

Various schemes exist to reward and provide incentives to employees. Not all intended outcomes will be the same. The intention of the employer and the intended behavioural effect will influence the design of the scheme. For example, plans may be intended to:

- Tie-in valued employees and create a disincentive for leaving and moving to a competitor, or,
- Motivate and reward outstanding performance by aligning the interests of employees with those of the shareholders

Schemes intended to aid retention may include the following features:

- Bonuses are paid after 3 – 5 years of satisfactory employment
- The employer has discretion to award or deny bonuses for good or bad leavers
- Part bonuses are paid year on year with other entitlement remaining in the Plan
- Part entitlement to bonuses "vests" each year, but is not paid until a later year

Schemes intended to motivate and reward outstanding performance may include:

- Employment targets linked to growth in the company's:
  - share price
  - turnover
  - net profits
  - expansion of certain markets
  - market share
- Granting employees real stocks and shares or "phantom" shares in the company. (In the phantom schemes, no stocks or shares are assigned to the employees. Bonus entitlement is calculated by reference to a notional share portfolio.)

Payments may be made up of amounts arising from different bonus periods and different deferred remuneration plans. If component amounts are "for" different tax years, different rules within Part 2 Chapters 4 and 5 may apply, to produce different liabilities to income tax.

Awards from both types of schemes are likely to be "for" the whole performance or reference period. If this is greater than one tax year then the final award should be apportioned over the tax years falling into the performance period on a reasonable basis.

40015. The year that awards from Long Term Incentive Plans and other deferred remuneration arrangements are "for" [March 2009]

Entry to Long Term Incentive Plans (LTIPs)

If employees perform exceptionally well, they may be invited to participate in an LTIP. LTIPs run for pre-determined period that can be as long as 10 years. This process may repeat year after year so that employees are simultaneously members of several Plans. In any particular year they may receive part awards from some and entire awards from

others.

The initial investment is often funded by part of the participant's bonus for the previous year. The employee may be obliged to defer all or part of the previous year's bonus or may do so voluntarily. Plans may require a mixture of the two. The initial contribution may be guaranteed, in the sense that it cannot be lost, and/or it may have the potential to increase and decrease dependant on what the Plan tracks, for example, share price or company turn-over.

Other plans, particularly phantom share schemes, may simply award notional stock without any requirement for deferral from an earlier bonus.

In addition to the anticipated growth in the share price that adds value to the participants' awards, employers may make additional awards of stock to increase the value of the notional portfolio. These "matching awards" may be granted throughout the life of the scheme at times specified in the plan document.

Deferred bonuses and matching awards

Employers may defer the payment of bonuses and make eventual payment subject to conditions. For example, the employer awards a bonus of £100,000 referenced to a performance period. £75,000 is paid in cash immediately following the bonus year; £25,000 is to be paid three years later in cash or shares, if the employee has not resigned or been dismissed before the vesting date. Such a deferral may be imposed by the employer, or it may be entered into voluntarily by the employee. To develop the example, the £25,000 deferral may be required by the employer but the employee has the choice of voluntarily deferring a further £25,000. In both scenarios, the employer may offer an enhancement or matching award. The matching award may be delivered in the form of shares or cash. The matching award may be added to the LTIP at the beginning of the period. Additional matching awards may be added at specified dates during the deferral or vesting period.

What year are LTIP awards "for"?

It is important to consider all of the relevant facts. The deferred bonus may be "for" the original bonus year, or for the whole deferral period. If there is particular emphasis on the employee remaining in service at a future date, it may be for the tax year in which that condition is met. However, this feature is unlikely to exist in isolation as the employer wants to motivate the employee to perform well while remaining in employment. In order to determine the period that the deferred bonus is "for", it is necessary to consider all of the relevant information and weigh the emphasis given to each factor.

In general terms, simple deferred bonuses will remain earnings for the original bonus period, and growth or matching awards will be "for" the deferral period. In more sophisticated schemes where the deferred bonus is "awarded" and "vests" after the bonus year, and especially where there are further performance conditions relating to this period, the deferred bonus may be earnings for the period between award and vest.

There may also be circumstances where "growth" in the value of the fund is treated as being "for" the performance period of the original deferred bonus. This view is likely where no additional performance criteria are imposed during the deferral period or, if there are, the conditions are the same as for the deferred bonus.

If the conditions are significantly different, e.g. the matching awards are conditional upon new performance criteria, the "growth" or matching awards are likely to be "for" the deferral or vesting period itself.

If the conditions of the matching award are referenced solely to the employee remaining

in employment on the vesting or payment date in order to receive payment, the matching award is likely to be earnings for the tax year in which entitlement to receive the award matures.

Enhancements or matching awards may be paid out of LTIPs at the same time as deferred bonuses. Awards may be aggregated amounts that are "for" different periods. It is important to understand how sums are calculated and whether different performance periods should be considered.

40016. Long Term Incentive Plans and Deferred Remuneration – staged vesting [Mar 2009]

Some Long Term Incentive Plans (LTIPs) pay out awards in tranches. The details of different schemes will vary. For example, an LTIP fund containing deferred bonuses and matching awards may pay out 20% per annum over five years or nothing in Years 1 and 2 and 33% per annum in Years 3 to 5. Entitlement may be conditional upon participants meeting performance conditions and remaining in employment.

The period that each tranche is "for" has to be determined. If the evidence shows that the Plan is intended to reward performance over the period from award to vest, each part of the final payment is "for" the period from the original award date until it vests, calculated as per Section 16(4) on a just and reasonable apportionment. In the first example, 20% is "for" Year 1; 20% is "for" Years 1 and 2, and so on. Alternatively, if there are no performance conditions and the Plan emphasises being in employment at each vesting date, each payment may be treated as earnings "for" the tax year of receipt.

22.9 Pre-commencement and post-cessation earnings

There are special rules for pre-commencement and post-cessation earnings. Section 17 ITEPA provides:

> (1) This section applies for the purposes of this Chapter in a case where general earnings from an employment would otherwise fall to be regarded as general earnings for a tax year in which the employee does not hold the employment.
>
> (2) If that year falls before the first tax year in which the employment is held, the earnings are to be treated as general earnings for that first tax year.
>
> (3) If that year falls after the last tax year in which the employment was held, the earnings are to be treated as general earnings for that last tax year.
>
> (4) This section does not apply in connection with determining the year for which amounts are to be treated as earnings under Chapters 2 to 11 of Part 3 (the benefits code).

Since this section only applies for the purposes of chapter 4, it has to be repeated verbatim in s.30 ITEPA for chapter 5.

The EI Manual provides:

> **40005. Special rules for determining the year that general earnings**

> **are "for": Pre-commencement and post-cessation earnings**
> **...** [February 2006]
> It is unlikely the rules will often apply in practice because general earnings can normally be attributed to periods in which the job is held.
> **40006. Effect of non-residence on pre-commencement and post-cessation earnings** [January 2009]
> Where the special rules in [s.17 ITEPA] apply general earnings will be taxable when received if the charging provisions in Sections 15 or 27 apply ... in the last or first year the taxpayer held the job. The same is true if the taxpayer left the job at the time of going abroad.
> ...
> **40007. Effect of non-residence on pre-commencement and post-cessation earnings: Examples** [January 2010]
> This page provides examples of how the above sections apply. ...

The first example concerns pre-commencement earnings of an employee who is resident and domiciled throughout:

> ***Example 1***
> An employee is approached by another employer. She is offered a job by the new organisation. As an inducement to change jobs she is paid £50,000 on 1 April 2009. She commenced work for the new employer on 1 May 2009. The employee is resident, ordinarily resident and domiciled in the UK so the relevant charging provision is Section 15 in Part 2 Chapter 4.
> Section 17 operates to make the payment earnings of the year in which the employment commences. Even though paid in tax year 2008/2009 they are earnings "for" the year 2009/10.

The Manual then considers whether domicile makes any difference:

> The result will be the same if the employee is resident, ordinarily resident but not domiciled in the UK.

It is assumed that the earnings are not chargeable overseas earnings.[4] The Manual now considers someone becoming UK resident:

> ***Example 2***
> An employee worked in Singapore for many years for a UK resident company. The employment ceased on 31 December 2008. For 10 years prior to that date the individual was not resident and not ordinarily resident although domiciled in the UK. On 6 April 2009 the employee

4 See 22.11 (COE remittance basis).

returned to the UK. From the date of arrival he became resident and ordinarily resident.
6 months after the job ended the employer made a payment of £50,000 to the former employee in recognition of the contribution he had made to the expansion of business in the Far East.
Section 17 makes the payment earnings of the year in which the employment was last held, 2008-2009. In that year the employee was not resident in the UK and performed all of the duties in Singapore. In consequence, the payment does not fall into any of the charging provisions in Part 2 Chapters 4 and 5 and is therefore not chargeable to tax as general earnings.

22.10 Resident UK domiciled employee

Section 15 ITEPA provides:

> (1) This section applies to general earnings for a tax year for which the employee is UK resident ...[5]
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.
> (3) Subsection (2) applies whether or not the employment is held when the earnings are received.

Section 15 sets out the general rule: in short, all earnings are "taxable earnings" and taxed on receipt, on an arising basis.

"Receipt" is defined in ss.18, 19 ITEPA (not discussed here).

The s.15 rule has two exceptions:

(1) COE remittance basis[6]
(2) Overseas workday relief[7]

22.10.1 *Split year*

Section 15(1)(1A) ITEPA need to be read together:

> (1) This section applies to general earnings for a tax year for which the employee is UK resident except that, in the case of a split year, it does not apply to any part of those earnings that is excluded.
> (1A) General earnings are "excluded" if they—
> (a) are attributable to the overseas part of the split year, and

5 The omitted words deal with split years and are considered below.
6 See 22.11 (COE remittance basis).
7 See 22.17 (Overseas workday relief).

(b) are neither—

(i) general earnings in respect of duties performed in the UK,[8] nor

(ii) general earnings from overseas Crown employment subject to UK tax...[9]

Section 15(4) ITEPA deals with attribution:

> Any attribution required for the purposes of subsection (1A)(a) is to be done on a just and reasonable basis.

22.11 COE remittance basis

The chargeable overseas earnings (COE) remittance basis is one of the two remittance bases for which UK resident foreign domiciled individuals may qualify.[10]

Section 809F ITA provides:

> (1) This section applies if section 809B, 809D or 809E applies to an individual for a tax year.
> (2) The individual's relevant foreign earnings for that year are charged in accordance with section 22 or 26 of ITEPA 2003.

So we turn to s.22 ITEPA which (somewhat repetitively) provides:

> (1) This section applies to general earnings for a tax year, to the extent that they are chargeable overseas earnings for that year, if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year, and
> (b) the employee does not meet the requirement of section 26A for

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8 Defined by reference: Section 15(5) ITEPA provides:
"The following provisions of Chapter 5 of this Part apply for the purposes of subsection (1A)(b) as for the purposes of section 27(2) ...
(b) sections 38 to 41 (which contain rules for determining the place of performance of duties of employment), and
(c) section 41ZA (which is about determining the extent to which general earnings are in respect of UK duties)."

9 Defined by reference: Section 15(5) ITEPA provides:
"The following provisions of Chapter 5 of this Part apply for the purposes of subsection (1A)(b) as for the purposes of section 27(2)—
(a) section 28 (which defines "general earnings from overseas Crown employment subject to UK tax")"
See 22.31 (Overseas Crown employment).

10 See 22.6 (Taxable earnings).

that year.

The point of para (b) is that Overseas Workday Relief (which is more generous) has priority, if it applies.

> (2) The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year. ...

In short, the remittance basis applies to chargeable overseas earnings. Section 22(7) ITEPA provides:

> Section 15(1) does not apply to general earnings within subsection (1).

Thus earnings which are not chargeable overseas earnings continue to fall under the s.15 arising basis.

22.11.1 *Transitional rules for pre-2008 earnings*

Suppose:
(1) Chargeable overseas earnings accrue to T before 2008/9 and
(2) The earnings are remitted in 2008/9 or later (when T is still resident).
In the absence of a transitional rule, the earnings would not be taxable under s.22 ITEPA because the condition in s.22(1)(a) would not be met. Sections 809B, 809D or 809E did not apply before 2008. Para 82(2)(a) Sch 7 FA 2008 fills that gap:

> (1) This paragraph applies in relation to an individual's general earnings for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if the individual—
> (a) was UK resident in that year, but
> (b) was not domiciled in the UK, or was not ordinarily UK resident, in that year.
> (2) Section 22 or 26 of ITEPA 2003 (as amended by this Part of this Schedule) applies in relation to the general earnings as if—
> (a) section 809B of ITA 2007 (claim for remittance basis to apply) applied to the individual for the relevant tax year and
> (b) section 22(7) or 26(6) of ITEPA 2003 were omitted.

I think para 82(2)(b) is misconceived, though it does no harm.

22.12 Chargeable overseas earnings

The expression "chargeable overseas earnings" is a label which brings in two sets of requirements: the earnings must be "overseas" earnings and

they must be "chargeable". The key part of the definition is "overseas earnings".

22.12.1 *"Overseas" earnings*

Section 23(2) ITEPA provides:

> General earnings for a tax year are "overseas earnings" for that year if—
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year,
> (aa) the employee does not meet the requirement of section 26A [OWR] for that year,
> (b) the employment is with a foreign employer, and
> (c) the duties of the employment are performed wholly outside the UK.

22.12.2 *"Chargeable" overseas earnings*

The concept of "chargeable" overseas earnings brings in rules for deductible expenses and associated employments. Section 23(3) ITEPA provides:

> (3) To calculate the amount of "chargeable overseas earnings" for a tax year—
> *Step 1*
> Identify—
> (a) in the case of a tax year that is not a split year, the full amount of the overseas earnings for that year, and
> (b) in the case of a split year, so much of the full amount of the overseas earnings for that year as is attributable to the UK part of the year.
> *Step 2*
> Subtract any amounts that would (assuming they were taxable earnings) be allowed to be deducted from the earnings identified under step 1 under—
> (a) section 232 or Part 5 (deductions allowed from earnings),
> (b) sections 188 to 194 of FA 2004 (contributions to registered pension schemes), or
> (d) section 262 of CAA 2001 (capital allowances to be given effect by treating them as deductions from earnings).
> *Step 3*
> Apply any limit imposed by section 24 (limit where duties of associated employment performed in UK).
> The result is the chargeable overseas earnings for the tax year.

Section 23(4) ITEPA provides:

> Any attribution required for the purposes of step 1 or step 2 in subsection (3) is to be done on a just and reasonable basis.

22.12.3 *Transitional rule for pre-2008 earnings*

Suppose earnings accrue before 2008/09. At first sight the earnings cannot be "chargeable overseas earnings" within the definition of s.23(2) ITEPA since they do not meet the condition in s.23(2)(a): section 809B, 809D, or 809E did not apply before 2008/09. Moreover, para 82 which fills that gap in s.22 does not fill the gap in s.23. Construed strictly, therefore, pre-2008 earnings which were not remitted before 6 April 2008 have fallen out of charge!

However, I expect that the courts will to strive to construe the section avoid that result. After all, it is obvious (and para 82 confirms) that this result was not intended. One way to do that is to say that if income arises before 2008, the question of whether it constitutes chargeable overseas earnings is to be decided by reference to the legislation in the year that it arises and not the legislation in the year that it is remitted. It has to be said that para 82(3) sch 7 FA 2008 would not then be necessary. The alternative is to read para 82(2) as if it applied to s.23 as well as to s.22 and 26. Neither of these solutions is comfortable reading, but the conclusion that all pre-2008 earnings fall out of charge seems even worse. This is only one of many infelicities in the 2008 legislation: but a modern court will strive to make it work.

22.13 Foreign employer

Section 23(2) ITEPA provides:

> General earnings for a tax year are "overseas earnings" for that year if ...
> (b) the employment is with a foreign employer...

The definition is in s.721(1) ITEPA:

> "foreign employer" means an individual, partnership or body of persons resident outside the UK and not resident in the UK.

EI Manual provides:

> **40102 Taxable earnings: Employee resident and ordinarily resident in the UK: "chargeable overseas earnings"** [January 2009]
> An employee may maintain that general earnings are chargeable overseas

> earnings taxable on remittance under section 22 rather than on receipt ... This is likely to lead to a significant reduction in the amount of taxable earnings. You should examine the facts closely before accepting that earnings are chargeable overseas earnings within section 22. In particular you should find out whether the employer has any place of business in the UK. If you can trace an accounts file for the employer, ask the accounts Inspector for instructions on the employer's residence status.

While tax rules often turn on whether a person is resident in the UK, it is rare to see a requirement that they must be resident outside the UK.[11] It is suggested that this should be removed so that the only requirement is that the employer is non UK resident. It should not matter whether or not they are resident elsewhere. In practice I doubt it is possible to be non UK resident without being resident outside the UK, so this simplification makes no practical difference and has no cost implication.

22.14 Incidental duties in UK

Section 23(2) ITEPA provides:

> General earnings for a tax year are "overseas earnings" for that year if ...
> (c) the duties of the employment are performed wholly outside the UK.

Section 39 ITEPA elucidates this concept:

> (1) This section applies if in a tax year an employment is in substance one whose duties fall to be performed outside the UK.
> (2) Duties of the employment performed in the UK whose performance is merely incidental to the performance of duties outside the UK are to be treated for the purposes of this Chapter as performed outside the UK.

In other words, UK duties may be ignored if they are "merely incidental" to the performance of the other duties outside the UK. What are incidental duties? HMRC interpret this strictly. The EI Manual provides:

> **40203 Employee resident, ordinarily resident or domiciled outside the UK: location of duties: "merely incidental" duties** [August 2012]
> The case of *Robson v Dixon* (48 TC 527) involved a pilot, resident and ordinarily resident in the UK, who was employed by a Dutch airline. He flew aircraft from Amsterdam to various parts of the world. There were relatively few take-offs and landings in the UK [on average, seven per annum]. He claimed that the small number of take-offs and landings meant that his duties in this country were

11 For an exception, see 28.4.3 ("Resident outside the UK").

"merely incidental" to those performed abroad. The Courts rejected his claim on the grounds that the test is one of quality, not quantity. The Judge commented that the core duties of a pilot include landing and taking off in aircraft. So when the aeroplane landed in the UK the pilot was performing substantive duties of his employment.

Quality not quantity of duties

The case of *Robson v Dixon* established that it is the quality not the quantity of duties performed in the UK that determines whether or not they are "merely incidental". However, where the employee works in the UK for more than three months in a year, you should not accept that work can be "merely incidental".

Statement of Practice A10: airline pilots

Despite the decision in *Robson v Dixon* a single take off and landing in the UK in any year is disregarded on de minimis grounds in considering whether any duties are performed in this country.[12]

Dealing with cases

It is not possible to list "merely incidental" duties. Substantive and "merely incidental" duties are relative and specific to employments. It is important to obtain as much information about the employment and employee as possible. The following list of documents is not intended to be comprehensive:

- employment contract
- job description
- summary of main duties and responsibilities
- business diaries and travel details.

These may help but if at all possible arrange a meeting with the employee to obtain information first hand. Once you have a clear idea of the main duties you are in a position to take a view as to what are "merely incidental"...

40204. Employee resident, ordinarily resident or domiciled outside the UK: Location of duties: "merely incidental" duties: Examples [August 2012]

The following examples illustrate how particular situations should be treated.

Example 1

An overseas marketing executive of a UK employer spends the majority of each year working overseas. Visits to the UK total less than three months in a year. While in the UK the representative carries out the following duties:

- reports on trade conditions and results in the territory
- establishes questions of policy
- receives instructions
- collects samples in preparation for the next tour.

The duties performed in the UK should be regarded as "merely incidental". If the employee is not ordinarily resident the duties may be disregarded and the general earnings arising from them not charged under Section 15 [ITEPA]. A charge may arise under Section 26 if the earnings are remitted here (see EIM40301).

Example 2

An overseas employee visits the UK and whilst here arranges a meeting with a

12 [Author's Note] SP A10 is officially withdrawn; but there has been no announcement that HMRC now adopt a different practice.

client overseas and the associated travel. As long as the employee does no more than arrange the meeting and travel, the duties performed are regarded as "merely incidental".

Example 3

The director of a limited company usually works abroad, but attends directors' meetings in the UK.

Attendance at board/directors' meetings is a fundamental and joint duty of a board of directors to manage the company. Therefore performance of these duties in the UK can never be "merely incidental" to work done overseas, even if the board member participates from the UK in a board meeting held overseas, for example via a telephone or video conference. Preparation in advance of board meetings (e.g. for a presentation) is also unlikely to be merely incidental to other duties, as preparation is essential to the contribution in the subsequent meeting.

Example 4

A courier for a tour operator visits many countries in the course of the employment. Visits to the UK, however few and however short, are of the same importance to the job as visits to other countries and therefore cannot be "merely incidental".

HMRC say:

Background to the exception for merely incidental duties

15. The Royal Commission Report [on the Taxation of Profits and Income][13] published in 1955 stated (paragraph 300)

"We recommend that work is not the less to be treated as performed wholly in one country because certain ***merely incidental duties,*** *such as returning for report, to acquire samples, etc., are carried out in another."*

16. Subsequently section 11(3) Finance Act 1956 addressed the circumstances where an employee would otherwise be chargeable to tax–

"*(3) Where an office or employment is in substance one of which the duties fall in the year of assessment to be performed outside the UK there shall be treated for the purposes of this section as so performed any duties performed in the UK the performance of which is* ***merely incidental*** *to the performance of the other duties outside the UK."*

17. However, the term "merely incidental" duties was not defined in FA1956 or in subsequent legislation. Following a common dictionary definition of "incidental", as something that is minor, casual or subordinate in nature, the Inland Revenue (as it was at the time) considered that a duty that formed part of the essential or fundamental requirements of the employment could not be incidental.

Robson v Dixon (48 TC 527)

18. This is the only case where the courts have considered the meaning of "merely incidental" duties. It was decided in the High Court in 1972 and concerned section 10 and 11 of the Finance Act 1956. Mr Robson was an airline pilot who lived in the UK but commuted to work in Amsterdam, where he was employed by a Dutch

13 Cmd 9474.

airline.

19. Robson flew aircraft on scheduled flights from Amsterdam to various parts of the world, mainly North and South America. None of the flights in the years under appeal commenced in the UK but of 811 take-offs and landings, 38 were made in the UK of which 16 were charter flights, which were outside his normal duties (he made in total only 22 charter flight landings and take-offs).

20. Robson contended that as his duties were performed substantially outside the UK, any duties in the UK were therefore merely incidental to his substantive duties abroad. Pennycuick VC disagreed –

> *"The expression "merely incidental" is a striking one, and effect must be given to the natural meaning of the words. The words "merely incidental to" are upon their ordinary use apt to denote an activity (here the performance of duties) which does not serve any independent purpose but is carried out in order to further some other purpose.*

The judge set out the duties performed by Robson and went on:

> *In the present case, the duties performed by the taxpayer, apart from his duties on the ground at Schiphol, mainly consisted (putting it shortly) of taking a plane up at Schiphol, flying it to whatever its destination was and then bringing it down. In the case of the flights from Schiphol to some destination (normally in America) on which there was a stop at England, his duties consisted of taking the plane up at Schiphol, flying it to England, bringing it down at Heathrow or elsewhere, and then taking it up again and flying it again to the next destination, in America. With the best will in the world, I find it impossible to say that the activities carried on in or over England are merely incidental to the performance of the comparable activities carried on in or over Holland or in or over the ultimate destination, in America. The activities are precisely co-ordinate, and I cannot see how it can properly be said that the activities in England are in some way incidental to the other activities. Going back to the words of the section, when one asks, 'What exactly are the other duties outside the UK to which the performance of the duties are incidental?', no satisfactory answer can be given. The other duties are simply co-ordinate duties.*

21. Pennycuick was clear as well that the test of "merely incidental duties" is one of quality not quantity –

> *"Again, I think it is impossible to construe s 11(3) in the way in which it was sought to construe it in the taxpayer's contentions in the case stated, as indicating merely relatively short periods of employment in the UK in relation to the period of employment outside the UK. It would have been quite simple for the section so to provide; and it may well be that if the condition were imported only by the expression 'in substance', that would be the result. But the second requirement is expressed in quite different terms and cannot, I think, be treated as referring merely to what has been described as a quantitative, in contra-distinction to a qualitative, basis. ...*
>
> *It would be tempting to say that all the duties performed by a pilot are incidental to the purpose of transporting passengers from one place to another, but that approach clearly would not help here. What has to be shown is that the particular duties in the UK are incidental to the performance of other particular duties outside the UK."*

22. Consequently duties performed in the UK that are the same or similar in nature to those performed overseas are not merely incidental to the overseas duties, even if performed for only a very short time. They are, in Pennycuick's words, "precisely co-ordinate" and therefore of equal importance to the duties performed overseas.

Tax Bulletin 76

23. Inland Revenue published a Tax Bulletin article in April 2005 titled "Non-domiciled employees: dual contract arrangements" which referred to a range of issues relating to dual contract arrangements, including "merely incidental" duties and to the decision in *Robson v Dixon*.

24. TB76 explained that given the ease and speed of twenty first century communications, an employee who performs duties of one employment overseas and another in the UK, is liable to find it increasingly difficult whilst working in the UK to avoid performing substantive duties of their overseas employment. For example, HMRC take the view that an employee working in the UK under a UK contract to service the needs of UK clients, but also responsible under their overseas contract for servicing the business needs of overseas clients, who responds to a telephone call or e-mail from an overseas client performs a substantive duty of the overseas employment. A response sent from the UK to an overseas client, is no different from a response sent from abroad to the same client. It represents a "precisely co-ordinate" duty.

Statement of Practice A10 – de minimis

25. In *Robson v Dixon*, Inland Revenue accepted that a landing in the UK caused by an emergency (e.g. due to weather conditions or mechanical trouble) might be regarded as incidental to duties performed outside the UK.

26. After the decision was handed down, counsel for Robson asked if the de minimis principle could apply to one of the years under appeal in which Robson completed only one take-off and landing in the UK. Despite his decision that the test of "merely incidental" duties was one of quality and not quantity, Pennycuick agreed that this would be "proper" for a single event in a year. SP A10 was published in 1975 as a response to Pennycuick's comments.

> *"Where only a single take-off and landing in this country occurred in a year, the Inland Revenue will normally disregard this on de minimis grounds in considering whether any duties were performed in this country."*

27.However, in another year, in which Robson performed four take-offs and landings in the UK (two for emergencies, plus two others for unspecified reasons) the Judge declined to accept the request for a de minimis exclusion.

Director - duties never merely incidental

28. The general principle in relation to a company director is that the management of a company is vested collectively in the board of directors. Therefore when a director attends a meeting of the board, HMRC takes the view that he or she performs a fundamental duty which is not "merely incidental" to other duties.

29. Consequently a director who in substance performs his duties overseas, except for visits to the UK to attend a meeting (whether as part of a formal board meeting or otherwise) cannot, in the view of HMRC, be within the exception in s39. Attendance at board meetings is part and parcel of a director's core duties and therefore if performed in the UK cannot be incidental to duties performed abroad.

A director's attendance at other meetings (e.g. finance, strategy, personnel) is also likely to represent a substantive duty, because the director would not attend these meetings unless participation was deemed necessary.

[Para 30-32 discuss the former s.830 ITA; this concerns residence, not employment income.

Examples of duties that are "merely incidental"

33. To determine whether duties performed in the UK are "merely incidental" to duties performed overseas, it is necessary to consider both the nature of the duties performed in the UK and their relationship to the duties performed abroad.

34. Ultimately each case will depend on its particular facts but the types of activities, if performed in the UK in relation to the duties of an overseas employment, which can be regarded as "merely incidental" duties include –

- arranging meetings and business travel;
- feedback on employee performance and/or business results, if this does not involve the employee concerned in preparation or analysis whilst in the UK and as long as responsibility for these matters is not part of the employee's core duties of employment;
- input to team restructuring and staff matters, provided that the employee does not have a management role; and
- reading generic business e-mails that do not relate directly to the employee's role/responsibilities.

35. The examples below illustrate some situations where duties are regarded by HMRC as "merely incidental" -

A. A junior employee who works for an overseas subsidiary of a UK company who, on occasional visits to the UK headquarters, presents a report prepared by the overseas business to report on trade conditions or results overseas, and/or receive instructions for the next tour of duty overseas. The employee performs no other duties in the UK and has no control over the overseas activities on which he reports and is required only to pass on the report from his overseas employer and to take instructions from the UK company to take back to the overseas employer. These duties are regarded as "merely incidental" to his overseas duties.

B. An overseas employee visits the UK and whilst here arranges a meeting with a client overseas and the associated travel. As long as the employee does no more than arrange the meeting and travel, the duties performed are regarded as "merely incidental".

C. Whilst in the UK, an employee of an overseas subsidiary receives an e-mail documenting the employer's global business results for the year. The employee is provided with the results for his information and is not required to take any further action or feedback to the sender of the e-mail. The reading of such an e-mail is "merely incidental" to those duties performed overseas. However, if the employee had any role or responsibility in producing the global results, and/or was involved in feedback or in confirming the results, reading the e-mail is not a "merely incidental" duty.

Examples of duties that are not "merely incidental"

36. Types of activities performed by an employee that are not regarded as "merely incidental" duties include -

- instructions and/or guidance to colleagues and/or team members;

- work carried out on issues or projects that do not come to fruition;
- reporting on performance/business results where these matters are part of the employee's core duties;
- analysis of reports/information with the intention to produce results/recommendations that can be reported upwards in the organisation;
- preparation work carried out prior to discussions, meetings or presentations with customers/clients, colleagues, board members or shareholders and follow-up work after such discussions, meetings or presentations;
- discussions and meetings (including by telephone, teleconference or video conference) with customers/clients, colleagues, board members or shareholders; and
- applying generally expertise in any role or function which the employee is contracted to perform in his or her duties for the employer.

37. The examples below illustrate some situations where duties are not "merely incidental" -

A. A courier for a tour operator visits many countries in the course of the employment. Visits to the UK, however few and however short, are of the same nature to the job as visits to other countries and therefore cannot be "merely incidental".

B. Preparation in advance of a presentation to, and/or a meeting/discussion with, customers or potential customers, or actions subsequently which result from decisions taken in the presentation or meeting/discussion are not merely incidental to other duties, as preparation in advance and follow-up work afterwards are essential to an employee's effective participation in a presentation and/or meeting/discussion.

C. A company director, who works overseas for a UK based multinational company, usually participates by video conference in board meetings held each month in the UK. However, sometimes the director visits the company headquarters in the UK and attends in person at monthly board meetings. As attendance at board meetings is a core function and fundamental joint duty of a board of directors to manage the company, attendance at a board meeting cannot represent "merely incidental" duties, regardless of the fact that the director does not normally attend the meeting in person.

D. A company director who is resident in the UK has two directorships within the same overseas based group. One role is as CEO of the UK subsidiary and the other as a board member of the overseas parent company. The parent company's board meetings are held monthly in the overseas location and the director usually attends in person. However, sometimes he participates in the board meetings by telephone or video conference from the UK. As attendance at board/directors' meetings is a fundamental and joint duty of a board of directors to manage the company, participation from the UK in the parent's board meetings can not be "merely incidental" to duties performed overseas.

E. An employee of an international bank based in Frankfurt, visits a UK branch of the bank. Whilst in the UK branch, the employee responds to an investment enquiry sent by email from a customer of the bank in Germany. This represents a duty of his employment in Germany and by answering the email from the UK he performs a duty that is "precisely co-ordinate" with his duties in Germany.

Consequently this cannot be a "merely incidental" duty.

Merely incidental duties: HMRC policy

38. Over more than half a century since the Royal Commission Report was published in 1955 and the introduction of the term "merely incidental" duties in FA1956, working arrangements have changed considerably.

39. At that time it was unusual for one employee to perform duties of two or more employments in different countries. Where such arrangements existed, there was likely to be a physical separation of duties between the two roles because of the restricted availability of effective international communications.

40. Clearly that is no longer the case but should the enormous advances in communications which allow an employee now to perform duties of an overseas employment and an UK employment consecutively, if not concurrently, be sufficient reason for HMRC to change its interpretation of, and policy for, "merely incidental" duties? The Royal Commission provided the example of a junior employee working in one country, returning to another country to report or to collect samples, as the type of duties that it considered should be "merely incidental". These duties would be still regarded as such today – see Example A in paragraph 35 above.

41. On the other hand, where duties performed in the UK are the same as, or similar to, duties performed overseas, they cannot be "merely incidental" because they are "precisely co-ordinate" duties.

42.HMRC accepts that it may be difficult in some circumstances for an employee to avoid performing co-ordinate duties unless, for example, the employee declines whilst in the UK to answer a mobile telephone, or respond to an e-mail, from an overseas client.

43. However, to apply a broader interpretation of "merely incidental" to duties performed in the UK, than would apply otherwise to similar duties performed overseas, in HMRC's view would be not consistent with the Royal Commission in 1955, the case law in *Robson v Dixon* or the legislation.

44. Consequently HMRC does not believe there is good reason to revise its interpretation of "merely incidental" duties set out in the Tax Bulletin in 2005 and reiterated in this paper.[14]

It is in practice just about impossible for a UK resident to satisfy the "incidental duties" requirement if it is understood in this way. HMRC have (more or less) got an arising basis for employment income which, in everyday language, is income of an overseas employment and so foreign income, through the rigorous statutory interpretation of *Robson v Dixon*.[15] So unless the matter comes to be reviewed by the courts, the only solution

14 "Dual contracts: record keeping, enquiries, completion of Self Assessment Returns and interpretation of "merely incidental" duties" published 19/3/2012. *http://www.hmrc.gov.uk/menus/dual-contracts.pdf*

15 A similar process applied to bring foreign trading income on to an arising basis: see 15.3 (Trading income of UK resident).

is dual contract arrangements.

22.15 Dual contract arrangements

EI Manual discusses dual contract arrangements. The manual first explains the planning:[16]

> **77030 Appendix 3: Non domiciled employees: Dual contract arrangements** [February 2006]
> ... The legislative scheme ... is advantageous to employees or office holders who can show that they are:
> - resident and ordinarily resident but not domiciled in the UK and
> - perform duties of an office or employment under a foreign employer wholly outside the UK.
>
> As chargeable overseas earnings are taxed on remittance, there is a clear incentive to ensure that such earnings are paid overseas and to minimise the amount of earnings remitted to the UK. However, the requirement that the duties of the employment are performed wholly outside the UK presents problems to foreign domiciled employees whose jobs require them to work partly in the UK and partly abroad. Earnings from an employment with duties performed in and outside the UK would be taxable under section [15 ITEPA] wherever received. An employee may therefore be offered two employment contracts, for example:
> Contract 1 covering the performance of duties in the UK and
> Contract 2 with an associated employer resident overseas covering duties performed in the rest of the world excluding the UK.
> The intention is that earnings from employment contract 2 will be chargeable overseas earnings and therefore taxable under section 22 only when remitted to the UK. For this reason, dual or multiple employment arrangements are popular with foreign domiciled employees whose duties are performed partly in the UK and partly outside the UK. The arrangement is generally that the individual enters into two separate written contracts, frequently referred to as the UK employment contract and the overseas employment contract.

Assuming the non-resident status of the employer and the non-domiciled status of the employee, HMRC can attack the planning in the following ways:

(1) Allege there is only one contract of employment (see below).

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16 An earlier version of the text was in Tax Bulletin 76 (also classified as RI 273). See Ladkin, "Domicile: Working at Home and Abroad" *Taxation*, 27 March 2003, p.632.

(2) Allege some duties of the "overseas" employment are performed in the UK; see 22.14 (Where are duties performed: incidental duties).
(3) Apportionment arguments (see below).

22.15.1 *One contract of employment or two?*

The EI Manual continues:

> **77030 Appendix 3: Non domiciled employees: Dual contract arrangements** [February 2006]...
> *Enquiries into dual contract arrangements*
> HMRC offices may make enquiries in order to check whether the earnings under the overseas contract are chargeable overseas earnings. They may also consider whether there is in fact a single employment contract notwithstanding the production of two written contracts. This approach has generally been deployed where there is concern that there has been an attempt to split a single employment to exploit the legislation that provides for chargeable overseas earnings to be taxed on remittance.
> Employers, employees and their advisers maintain that there are separate and distinct employments. They invariably argue that the employee performs a different role with different responsibilities under each contract of employment and that the duties under each do not overlap and are not dependent on each other. In many cases written contracts have been drafted that fairly represent the true employment relationships and include a proper job description along with details of the remuneration package and other entitlements (annual leave etc) relating to each employment. Care has been taken to ensure that the roles described in each contract are capable of independent existence with proper regard given to what would happen on termination of one of the employments. Best practice has recognised the importance of maintaining separate payroll and expenses regimes and different line management and reporting arrangements.
> Where there are two employment contracts and the written contracts reflect this, dual contract arrangements provide a legitimate way to structure an individual's employment relationships. Where the arrangements reflect the true employment relationships, enquiries focus on:
> - whether the employee has in fact performed substantive duties under the overseas contract in the UK
> - whether a section 24 adjustment is needed to address an imbalance between the earnings from the UK and overseas contracts.

22.15.2 *Are some duties performed in the UK?*

The EI Manual goes on to consider this line of attack:

Given the way in which modern business operates and the ease and speed of communication, some employees may find it increasingly difficult to avoid performing substantive UK duties under their overseas contracts. For example, an employee who is responsible under their overseas contract for servicing the business of overseas clients may have to respond to a telephone call or e-mail from a worried overseas client with an urgent problem when the employee is in the UK. Formulating and communicating a response to such a problem would be regarded as a fundamental duty under the overseas contract. It follows that the performance of such duties in the UK will not be merely incidental to the performance of duties outside the UK as they will be of equal importance to the overseas duties. It is the quality of the UK duties and not the time devoted to their performance that determines whether they are merely incidental.

The EI Manual then considers and dismisses a possible defence:

Recent developments

In a number of cases, the duties required under each purported employment contract are defined according to where those duties are performed. For example, the UK contract states that the duties of the employment are all those duties performed in the UK whereas the overseas contract states that the duties of the employment are all those duties performed wholly overseas. Employees and their advisers may contend that all overseas duties are duties of the overseas employment and all UK duties are duties of the UK employment. On that analysis, duties performed in the UK in connection with the business of the overseas employer are performed under the terms of the UK contract and are not duties of the overseas employment.

HMRC does not consider that the existence of separate and distinct employments is determined by the terms of written contracts where the main distinction between the duties required under each contract is geographical. There are concerns that arrangements of this nature artificially divide a single job so earnings attributable to overseas duties can be treated as chargeable overseas earnings. HMRC has received legal advice that supports a robust challenge to such arrangements.

The commercial context

As a result of the legal advice referred to above, HMRC considers that a dual contract arrangement based solely or mainly on a geographical split of employment duties without commercial underpinning is vulnerable to challenge on the grounds that there is in reality a single employment with duties in and outside the UK. In such cases, HMRC offices should fully investigate the facts and circumstances including the commercial rationale and context and assess an employee to tax where the evidence shows that

there is in fact a single employment.

HMRC takes the view that a dual contract arrangement is unlikely to work unless there are two distinguishable jobs. For example, a French resident employer 'A' sends employee 'B' who is domiciled outside the UK to establish an office in London for its UK subsidiary 'C'. A requires B to work in its Paris office servicing their existing portfolio of French clients two days per week. On the other three days, C requires B to work in London. This is likely to constitute a proper basis for B holding separate employment contracts with A and C.

In order to decide whether the arrangements create two employments, rather than artificially divide a single employment for tax purposes, it is appropriate to look at the economic advantage that an employer gains from the employee's activity. If the contractual arrangements are to have any meaning, they must be seen in the context of the underlying commerciality of the arrangements. Regardless of there being two written contracts, HMRC would not accept that there were two employments if the risks and rewards relating to work done in the UK and overseas were in fact substantially borne and received by a single employer. Moreover, an arrangement requiring a written contract between an employee and a UK employer which provides only for the performance of duties in the UK would appear artificial if the employer's business extends outside the UK. An employer's interest does not lie in having the employee work in a defined geographical area but in an economic activity that benefits the employer. An employee may perform duties overseas that directly benefit the business of the UK employer. When performing those duties, the employee is not working for the overseas employer but for the UK employer overseas. If the arrangement were genuine, the employee would not be paid by the overseas employer to work for the UK employer overseas. If that is what the contract requires, it would indicate a lack of commerciality. Conversely, an employee who performs duties in the UK that directly benefit the business of the overseas employer is working for the overseas employer in the UK. It is difficult to imagine circumstances in which contracts that can require an employee to work for the benefit of a UK employer whilst being paid by an overseas employer or vice versa would be offered by employers that were not associated.

Various mechanisms exist for allocating costs to another entity that benefits from an employee's services. These include transfer pricing adjustments. It has been suggested that such adjustments restore the commercial equilibrium and thus support the existence of separate employments. However, the fact that such adjustments are necessary indicates that the employer has misjudged the commercial reality of the arrangements. Separate employers do not for sensible commercial reasons

> pay employees to work for someone else, with or without transfer pricing. Dual contract arrangements are sometimes used when a UK resident employee holding one employment with worldwide duties first becomes ordinarily resident. Some individuals who are self employed before they arrive in the UK become employees with dual contract arrangements on attaining UK resident and ordinarily resident status without any significant change in the way in which they carry out their professional activities. In other cases, recruitment material suggests that the employer has a single vacancy to fill and a dual contract arrangement is only implemented following the appointment of a non-domiciled individual. In such scenarios, HMRC offices will test whether the facts reflect commercial reality.

This is very doubtful. Whether two contracts of employment exist is a matter of contract law, not of commercial reality. Whether or not it is described as artificial is not the test.

The EI Manual continues:

> **77030 Appendix 3: Non domiciled employees: Dual contract arrangements** [February 2006]...
> *Overseas contracts and UK duties*
> Where the commercial reality shows the existence of separate employment contracts, it is sometimes argued that contractual terms that prohibit the performance in the UK of duties connected with the business of the overseas employer, preclude HMRC offices from arguing that the employee has performed duties of the overseas employment in the UK. These arguments are based on the UK duties being "ultra vires".
> HMRC does not consider that the presence of such clauses allows the performance of duties in the UK that clearly benefit the overseas employer to be ignored. To that end, both employers ought to be closely monitoring the employee's UK activities. For example, where the employee has performed substantive duties in the UK that directly benefit the overseas employer, HMRC would expect the UK employer to mark the fact that the employee is effectively abusing its time and take appropriate disciplinary action. And if the UK work in question was valuable, the overseas employer should take it into account when calculating bonus entitlement. It is possible that clauses like this are frequently waived or ignored and may be inserted to create a misleading impression.

This may be correct but it depends on the facts of the case.

> *Tax impact where dual contract arrangements fail*
> Where the facts indicate that there is, in commercial reality, only one employment contract whereby the employee performs duties for the

> benefit of one employer both in and outside the UK, all of the employee's general earnings will be taxable under section 21 ITEPA. As earnings attributable to overseas duties will not be chargeable overseas earnings, tax will be charged on receipt rather than on remittance to the UK. The identity of the "employer" will depend on all the facts and circumstances of the individual case.

As a matter of contract law, I think this is wrong. If the drafting is correct, there will be two separate contracts. The fact that on HMRC analysis it is unclear who is the employer suggests there must be something wrong with it.

The HMRC view might conceivably be defended on the basis of *IRC v Scottish Provident Institution* 76 TC 538: the two contracts being regarded as one composite contract for tax purposes, even though they are (if the drafting is right) separate contracts as a matter of contract law. But that assumes that dual contracts are contrary to the intention of parliament which is (to say the least) very far from clear.

The EI Manual then turns to PAYE:

> However, the UK entity that receives the benefit of an individual's services will be obliged to apply PAYE to all payments of PAYE income made to the employee during the period that the employee works for that entity. This is because the UK entity will either be the employer or (for the purposes of section 689 ITEPA) the relevant person.
>
> If there are genuine separate employments but the employee has performed substantive duties in the UK for the overseas employer, then all earnings from the overseas contract will be taxable under section 21 in the relevant year. They will not qualify as chargeable overseas earnings under section 22 because the duties of employment with a foreign employer will not have been performed wholly outside the UK in the year in question. There is unlikely to be an obligation to operate PAYE on earnings from the foreign employer, as that employer will not have the necessary presence in the UK for PAYE purposes, and the UK employer will not be the relevant person in relation to duties performed by the employee under the separate overseas employment.

The EI Manual concludes with a comment on NIC:

> *National Insurance*
>
> Where for tax purposes the facts indicate that despite the existence of two written employment contracts, there is a single employment covering UK and overseas duties, there could also be National Insurance consequences. If it is found that the earnings relating to overseas duties are attributable

to employment with the UK employer, there will be liability to pay further National Insurance.

The first sentence is tentatively expressed; the Manual wisely does not try to grapple with the complexities of NIC.[17]

22.15.3 *Apportionment*

Section 24 ITEPA prevents an over-generous attribution of income to the foreign contract:

(1) This section imposes a limit on how much of an employee's general earnings are chargeable overseas earnings for a tax year under section 23 if—
(a) in that year the employee holds associated employments as well as the employment to which subsection (2) of that section applies ("the relevant employment"), and
(b) the duties of the associated employments are not performed wholly outside the UK.
(2) The limit is the proportion of the aggregate earnings for that year from all the employments concerned that is reasonable having regard to—
(a) the nature of and time devoted to each of the following—
(i) the duties performed outside the UK, and
(ii) those performed in the UK, and
(b) all other relevant circumstances.
(2A) If the tax year is a split year as respects the employee, subsection (2) has effect as if for "the aggregate earnings for that year from all the employments concerned" there were substituted "so much of the aggregate earnings for that year from all the employments concerned as is attributable to the UK part of that year
(3) For the purposes of subsection (2) "the aggregate earnings for a year from all the employments concerned" means the amount produced by aggregating the full amount of earnings from each of those employments for the year mentioned in subsection (1) so far as remaining after subtracting any amounts of the kind mentioned in step 2 in section 23(3).
(3A) Any attribution required for the purposes of subsection (2A) is to be done on a just and reasonable basis.
(4) In this section—
(a) "the employments concerned" means the relevant employment and the associated employments;
(b) "associated employments" means employments with the same employer or with associated employers.
(5) The following rules apply to determine whether employers are associated—
Rule A An individual is associated with a partnership or company if that individual has control of the partnership or company.

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17 See 48.1 (National insurance contributions).

Rule B A partnership is associated with another partnership or with a company if one has control of the other or both are under the control of the same person or persons.

Rule C A company is associated with another company if one has control of the other or both are under the control of the same person or persons.

(6) In subsection (5)—

(a) in rules A and B "control" has the meaning given by section 995 of ITA (in accordance with section 719 of this Act), and

(b) in rule C "control" means control within the meaning given by sections 450 and 451 of CTA 2010 (meaning of expressions relating to close companies).

(7) If an amount of chargeable overseas earnings is reduced under step 3 in section 23(3) as a result of applying any limit imposed by this section, the amount of general earnings corresponding to the reduction remains an amount of general earnings within section 15(1).

22.15.4 *Implications for employer*

The former Inspectors Manual para 5348 provided:

> Apart from the Schedule E implications there are other questions to consider:-
>
> [1] Is the cost of remunerating the individual under his contract for overseas duties effectively borne by a UK company and claimed as a deduction in computing profits which are chargeable to Corporation Tax? If so, there is a mismatch which will need to be considered with some care.
>
> [2] Do the individual's activities under the contract for overseas duties generate income, and if so to whom does it accrue? Is income which would otherwise accrue to a company which is liable to Corporation Tax being routed to an overseas company?
>
> [3] If the profits of a company which is liable to Corporation Tax are computed on a cost plus basis are the costs being depressed by reason of the split employment?

Point [1] raises deductibility issues; point [2] raises Controlled Foreign Company issues; point [3] raises transfer pricing issues. All these should be considered before entering into dual contract arrangements.

22.15.5 *Record keeping*

HMRC say:

> 4. For the purpose of enquiries into dual contract arrangements, HMRC considers it is reasonable to require access to the following documents, for some or all of the period under review:

- diaries
- e-mails
- expenses claims and supporting receipts
- telephone records
- client files.

5. A document means anything in which information of any description is recorded. This includes records held on a computer, on magnetic tape, optical disk (CD-ROM/DVD), hard disk, memory stick, flash drive, floppy disk or other recording media.

6. Where such records are in the possession of the employee, HMRC would expect the individual to comply with Section 12B TMA 1970 and retain any documents or information that would have enabled him or her to deliver a complete and correct return, until the later of either the closure of the enquiry window or, if applicable, the date an enquiry into the return is closed.

Section 12B TMA provides:

(1) Any person who may be required by a notice under section 8, 8A …11 or 12AA of this Act …17 to make and deliver a return for a year of assessment or other period shall—

(a) keep all such records as may be requisite for the purpose of enabling him to make and deliver a correct and complete return for the year or period; and

(b) preserve those records until the end of the relevant day ...

HMRC continue:

7. However where the employee does not have power or possession of the documents, HMRC will consider approaching the employer for the records they hold.

8. HMRC has sometimes experienced difficulty in obtaining documents which have not been retained by the employer. In a spirit of collaborative engagement HMRC asks all employers who utilise dual contract arrangements to implement a retention policy that will retain relevant documents for at least two years from the end of the tax year to which the document relates.

9. HMRC has also sometimes experienced difficulties in obtaining documents which have been retained by the employer or the employee. HMRC will not hesitate to use the powers in Schedule 36 Finance Act 2008 to require production of documents. Where the individual is employed by an overseas employer and the information is not available to the individual, HMRC will make full use of Exchange of Information powers with the relevant overseas authorities.

Multiple risks
10.HMRC will address all avenues of enquiry into dual contract arrangements (e.g. those relevant to both employee and employer) as equal risks from the outset of the enquiry; no risks will be deferred pending the outcome of enquiries into others. This should serve to mitigate some of the delays and other problems sometimes faced in obtaining the relevant records.[18]

22.15.6 *Disclosure of dual contracts on tax return*

HMRC say:

Self Assessment
11. An employee who has dual (or multiple) contracts of employment is required to complete a separate Employment page of the Self Assessment Tax Return for each employment, as specified at page EN1 of the Tax Return Guide.[19]

22.16 Statutory dual contract rules

HMRC verbal attack on dual contract arrangements was not altogether successful[20] and HMRC did not feel sufficiently confident in their view to defend it before the Tribunal. Instead the FA 2014 introduces new rules which I call **"the statutory dual contract rules"**. These rules are in addition to the rules set out above, thus adding another layer of legislation. They will prevent use of split year contracts in most cases.

Development of the rules can be traced through draft legislation, together with a TIIN published in January 2014, but that is now of historic interest only.

HMRC have issued guidance **("HMRC dual contract guidance")**.[21]

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18 "Dual contracts: record keeping, enquiries, completion of Self Assessment Returns and interpretation of "merely incidental" duties" published 19/3/2012.
http://www.hmrc.gov.uk/menus/dual-contracts.pdf

19 "Dual contracts: record keeping, enquiries, completion of Self Assessment Returns and interpretation of "merely incidental" duties" published 19/3/2012.
The reference is to the form SA102 notes (Employment Notes).
http://www.hmrc.gov.uk/menus/dual-contracts.pdf

20 This can be seen from the TIIN estimate of the yield of the statutory dual contract rules:

2015/16	2016/17	2017/18	2018/19	
£75m	£55m	£55m	£60m	*Revised TIIN (19 March 2014)*

21 Restrictions on the remittance basis – dual contracts (18 July 2014)
http://www.hmrc.gov.uk/international/dualcontracts.pdf

22.16.1 *"Relevant" employer/employee and other definitions*

It is helpful first to deal with the definitions used. Section 24A(4) ITEPA provides:

> In this section—
> (a) "the relevant employee" means the employee in respect of the relevant employment,
> (b) "the relevant employer" means the employer in respect of the relevant employment, and
> (c) "UK employment" means an employment the duties of which are not performed wholly outside the UK and "UK employer" is to be read accordingly...

22.16.2 *The statutory dual contract rule*

Section 24A(1) ITEPA provides:

> This section applies in relation to an employment ("the relevant employment") for a tax year ("the relevant tax year") if—
> (a) one or more of the paragraphs in subsection (5) applies,[22]
> (b) conditions 1 to 4 are met, and
> (c) condition 5 is not met.

I refer to **"dual contract conditions 1 - 5"**.

Section 24A(2) ITEPA provides:

> The consequences of this section applying are set out in sections

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22 This will normally be the case. Section 24A ITEPA provides:

(5) The paragraphs referred to in subsection (1)(a) are—

(a) general earnings from the relevant employment which are for the relevant tax year would, apart from section 23(1A) and Step 3 in section 23(3), be "chargeable overseas earnings" under section 23(3);

(b) employment income in respect of the relevant employment which is treated as accruing in the relevant tax year under section 41C(2) would, apart from sections 41C(4A), 41D and 41E, be "foreign" under section 41C(3);

(c) employment income in respect of the relevant employment which is treated as accruing in the relevant tax year under section 41H(2) would, apart from sections 41H(5), 41I and 41L, be "chargeable foreign securities income" under section 41H(3);

(d section 554Z9(2) would, apart from section 554Z9(1A) and (4) and (5), apply to employment income in respect of the relevant employment which corresponds to the value of a relevant step, or a part of the value of a relevant step, which is "for" the relevant tax year as determined under section 554Z4."

23(1A), 41C(4A), 41H(5) and 554Z9(1A).

The main rule is in s.23(1A) ITEPA which provides:

> But none of an employee's general earnings from an employment for a tax year are to be "chargeable overseas earnings" if section 24A applies in relation to the employment for the tax year.

This disapplies the employment income remittance basis and brings the earnings back to the arising basis.

Section 24A(3) ITEPA provides an exception:

> But, for the purpose of determining if, and the extent to which, any provision of Part 11 (PAYE), or of PAYE regulations, applies in relation to any income, the application of any provision mentioned in subsection (2) in relation to the income is to be ignored.

22.16.3 *Dual contract condition 1: UK employment*

Section 24A(6) ITEPA provides:

> Condition 1 is that the relevant employee holds a UK employment—
>
> (a) at a time in the relevant tax year when the relevant employee also holds the relevant employment, or
>
> (b) if the relevant tax year is a split year as respects the relevant employee, at a time in the UK part of the relevant tax year when the relevant employee also holds the relevant employment.

22.16.4 *Dual contract condition 2: Associated employers*

Section 24A(7) ITEPA provides:

> Condition 2 is that the UK employer is the same as, or is associated with, the relevant employer.

Section 24A(4) ITEPA provides:

> ...the rules in section 24(5) ("associated" persons)[23] apply for the purposes of this section.

22.16.5 *Dual contract condition 3: Related employments*

The definition of related employment is wide and vague. Section 24A

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23 See 22.15.2 (Apportionment).

ITEPA provides:

> (8) Condition 3 is that the UK employment and the relevant employment are related to each other.
> (9) Without prejudice to the generality of subsection (8), the UK employment and the relevant employment are to be assumed to be related to each other if one or more of the following paragraphs applies—
>
> (a) it is reasonable to suppose that—
>
> (i) the relevant employee would not hold one employment without holding the other employment, or
>
> (ii) the employments will cease at the same time or one employment will cease in consequence of the other employment ceasing;
>
> (b) the terms of one employment operate to any extent by reference to the other employment;

HMRC dual contract guidance provides:

> **When might the terms of employments operate by reference to each other?**
> Employments might operate by reference to each other in lots of different ways, and will depend on the individual circumstances. You should take into consideration the terms of your employment contract, as well as the commercial reality of the relationship between your employments.
> For example, the contracts may take into account hours worked or leave taken under the other contract or may refer directly to duties performed under the other contract. There may be other circumstances in which the employments deal with the same customer or clients, so you will need to consider your individual circumstances.

> (c) the performance of duties of one employment is (wholly or partly) dependent upon, or otherwise linked (directly or indirectly) to, the performance of duties of the other employment;

HMRC dual contract guidance provides:

> **How can the duties of different employments be linked?**
> Generally, employment duties will be linked where one employment's duties enables the other employment duties to be carried out. For example, where an individual carries out research under one employment, and under their other employment carries out marketing

work made possible by the research. Duties of different employments may be linked in a number of different ways, and will depend on the facts of your individual circumstances.

(d) the duties of the employments are wholly or mainly of the same type (ignoring the fact that they may be performed (wholly or partly) in different locations);

HMRC dual contract guidance provides:

When might the duties of the employments be of the same type?
Where the duties of two or more employments are the same, but the client base or geographical location differs, the duties of the employments are of the same type. For example, marketing under a UK contract to UK clients has duties of the same type to an overseas contract involving marketing to clients in the rest of the world. There may be other circumstances in which the duties of the employments are of the same type, and you will need to consider your individual circumstances.

(e) the duties of the employments involve (wholly or partly) the provision of goods or services to the same customers or clients;

HMRC dual contract guidance provides:

When do employments deal with the same customer or clients?
The employments will deal with the same customer or clients where duties are performed in the provision of goods or services to the same customer or client. For example, if you give financial advice to a client under one employment and manage that client's investments under another employment. This might apply equally to an individual client, a group of clients or a client base. There may be other circumstances in which the employments deal with the same customer or clients, and you will need to consider your individual circumstances.

(f) the relevant employee is—

(i) a director (as defined in section 67) of the UK employer or the relevant employer who has a material interest (as defined in section 68) in the UK employer or the relevant employer,

(ii) a senior employee of the UK employer or the relevant employer, or

(iii) one of the employees of the UK employer or the relevant employer who receives the higher or highest levels of remuneration.

The term "senior employee" is not defined; it is a novel concept in tax law (or indeed in any area of the law). HMRC dual contract guidance provides:

> **What does the term senior employee mean?**
> Whether you are a senior employee will depend on the facts of your case, taking into account your responsibilities and the size, nature and structure of your employer's organisation. HMRC will generally consider that employees involved in higher-level management and decision-making will be senior. For example, the following might be classed as activities of senior employees:
> • you are responsible for implementing higher-level or global business strategies
> • you participate in higher-level decision-making relating to management issues, finance, corporate restructuring or governance
> These indicators are not intended as a definitive list and you will need to consider your individual circumstances.
> **What does higher or highest paid mean?**
> The higher or highest levels of pay refers to the total pay from your UK and overseas employments, and whether your pay level is high relative to other employees in the same group of companies. There is no absolute level of pay that is relevant – rather it is a matter of comparing your overall remuneration from all your related employments to that of your fellow employees. HMRC considers that if you would be liable to tax at the additional rate on your combined pay (ignoring personal reliefs like donations to charities), it will be a good indication of an employee who is higher or highest paid. The UK additional rate of Income Tax is the highest rate for the tax year. Follow this link to see the UK's Income Tax rates and taxable bands. Pay includes any amounts which would constitute earnings, an amount treated as earnings or specific employment income.

(10) In subsection (9)(f) references to the UK employer or the relevant employer include references to—

(a) any person with which the UK employer or the relevant employer (as the case may be) is associated, and

(b) if the UK employer or the relevant employer (as the case may be) is a company, the following companies taken together as if they were one company—

(i) the UK employer or the relevant employer (as the case may be), and

(ii) all the companies with which the UK employer or the relevant employer (as the case may be) is associated.

The statute includes a power to amend this by statutory instrument.[24] I am not sure if that is because the drafter did not have complete confidence in this definition, or to anticipate criticism as to its breadth. I do not expect that the power will ever be used.

It is hard to see that many, if any, dual contracts would not be caught by one of dual contract conditions 1 - 3.

22.16.6 *Dual contract condition 4: 65% foreign tax credit*

Section 24A ITEPA provides:

> (13) Condition 4 is that X% is less than Y%.
> (14) "X%" is given by the following formula — (C÷I) × 100%
> See section 24B for the definitions of "C" and "I".
> (15) "Y%" is 65% of the additional rate for the relevant tax year.
> (16) The Treasury may by regulations amend this section so as to amend the definition of "Y%".

So we turn to s.24B ITEPA for the definitions of C and I. In short:

C is foreign tax **C**redit.

I is the dual contract **I**ncome.

In full detail, s.24B ITEPA provides:

> (1) This section applies for the purposes of section 24A(14).
> (2) "C" is the total amount of credit which would be allowed under section 18(2) of TIOPA 2010 (double taxation relief by way of credit) against income tax in respect of all the employment income falling within section 24A(5)(a) to (d) were none of that income to be, as relevant—
> (a) "chargeable overseas earnings",
> (b) "foreign",
> (c) "chargeable foreign securities income", or
> (d) income to which section 554Z9(2) applies.
> (3) For this purpose, assume—
> (a) that all relief is claimed within the applicable time limit given by section 19 of TIOPA 2010, and
> (b) that all reasonable steps are taken to minimise any amounts of tax payable as mentioned in section 33 of that Act.
> (4) "I" is the total amount of all the employment income falling within

24 Section 24A(11)(12) FA 2014.

section 24A(5)(a) to (d).

This takes out cases where the foreign tax rate is 65% × 45% = 29.25%. The effective overseas tax rate will be lower than the headline rate and in practice I expect that few arrangements will be excluded by this condition.

HMRC dual contract guidance provides a straightforward worked example:

Overseas employment income for duties in country Z	£500,000
Country Z tax paid on overseas employment income for duties in country Z (Foreign Tax Credit Relief)	£120,000
Effective rate of country Z tax £120,000 / £500,000 × 100%	24% (X%)
UK additional rate	45%
UK additional rate × 65%	29.25% (Y%)

As X% is less than Y% Condition 4 is met.

The CIOT commented:

> There will also be timing issues in regard to working out available foreign tax credits and in allowing sufficient time for amendments to Self-Assessment returns. In particular, if the arising basis is used on a return and later on it is determined that the remittance basis could be claimed, eg because the final foreign tax credit proves to be higher than expected (which given that the UK and overseas territories will not have coterminous tax years could take a couple of years or so to determine) then might not the taxpayer out of time to amend their return?[25]

HMRC dual contract guidance provides:

> **What if I do not know the foreign tax amount when I have to submit my UK Self Assessment tax return?**
> Different tax laws in overseas territories may mean that you have to file a provisional UK tax return based on expected overseas taxes. When the actual amount of foreign tax is known you should submit an amended Self Assessment return, if necessary. You must do this within 12 months of the 31 January that follows the tax year in question.
> **What should I do if I have paid too much or too little tax to the foreign tax authorities?**

25 CIOT, "Artificial use of dual contracts by non-domiciles: Response" (19 February 2014) *http://www.tax.org.uk/Resources/CIOT/Documents/2014/02/140219%20Dual%20Contracts%20for%20Non-Doms%20-%20CIOT%20comments.pdf*

You must tell HMRC as soon as possible so that any under or overpayment of UK Income Tax can be corrected.

What should I do if I have paid the Remittance Basis Charge but my overseas employment income becomes taxable on the arising basis?

If you are within the time frame to amend your return you may withdraw your claim to the remittance basis.

22.16.7 *Dual contract condition 5: Regulatory requirement to work offshore*

Section 24A(17) ITEPA provides:

Condition 5 is that—

(a) were the duties of the relevant employment to be duties of the UK employment instead, all or substantially all of them could not lawfully be performed in the relevant territory (whether on the meeting of any condition or otherwise) by virtue of any regulatory requirements imposed by or under the law of that territory, and

(b) were the UK duties of the UK employment to be duties of the relevant employment instead, all or substantially all of them could not lawfully be performed in the part of the UK in which they are performed (whether on the meeting of any condition or otherwise) by virtue of any regulatory requirements imposed by or under the law of that part of the UK.

(18) In subsection (17)—

"the relevant territory" means the territory in which the duties of the relevant employment are performed, and

"UK duties" means duties performed in the UK.

HMRC dual contract guidance provides:

Examples of regulatory requirements include:

- in order to get a work permit in some countries, you have to have an employment contract in that country
- in order to provide certain types of financial services in the UK, you have to be employed by a person authorised by the Financial Conduct Authority

22.16.8 *Commencement of dual contract rules*

Para 7 sch 3(1) FA 2014 provides:

Section 23(1A) of ITEPA 2003 (as inserted by paragraph 2) has effect in relation to general earnings which are general earnings from an employment for the tax year 2014-15 or any subsequent tax year.

22.16.9 *Dual contract rules: commentary*

HMRC describe the use of dual contracts as "artificial". In case the reader should miss the point, the word "artificial" occurs 6 times in the two page press release announcing the new rules.[26]

In fact the view that these arrangements are "artificial", in the more pejorative sense of that rather vague expression, is difficult to defend. The 1955 Royal Commission did not consider that there was anything objectionable in dual contract arrangements.[27] In 2004 HMRC said:

> We can confirm again that we do not intend promoters or employers to have to disclose everyday advice and arrangements. In the context of employment products this would include ... standard dual contract arrangements ...[28]

The EI Manual provides:

> **77030 Appendix 3: Non domiciled employees: Dual contract arrangements** [February 2006]
> ... Where there are two employment contracts and the written contracts reflect this, dual contract arrangements provide a legitimate way to structure an individual's employment relationships.

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26 HMRC, "Artificial use of dual contracts by non-domiciles" (19 March 2014).

27 Report Cmd 9474 para 305 proposed:

"(3) Let the resident be taxed— ...

(c) on the apportioned basis, if he is domiciled outside the UK, in respect of income from an employment which is performed partly inside and partly outside the UK, the part of his income attributed to the work performed outside the UK being itself taxed on the remittance basis;

(d) on the whole income, if he is domiciled in the UK, in respect of income from an employment which is performed partly inside and partly outside the UK.

306. The reason for the special treatment of the non-domiciled resident is that the person most likely to be affected is the employee of a foreign concern who makes his home and headquarters in the UK, while his duties include a good deal of work in Europe. It seems fair to treat his 'European' earnings as if they were truly foreign income, and it is probably to the advantage of this country to recognise the special case. *Even if it did not, most of such employees could get into an equivalent position by having two separate contracts of service, one providing for UK duties and remuneration and the other for European duties and remuneration, in which event the latter income would be taxed on the remittance basis as at present.*" (Emphasis added)

28 Statement to CIOT 23/08/04 accessible *http://old.tax.org.uk/showarticle.pl?id=2704*

Those affected may well feel irritated by HMRC's claim that:

> This measure is expected to have a negligible impact on businesses and civil society organisations. It is directed at a small number[29] of individuals seeking to use artificial tax arrangements in conjunction with their employers. There will be no effect on compliant[30] employers.

The rules are a breach of the promise of stability,[31] though no-one took that seriously.

The ICEAW stated:

> Given that internationally mobile senior employees are the decision makers in a multi-national organisation targeting them in this manner could have significant long term implications for the competitiveness of the UK.[32]

22.17 Overseas workday relief

Before 2013 there was a relief for employees who were UK resident but not ordinarily resident. Following the abolition of ordinary residence the relief was recast without using the term ordinary residence, but it covers similar ground. HMRC call this **"overseas workday relief"** and I adopt that label, though it is not particularly apt.

The development of the relief can be traced in the residence consultation papers,[33] but that is now of historic interest only.

Section 26(1) ITEPA provides:

> (1) This section applies to general earnings for a tax year where
> [i] section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year and
> [ii] the employee meets the requirement of section 26A [OWR] for that year,

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29 The TIIN quantified this as 350 individuals: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293818/TIIN_6040__artificial_use_of_dual_contracts_by_non-domiciles.pdf*

30 On this use of the contested word "compliant", see 44.6.4 (Investment manager condition E: customary remuneration). Note in this case non-compliance (if the term is permissible) arose as a result of a change of HMRC policy.

31 See 1.8 (The promise of stability).

32 TAXREP 14/14 *http://www.icaew.com/~/media/Files/Technical/Tax/Tax-faculty/TAXREPs/2014/taxrep-14-14-artificial-use-of-dual-contracts-by-non-domiciles.pdf*

33 See 4.1 (Residence – Introduction).

if the general earnings meet all of the following conditions—

(a) they are neither—
  (i) general earnings in respect of duties performed in the UK, nor
  (ii) general earnings from overseas Crown employment subject to UK tax,[34] and

(b) if the tax year is a split year as respects the employee, they are attributable to the UK part of the year.

I refer to earnings within s.26(1) as **"OWR earnings"**. Section 26(2) ITEPA provides the remittance basis for OWR earnings:

> The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year.

Section 26(6) ITEPA provides:

> Section 15(1) does not apply to general earnings within subsection (1).

Thus earnings which do not qualify for OWR continue to fall under the s.15 arising basis.

In short, under overseas workday relief, a remittance basis taxpayer pays tax:

(1) on an arising basis on general earnings in respect of duties performed in the UK; and
(2) on a remittance basis on other earnings.

If the s.26A requirements are met, it is easier to qualify for OWR than for the COE remittance basis:

(1) It is not necessary to have a foreign employer.
(2) It is not necessary that duties are performed *wholly* outside the UK. (So it is not necessary to consider dual contract arrangements.)

Much of the wording of the OWR remittance basis repeats that found in the COE remittance basis; so the reader is referred back to 22.11 (COE remittance basis).

See too 22.26 (OWR mixed fund rule).

22.17.1 *Section 26A requirements*

The section 26A requirements roughly equate to the pre-2013 requirement to be non-ordinary resident in the UK. Section 26A ITEPA provides:

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34 See 22.31 (Overseas Crown employment).

(1) An employee meets the requirement of this section for a tax year if the employee was—

(a) non-UK resident for the previous 3 tax years, or

(b) UK resident for the previous tax year but non-UK resident for the 3 tax years before that, or

(c) UK resident for the previous 2 tax years but non-UK resident for the 3 tax years before that, or

(d) non-UK resident for the previous tax year, UK resident for the tax year before that and non-UK resident for the 3 tax years before that.

(2) The residence status of the employee before the 3 years of non-UK residence is not relevant for these purposes.

22.17.2 *HMRC examples*

HMRC have issued guidance in RDR4.[35] The current guidance is based on the Finance Bill 2013. Further guidance will no doubt be issued in due course.

RDR4 provides:

> 6. The number of tax years for which you can be eligible for OWR in your lifetime is not limited. As long as there is a period of three consecutive tax years where you were not resident in the UK, you may be eligible for OWR even if you have already previously benefited from the relief.
>
> 7. Where the tax year for which OWR applies is a split year for you, OWR will only apply to foreign earnings which relate to the UK part of the year. For these purposes it does not matter whether the year is split into a UK part and then an overseas part of the year or the other way round.
>
> 8. Where the tax year for which OWR applies is not a split year, OWR will apply to foreign earnings relating to duties in any part of that tax year.
>
> 9. OWR does not apply to earnings which relate to duties you perform overseas in the overseas part of a split year. Such earnings are not taxable in the UK, even if they are remitted. Earnings which relate to duties you perform in the UK in the overseas part of a split year are taxable in full unless they are exempt from UK tax under the terms of a Double Taxation Arrangement.

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35 HMRC "Guidance Note: Overseas Workday Relief" (May 2013) *http://www.hmrc.gov.uk/international/rdr4.pdf*

10. OWR does not apply to earnings which relate to duties you perform overseas in a tax year for which you are not resident in the UK. Such earnings are not taxable in the UK, even if they are remitted. Earnings which relate to duties that you perform in the UK in a tax year for which you are not resident in the UK are taxable in full unless they are exempt from UK tax under the terms of a Double Taxation Arrangement.
11. Note that, when calculating your taxable earnings for a tax year in which your are not resident in the UK, or for an overseas part of a tax year of UK residence, special rules apply to the general earnings from overseas Crown employment subject to UK tax.
12. Earnings are usually received at the same time as, or shortly after, you earn them. However you may receive some earnings in a year, such as a bonus, which is for an earlier period because it relates to duties you performed in that period.
13. For instance, you may perform duties in one tax year but receive some of the earnings for those duties in a later tax year. Or you may perform duties in an overseas or UK part of a split year, but receive payment in the other part of the split year (UK or overseas), or indeed in another tax year altogether.
14. It is your circumstances in the period that the earnings are for which determines your eligibility to OWR in relation to those earnings, and not, if they are different, your circumstances in the year you receive them.
15. The following examples demonstrate how the rules apply in practice. In each example, unless otherwise stated, the individual is not domiciled in the UK throughout the period and performs employment duties partly in the UK and partly overseas.

Example 1 (Abdul)
A arrives in the UK on 1 February 2014 to begin a work secondment; he has not previously been to the UK and so has not been resident here before. He leaves the UK on 5 April 2017.
Under the SRT, A is resident in the UK for the tax year 2013-14 and is eligible for split year treatment. The UK part of his split year begins on 1 February 2014.
A is also resident in the UK for the tax years 2014-15, 2015-16 and 2016-17. He claims the remittance basis of taxation for the tax years 2013-14, 2014-15, 2015-16 and 2016-17. He is not resident in the UK for the tax year 2017-18.
A's foreign earnings for 2013-14 (from 1 February 2014), 2014-15 and 2015-16 are eligible for OWR and are only taxable in the UK if and when they are remitted to the UK. In 2016-17 A is not eligible for OWR

as he has received the relief in the three preceding tax years. As such his foreign earnings for 2016-17 are fully taxable in the UK.
Provided A remains not resident in the UK for three consecutive tax years following 2016-17 he may be eligible for OWR again from the 2020-21 tax year.

Example 2 (Burril)
B arrives in the UK on 1 March 2014 to begin a work secondment. He has not been to the UK previously and so has not been resident here. He leaves the UK on 5 April 2017.
He is not resident in the UK under the SRT for the tax year 2013-14. He is resident in the UK for the tax years 2014-15, 2015-16 and 2016-17. He claims the remittance basis of taxation for the tax years 2014-15, 2015-16 and 2016-17. He is not resident in the UK for the tax year 2017-18.
B's foreign earnings for 2014-15, 2015-16 and 2016-17 are eligible for OWR and are only taxable in the UK if and when they are remitted to the UK.
Unlike Abdul, B is not resident in the UK in 2013-14 (the tax year in which his UK secondment commenced). B is therefore eligible for OWR for 2016-17 because this is the third year for which he is UK resident.
Provided B remains not resident in the UK for three consecutive tax years following 2016-17 he may be eligible for OWR from the 2020-21 tax year.

Example 3 (Colar)
C arrives in the UK on 1 February 2014 to begin a work secondment. He has previously been resident in the UK. He ceased to be resident in the UK on 5 April 2011.
He was not resident in the UK for the tax years 2011-12 and 2012-13. He leaves the UK on 5 April 2017.
He is resident in the UK for the tax year 2013-14 under the SRT and is eligible for split year treatment. The UK part of his split year begins on 1 February 2014.
He is resident in the UK for the tax years 2014-15, 2015-16 and 2016-17. He claims the remittance basis of taxation for the tax years 2013-14, 2014-15, 2015-16 and 2016-17. He is not resident in the UK for the tax year 2017-18.
C has not been non-resident in the UK for three consecutive tax years immediately prior to his secondment to the UK. He is not eligible for OWR for 2013-14, 2014-15, 2015-16 or 2016-17. If he remains not resident in the UK for three consecutive tax years following 2016-17 he

may be eligible for OWR from the 2020-21 tax year.

Example 4 (Drey)
D is employed by a US company and has visited the company's group office in the UK on short business projects on a number of occasions in each of several tax years prior to 2013-14. He has not been UK resident prior to 2013-14.
In 2013-14 D works on a short business project in the UK and is resident for the year under the SRT. He has further business visits to the UK during 2014-15 but is not resident in the UK for that year. He is seconded to work at the company's group office in the UK for three years from 1 May 2015. D leaves the UK on 5 April 2018.
D is resident in the UK for the tax year 2015-16 and is eligible for split year treatment. The UK part of his split year begins on 1 May 2015.
He is resident in the UK for the tax years 2016-17 and 2017-18. He does not claim the remittance basis of taxation for 2013-14. He claims the remittance basis of taxation for 2015-16, 2016-17 and 2017-18.
In 2013-14 D was not eligible for OWR because, even though he was not resident in the UK for the three previous consecutive tax years, he had not claimed the remittance basis of taxation for that year.
D's foreign earnings for (the UK part of) 2015-16 are eligible for OWR because 2015-16 is one of three tax years immediately following three consecutive tax years for which he was not resident.
His earnings for 2016-17 and 2017-18 are not eligible for OWR because neither year is one of three tax years immediately following three consecutive tax years for which he was not resident.

Example 5
In January 2017 D receives his 2016 performance bonus which is in respect of his duties throughout the calendar year 2016.
He is not eligible for OWR for 2016-17 when he receives his bonus but as part of it was earned in respect of duties performed in 2015-16, that part is eligible for OWR.

16. If you were ordinarily resident in the UK and so not eligible for OWR for tax years before 2013-14, you may still be eligible for relief for 2013-14 and 2014-15 under the new rules. Even if it was your intention when you came to the UK to settle here and you became ordinarily resident, this does not prevent you from being eligible for OWR from 6 April 2013 under the new rules.
If you were not eligible for OWR at 5 April 2013, the new eligibility rules will apply to you from 6 April 2013.

Example 6 (Estelle)
E arrives in the UK on 6 April 2012 to begin a work secondment which will last for four years. She has not previously been to the UK and so has not been resident here before.
For 2012-13 she is resident and ordinarily resident in the UK and claims the remittance basis of taxation. Her earnings for 2012-13 are not eligible for OWR because she is ordinarily resident for that year.
She is resident in the UK for 2013-14, 2014-15 and 2015-16 and claims the remittance basis of taxation for each of these tax years.
Her foreign earnings for 2013-14 and 2014-15 are eligible for OWR and are only taxable if and when they are remitted to the UK. Her earnings for 2015-16 do not qualify for OWR because this is not one of the three tax years immediately following three consecutive tax years for which she was not resident.

22.17.3 *2013 Transitional relief*

RDR4 provides:

Transitional rules
17. Only eligibility to OWR that commences on or after 6 April 2013 will be subject to the rules contained in this guidance note.
18. If you were resident but not ordinarily resident in the UK at 5 April 2013, and so eligible for OWR at that date under the old rules (see HMRC6, Chapter 3 'Ordinary Residence in the UK'), the new rules will not apply to you. You may still have OWR for 2013-14, 2014-15 and 2015-16 as appropriate, if you would have been entitled to relief under the old rules. However, you must meet these old rules for each year concerned. If your circumstances are such that you would have been ordinarily resident for a year, you will not be eligible for relief for that year even if you are able to meet the new conditions.
If you were in receipt of OWR for:

- 2010-11, 2011-12 and 2012-13, you may continue to be eligible for OWR under the old rules for 2013-14, so long as you were nonresident in the UK for 2009-10
- 2011-12 and 2012-13, you may continue to be eligible under the old rules for 2013-14 and 2014-15, so long as you were non-resident in the UK for 2010-11
- 2012-13, you may continue to be eligible under the old rules for 2013-14, 2014-15 and 2015-16, so long as you were non-resident in the UK for 2011-12

19. The new rules will apply to you after you have been non-resident in the UK for three consecutive tax years.

Example 7 (Francis)
F arrives in the UK on 1 December 2011 to begin a work secondment which is expected to last for 35 months. He has not previously been in the UK and so has not been resident here before.
For the tax years 2011-12 and 2012-13 he is resident but not ordinarily resident in the UK and claims the remittance basis of taxation. His foreign earnings for these years are eligible for OWR and are only taxable if remitted.
However, as F was eligible for OWR for 2012-13, the new rules do not apply to him.
He leaves the UK permanently in 1 November 2014. Under the SRT, F is resident for 2013-14 and 2014-15 and claims the remittance basis of taxation. He would have been not ordinarily resident for 2013-14 and 2014-15 under the old rules.
He may have OWR for 2013-14 and 2014-15 on the same basis as for 2012-13 because he would have been eligible if the rules had not changed.

Example 8 (Greta)
G arrives in the UK on 1 December 2012 to begin a work secondment which is expected to last for 35 months. She has not previously been in the UK and so has not been resident here before.
For 2012-13 she is resident but not ordinarily resident in the UK and claims the remittance basis of taxation. Her foreign earnings for 2012-13 are eligible for OWR and are only taxable if and when they are remitted to the UK. As G was eligible to OWR for 2012-13, the new rules do not apply.
In March 2015 G decides to settle in the UK and buys a house here. As a result, she would have been ordinarily resident in the UK from 6 April 2014 if the rules had not changed.
G may have OWR on her foreign earnings for 2013-14 because she would have been not ordinarily resident and eligible for relief for that year if the rules had not changed.
For 2014-15 she is not eligible for OWR because she would have been ordinarily resident for that year. She is not eligible under the new rules because they do not apply to her.

Example 9 (Herman)
H was born in the UK and is domiciled here. He has lived and worked overseas for eight years before coming here on 1 December 2012 for a work secondment which is expected to last for 30 months. During the secondment H performs some of his employment duties overseas.

For 2012-13 he is resident but not ordinarily resident in the UK and claims the remittance basis of taxation. Although he is domiciled in the UK he is still able to claim the remittance basis of taxation because he is not ordinarily resident. His foreign earnings for 2012-13 are eligible for OWR.

Because H was eligible for OWR for 2012-13, the new rules do not apply.

The work secondment ends on 1 June 2015 when H leaves the UK to live and work overseas for the next five years.

H is resident in the UK for 2013-14, 2014-15 and 2015-16 but is not able to claim the remittance basis of taxation for these years because he is domiciled in the UK. If the rules had not changed he would have been not ordinarily resident for 2013-14, 2014-15 and 2015-16

Under the transitional rules he is able to access the remittance basis and his foreign earnings for 2013-14, 2014-15 and 2015-16 are eligible for OWR on the same basis as for 2012-13.

22.18 Non-resident employee

Section 27 ITEPA provides:

> (1) This section applies to general earnings for a tax year for which the employee is not resident in the UK if they are—
>
> (a) general earnings in respect of duties performed in the UK, or
>
> (b) general earnings from overseas Crown employment subject to UK tax.[36]
>
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.
>
> (3) Subsection (2) applies whether or not the employment is held when the earnings are received.

This applies regardless of domicile. DTAs often override the charge to UK tax.[37]

There are two requirements in para (a):

(1) Duties performed in the UK; and

(2) Earnings in respect of those duties.

These concepts are both relevant for:

(1) Workday relief, where it makes the difference between an arising and

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36 See 22.31 (Overseas Crown employment).

37 See 22.36 (DT Relief: employment exercised outside UK).

a remittance basis.

(2) A non-resident employee, where it makes the difference between taxable earnings and tax-free earnings.

It is best to consider these separately.

22.19 Duties "performed in the UK"

Section 38 ITEPA elucidates the concept of where duties are performed:

> (1) This section applies if a person ordinarily performs the whole or part of the duties of an employment in the UK.
>
> (2) General earnings for a period of absence from the employment are to be treated for the purposes of this Chapter as general earnings for[38] duties performed in the UK except in so far as they would, but for that absence, have been general earnings for duties performed outside the UK.[39]

EI Manual provides:

> **40202 Employee resident, ordinarily resident or domiciled outside the UK: Location of duties: Absence from duties** [January 2009]
>
> If an employee who ordinarily works in the UK is absent from work, the general earnings for the period of absence must be treated as being for duties performed in the UK, even if the employee is in fact abroad at that time. If, exceptionally, the employee can show that if he had been working, the earnings would have been for working abroad then this rule is not applied.
>
> *Example*
>
> An employee who is not ordinarily resident in the UK performs the duties of the employment in Manchester. Illness meant that a holiday in Florida was unexpectedly extended so the days normally spent in the UK were lost. The Inspector received a calculation of earnings chargeable under s.15 [ITEPA][40] that excluded salary attributable to the days of absence.
>
> The Inspector successfully contended that s.38 [ITEPA] applied on the basis that the duties of the employment were normally performed in the

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38 S.38 refers to earnings "for" duties performed in the UK, whereas ss.26, 27 ITEPA refer to earnings "in respect of" duties performed in the UK, but the meaning must be the same.

39 Special rules apply for:
(1) duties on board vessels or aircraft: s.40 ITEPA;
(2) duties performed in the UK sector of the Continental Shelf: s.41 ITEPA.

40 The reference from 2008/2009 is now s.26 ITEPA.

> UK. The earnings that had been excluded were therefore UK-based earnings within s.15 [ITEPA]

22.20 Earnings "in respect of" duties performed in the UK

Section 41ZA ITEPA provides:

> The extent to which general earnings are in respect of duties performed in the UK is to be determined under this Chapter on a just and reasonable basis.

The question whether earnings are "in respect of" duties performed in the UK is relevant for non-ordinarily resident employees as earnings in respect of duties performed in the UK are taxed on an arising basis and other earnings are taxed on a remittance basis. SP 1/09 explained how this was applied where duties of a single employment are performed both in and outside the UK and presumably the same principles will continue to apply:

> 13. Where the duties of a single office or employment are performed both in and outside the UK, an apportionment is required to determine how much of the general earnings are attributable to the UK duties. Apportionment of general earnings is essentially a question of fact, but for many years HMRC has accepted time apportionment, based on the number of days worked abroad and in the UK, except where this would clearly be inappropriate. For example, in the case of an employee with 200 working days in the UK and 50 working days outside the UK, the proportion of general earnings attributable to UK duties would be 200/250. This practice does not, of course, apply where the charge arises under Section 15 ITEPA and relief is due under Part 5 Chapter 6 ITEPA (Deductions from seafarers' earnings).

See too *Coxon v Williams* 60 TC 659. EI M77020 provides:

> **77020. Appendix 2: General earnings in respect of duties performed in the UK** [August 2008]
> (Adapted from an article in Tax Bulletin 63 – February 2003. The section headed "Practical issues - international business travel" sets out a methodology that first appeared as Appendix 2 to the Minutes of the meeting of the Joint Forum on Expatriate Tax and NICs held on 18 April 2007.)
> ... Whether general earnings (emoluments) are in respect of UK duties is essentially a question of fact. In *Taylor v Provan* (49 TC 579), the courts agreed that the touchstone must be the wording of the statute. In that case, travel expenses paid to a director to come to the UK in order to perform duties here were considered to be "emoluments in respect of duties performed in the UK". In *Perro v Mansworth* [2001] STC (SCD) 179, a Special Commissioner found that the payment by an employer of an employee's liability to tax on UK-based earnings (Case II Schedule E) was itself "an emolument in respect of duties

performed in the UK".

Where an attribution is required, Statement of Practice 5/84 (SP5/84) approves time apportionment according to the number of days worked abroad and in the UK except where this would clearly be inappropriate. The *Perro* case is an example of where time apportionment is not appropriate. The starting point for the SP5/84 approach to time apportionment is that the employee's contractual right to earnings for the work performed usually accrues from day to day. Authority for this view comes from *Varnam v Deeble* (58 TC 501), although that case was not directly concerned with attributing earnings to UK duties for the purposes of the charge to UK tax. In *Platten v Brown* (59 TC 408), it was held that correct attribution on a time apportionment basis should employ units of days rather than hours.

The courts have consistently taken the view that time apportionment should not be applied to earnings that can be specifically allocated either to duties performed in the UK or to duties performed elsewhere. So time apportionment would be inappropriate in a case where the contract of employment specifically allocated earnings to periods spent working in the UK or overseas. Provisions in a contract of employment that regulate the amount of time to be devoted to the employment, dealing with matters such as the number of days to be worked, the length of holidays or how to calculate compensation do not amount to an allocation of particular parts of remuneration to particular days of work.

This appendix gives examples of how the time apportionment approach envisaged by SP5/84 applies in practice. Self-Assessment Helpsheet IR211 approaches apportionment by calculating the earnings from the employment that are not taxable in the UK. The total earnings are multiplied by a fraction where the numerator is the number of days worked outside the UK and the denominator is the number of days worked in pursuit of the employment during the tax year. Where there are no UK-based earnings taxable under either section 25 or section 27 ITEPA, the resultant figure will be entered at Box 1.31 on the employment page as foreign earnings not taxable in the UK. Although the amount that is not taxable is sometimes referred to as "overseas workday relief", it is not a statutory relief from tax subject to the claims machinery in Section 42 TMA 1970.

Note 4 to IR211 clarifies what is meant by days worked overseas. They are defined as those days that have been spent outside the UK substantially performing the duties of the employment. "Substantially" should be taken as meaning "for the most part". In *Platten v Brown* there is the example of an employee who spends a whole day working in the UK but then leaves the country that evening on an overseas business trip. It would be difficult to say as a matter of contract that the employee's earnings for that day were not attributable on a time apportionment basis to duties performed in the UK. It follows that the earnings for a day spent working overseas before returning to the UK in the evening will be attributable to duties performed overseas.

There are two questions of fact to be addressed in order to attribute the earnings for a particular day. These are:

- whether the day has been spent substantially performing the duties of the employment
- where those duties have been performed.

Employees should retain evidence such as travel documents and business diaries to demonstrate how they have calculated the earnings from overseas workdays. The following comprehensive example illustrates some practical issues.

***Example** (Monica)*

M is resident but not ordinarily resident in the UK. Her salary of £100,000 is paid

directly into an offshore bank account. Her contract of employment provides for a five-day 40-hour working week with 22 days holiday plus public holidays - a total of 230 workdays.

During 2005-06, her employer sent her to work at its branch in India for the whole of October and November, a period of 45 weekdays. She also attended the branch office in India on the first Saturday and Sunday in October and spent three other Saturdays working on her employer's Indian premises. She received a special bonus of £15,000 awarded solely in recognition of her work in India.

In addition, she attended her employer's Munich office on five separate occasions during the year. On four of these occasions, she left the UK after work and stayed overnight before returning to the UK on the following evening. On the final occasion, she left the UK on a Friday evening and spent the weekend in Munich. She spent three hours of the Sunday reading papers relevant to a meeting on the following day. She returned to the UK on Monday evening.

M was substantially performing the duties of her employment on the five non-weekdays spent working in India, giving a total 50 workdays in India. The Sunday in Munich was not an overseas workday so her duties in Germany encompassed five workdays. The special bonus was on the facts solely attributable to the performance of duties in India.

Time apportionment produces the following result –

UK duties - Salary 100,000 × 180/235 = 76,595 (Section 25 ITEPA)

Overseas duties - Salary 100,000 × 55/235 = 23,405 plus 15,000 = 38,405

Example - variation A

Following her return to the UK, M's employer gave her time off in lieu of the weekends spent working in India. The denominator in the fraction would become 230 and not 235.

UK duties - Salary 100,000 × 175/230 = 76,086 (Section 25 ITEPA)

Overseas duties - Salary 100,000 × 55/230 = 23,914 plus 15,000 = 38,914

Example - variation B

Facts are as variation A plus M spent the whole of Sunday 30 September travelling to India and was granted a further day off in lieu when she returned to the UK. That day should also be counted as an overseas workday increasing the numerator by one to 56.

UK duties - Salary 100,000 × 174/230 = 75,652 (Section 25 ITEPA)

Overseas duties - Salary 100,000 × 56/230 = 24,348 plus 15,000 = 39,348

Practical issues – international business travel

The time of departure or arrival and the duration of international business travel can make it extremely difficult to decide whether a particular day should be regarded as a UK or an overseas workday. In these specific circumstances, HMRC is prepared to accept that the following treatment provides a reasonable basis for determining the status of such a day:

International flight or journey lasting no more than seven hours

- Morning arrival – UK workday
- Morning departure – overseas workday
- Afternoon arrival – overseas workday
- Afternoon departure – UK workday

International flight or journey lasting more than seven hours

- Morning arrival – half UK workday and half overseas workday
- Morning departure – overseas workday
- Afternoon arrival – overseas workday

• Afternoon departure – half UK workday and half overseas workday

A morning or afternoon arrival or departure is judged according to the time that the aircraft, vessel or train actually arrives or departs, not the scheduled times.

Where a journey involves more than one international flight, a one hour transfer addition may be added to the actual flight times to determine whether the total flight time lasts more than seven hours. International business travel that takes place on a Saturday, Sunday or Bank Holiday is subject to the same treatment as any other day. Note: HMRC may accept alternative approaches to quantifying overseas workdays if the available evidence indicates that such an approach better reflects the facts.

22.21 Remittance after year which earnings are "for"

Suppose:

(1) T receives earnings for year 1; the earnings are taxed on the remittance basis and are not remitted in that year.

(2) The earnings are remitted in year 2.

For the COE remittance basis, s.22 ITEPA provides:

> (1) This section applies to general earnings for a tax year, to the extent that they are chargeable overseas earnings for that year, if—
>
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year, and
>
> (b) the employee does not meet the requirement of section 26A [OWR] for that year.
>
> (2) The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year. ...

Similarly, for the OWR remittance basis, s.26 ITEPA provides:

> (1) [a] This section applies to general earnings for a tax year where section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the employee for that year and the employee meets the requirement of section 26A [OWR] for that year, if
>
> [b] the general earnings are neither—
>
> (a) general earnings in respect of duties performed in the UK, nor
>
> (b) general earnings from overseas Crown employment subject to UK tax.
>
> (2) The full amount of any general earnings within subsection (1) which are remitted to the UK in a tax year is an amount of "taxable earnings" from the employment in that year.

The earnings are "taxable earnings from the employment in that year" ie year (2). In year (1) the earnings are not "taxable earnings" (as defined).

22.22 Remittance after employment ceases

Section 22(3) ITEPA provides:

> Subsection (2) [charge on remittance of COE] applies whether or not the employment is held when the earnings are remitted.

Section 26(3) ITEPA provides the same rule for the OWR remittance basis.

22.23 Remittance of earnings "for" year that employee is not UK resident

To be "overseas earnings" the earnings must be "for" a year of assessment in which the employee was resident in the UK. Accordingly, any earnings "for" a year during which the employee was not UK resident can be remitted at any time without a charge to tax.

22.24 Remittance when non-resident

Suppose earnings taxable on the remittance basis are remitted in a year when the employee is non-resident. In the HMRC view the earnings are taxable. EI Manual provides:

> **42371. Foreign earnings taxed at time of receipt in UK: *Example***
> [February 2006]
> An employee is resident but not ordinarily resident in the UK in 2004/05. She has earnings for that year of £10,000 in respect of duties performed outside the UK. She is paid the £10,000 in New York in 2005/06. In 2006/07 she remits £5,000 of those earnings to the UK. The result is that this employee is chargeable under Section 26(2) ITEPA 2003 on £5,000 in 2006/07.
> This employee is likely to be resident in the UK in the year of remittance but she is assessable on the remittance even if she is not. What matters is her residence status in the year when the money was earned (see EIM42201). She will also be assessable on any further remittances out of the £5,000 balance that remains.
> Note that the employee is chargeable on any remittances to the UK even if her employment ceases in 2005/06 (see EIM42370).

Is this correct? It is a surprising anomaly compared to the position for RFI, and enforcement may be difficult, but this is the natural reading of the legislation. The TNR rules are drafted on that basis: hence they apply to RFI but not to employment income.

22.25 Receipt or remittance after death of employee

Section 13(4) ITEPA provides:

> If the tax is on general earnings received, or remitted to the UK, after the death of the person to whose employment the earnings relate, the person's personal representatives are liable for the tax.

EI Manual provides:

> **42380. Basis of assessment for general earnings: Earnings received after the death of an employee or office holder** [August 2012]
> When an employee or office holder dies, earnings received (or, if the employee was subject to the special rule for certain foreign earnings, received in the UK) after the date of death are treated as income of the personal representatives and not the income of the deceased. They are assessable on the personal representatives in the same way as if they had been received by the employee or office holder (see generally EIM42201). The earnings will, of course, all have been earned in periods before the date of death even though they are assessable only on receipt.
> If it is contended that earnings cannot be attributed to any particular period during the lifetime of the deceased employee or office holder, see EIM40005. So it is the place where duties were performed and the residence and ordinary residence status of the employee when the remuneration was earned that counts. The residence position of the personal representatives at the time the earnings are received (or, where the special rules for certain foreign earnings apply, received in the UK) is irrelevant.
> In cases where an employee or office holder has died the employer will follow the instructions at page 16 of the Employer's Further Guide to PAYE. By following those instructions the employer will account for tax in the following way:
> - where payments are made in the tax year in which the employee died, and before a P45 is issued, the employer will calculate the tax due using the tax code in use before the employee died
> - where payments are made in the tax year in which the employee died, but after the P45 has been issued, the employer will use code OT Week1/Month1
> - when payments are made in a tax year following that in which the employee died the employer will prepare a new deductions working sheet and will use code OT Week1/Month1.
>
> The statutory assessing position for earnings received by personal representatives after the death of an employee or office holder is set out in EIM42390. In many cases, adopting the statutory position would place an additional burden upon the personal representatives and family of the deceased but would not result in materially different overall tax liability. Sensible administrative procedures should be used in this type of case.
> Normally, you can take the pay and tax shown on the deceased's P45 as received

in the period before the date of death, and follow EIM42410. However you should use the strict basis of assessment, and follow EIM42390, in cases:

- where it is requested, or
- where you know that a substantial amount has been paid after the date of death. For these purposes a substantial amount means a sum in excess of £1,500.

The tax chargeable on the personal representatives is a debt due from and payable out of the deceased's estate.

As regards:

- the strict basis of assessment for the personal representatives of a deceased employee or office holder, see EIM42390
- the time limit for assessments on the personal representatives, see EIM42400
- the treatment of earnings received up to the date of death, see EIM42410.

42390. Earnings received after the death of an employee or office holder: The charge on personal representatives [February 2006]

If an employee or office holder dies and earnings are received after the date of death, the personal representatives are charged to tax on them (see EIM42380). They are charged:

- at the basic rate only
- in the year the earnings are received (or, where the special rules for certain foreign earnings apply, received in the UK)
- without any allowances, deductions or reliefs except for the deductions, reliefs and exemptions that would have been due to the employee had they lived.

The personal representatives cannot claim deductions for expenses that they incur separately themselves. The main deductions due are therefore:

- expenses within Sections 336 to 338 ITEPA 2003 incurred by the employee or office holder (see EIM31620 onwards)
- balancing allowances due to the employee or office holder; balancing charges will also fall on the personal representatives (see EIM36500 onwards)
- foreign travel and accommodation expenses within Sections 341, 342 and 370 to 376 ITEPA 2003 incurred by the employee or office holder (see EIM34000 onwards)
- professional fees and subscriptions within Sections 343 and 344 ITEPA 2003 (see EIM32880 onwards)
- where a lump sum is assessable under the "golden handshake" provisions the various exemptions that are available under Sections 404 to 414 ITEPA 2003 (see EIM13500 onwards).

A deduction that is due is not limited to expenses actually paid by the deceased. The personal representatives can have a deduction for an expense that the deceased was due to pay but that the representatives actually settle.

As regards:

- the time limit for assessing personal representatives, see EIM42400
- the treatment of earnings received up to the date of death, see EIM42410.

42400. Earnings received after the death of an employee or office holder: Time limits for assessments on personal representatives [May 2010]

> The normal 5 year 10 month time limit for making assessments applies where earnings are received after the death of an employee.[41]
> This is because the earnings are deemed to be the income of the personal representatives (see EIM42380). So the 3 year 10 month assessing time limit in Section 40 TMA 1970 relating to income arising or accruing up to the date of death does not apply.
> The SA Manual sets out the procedures relating to personal representatives.
> As regards earnings received before the date of death see EIM42410.
> **42410. Death of employee or office holder: Earnings received up to the date of death** [May 2010]
> When an employee or office holder dies, any earnings received before the date of death are chargeable on the employee in the normal way. But if the employee has died before filing a return for the period in which the earnings were received, the executors or personal representatives will be asked to complete returns to the date of death. In these circumstances the special rules at EIM42380 to EIM42400 do not apply and any assessment on the personal representatives must be made within 3 years and 10 months from the end of the year of assessment in which the employee died.
> With effect from 1 April 2010 the time limit is 4 years from the end of the tax year in which the employee dies.
> The SA Manual sets out the procedures relating to personal representatives.

Where the arising basis applies, there is clearly a tax charge for earnings received after death by the PRs.

Where the remittance basis applies, it is difficult to see how there could be a charge on earnings received in the UK after the death of the employee, since the tax charge only arises on receipt by a relevant person, and there are no relevant persons after the death of an employee.

22.26 OWR mixed fund rule

22.26.1 *The need for an OWR mixed fund rule*

This section considers the position where:

(1) an OWR employee receives earnings for duties which are performed partly in and partly out of the UK.
(2) The earnings are received abroad.

The earnings received constitute a mixed fund consisting of:

(1) Earnings taxed on an arising basis under s.15 ITEPA. Statute calls this "s.15 earnings" but I will use the term **"taxed UK earnings"**
(2) Earnings taxed on the remittance basis under s.26 ITEPA. Statute calls this "s.26 earnings" but I will use the term **"untaxed foreign**

41 [Author's note: This is out of date from 2010/11].

earnings".

In the absence of relief, the statutory position is (in short) taxed UK earnings (mixed fund category (a)) are remitted before untaxed foreign earnings (mixed fund category (b)), but later years' earnings are taxed before earlier years. So employees would need to keep each year's earnings in separate accounts and never remit more than the taxed income in the account.

22.26.2 *OWR mixed fund rule*

In the past, relief was allowed by concession. After consultation and response papers[42] the FA 2013 introduced a statutory rule. HMRC call this the Special Mixed Fund rules, but I will use the term **"OWR mixed fund rule"**. HMRC have issued 11 pages of interim guidance under the title FAQs; (**"OWR Mixed Fund FAQs"**).[43]

Section 809RA ITA provides:

> (1) This section applies if—
>
> (a) an individual has general earnings from an employment for a tax year,
>
> (b) those earnings include both
>
> [i] general earnings within section 15(1) of ITEPA 2003 ("section 15(1) earnings") and
>
> [ii] general earnings within section 26(1) of that Act ("section 26(1) earnings"),
>
> (c) at least some of the section 15(1) earnings, or sums deriving (wholly or in part, and directly or indirectly) from at least some of the section 15(1) earnings, are paid into an account in that tax year at a time (a "relevant time") when the account is a qualifying account of the individual, and
>
> (d) at least some of the section 26(1) earnings, or sums deriving (wholly or in part, and directly or indirectly) from at least some of the section 26(1) earnings, are also paid into the account in that tax year at a relevant time.

In short, we are looking at a mixed account with taxed UK earnings and

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42 HMRC, *Reform of the taxation of non-domiciled individuals: a consultation* (June 2011).

HMRC, *Legislation of Statement of Practice 1/09 (SP1/09): summary of responses and draft legislation* (October 2012).

43 *http://www.hmrc.gov.uk/international/faqs-special-mixed-fund-rules.htm*

untaxed OWR earnings. This will arise when an employee has mixed UK/foreign duties.

OWR Mixed Fund FAQs provide:

> **I no longer qualify for Overseas Workday Relief but I still have money in what was my qualifying account. Can I still use the Special Mixed Fund rules?**
> No. You are only eligible to use the Special Mixed Fund rules where the conditions set out in the answer to Q1 are met. As one of the conditions is that you qualify for OWR, the special mixed fund rules can't apply to the account after you have ceased to qualify for OWR.

22.26.3 *"Condition A transfer"*

Section 809RA ITA provides:

> (6) A transfer from the account is a "condition A transfer" if and to the extent that—
> (a) condition A in section 809L is met, and
> (b) either—
> (i) the property or consideration for the service is (wholly or in part), or derives (wholly or in part, and directly or indirectly) from, the transfer, or
> (ii) the transfer, or anything deriving (wholly or in part, and directly or indirectly) from the transfer, is used as mentioned in section 809L(3)(c).

In short, a condition A transfer is one where property from the earnings account is received in the UK.

22.26.4 *"Other transfer"*

Section 809RA ITA provides:

> (7) A transfer from the account is an "other transfer" if and to the extent that it is not a condition A transfer.
> (8) Treat a transfer as an "other transfer" if and to the extent that, at the end of the tax year—
> (a) it is not a condition A transfer, and
> (b) on the basis of the best estimate that can reasonably be made at that time, it will not become a condition A transfer.

What is the position if the transfer is not a condition A transfer, but it will become one later, so it is also not an "other transfer"?

22.26.5 *The OWR mixed fund rule*

Armed with these definitions, we can turn to the OWR mixed fund rule. Section 809RA ITA provides:

> (2) If this section applies, the composition of each transfer made from the account in that tax year at a relevant time is to be determined as follows—
> *Step 1* Suppose that all the condition A transfers made from the account in the tax year at a relevant time had been a single transfer made from the account at the end of the tax year.
> *Step 2* Suppose that all the other transfers made from the account in the tax year at a relevant time had been a single offshore transfer made at the end of the tax year immediately after the single transfer mentioned in step 1.
> *Step 3* Applying those suppositions—
> (a) find under section 809Q(3) the extent to which the single transfer mentioned in step 1 is of the individual's income or chargeable gains, and
> (b) find under section 809R(4) the content of the single offshore transfer mentioned in step 2.
> *Step 4* Each transfer made from the account in the tax year at a relevant time is to be treated as containing the specified proportion of each kind of income or capital contained in the relevant deemed transfer.
> "The specified proportion" is the amount of the transfer divided by the amount of the relevant deemed transfer.
> "The relevant deemed transfer" is—
> (a) if the transfer is a condition A transfer, the single transfer mentioned in step 1, and
> (b) otherwise, the single offshore transfer mentioned in step 2.
> (3) Subsection (2) applies in determining the composition of a transfer for the purposes of sections 809Q and 809R but it does not otherwise affect the date on which a transfer is considered to occur for the purposes of this Chapter.
> (4) If the tax year is the tax year in which the account becomes a qualifying account, for the purpose of applying section 809Q(3) in relation to the single transfer mentioned in step 1 of subsection (2), treat the part of the tax year falling before the qualifying date for the account as a separate tax year.
> (5) If the account ceases to be a qualifying account of the individual during the tax year other than as a result of a breach of the deposit rule—
> (a) subsection (2) has effect as if references to the end of the tax

year were to the end of the day on which the account ceases to be a qualifying account, and

(b) for the purpose of applying section 809Q(3) in relation to the single transfer mentioned in step 1 of subsection (2), treat the part of the tax year falling after the day mentioned in paragraph (a) as a separate tax year.

(9) If the account ceases to be a qualifying account of the individual during the tax year other than as a result of a breach of the deposit rule, subsection (8) has effect as if the reference to the end of the tax year were to the end of the day on which the account ceases to be a qualifying account.

(10) "Qualifying account" and "the qualifying date" for an account are defined in section 809RB.

(11) For the purposes of this section and sections 809RB to 809RD—

(a) "employment" is to be read in accordance with section 4(1) of ITEPA 2003, and includes an office (as read in accordance with section 5(3) of that Act),

(b) whether general earnings are "for" a tax year is to be determined as for the purposes of the employment income Parts of ITEPA 2003 (see section 3(2) of that Act),

(c) a reference to anything "paid into" an account includes anything credited to the account by whatever means, and

(d) references to a breach of the deposit rule are to be read in accordance with section 809RC.

22.26.6 *"Qualifying account"*

Section 809RB ITA provides:

(1) An individual may by notice to the Commissioners nominate an account to be a qualifying account of the individual for the purposes of section 809RA.

(2) The notice must specify the qualifying date for the account.

OWR Mixed Fund FAQs provide:

How do I tell HMRC which account is my qualifying account?

You can notify HMRC which account was your qualifying account for the tax year in the whitespace notes of your tax return. Where you have changed qualifying accounts part way through the year, you must include details of all qualifying accounts which you have used during the year.

You will need to set out which accounts you have used as qualifying accounts for the tax year and the dates on which each account was a

qualifying account.

Section 809RB ITA provides:

(3) "The qualifying date" for the account is the first date on which there is paid into the account sums falling within subsection (4) which (in total) are more than £10.
(4) A sum falls within this subsection if it is, or derives wholly (whether directly or indirectly) from, general earnings of the individual from an employment for a tax year which is a relevant tax year in relation to the employment.
(5) A tax year is a "relevant" tax year in relation to an employment if the general earnings which the individual has for the tax year from the employment include both general earnings within section 15(1) of ITEPA 2003 and general earnings within section 26(1) of that Act.
(6) The individual may withdraw the nomination by giving a further notice to the Commissioners, specifying the date with effect from which the nomination is withdrawn.
(7) A notice under subsection (1) or (6) must be in writing and include such information as the Commissioners may reasonably require.
(8) A notice under subsection (1) or (6) must be given no later than—
(a) 31 January in the tax year following the tax year in which falls, as the case may be—
(i) the qualifying date for the account, or
(ii) the date with effect from which the nomination is withdrawn, or
(b) such later date as the Commissioners may allow.
(9) If an individual nominates an account under this section, the account is a "qualifying account" of the individual throughout the period—
(a) beginning with the qualifying date, and
(b) ending with the date before the earliest of the following dates—
(i) the date on which the account is closed or ceases to be an ordinary bank account held by and for the benefit of the individual (alone or jointly with others);
(ii) the date with effect from which the nomination is withdrawn under this section;
(iii) the qualifying date for another qualifying account of the individual;
(iv) 6 April in a tax year in which there is a breach of the deposit rule which is not remedied or cannot be remedied;
(v) 6 April in a tax year for which the individual has no general earnings within section 26(1) of ITEPA 2003.
(10) The account is not to be a qualifying account at all if—

(a) at any time on the qualifying date, the account is not an ordinary bank account held by and for the benefit of the individual (alone or jointly with others), or

(b) immediately before the qualifying date, the account has a credit balance of more than £10.

(11) The account is not to be a qualifying account at all if the qualifying date falls in a tax year—

(a) for which the individual has no general earnings within section 26(1) of ITEPA 2003, or

(b) in which there is a breach of the deposit rule which is not remedied or cannot be remedied.

(12) Subsection (9)(b)(iv) or (11)(b) (as relevant) is to be ignored if the breach occurs on or after a date falling within subsection (9)(b)(i) to (iii).

(13) If, apart from this subsection, an individual might have nominated two or more accounts for which the qualifying date would be the same, the individual may nominate only one of those accounts.

(14) If, apart from this subsection, an account would be a qualifying account of two or more individuals at any time, it is not to be a qualifying account of either or any of them at that time or any other time.

22.26.7 *"Ordinary bank account"*

Section 809RB ITA provides a commonsense definition:

(15) For the purposes of this section an account is an "ordinary bank account" if it is a cash account in a bank (whether a current or savings account) where sums standing to the credit of the account from time to time represent a debt owed by the bank to the account-holder.

22.27 The deposit rule

Section 809RC ITA provides:

(1) There is a breach of the deposit rule if a prohibited sum is paid into the account on or after the qualifying date.

The employee should take care not to pay any dividend income into the qualifying account! But it is (just) possible to remedy a breach of the deposit rule. Section 809RC ITA provides:

(2) A breach of the deposit rule is remedied if, within 30 days beginning with the day on which the individual became or ought reasonably to have become aware of the payment of the prohibited sum, the required

amount is transferred out of the account by way of a single one-off transfer.

(3) "The required amount" is an amount equal to—

(a) the prohibited sum, plus

(b) all the other prohibited sums (if any) that have been paid into the account since that sum was paid in.

But only two breaches are permitted. Section 809RC ITA provides:

(4) If there are 3 breaches of the deposit rule in any 12 month period, subsection (2) does not apply to the third breach and, accordingly, the third breach cannot be remedied.

Section 809RC ITA provides:

(5) The payment of a prohibited sum ("the later prohibited sum") into the account does not result in a breach of the deposit rule if—

(a) a breach resulting from an earlier payment of a prohibited sum into the account is remedied, and

(b) the later prohibited sum is represented by the required amount in relation to that breach.

22.27.1 *"Prohibited sum"*

Section 809RC ITA provides:

(6) A "prohibited sum" is anything other than a sum that is, or derives wholly (whether directly or indirectly) from, any of the following kinds of income or capital—

(a) general earnings of the individual from an employment for a tax year which is a relevant tax year in relation to the employment,

(b) general earnings of the individual from an employment which consist of money and are paid in a tax year which is a relevant tax year in relation to the employment,

(c) an amount of specific employment income which, by virtue of Part 6, 7 or 7A of ITEPA 2003 or any other enactment, counts as employment income of the individual in respect of an employment for a tax year which is a relevant tax year in relation to the employment,

(d) interest on the account, or

(e) consideration for the disposal of employment-related securities or employment-related securities options in the circumstances described in subsection (7).

The rules for employment-related securities are, as one would expect, very

complicated. Section 809RC ITA provides:

(7) The circumstances are—

(a) the securities or options were acquired pursuant to a right or opportunity available by reason of an employment of the individual,

(b) the disposal is or occurs in conjunction with, or as soon as reasonably practicable after, a relevant event involving those securities or options, and

(c) the tax year in which the relevant event occurs is a relevant tax year in relation to the employment.

(8) For the purposes of subsection (7) each of the following is a "relevant event"—

(a) the acquisition mentioned in subsection (7)(a), and

(b) any event on the occurrence of which an amount (if positive) counts as employment income by virtue of Part 7 of ITEPA 2003 or would do so but for—

(i) section 421E or 474 of that Act (exclusions: residence etc), or

(ii) an election under section 430 or 431 of that Act.

22.27.2 *"Relevant tax year"*

Section 809RC ITA provides:

(9) For the purposes of this section a tax year is a "relevant" tax year in relation to an employment if—

(a) the individual has general earnings from the employment for the tax year,

(b) those earnings include both general earnings within section 15(1) of ITEPA 2003 ("section 15(1) earnings") and general earnings within section 26(1) of that Act ("section 26(1) earnings"),

(c) at least some of the section 15(1) earnings, or sums deriving (wholly or in part, and directly or indirectly) from at least some of the section 15(1) earnings, are paid into the account in the tax year, and

(d) at least some of the section 26(1) earnings, or sums deriving (wholly or in part, and directly or indirectly) from at least some of the section 26(1) earnings, are also paid into the account in the tax year.

(10) For the purposes of this section—

(a) "employment-related securities" has the meaning given in section 421B(8) of ITEPA 2003, and

(b) "employment-related securities options" has the meaning given in section 471(5) of that Act.

22.27.3 *Position where 30-day deadline is met*

Section 809RD ITA provides:

(1) This section applies if the required amount in relation to a breach of the deposit rule was transferred out of the account in accordance with section 809RC(2).
(2) Sections 809Q and 809R have effect as if—
(a) the intervening transactions had never taken place, and
(b) each prohibited sum represented by the required amount had instead been transferred directly (at the time that sum was paid into the qualifying account) into the account or other property into which the required amount was transferred by virtue of the single one-off transfer.
(3) Each of the following is an "intervening transaction"—
(a) each payment into the qualifying account of a prohibited sum represented by the required amount, and
(b) the single one-off transfer out of the qualifying account.
(4) If it is supposed under step 1 or 2 of section 809RA(2) that a single transfer had been made in the intervening period, re-apply section 809Q or 809R in relation to that transfer taking account of subsection (2).
(5) "The intervening period" is the period—
(a) beginning with the day on which the breach occurred, and
(b) ending with the day on which the single one-off transfer was made in accordance with section 809RC(2).
(6) If more than one transfer of a sum equal to the required amount was transferred out of the qualifying account within the 30-day grace period, the first of those transfers is assumed to be the single one-off transfer.
(7) "The 30-day grace period" is the period of 30 days mentioned in section 809RC(2).

22.27.4 *HMRC examples:*

The minutes of the Joint Forum on Expatriate Tax and NICs provide:

Remittances from a non-qualifying account only
Assumptions
Individual is paid £120,000 p.a., £10,000 pcm via the US payroll. He is paid 60% into a qualifying US account (US$) and 40% into a non-qualifying account in Jersey (GBP) Despite the fact that the Jersey account is non-qualifying, the only monies that have ever been paid into

the account are assignment related earnings The individual is entitled to OWR and performs 20% of his duties outside of the UK The only money remitted to the UK is £3,600 pcm. from the Jersey account.

Assumed UK tax position

There are no remittances from the US qualifying account so the SMFRs are not in point Per HMRC's analysis, the amount credited to each account would, in the first instance be:?

- US qualifying account - £4,800 of S15 income and £1,200 of S26 income pcm.
- Jersey non-qualifying account - £3,200 of S15 income and £800 of S26 income pcm.

However, £3,600 is remitted to the UK from the Jersey account each month so S809R(4) is overridden by S809R(5) such that the rules in S809Q are applied. The remittance of £3,600 pcm. is less than the amount of S15 received each month and so all of the amount remitted is regarded as S15 income

This analysis is repeated each month so the balance on the Jersey account is:

Month	**S15**	**S26**
April	£3,600	£400
Less remittance	(£3,600)	
Balance	£0	£400
May	£3,600	£400
Less remittance	(£3,600)	
Balance	£0	£800
Etc		

The amounts remaining is each account at the end of the tax year are:

- U S qualifying account – £52,800 of S15 income and £19,200 of S26 income
- Jersey non-qualifying account - £0 of S15 income and £4,800 of S26 income

The above assumes that you do not re-apportion the balance of the two accounts at year end.

HMRC answer: We would agree with the analysis on the facts given and the assumption there are no "other transfers" from the qualifying account. However there may be a different result if there were "other transfers" from the qualifying account. Because the qualifying account must be looked at in priority to the non qualifying account "other transfers" would reduce the amount of section 15 and section 26 income available to remit from the non qualifying account.

To take an example, if you assume that all of the payments made to the

qualifying account were spent overseas in the year (£72,000 in total) it would remove £57,600 section 15 income and £14,400 section 26 income as an "other transfer" within section 809RA(2) ITA. The only monthly amounts available for remittance from the non qualifying account would be £3,200 section 15 income and £800 section 26 income credited to it. Each monthly remittance of £3,600 on a transactional basis would therefore consist of £3,200 section 15 income and £400 section 26 income.

Remittances from both qualifying and non-qualifying accounts

Assumptions

Individual is paid £120,000 p.a., £10,000 pcm via the US payroll. He is paid 60% into a qualifying US account (US$) and 40% into a non-qualifying account in Jersey (GBP) Despite the fact that the Jersey account is non-qualifying, the only monies that have ever been paid into the account are assignment related earnings The individual is entitled to OWR and performs 20% of his duties outside of the UK The individual remits £3,600 pcm. to the UK from the Jersey account and also makes a one-off remittance of £20,000 to the UK from the qualifying US account in December after the earnings for November have been paid into the account but before the earnings for December have been added.

Assumed UK tax position

There is a remittance from the US qualifying account so the SMFRs are in point Per HMRC's analysis, the amount credited to each account would, in the first instance be:

- US qualifying account - £4,800 of S15 income and £1,200 of S26 income pcm. or £57,600 of S15 income and £14,400 of S26 income per annum
- Jersey non-qualifying account - £3,200 of S15 income and £800 of S26 income pcm.

The SMFRs take precedence over the normal MFRs and so the position on the US account needs to be analysed first.

	S15	**S26**
Apportionment of earnings for the year	£57,600	£14,400
Less remittance	£20,000	
Position after applying S809RA but before applying S809R	£37,600	£14,400

The next step is to analyse the Jersey account which must be analysed on a month by month basis. The starting point for the Jersey account is that £3,200 of S15 and £800 of S26 income is paid into the account each month. However, S809R(4) is overridden by S809R(5) which allows us to

apply S809Q to the monthly remittance. This is where we run into difficulty because of the interaction with the SMFRs that have been applied to the US qualifying account. We do not know how HMRC intend to apply the rules but one possible approach is to say that if you ignored the SMFRs there would have been £38,400 of S15 income in the US qualifying account immediately prior to the one-off remittance of £20,000. This leaves £18,400. The amount of 'extra' S15 income we need to allocate to the non-qualifying Jersey account is £400 per month and £18,400/8 is £2,300 which is more than £400 and so the amount remitted each month from the Jersey account is regarded as S15 income only, i.e.

Month	**S15**	**S26**
April	£3,600	£400
Less remittance	(£3,600)	
Balance	£0	£400
May	£3,600	£400
Less remittance	(£3,600)	
Balance	£0	£800
Etc.		

The amounts remaining in each account at the end of the year are:

- US qualifying account – £32, 800 of S15 (£57,600 - £20,000 – (£400 x 12*)) and £19,200 of S26
- Jersey account - £0 of S15 and £4,800 of S26

*£400 is the amount reallocated each month from the US account to the Jersey account as a result of S809R(5).

Our analysis of the example is as follows:

a) We agree you must look at the qualifying account first
b) After the £20,000 condition A transfer has been accounted for, the balance of income remaining is £76,000 section 15 income and £24,000 section 26 income (£100,000 total) - assuming there are no "other transfers" (see example (a)).
c) HMRCs view is the income is apportioned between the 2 accounts proportionately (see the final example in the FAQs) following the offshore transfer rule in section 809R ITA. Of course that will only total £100,000 (£76,000 + £24,000) so the £20,000 already identified as a remittance from the qualifying account must be included to match the apportionment with the amounts paid into the 2 accounts on a monthly basis. For the purposes of this example we will call this "remitted income" as it has already been identified as remitted section 15 income.
d) Each monthly salary payment to the qualifying account will consist of:

- £3,800 section 15 income
- £1,200 section 26 income
- £1,000 "remitted income"

e) Each monthly salary payment to the non qualifying account will consist of:
   - £2,533 section 15 income
   - £800 section 26 income
   - £667 "remitted income"

f) There is enough section 15 income in the monthly payments to the offshore accounts to ensure the £3,600 monthly remittance is entirely of section 15 income. This is the same result as CIOTs calculation, but arrived at via a slightly different methodology.

g) We believe this methodology ensures t he transfers identified by the special mixed fund rules are not double counted when looking at remittances from the non qualifying account and the transaction by transaction basis of the normal mixed fund rules can be calculated accurately.

h) For example, if the condition A transfers from the qualifying account totalled £72,000 rather than £20,000 the monthly payments to the qualifying account would be £1,200 section 15 income:
   - £1,200 section 26 income and
   - £3,600 "remitted income"

   Monthly payments to the non qualifying account would be:
   - £800 section 15 income,
   - £800 section 26 income and
   - £2,400 "remitted income".

   The £3,600 monthly remittance from the non qualifying account would consist of £2,000 section 15 income (£1,200 + £800) and £1,600 section 26 income.[44]

22.28 Earnings from Ireland

In the following discussion:

"Irish earnings" means earnings from an Irish resident employer; it is assumed that the conditions for the remittance basis are in principle all met (duties performed outside the UK, etc).

"Pre-2008 earnings" means earnings arising before 6 April 2008.

The UK/Ireland DTA also needs to be considered but it is not discussed

44 29 January 2014
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf

here.

Similar points arise in relation to RFI; see 10.21 (RFI from Ireland).

22.28.1 *Earnings from 2008/09*

The position for earnings from 2008/09 is straightforward. The ITA remittance basis treats Irish earnings in the same way as any other foreign earnings. The FA 2008 repealed the rule of the pre-2008 remittance basis which provided (unlawfully and probably ineffectively) that Irish earnings were taxed on an arising basis.

22.28.2 *Pre-2008 earnings remitted from 2008/09*

This change raised the problem of transition. Para 82 Sch 7 FA 2008 provides:

> (1) This paragraph applies in relation to an individual's general earnings for the tax year 2007–08 or any earlier tax year ("the relevant tax year") if the individual—
>
> (a) was UK resident in that year, but
>
> (b) was not domiciled in the UK, or was not ordinarily UK resident, in that year...
>
> (3) In relation to the general earnings, the definition of "foreign employer" in section 721(1) of ITEPA 2003 has effect as if at the end there were inserted "and not resident in the Republic of Ireland".

Amended as para 82(3) directs, s.721(1) ITEPA provides:

> "foreign employer" means an individual, partnership or body of persons resident outside the UK and not resident in the UK *and not resident in the Republic of Ireland*.

Thus (although this might surprise the residents of Eire) an Irish resident employer was not (for this purpose) a "foreign employer" so pre-2008 Irish earnings were not "chargeable overseas earnings" so the remittance basis does not apply to them. Para 82(3) is simply a roundabout way of disapplying the remittance basis charge for pre-2008 Irish earnings.

EN FB 2008 provides:

> 395. Subsection (3) ensures that the existing restriction on the application of the remittance basis in the case of employment income from employers resident in the Republic of Ireland continues to apply in relation to the remittance on or after 6 April 2008 of general earnings arising before that date. This will prevent double taxation as the general earnings have already been taxed when they arose.

In short, if:
(1) Irish earnings arose before 2008/09; and
(2) The earnings are remitted on or after 2008/09
there is no tax charge on remittance.

22.28.3 *Why is para 82(3) needed?*

Before 2008, s.721 ITEPA provided:

> *"foreign employer" means*
> *(a) in the case of an employee resident in the UK, an individual, partnership or body of persons resident outside the UK and not resident in the UK* ***or the Republic of Ireland,***

Under this definition, earnings from an Irish resident employer could not have been chargeable overseas earnings so at first it seems that para 82(3) is not needed. It may be that para 82(3) is otiose; it is inserted by mistaken analogy with para 83(3) (which is needed). However para 82(3) is needed on the assumption that where
(1) earnings arose before 2008/09 and
(2) the earnings are remitted from or after 2008/09
the question of whether the earnings qualify as chargeable overseas earnings is to be determined by the legislation as it stands in the year of remittance, and not by the legislation as it stood at the time that the earnings arose.

22.28.4 *Pre-2008 Irish earnings: tax position before 2008/09*

As noted above, according to statute, the remittance basis did not apply if the employer was resident in the Republic of Ireland: pre-2008 Irish earnings were taxable on the arising basis and not the remittance basis. The discrimination against Ireland was contrary to EU law.[45] Under para 82(3) discussed above, pre-2008 Irish source income which was not remitted before 2008/09 escapes UK tax altogether, since unremitted Irish source income was not lawfully taxable when it arose and it is not (from 2008/09) taxable on remittance. But the point will not now often arise.

22.29 Termination payments

A termination payment is charged under part 6 ITEPA. A full discussion

45 The point was discussed in the 6th edition of this book para 9.51 and 10.4.2.

would need a long chapter. The income is categorised as specific employment income rather than general earnings. The consequence is to disapply the usual territorial rules. Instead, s.413(1) ITEPA provides a different territorial exemption:

> (1) This Chapter does not apply if the service of the employee or former employee in the employment in respect of which the payment or other benefit is received included foreign service comprising—
>
> (a) three-quarters or more of the whole period of service ending with the date of the termination or change in question, or
>
> (b) if the period of service ending with that date exceeded 10 years, the whole of the last 10 years, or
>
> (c) if the period of service ending with that date exceeded 20 years, one-half or more of that period, including any 10 of the last 20 years.

The key term is "foreign service". The definition covers the entire history of the taxation of employment income. Section 413(2) ITEPA provides:

> (2) In subsection (1) "foreign service" means service to which subsection (2A), (3), (4) or (6) applies.
>
> (2A) This subsection applies to service in or after the tax year 2013-14—
>
> (a) to the extent that it consists of duties performed outside the UK in respect of which earnings would not be relevant earnings, or
>
> (b) if a deduction equal to the whole amount of the earnings from the employment was or would have been allowable under Chapter 6 of Part 5 (deductions from seafarers' earnings).
>
> (3) This subsection applies to service in or after the tax year 2003–04 but before the tax year 2013-14 such that—
>
> (a) any earnings from the employment would not be relevant earnings, or
>
> (b) a deduction equal to the whole amount of the earnings from the employment was or would have been allowable under Chapter 6 of Part 5 (deductions from seafarers' earnings).
>
> (3ZA) In subsection (2A)(a) "relevant earnings" means earnings for a tax year that are earnings to which section 15 applies and to which that section would apply even if the employee made a claim under section 809B of ITA 2007 (claim for remittance basis) for that year.
>
> (3A) In subsection (3)(a) "relevant earnings" means—
>
> (a) for service in or after the tax year 2008–09, earnings—
>
> (i) which are for a tax year in which the employee is ordinarily UK resident,
>
> (ii) to which section 15 applies, and

(iii) to which that section would apply, even if the employee made a claim under section 809B of ITA 2007 (claim for remittance basis) for that year, and

(b) for service before the tax year 2008–09, general earnings to which section 15 or 21 as originally enacted applies.

(4) This subsection applies to service before the tax year 2003–04 and after the tax year 1973–74 such that—

(a) the emoluments from the employment were not chargeable under Case I of Schedule E, or would not have been so chargeable had there been any, or

(b) a deduction equal to the whole amount of the emoluments from the employment was or would have been allowable under a foreign earnings deduction provision.

(5) In subsection (4) "foreign earnings deduction provision" means—

(a) paragraph 1 of Schedule 2 to FA 1974,

(b) paragraph 1 of Schedule 7 to FA 1977, or

(c) section 192A or 193(1) of ICTA.

(6) This subsection applies to service before the tax year 1974–75 such that tax was not chargeable in respect of the emoluments of the employment—

(a) in the tax year 1956–57 or later, under Case I of Schedule E, or

(b) in earlier tax years, under Schedule E,

or it would not have been so chargeable had there been any such emoluments.

The EI Manual provides:

13690. Exceptions: "Foreign service": Definition [January 2010]
Section 413 ITEPA 2003 (as amended by Section 30 Schedule 7 FA 2008)
EIM13680 explained that a payment or benefit may be fully excepted from the charge under Section 401 ITEPA 2003 if sufficient of the employee's service counts as "foreign service". Foreign service has a special meaning for this purpose.
All periods when an employee is a seafarer eligible for 100% deduction from earnings under Part 5 Chapter 6 ITEPA 2003 (see EIM33000) count as "foreign service".
Otherwise, this guidance deals only with the legislation relating to periods of service after 5 April 2003. For earlier periods after 5 April 1974 the rules are effectively the same but they are expressed in different statutory language (see SE13690 for details if necessary). If service before 6 April 1974 is involved, see EIM13705.
A period of service counts as "foreign service" where the earnings from the employment are not "relevant earnings". Note that this is a negative test so that

if the earnings are found to be "relevant earnings", that period will not count towards the exception.

If there is a period of service when there are no earnings from the employment, apply the guidance as if there were.

Up to 5 April 2008 "relevant earnings" means earnings within Section 15 or Section 21 ITEPA 2003 as then enacted (see EIM40002). So if the earnings fall within any other provision, the period counts as "foreign service".From 6 April 2008, "relevant earnings" means that the employee is ordinarily resident in the UK and the earnings are within Section 15 ITEPA 2003 (see EIM40002). So if any other situation applies to the earnings, the period counts as "foreign service".

Combine the periods that count as "foreign service" by applying the rules above and then give the full exception if any one of the requirements from the table below are met (see example EIM13970):

Total period of service to the relevant date	**Requirement for full exception**
All cases of whatever duration:	3/4 of the whole period of service is foreign service.
More than 10 years:	The last 10 years are foreign service.
More than 20 years:	½ of the whole period of service (including 10 of the last 20 years) is foreign service.

For this purpose treat successive employments with different members of the same group of companies as if they were a single continuing employment where the payment takes account of that service, see example EIM13975.

Note: a taxpayer with some foreign service who does not meet the requirements in the table above may be able to claim a foreign service reduction instead, see EIM13700.

13700. Foreign service: Reduction of charge [May 2010]

EIM13690 explained that if an employee whose service includes foreign service fails to satisfy the conditions for full exception, the employee might still qualify for a reduction in the Section 401 ITEPA 2003 charge.

If service before 6 April 1974 is involved, see EIM13705.

The £30,000 threshold must be deducted before calculating the reduction (see example EIM13980). The result, for this purpose, is called the amount charged to tax (in Section 414(2) ITEPA 2003 it is called the amount that would otherwise count as employment income). It is this amount charged to tax that is reduced if the qualifying conditions are met.

The amount of the reduction is the amount charged to tax multiplied by the length of foreign service and divided by the length of total service before the relevant date (the meaning of relevant date is the same as in EIM13680). See example EIM13985.

Note that:

- the taxpayer can claim the foreign service reduction by notice in writing to the Inspector at any time up to four years from the end of the year of assessment to which the claim relates (for claims made before 2 April 2010

the limit is five years after 31 January following the end of the relevant year of assessment)

13705. Exceptions: Foreign service: Service before 6 April 1974 [February 2006]

This guidance applies only if you have a case involving foreign service (see EIM13680) and it includes service before 6 April 1974.

The rules were different before 6 April 1974. This may affect the calculation of full exemption (see EIM13690) and will affect the calculation of a reduction (see EIM13700).

In testing whether full exemption is due under EIM13690 this difference is now likely to matter only for the first and last tests of exemption bulleted there (namely, where 3/4 of the whole period of service is needed to be foreign service, or where ½ of the whole period including 10 of the last 20 years is needed). So:

- consider the other test in EIM13690 first. If the last 10 years are foreign service give the exemption without considering the pre-6 April 1974 period. If not
- assume that all the pre-6 April 1974 service is not foreign service and see whether either of the other two tests in EIM13690 is satisfied. If either of them is met, give the exemption without considering the pre-6 April 1974 period. Otherwise
- if none of the three tests in EIM13690 are satisfied without considering some of the pre-6 April 1974 period, see SE13710 (last paragraph) to find out whether the service of that period counts as foreign service. Then apply the first (and if necessary the third) bulleted test in EIM13690.

In testing whether reduction of charge is due under EIM13700, any service before 6 April 1974 will affect the calculation. See SE13710 (last paragraph) to find out whether the service of that period counts as foreign service. Then finish the calculation required by EIM13700.

A payment satisfying the above conditions can be remitted free of income tax to the UK. It is a moot point why the payment does not give rise to CGT, but in practice HMRC do not take that point.

HMRC say:

> Attention was drawn to the agreement published in Germany in December 2011, whereby termination payments were to be treated as remuneration falling within the employment services article of the double tax treaty. HMRC confirmed that this treatment would not apply for the purposes of treaties other than the UK/German treaty.[46]

46 Minutes of Joint Expatriate Forum on Tax and NICs (January 2012) *http://www.hmrc.gov.uk/consultations/epf-mins-jan12.pdf*

22.30 Relocation expenses

Section 271(1) ITEPA provides a somewhat limited relief for relocation expenses.

> (1) No liability to income tax in respect of earnings arises by virtue of—
>
> (a) the provision of removal benefits to which this section applies, or
>
> (b) the payment or reimbursement of removal expenses to which this section applies.

A full discussion of this relief requires a chapter to itself, but one point is relevant here. Section 271(2) ITEPA disapplies the relief for employees taxed on the remittance basis:

> Subsection (1) does not apply if (disregarding this section) the earnings are general earnings to which either of the following sections applies—
>
> (a) section 22 (chargeable overseas earnings for year when remittance basis applies and employee outside section 26), or
>
> (b) section 26 (foreign earnings for year when remittance basis applies and employee meets section 26A requirement).

However this is relaxed by informal concession:

> HMRC were asked to clarify whether or not the exemption for relocation expenses within Section 271 ITEPA 2003 was available against earnings taxed on the remittance basis. HMRC confirmed that the current legislation does not provide for relocation exemption to be available where the remittance basis is claimed. However HMRC were aware of existing practice whereby the relocation exemption was applied before apportionment in respect of non-UK workdays. Although this methodology was not consistent with the existing legislation HMRC were content to allow the practice to continue.[47]

22.31 Overseas Crown employment

General earnings from overseas Crown employment subject to UK tax[48] are taxed on an arising basis, regardless of residence, domicile and place of work. In the case of UK resident and ordinarily resident employees,

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47 Joint Forum on Expatriates Tax and NICs Note of Meeting (September 2008) *http://www.hmrc.gov.uk/consultations/expat-mins-180908.htm*.

48 The expression "general earnings from overseas Crown employment subject to UK tax" is defined in s.28 ITEPA.

such earnings are charged in the normal way under s.15 ITEPA and excluded from the remittance basis because the Crown is not a foreign employer. In the case of a UK resident employee, the earnings are charged in the normal way under s.15 and excluded from OWR by s.26(1)(b) ITEPA.[49] In the case of a non-resident employee, the charge is under s.27 ITEPA.[50]

The 1955 Royal Commission Report explains the reason:

> International comity does not permit the salary of the servant of one State to be taxed by another State: consequently a Crown servant, even if spending his whole time on work abroad, is not amenable to the local taxing jurisdiction and, if he is to be taxed at all, must be taxed by the UK taxing authority. No doubt the scale of remuneration for Crown servants abroad is fixed with these considerations in mind.[51]

22.31.1 *Exception for low paid overseas crown employees*

EIM40209 records that HMRC have made the following orders under s.28(5) ITEPA:

> General earnings from overseas Crown employment in respect of an employee who:
> 1. is not resident in the UK;
> 2. was engaged outside the UK; and
> 3. is employed in a grade the maximum rate of pay of which is less than the maximum rate of pay of an executive officer employed in the same department of the UK Civil Service and working in inner London,
>
> is excepted from the operation of Section 27(2) of the Act.
> With effect from 13 June 2006, the order does not apply to Queen's Gurkha Officers or any other members of the Brigade of Gurkhas who were recruited for that Brigade in Nepal.

This replaces the former concession A25. EN ITEPA provides:

> The concession reflects long-standing practice and is in keeping with international treaty obligations.
> The use of a salary level and grade in the concession is an attempt to focus its benefits on genuinely temporary or unestablished staff. However, enshrining these existing limits in primary legislation is not

49 See 22.17 (Overseas workday relief).
50 See 22.18 (Non-resident employee).
51 Cmd 9474 para 307.

thought to be desirable. Instead it is intended to preserve the existing flexibility of the Inland Revenue to adapt the concession to new circumstances by enabling the Board of Inland Revenue to make an order which sets out the limits of the new statutory exception: see section 28(5) and (6) of the Act. Section 28(7) and (8) of the Act, which deal with the factors by reference to which the statutory exception may be expressed, are intended to reflect the scope of this existing flexibility. Section 717(2) of the Act means that an order does not need to be made by statutory instrument.

The new statutory exception will operate on the charges to tax arising by virtue of section 25(2) of the Act (UK-based earnings for year when employee resident, but not ordinarily resident, in UK) or section 27(2) (UK-based earnings for year when employee not resident in UK). It is intended that it should operate at least as widely as the present exception conferred by ESC A25.

22.32 Seafarers

The rules relating to seafarers and duties performed on vessels and aircraft are too specialist to be considered here; see s.39(3) and ss.40, 372 and Chapter 6 Part 5 ITEPA.

22.33 Lower-paid employee exemption

BN55 (22 April 2009) provides:

Individuals with small amounts of foreign employment income

5. Individuals employed in the UK are currently required to file a Self Assessment tax return if they have also received income from overseas employment in the same tax year. This is the case even where there is little or no tax to pay in the UK because the overseas employment income has already been subject to tax in the other country.

6. This obligation to file a return will be removed with effect from 6 April 2008 where such individuals have overseas employment income of less than £10,000 and overseas bank interest of less than £100 in any tax year, all of which is subject to a foreign tax.

EN FB 2009 provides:

11. This clause introduces a new income tax exemption for low-income employees working in the UK who meet certain conditions. Such individuals will typically be migrant workers employed in seasonal work in the agricultural or service sectors in UK and in other countries in the same tax year and whose overseas income is subject to tax where it is earned. Previously they were required to file a Self Assessment tax

return, even in situations where there was no, or very little, tax to pay. This exemption removes that requirement in most cases.

According, s.828A ITA provides:

> This Chapter provides for an exemption from liability to income tax for an individual for a tax year if-
>
> (a) the individual is UK resident in the tax year but not domiciled in the UK in the tax year,
>
> (b) section 809B does not apply to the individual for the tax year, and
>
> (c) conditions A to F in section 828B are met.

I refer to these conditions as "**LPE conditions A to F"**.

Section 809B will only apply if the individual makes a claim under s.809B, which where the LPE conditions are satisfied will never happen, so the important requirements are the LPE conditions.

22.33.1 *LPE condition A: UK employment*

Section 828B(1) ITA provides:

> Condition A is that in the tax year the individual has income from an employment the duties of which are performed wholly or partly in the UK.

Section 828D ITA defines "employment":

> (1) This section applies for the purposes of this Chapter.
>
> (2) "Employed" and "employment" have the same meaning as in the employment income Parts of ITEPA 2003: see Chapter 1 of Part 2 of that Act.

If these were income-tax wide definitions it would not be necessary to say this here.

22.33.2 *LPE condition B: Cap on RFE*

Section 828B(2) ITA provides:

> Condition B is that, if the individual's income for the tax year consists of or includes relevant foreign earnings—
>
> (a) the amount of the relevant foreign earnings does not exceed £10,000, and

(b) all of that amount is subject to a foreign tax.

Section 828D(5) defines "relevant foreign earnings":

> "Relevant foreign earnings", in relation to an individual, means what would be the individual's relevant foreign earnings for the purposes of Chapter A1 of this Part if section 809B applied to the individual (see section 809Z7(3)).

Section 828D(4) ITA defines "foreign tax":

> "Foreign tax" means any tax chargeable under the law of a territory outside the UK.

See 59.17 ("Subject to tax").

The £10,000 limit for relevant foreign earnings applied for the full year and is not affected by split year treatment. Therefore, an individual who has already earned more than £10,000 abroad in the UK tax year before he or she arrived is not be eligible.

22.33.3 *LPE condition C: Cap on interest received*

Section 828B(3) ITA provides:

> Condition C is that, if the individual's income for the tax year consists of or includes income that is relevant foreign income by virtue of section 830(2)(e) of ITTOIA 2005—
>
> (a) the amount of that income does not exceed £100, and
>
> (b) all of that amount is subject to a foreign tax.

In order to understand the reference to s.830(2)(e) ITTOIA one needs to read it together with s.830(1):

> (1) In this Act "relevant foreign income" means income which—
>
> (a) arises from a source outside the UK, and
>
> (b) is chargeable under any of the provisions specified in subsection (2) (or would be so chargeable if section 832 did not apply to it).
>
> (2) The provisions are ...
>
> (e) Chapter 2 of Part 4 (interest)

22.33.4 *LPE condition D: o other income/gains*

Section 828B(4) ITA provides:

> Condition D is that the individual has no other foreign income and

gains[52] for the tax year.

22.33.5 *LPE condition E: Exclusion of higher rate taxpayers*

Section 828B(5) ITA provides:

> Condition E is that the individual would not for the tax year be liable to income tax at a rate other than the basic rate or the starting rate for savings if this Chapter did not apply to the individual for the tax year.

22.33.6 *LPE condition F: No tax return*

Section 828B(6) ITA provides:

> Condition F is that the individual does not make a return under section 8 of TMA 1970 for the tax year.

Since a return is due if HMRC choose to require it, the position is that HMRC have a power to withdraw the exemption (by requiring a return). The rule is thus: no tax is due unless HMRC happen to ask for it. This is a new development in tax policy; one hopes it does not become standard.

HMRC say:

> HMRC sought to clarify the intention behind the new legislation which was to remove the obligation on overseas migrant workers on low incomes to file an SA return in cases where there was little or no tax to pay in the UK. It was true that such individuals would no longer qualify for the tax exemption if they filed a return to claim a tax repayment, but the tax exemption was merely the vehicle for delivering the administrative saving. External delegates failed to understand why the exemption should also be lost if the individual filed not a tax return but an R40 to claim repayment of PAYE on UK income.[53]

In fact, the R40 form is not a tax return under s.8 TMA: *Osborne v Dickinson* [2004] STC (SCD) 104.

The RDR Manual provides:

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52 Section 828D(3) ITA incorporates the standard commonsense definition of "foreign income and gains":
""Foreign income and gains", in relation to an individual, means what would be the individual's foreign income and gains for the purposes of Chapter A1 of this Part if section 809B applied to the individual (see section 809Z7(2))."

53 Joint Forum on Expatriates Tax and NICs July 2009, accessible *http://www.hmrc.gov.uk/consultations/expat-mins-160709.htm*.

32070 - Remittance Basis: Accessing the remittance basis: Claiming the remittance basis: Calculation of income tax liability - exemption for non-domiciles with small amounts of foreign employment income
[June 2010]
Individuals employed in the UK are usually required to file a Self Assessment tax return if they have also received income from overseas employment in the same tax year. However in many cases there is little or no tax to pay in the UK because the overseas employment income has already been subject to tax in the other country.
From 6 April 2008 there is no obligation for individuals who are resident but not domiciled in the UK for a tax year to file a return as long as the individual is not claiming the remittance basis under ITA07/s809B and meets all of the following conditions (ITA07/s828A).
[The Manual summarises conditions A - F and continues:] If all of these conditions apply, the individual receives an exemption from liability to income tax, in so far as that liability is attributable to the individual's foreign income or gains for the tax year (termed the 'relevant amount'). Broadly, the relevant amount is deducted from what would otherwise be the amount of the individual's liability to income tax for the tax year under ITA07/s23.
This means that the individual is automatically taxed on the Arising Basis for that tax year, and does not have to complete a return.
Most individuals who fulfil Conditions A to F are expected to use the Arising Basis and not complete a return. However there may be a small number of non-domiciled individuals who fulfil these conditions but who wish to use the remittance basis in respect of their foreign income and gains and are within the 'below £2,000 threshold' user group (ITA07/s809D). Such individuals will have to complete a return in order to claim the remittance basis under s809D; this will of course mean that Condition F of ITA07/s828A is no longer met, refer to RDRM32110 Unremitted foreign income and gains below £2,000 threshold.

22.33.7 *The exemption*

Section 828C ITA provides:

(1) The exemption is given by deducting the relevant amount from what would otherwise be the amount of the individual's liability to income tax for the tax year under section 23.
(2) "The relevant amount" is so much of the amount of the individual's liability to income tax as is attributable to the individual's foreign income or gains for the tax year.

I refer to this as the **"Lower-paid employee exemption."**

22.33.8 *Restriction on exemption*

Section 828C ITA provides:

> (3) But if for the tax year the individual's total income is reduced by any deductions which fall to be made at Step 3 of the calculation in section 23 from the individual's foreign income or gains for the tax year, subsection (2) has effect as if the individual's foreign income or gains for the tax year were reduced by the amount of the deductions.
> (4) And if the individual is entitled under.
> (a) sections 2 and 6 of TIOPA 2010(double taxation arrangements: relief by agreement), or
> (b) section 18(1)(b) and (2) of that Act (relief for foreign tax where no double taxation arrangements),
> to a tax reduction in respect of the individual's foreign income or gains for the tax year, what would otherwise be the relevant amount is reduced by the amount of that reduction.

22.33.9 *Administration: avoiding issue of SA return*

HMRC say:

> HMRC stressed that, whilst the exemption was not designed for employees on inter-company transfers, it had become clear that the exemption could be applied to certain assignees, in particular those from India and China.
> 3 The main issue was the difficulty in identifying the relevant individuals. Unless informed that they qualify for filing exemption, HMRC would issue SA returns, thereby preventing them from taking advantage of s828A. HMRC had designed an election letter for Expats to meet this need: agents should submit this letter at the same time as the 64-8, and after the P46 (Expat) had been filed, which would ensure that no SA return is issued.

This is essential as if a SA return is issued, the relief is lost. For the form of the letter, see Fisher, "Expat Exemption", *Taxation* 3 March 2011 p.18.

HMRC continue:

> There was a separate issue with employers using EPM App 6 with a month 12 adjustment to eliminate any residual liability whose employees are required to submit a SA return. However, as some had very simple tax affairs, there was a case for allowing them to use s828A whilst remaining within EPM6. HMRC will seek to engage with such employers to reach

a suitable agreement for their employee base. In such cases, the election letter will need to be completed but retained by the employer. If there are individuals who do not qualify, the employer or agent will need to submit an SA1 to request a return.
A similar case existed for NR individuals who submit SA returns to get personal allowances under DTAs.[54]

22.33.10 *Commentary*

Almost every requirement of the lower-paid employee exemption is anomalous. If the aim is to remove obligations to file a return where there is little or no UK tax at stake, why is it so limited? The provision presumably reflects effective lobbying by special interest groups concerned with lower-paid employees rather than a serious attempt to address compliance cost issues.

22.34 Tax equalisation

The EIM provides:

77040. Appendix 4: Not ordinarily resident employees: Tax equalisation [February 2006][55]
... In addition to salaries and benefits, employers may also provide their employees with the benefit of tax equalisation. This usually means that the employer undertakes to meet on the employee's behalf any additional tax payable above the tax that the employee would have paid in his home country. It is well established that such payments made on behalf of employees form part of their earnings. But before 2002, there was a difference of view between the then Inland Revenue and a number of accountancy firms about the extent to which such tax equalisation payments represent earnings in respect of duties performed in the UK.

The issue matters for NOR and NR employees: see 22.18 (Non-resident employee).

The view taken by the Inland Revenue and subsequently by HMRC is that tax equalisation payments represent earnings wholly referable to duties performed in the UK where the underlying tax liability is similarly wholly referable to duties performed in the UK. Therefore, where an employer pays a tax liability arising under section 25 on an employee's behalf, that payment will itself represent earnings wholly chargeable under section 25.
This view was approved by a Special Commissioner in 2001 in the case of *Perro v Mansworth* [2001] STC (SCD) 179. The Special Commissioner stated that it was an

54 Joint Expatriate Forum on Tax and Nics: 29 July 2010 Meeting Note *http://www.hmrc.gov.uk/consultations/expat-mins-290710.pdf*

55 The text is derived from Tax Bulletin 59.

inescapable fact that the payment of tax by the appellant's employer was an emolument (earnings) in respect of UK duties since that tax was only payable because of the performance of duties in the UK.

Ms Perro's net earnings were time apportioned in accordance with SP5/84 in order to find the net attributable to UK duties as there was no specific attribution of salary or other benefits between UK and overseas duties. Following *Perro*, it has been accepted practice to gross up this net figure on the basis that the payment of tax on UK-based earnings represents additional earnings wholly referable to duties performed in the UK.

The Special Commissioner did not consider the treatment of reimbursement of tax on income other than employment income chargeable under what is now section 25. The employer of a tax-equalised employee may reimburse UK tax on investment income or capital gains. Employers may also pay foreign tax liabilities on the employee's behalf. Following the decision in *Perro*, the Inland Revenue was asked to give its view on the treatment of such reimbursements.

When apportioning earnings between sections 25 and 26, it is necessary first to consider whether those earnings are wholly referable to UK or non-UK duties on the facts. Clearly if this is so, there is no need to consider time apportionment. If the earnings are not wholly referable either to UK or non-UK duties, then time apportionment will be necessary in accordance with SP5/84.

If an employer reimburses personal tax liability arising on non employment income[56] such as bank interest, dividends or capital gains, then the first question is whether that reimbursement is a payment of earnings that relates wholly to either UK or non-UK duties. We do not consider that the physical presence of the employee in the UK in order to perform employment duties is sufficient justification for treating such reimbursements as wholly in respect of duties performed in the UK. In the absence of unusual facts, we believe that such earnings should be time apportioned. This will produce net section 25 earnings that will then need to be grossed up. The gross up will be on the basis that the payment of UK tax on earnings within section 25 is itself a payment of earnings wholly chargeable under section 25.

With regard to foreign tax payments, the attribution between sections 25 and 26 will depend upon the facts and circumstances. If the foreign tax relates solely to overseas duties, then the payment of that tax by the employer will comprise earnings wholly referable to duties performed outside the UK that cannot be charged to tax under section 25. Alternatively, the foreign tax may be charged on worldwide income so that time apportionment is likely to provide the only practical mechanism for determining the attribution between sections 25 and 26.

With regard to the treatment of employer payment / reimbursement of tax chargeable under section 26, SP5/84 states that provided the earnings chargeable under section 25 are arrived at in a reasonable manner; HMRC is prepared to accept that a charge under section 26 will arise only where the aggregate of earnings received in the UK exceeds the amount chargeable under section 25 for that year. The amount chargeable under section 26 is

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56 [Author's note]. Employees are likely to claim the remittance basis so the tax charge is only on remitted income and remitted foreign gains. It is not clear that the employee ought to pay the charge on remitted income or gains as remittance is a decision of the employee. However it may be appropriate to do so.

therefore restricted to the excess of the aggregate over the amount chargeable under section 25.

Where the employer meets UK tax liability under section 26, the payment of that tax to HMRC will clearly be remitted to the UK. It is logical that the payment of the section 26 liability will itself be a payment of earnings chargeable under section 26 and as the tax payment will be remitted to the UK, the related gross up will also be wholly chargeable under section 26.

There can be significant practical difficulties in identifying whether earnings relate solely to non-UK duties and therefore fall within section 26. In such cases, HMRC would not generally dispute time apportionment between sections 25 and 26 on the basis of working days. If any earnings were allocated solely to section 26 as attributable wholly to non-UK duties, evidence should be available to justify the attribution, in the event of an HMRC enquiry.

Non resident employees

Some tax-equalised employees are not resident in the UK. They may perform substantive duties of their employment in this country. Unless the specific terms of a Double Taxation Agreement confer an exemption from UK tax on UK source employment income, such employees will be liable under section 27 ITEPA on earnings in respect of duties performed in the UK. Earnings for duties performed outside the UK will fall outside of the charge to UK tax on employment income. HMRC adopts the same approach to tax equalisation for non-resident employees as for those resident but not ordinarily resident employees whose earnings are apportioned between sections 25 and 26.

The following simple examples are intended to illustrate the basic approach to tax equalisation earnings described in this appendix. It is recognised that many cases will have much more complex facts and that the ensuing calculations will be similarly complex.

Example (Tanya)

T has been sent to the UK to work at her employer's UK branch for two years from 1 January 2005. She is resident but not ordinarily resident in the UK from the day of her arrival. In addition to her UK duties, her employer requires her to make regular and extensive visits to an overseas branch of its business in order to monitor an important project. Whilst assigned to the UK, T is subject to her employer's policy on tax equalisation which provides for her to receive the same net salary and benefits as if she had remained in her home state.

During 2005-06, T performed the duties of her employment on 225 days. She spent 158 days working in the UK and 67 days working overseas. Net salary and benefits from her employment were £100,000 of which £60,000 was received in the UK. Her employer was obliged to pay her tax liabilities in accordance with its tax equalisation policy. For simplicity, all calculations assume that T's income is chargeable to UK tax at 40%.

Scenario 1

T's only tax liability was incurred in the UK on the earnings from her employment.

Calculation of UK tax for 2005-06

Net salary and benefits	100,000
Less amount attributable to overseas workdays – 67/225 (30%)	(30,000)
Attributable to the performance of UK duties	70,000
Gross up for UK tax at 4/6	46,666
UK-based earnings taxable under section 25 ITEPA	116,666

Tax at 40% 46,666

Remitted to the UK - 60,000 plus section 25 tax of 46,666	106,666
Section 26 ITEPA - SP5/84	Nil

Scenario 2

Facts as above but T's employer also paid UK tax liability of £5,000 on her investment income. As the £5,000 is not directly referable to the performance of duties inside or outside the UK, it falls to be time apportioned in accordance with SP5/84. Therefore, the £5,000 has been added to net salary and benefits before calculating and deducting the amount attributable to overseas workdays.

Calculation of UK tax for 2005-06

Net salary and benefits	105,000
Less amount attributable to overseas workdays – 67/225 (30%)	(31,500)
Attributable to the performance of UK duties	73,500
Gross up for UK tax at 4/6	49,000
UK-based earnings taxable under section 25 ITEPA	122,500
Tax at 40% 49,000	
Remitted to the UK - 60,000 plus section 25 tax 49,000 and other UK tax 5,000	114,000
Section 26 ITEPA - SP5/84	Nil

Scenario 3

Additionally, T's employer pays overseas tax liability of £5,000 direct to an overseas tax authority. The overseas tax is referable solely to the performance of duties outside the UK and is therefore excluded from the section 25 calculation.

Calculation of UK tax for 2005-06

Net salary and benefits	110,000
Less overseas tax payment	(5,000)
Salary and benefits to be time apportioned	105,000
Less amount attributable to overseas workdays – 67/225 (30%)	(31,500)
Attributable to the performance of UK duties	73,500
Gross up for UK tax at 4/6	49,000
UK-based earnings taxable under section 25 ITEPA	122,500
Tax at 40% 49,000	
Remitted to the UK - 60,000 plus section 25 tax 49,000 and other UK tax 5,000	114,000
Section 26 ITEPA - SP5/84	Nil

Scenario 4

Facts are the same as in Scenario 2 except that £70,000 out of the £100,000 net salary and benefits has been remitted to the UK.

Calculation of UK tax for 2005-06

Net salary and benefits	105,000
Less amount attributable to overseas workdays – 67/225 (30%)	(31,500)
Attributable to the performance of UK duties	73,500
Gross up for UK tax at 4/6	49,000
UK-based earnings taxable under section 25 ITEPA	122,500
Tax at 40% 49,000	
Remitted to the UK - 70,000 plus section 25 tax 49,000 and other UK tax 5,000	124,000

Net section 26 ITEPA - SP5/84	1,500
Gross up for UK tax at 4/6	1,000
Foreign earnings taxable under section 26	2,500
Total taxable earnings (sections 25 and 26)	125,000
Tax at 40% 50,000	

HMRC say:

6.1 HMRC explained the background to the Short Term Business Visitor Arrangement (EP Appendix 4) which has been in place since the early 1990s. The arrangement is specifically for Short Term Business Visitors who come to the UK from countries with which the UK has a Double Taxation agreement, which includes an Employment /Dependant Personal services article. The introduction of the SRT means that some Short Term Business Visitors who visit the UK for less than 6 months may become resident in the UK when previously they would not have been resident.

56.2 HMRC has decided to allow employers to include resident Short Term Business Visitors within the arrangement where the visit(s) are for no more than 150 days in any 12 month period. Those Short Term Business Visitors who stay in the UK between 151 and 183 days may be entitled to exemption but for this small group, named applications must be made. This is a risk based approach which HMRC will monitor and review after the end of 2014/15. Where the employee has let his overseas property and his permanent home for the purposes of the treaty tie-breaker is likely to be in the UK, PAYE must apply. In uncertain cases HMRC will issue an NT code but require a Self Assessment return.

6.3 HMRC welcomes comments on the draft revised arrangement previously circulated and intends to publish the final arrangement by April 2013. It was suggested that as claims to treaty exemption ultimately depend on the application of the employment services article, the PAYE guidance should follow the OECD Commentary.

HMRC insisted that the PAYE relaxation should continue to be denied to earnings borne by the UK employer. Any other claims should be made to HMRC separately.

6.4 HMRC confirmed that new agreements for existing arrangements would not be required but employers would need to take account of the revised wording. Employers who currently rely on the terms of the arrangement without HMRC agreement, will be encouraged to contact HMRC to "sign up". Employers will need to have received HMRC agreement to use the arrangement from April 2013. As such they should not rely on previous Forum notes. The new arrangement will be

publicised via a What's New Article on the HMRC website.[57]

The April deadline was missed and at the time of writing the new rules have not yet been published.

The minutes of the Joint Forum on Expatriate Tax and NICs provide:

> **EP Appendix 4**
> Question: Can an employer operate the arrangements detailed in PAYE82000 known as EP Appendix 4 without written agreement from HMRC?
> HMRC answer: Prior to 2013-14 HMRC did allow employers to rely on the terms of the arrangement without making a formal application to HMRC to use it. This practice was withdrawn from the 6 April 2013. As such, the statements published following the Forum meetings on 30 November 2006 and 18 April 2007 no longer apply. Employers must put an agreement in place with HMRC to operate The PAYE relaxation known as EP Appendix 4 for the ta x year 2013-14 onwards. Applications for 2013-14 onwards should be made by 5 April 2014. Employers who already hold agreements signed by HMRC do not need to sign new application forms but should apply the revised terms in the current version on the HMRC website using the link below:
> *http://www.hmrc.gov.uk/manuals/pommanual/PAYE82000.htm*
> Employers without signed agreements must operate PAYE on the earnings of all their short term business visitors unless they receive a tax code NT from HMRC for the named individual. Those employees may make a claim to HMRC for treaty relief if they meet the relevant criteria in the relevant Double Taxation Agreement.[58]

22.35 Accountancy services benefit

Joint Forum on Expatriates Tax and NICs records a discussion on tax return preparation fee benefits:

> It was made clear that these discussions and any proposals or guidance based on them will relate only to circumstances where:
> - due to tax equalisation arrangements, the employer pays for accountancy services relating to the preparation and submission of the individual assignees' Tax Returns

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57 Joint Expatriate Forum on Tax and NICs: (January 2013)
http://www.hmrc.gov.uk/consultations/expat-mins-jan2013.pdf

58 29 January 2014
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf

- tax return preparation is part of a wider bundle of services provided by the adviser as negotiated with the employer
- S9A enquiry services are not included as part of the bundle

In such circumstances HMRC accept that the level of benefit in kind should be arrived at by apportionment based on the facts. The mechanics of how the apportionment should be calculated are an operational issue and CPTT had already shared with delegates (within the meeting notes of 30 August 2007) an exchange with Ernst & Young LLP on this topic. CPTT did not have authority to agree fixed round sum figures applicable in all cases. Indeed, it was clear from the evidence submitted that there is no 'one size fits all'. However, CPTT were prepared, in due course, to provide some clarity of the level at which they perceive there to be a risk worthy of enquiry.

The intention therefore would be to:

- establish a level of tax return preparation benefit which if returned or exceeded will not prompt any enquiry
- continue to allow for different figures to be reported based on the available facts
- highlight that where levels of tax return preparation benefits are reported below this level it remains open to HMRC/CPTT to enquire into the precise figures and apportionment methodology to check the accuracy of Returns submitted

CPTT is still analysing the information provided but Martin Dwyer was able to say that the available evidence suggested that a level of around £600 per head would be reflective of a situation where a home and host country Return was completed.

HMRC remain of the view that any accountancy fees paid in respect of S9A enquiry work should be reported as benefits in kind. HMRC will continue to look for evidence of the payment of such fees and their position will be as clarified within the meeting notes of the Forum held on 30 August 2007, as follows:

> 'Where we find evidence to indicate that the costs of accountancy services related entirely to resolving the S9A enquiry, we will regard these costs as giving rise to a taxable benefit in kind. If your clients are unable to accept this treatment, we will need to refer an appropriate case to the Commissioners.'

Subsequent to the meeting HMRC has now completed its analysis of the information provided. From this we conclude that the levels of benefits which appear both realistic and reasonable are £650 per head where a home and host country Return is completed and £250 per head where only the host country (UK) Return is completed. Under existing circumstances these figures will represent levels which if returned or

exceeded will not prompt an enquiry from CPTT. However, it has been recently highlighted by external representatives that the proposed levels of analysis necessary to support access to the remittance basis from 6 April 2008 is likely to lead to increases in the costs charged for UK Tax Return preparation where the remittance basis is claimed. If this proves to be the case there would be a need to recognise this and revise the figures for 2008-09 onwards accordingly.

HMRC reiterate that the sums quoted above are not intended to represent an agreed level of benefits which must be reported across the board. We recognise that there is unlikely to be consistency in the precise make up of the bundle of accountancy services provided across different cases and by the variety of advisers involved. Rather, the aim is to indicate a level at which CPTT perceive the level of risk to be worthy of enquiry.[59]

A subsequent meeting of the forum records:

Q10: Accountancy fees in regard to partially tax-equalised employees

It is not clear which partially tax-equalised cases are covered by the agreement announced in the 18 September 2008 forum notes. By 'partially tax-equalised' we mean when the employer agrees to tax-equalise part of the employee's income/gains but not the whole. This is very common, often employers will tax equalise only employment income and even then might exclude elements such as share options.

The notes mention 'due to tax equalisation arrangements, the employer pays for accountancy services' which perhaps suggests the precise nature of the equalisation arrangements is not in point. However, Appendix 6 of HMRC's Employment Procedures Manual – 'Modified PAYE' arrangements – says that those arrangements may be applied only to tax-equalised employees and, for that purpose, 'tax-equalised' means that:

' ... the employer must equalise liability to UK Income Tax on all general earnings (see note) subject to the rules in part 2 Chapters 4 and 5 ITEPA applying to employees resident, ordinarily resident or domiciled outside the UK.

Note: Where the employee is tax-equalised on all general earnings but not, for example, on taxable awards of securities options or the award of securities at undervalue (which is specific employment income) the employee may still be included within the arrangement as long as all the other conditions are satisfied'.

It would seem rather restrictive to take the same approach in relation to accountancy fees as an employee's tax equalisation computations can be

59 Note of Meeting 18 September 2008, accessible *http://www.hmrc.gov.uk/consultations/expat-mins-180908.htm*

just as (possibly more) complex if only part of the earnings are equalised.
HMRC Answer: It is the case that the guidance contained within the Forum meeting notes of 18 September 2008 was intended to relate to 'fully' tax equalised cases including those capable of inclusion within an EP Appendix 6 agreement.
Where partial tax equalisation applies it seems to me that the extent to which the accountancy advice directly benefits the individual rather than the employer must increase and I would expect this to be reflected within the level of benefits reported.
As in the case of tax equalised individuals, where HMRC wishes to check the amounts reported we will look at the amounts paid for the basket of services provided and seek to establish those parts of this basket which directly benefit the employer. It should then be possible to calculate a benefit in kind figure by reference to the balance on a per head basis.
...
HMRC were asked to give clarification regarding whether or not the levels of accountancy fees, clarified at the meeting held on 18 September 2008, could be applied in respect of the 2008-09 SA Tax Returns. Martin Dwyer confirmed that these amounts were intended to reflect levels below which HMRC perceive there to be a risk and above which it was unlikely that HMRC would make an enquiry into the matter of accountancy fees relating to Tax Return preparation. They were not intended to represent mandatory levels of benefits which should be included on Tax Returns as HMRC accept that there will be cases where the true level of benefit varies from the figures provided for guidance. Against this background, however, HMRC confirmed that the same guidance could be extended to apply to 2008-09 SA Returns. As was confirmed in the answer to Q10, however, that guidance was intended to relate to fully tax equalised cases, including those capable of inclusion within an EP Appendix 6 agreement. Whilst it was accepted that this would include cases where tax equalisation applied to all employment income other than share based remuneration, the guidance was not intended to apply to circumstances where partial tax equalisation arrangements are in place which can often apply to a small proportion of the overall compensation package.[60]

The figures have since been increased:

HMRC has .. taken a view to increase the levels for 2014-15 benefits in kind to £275 for one return and £700 for a home and host country return.

60 Note of meeting July 2009, accessible *http://www.hmrc.gov.uk/consultations/expat-mins-160709.htm*

The next review will be in April 2016.
Members were reminded that the amounts are applied to fully tax equalised employees and are for tax return preparation fees only. Further benefits in kind should be reported where employers also bear the agent's fees for dealing with Section 9A enquires.[61]

22.36 DT Relief: employment exercised outside UK

Article 15(1) OECD Model provides:

> 1. Subject to the provisions of Articles 16,[directors][62] 18 [pensions][63] and 19 [government service][64], salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

To follow this one must bear in mind which Contracting State is which. It is easier to follow if rewritten with the UK in mind, thus:

> 1. ... salaries, wages and other similar remuneration derived by a resident of a *foreign* Contracting State in respect of an employment shall be taxable only in that *foreign* State unless the employment is exercised in *the UK* [the other Contracting State]. If the employment is so exercised *in the UK*, such remuneration as is derived therefrom may be taxed in *the UK* [that other State].

The OECD commentary provides:

> 1. Paragraph 1 establishes the general rule as to the taxation of income from employment (other than pensions), namely, that such income is taxable in the State where the employment is actually exercised. ... One consequence of this would be that a resident of a Contracting State who derived remuneration, in respect of an employment, from sources in the other State could not be taxed in that other State in respect of that remuneration merely because the results of this work were exploited in that other State.

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61 Joint Expatriate Forum on Tax and NICs (29 April 2014) *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/327284/140704_Expat_Forum_Minutes_FINAL.pdf*

62 See 22.43 (DTAs: Directors Fees).

63 See 24.7 (DT relief for pension income).

64 See 22.44 (DT relief: government service).

> 2. The general rule is subject to exception only in the case of pensions (Article 18) and of remuneration and pensions in respect of government service (Article 19). Non-employment remuneration of members of boards of directors of companies is the subject of Article 16....
> 2.2 The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee.

The DTR Manual provides:

> **1920 Employment** [April 2007]
> The employment Article in our double taxation agreements is normally called the Dependent Personal Services Article. In most of the UK's agreements the Article is based on Article 15 (Dependent Personal Services) of the OECD Model Convention (see DT153) and the terms of this Model Article are summarised below. It must, however, always be checked that the Article in the particular agreement with which you are concerned follows the OECD Model Article before reliance is placed upon the guidance below.

22.36.1 *"Salaries, wages and other similar remuneration"*

The OECD commentary provides:

> 2.1 Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships).

The DTR Manual provides:

> **1920 Employment** [April 2007]
> ... The words 'salaries, wages and other similar remuneration' should be understood in the broadest sense as covering all income from an employment, including benefits and share option gains chargeable under Section 135 ICTA 1988 (see DT1925).

22.36.2 *Where is employment exercised?*

The OECD commentary provides:

> 1. ... Employment is exercised in the place where the employee is physically present when performing the activities for which the

employment income is paid.

In *Kljun v HMRC* [2011] UKFTT 371 (TC) the Judge said:

> [18] What does exercised mean? The English is clear and it is where the employee is physically present when performing the activities for which the employee is being paid.

22.37 DT relief: employment exercised in UK

This takes us to Art. 15(2) OECD Model:

> 2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
>
> a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
> b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
> c) the remuneration is not borne by a permanent establishment which the employer has in the other State.[65]

For convenience I set this out as it applies to the UK:

> 2. ... remuneration derived by a resident of a *foreign* Contracting State in respect of an employment exercised in *the UK* [the other Contracting State] shall be taxable only in the *foreign* [first-mentioned] State if:
>
> a) the recipient is present in *the UK* [the other State] for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
> b) the remuneration is paid by, or on behalf of, an employer who is not a resident of *the UK* [the other State], and
> c) the remuneration is not borne by a permanent establishment which the employer has in *the UK* [the other State].

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65 For completeness, article 15(3) continues: "3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated." This is not discussed here; see OECD commentary para 9.

The OECD commentary provides:

> 3. Paragraph 2 contains, however, a general exception to the rule in paragraph 1. This exception covers all individuals rendering services in the course of an employment (sales representatives, construction workers, engineers, etc.), to the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or artistes and sportsmen.

22.38 Article 15(2)(a): Limited days of presence

Article 15(2)(a) provides:

> a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned

The OECD commentary provides:

> 4. The three conditions prescribed in this paragraph must be satisfied for the remuneration to qualify for the exemption. The first condition is that the exemption is limited to the 183 day period. It is further stipulated that this time period may not be exceeded "in any twelve month period commencing or ending in the fiscal year concerned". This contrasts with the 1963 Draft Convention and the 1977 Model Convention which provided that the 183 day period should not be exceeded "in the fiscal year concerned", a formulation that created difficulties where the fiscal years of the Contracting States did not coincide and which opened up opportunities in the sense that operations were sometimes organised in such a way that, for example, workers stayed in the State concerned for the last 5 ½ months of one year and the first 5 ½ months of the following year. The present wording of subparagraph 2 a) does away with such opportunities for tax avoidance. In applying that wording, all possible periods of twelve consecutive months must be considered, even periods which overlap others to a certain extent. For instance, if an employee is present in a State during 150 days between 1 April 01 and 31 March 02 but is present there during 210 days between 1 August 01 and 31 July 02, the employee will have been present for a period exceeding 183 days during the second 12 month period identified above even though he did not meet the minimum presence test during the first period considered and that first period partly overlaps the second.
>
> 5. Although various formulas have been used by Member countries to calculate the 183 day period, there is only one way which is consistent with the wording of this paragraph: the "days of physical presence"

method. The application of this method is straightforward as the individual is either present in a country or he is not. The presence could also relatively easily be documented by the taxpayer when evidence is required by the tax authorities. Under this method the following days are included in the calculation: part of a day, day of arrival, day of departure and all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the exemption) and death or sickness in the family. However, days spent in the State of activity in transit in the course of a trip between two points outside the State of activity should be excluded from the computation. It follows from these principles that any entire day spent outside the State of activity, whether for holidays, business trips, or any other reason, should not be taken into account. A day during any part of which, however brief, the taxpayer is present in a State counts as a day of presence in that State for purposes of computing the 183 day period.

5.1 Days during which the taxpayer is a resident of the source State should not, however, be taken into account in the calculation. Subparagraph a) has to be read in the context of the first part of paragraph 2, which refers to "remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State", which does not apply to a person who resides and works in the same State. The words "the recipient is present", found in subparagraph a), refer to the recipient of such remuneration and, during a period of residence in the source State, a person cannot be said to be the recipient of remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State. The following examples illustrate this conclusion:

— Example 1: From January 01 to December 01, X lives in, and is a resident of, State S. On 1 January 02, X is hired by an employer who is a resident of State R and moves to State R where he becomes a resident. X is subsequently sent to State S by his employer from 15 to 31 March 02. In that case, X is present in State S for 292 days between 1 April 01 and 31 March 02 but since he is a resident of State S between 1 April 01 and 31 December 01, this first period is not taken into account for purposes of the calculation of the periods referred to in subparagraph a).

— Example 2: From 15 to 31 October 01, Y, a resident of State R, is present in State S to prepare the expansion in that country of the business of ACO, also a resident of State R. On 1 May 02, Y moves to State S where she becomes a resident and works as the manager of a newly

created subsidiary of ACO resident of State S. In that case, Y is present in State S for 184 days between 15 October 01 and 14 October 02 but since she is a resident of State S between 1 May and 14 October 02, this last period is not taken into account for purposes of the calculation of the periods referred to in subparagraph a).

The DTR Manual provides:

1921 Short term visitor exemption 183 day rule [June 2009]
The first condition for exemption under Article 15(2) is that the employee must not be present in the UK for more than 183 days either 'in the tax year concerned' (as in Article 15(2)(a) of the 1980 UK/USA agreement) or 'in any period of 12 months' (found in Article 15(2)(a) of the 1985 UK/Norway agreement). It is important to distinguish between these formulae. The latter formula is a much tighter test than that used in the agreement with the USA.
For example, a US resident seconded to work in the UK for a two year assignment arrives here on 15 October 1990 and leaves the UK on 1 October 1992. Depending on all the circumstances, he could be taxable in the UK only for the year 1991-92. For the years 1990-91 and 1992-93 he could meet the condition in Article 15(2)(a) because in both periods he was not present in the UK for 183 days 'in the tax year concerned'.
By contrast, a Norwegian resident working in the UK would be taxable here throughout the period 15 October 1990 to 1 October 1992 under the test in the agreement with Norway.
Our agreements with Azerbaijan, Belgium, Bolivia, Denmark, Estonia, France, Ghana, Guyana, Iceland, Indonesia, Ivory Coast, Kazakhstan, Korea, Latvia, Malta, Mexico, Mongolia, Pakistan, Papua New Guinea, Sweden, Uganda, Ukraine, Uzbekistan, Venezuela and Vietnam also use the wording of the Norwegian agreement; and the agreement with New Zealand is similar. Most of the UK's agreements, however, use the tax/fiscal year formula.
Up until 5th April 2009, when counting to 183 days under Article 15(2)(a), a part day counts as a part day and days of arrival and departure and all other days spent inside the country of activity should be included in the calculation.
From 6th April 2009 onwards, when counting to 183 days under Article 15(2)(a), any part of a day, day of arrival, day of departure, and all other days spent in the UK such as Saturdays, Sundays, national holidays, holidays before during and after the period of work, short breaks (training, strikes, lock-out, delay in supplies), days of sickness (unless they prevent the individual from leaving and he would otherwise have qualified for the exemption) and death and sickness in the family should

be included in the calculation as a day the person is present in the country of activity.

Days spent in the UK in transit in the course of a trip between two non-UK points should be excluded from the computation.

From 2008/09 onwards (this overlaps for a year with the previous day counting method), days during which the tax payer is a resident of the UK should not be included in the calculation. The conditions in the treaty are for remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and does not apply to a person who is resident and works in the same State. For example if a person is a resident of the UK but is hired by an employer in another State, moves to that State where he becomes resident and is subsequently sent to work for a short period in the UK by his employer, we would only include days in the UK after the taxpayer became a resident of the other State for the purposes of computing whether they had exceeded 183 days in the UK. Days in the UK when the taxpayer was a resident of the UK should not be included.

Similarly if a non-resident taxpayer is seconded to the UK for a short period by their employer and subsequently moves to and becomes a resident of the UK, days in the UK after they became a resident here should not be taken into account for the purposes of the calculation of the 183 days.

22.39 Article 15(2)(b): Payment by non-resident employer

Article 15(2)(b) provides:

> b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and

The DTR Manual provides:

> **1922 Employment** [June 2011]
>
> The second condition for exemption under Article 15(2) is that the remuneration which is the subject of the claim must be paid by, or on behalf of, an employer who is not UK resident.
>
> What follows is guidance regarding when a claim can be accepted and when an enquiry into the claim may be required. It is not intended to replace or expand the commentary on the application of Article 15 in the OECD Model Tax Convention on Income and Capital.
>
> The fact that an individual formally remains an employee of an overseas company does not on its own satisfy the test in Article 15(2)(b). Not only must the claimant remain an employee of the overseas company but the remuneration in respect of which the exemption is claimed must be paid

by the overseas employer and not, for example, by a UK subsidiary company to whom the employee may have been seconded. Any statement on this aspect of a claim should be checked to ensure that it is consistent with

i) other information in the papers (for example what does the return show?) and
ii) the position in other similar cases involving the same UK employer.

If there is any doubt you should ask the agents to provide a statement from the UK company or the overseas employer, to confirm the extent to which, if at all, the overseas employer has continued to pay the claimant's remuneration either directly or by reimbursing the UK company.

Cases where remuneration continues to be 'paid by' the overseas employer, but there is a recharge of the cost of that remuneration to the UK company to whom the employee has been seconded, are frequently a cause of difficulty. Claims should not be admitted where

- the employee remains formally employed by a company which is not resident in the UK and
- he is seconded to work for a UK resident company and
- the UK company for practical purposes functions as his employer during the UK assignment and
- the UK company bears the cost of the employee's remuneration, either by a direct recharge or as part of a management charge made by the non-resident employer.

When does a UK company function as an employer?

Guidance on the criteria for identifying the employer for the purposes of the Article is to be found in paragraphs 8 to 8.28 of the Commentary on Article 15 of the OECD Model Double Taxation Convention which should be considered in cases of difficulty and CAR PTI advisory will also be able to provide assistance. The starting point is whether under the domestic laws of the State of Source the services rendered in that State are provided in an employment relationship and that will determine how that State applies the Convention, i.e. whether the services are provided under a contract of service or under a contract for services. Where an employee works in the business of a UK company and that company obtains the benefits and bears any risks in relation to the work undertaken by the employee then that company is likely to be treated as his employer.

The mere fact that the UK company has borne the cost of the employee's remuneration is not on its own sufficient for that company to be treated as the employer. A UK company would not be regarded as the employer where the employee continued to work in the business of a non-resident

company even though working at the premises of the UK company - for instance, an employee sent to the UK company to service equipment supplied by a non-resident company.

In this situation the services are being provided under a contract for services between the two companies and not under a contract of service with the UK company.

Paragraphs 8.16 to 8.27 of the Commentary provide other examples of cases where services are rendered under a contract of employment and where, alternatively, they are provided under a contract for services between two enterprises.

The following guidance may also be of assistance in practice. In the case of very short term secondees it is unlikely that an employee would be sufficiently integrated within the business of the UK company for that company to be regarded as his employer. For that reason it may be accepted that a UK company with whom an employee does not have a formal contract of employment should not be treated as the employer for the purposes of Article15 where that employee is in the UK for less than 60 days in a tax year and that period does not form part of a more substantial period when the taxpayer is present in the UK. The 60 days are to be counted using the "days of physical presence method" set out paragraph 5 of the Commentary. Basically, if a person is physically present in the UK during any part of a day then that counts as a day in the UK for the purposes of this rule.

Further details about how this 60 day rule is applied can be found in Tax Bulletin issue 68.

Avoidance cases

Claims should not be admitted where payment by an overseas company forms part of an arrangement to avoid UK tax. PAYE Technical will advise in cases where, for example, the overseas employer is based in a tax haven or the employee is nominally employed by a company which exists to provide his services to the UK user of those services. Cases where an employment which existed prior to the employee's assignment to the UK continues during that assignment usually do not cause difficulty. Cases where the employee has taken up a new formal employment with an overseas company at the time of assignment should be reviewed critically.

'On behalf of'

Payments may be made 'on behalf of' a non-resident employer in cases where the payment is physically made by a UK company. It may be accepted that remuneration has been paid or benefits provided 'on behalf of' a non-resident employer if that non-resident ultimately bears the cost of such remuneration and benefits. Claims should not be admitted where

a UK company pays remuneration or incurs the cost of benefits and does not receive reimbursement from the overseas employer. Such payments and costs are incurred in the interest of the UK company and not on behalf of the overseas employer.

Unless the claimant offers evidence that the UK company was reimbursed the cost of the taxpayer's remuneration and benefits by the non-resident employer (and this can be checked with the relevant HMRC corporation tax specialist or Customer Relationship Manager dealing with the UK company's Corporation Tax affairs) a claim under Article 15(2) should be resisted.

Where it is argued that remuneration has been paid 'on behalf of' an overseas employer, even though a UK company has paid the individual's remuneration and the overseas employer has not reimbursed the cost, it should be pointed out that it is unlikely that, in these circumstances, the cost of the remuneration could be regarded as wholly and exclusively incurred for the purposes of the UK company's trade and that, therefore, no deduction should be claimed for the cost of the remuneration in computing the UK company's taxable profit. Reference should be made to the tax case of *Robinson v Scott Bader and Co* (54TC757) which considers the inadmissibility of remuneration paid on behalf of another employer.

The decision in the Scott Bader case makes clear that the object of the person making the payment is decisive in determining whether or not a deduction is permissible in accordance with Section 74 ICTA 1988.

In relation to seconded employees there are three possible situations

- the payment to the employee is made solely in the interests of the overseas company;
- the payment is made partly in the interests of the UK company and partly in the interest of the overseas company or
- the payment is made solely in the interests of the UK company.

Only in the third case is a deduction available to the UK company in computing its profits.

Benefits

Even where basic remuneration continues to be paid by the overseas employer it is common for benefits (for example, the use of a flat) to be provided at the cost of the UK employer to whom the employee has been seconded. Subject to the other conditions in the Article, the basic remuneration may be exempt from UK tax but the condition in Article 15(2)(b) is not satisfied in relation to benefits in these circumstances because they are not 'remuneration paid by, or on behalf of,'the overseas employer (unless the cost of the benefits is borne by the overseas employer through a recharge).

Kljun v HMRC [2011] UKFTT 371 (TC) offers an illustration of a case within art 15(2)(b).

22.39.1 *Employer a partnership*

The OECD commentary provides:

> 6.1 The application of the second condition in the case of fiscally transparent partnerships presents difficulties since such partnerships cannot qualify as a resident of a Contracting State under Article 4 (cf. paragraph 8.2 of the Commentary on Article 4). While it is clear that such a partnership could qualify as an "employer" (especially under the domestic law definitions of the term in some countries, e.g. where an employer is defined as a person liable for a wage tax), the application of the condition at the level of the partnership regardless of the situation of the partners would therefore render the condition totally meaningless.
> 6.2 The object and purpose of subparagraphs b) and c) of paragraph 2 are to avoid the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as he neither is a resident nor has a permanent establishment therein. These subparagraphs can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given State may be considered to constitute an excessive administrative burden where the employer neither resides nor has a permanent establishment in that State. In order to achieve a meaningful interpretation of subparagraph b) that would accord with its context and its object, it should therefore be considered that, in the case of fiscally transparent partnerships, that subparagraph applies at the level of the partners. Thus, the concepts of "employer" and "resident", as found in subparagraph b), are applied at the level of the partners rather than at the level of a fiscally transparent partnership. This approach is consistent with that under which other provisions of tax Conventions must be applied at the partners' rather than at the partnership's level. While this interpretation could create difficulties where the partners reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners who own the majority of the interests in the partnership reside (i.e. the State in which the greatest part of the deduction will be claimed).

22.40 Article 15(2)(c): Remuneration borne by UK PE

Article 15(2)(c) provides:

> (c) the remuneration is not borne by a permanent establishment which the employer has in the other State.

The OECD commentary provides:

> 7. Under the third condition, if the employer has a permanent establishment in the State in which the employment is exercised, the exemption is given on condition that the remuneration is not borne by that permanent establishment. The phrase "borne by" must be interpreted in the light of the underlying purpose of subparagraph c) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that could give rise to a deduction, having regard to the principles of Article 7 and the nature of the remuneration, in computing the profits of a permanent establishment situated in the State in which the employment is exercised. In this regard, it must be noted that the fact that the employer has, or has not, actually claimed a deduction for the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether any deduction otherwise available for that remuneration would be allocated to the permanent establishment. That test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled. The test would also be met where the remuneration is not deductible merely because of its nature (e.g. where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment.

Kljun v HMRC [2011] UKFTT 371 (TC) offers an illustration of a case within art 15(2)(c).

22.40.1 *Grant of beneficial share options*

Share options granted by reason of employment are in principle earnings and subject to income tax on the grant of the option: *Abbott v Philbin* 39 TC 82. For UK resident employees, s.475 ITEPA overrides that charge. That does not however apply to non-resident employees, and it is not uncommon to find non-resident employees who have taxable duties in the UK. In this case, the grant of an option falls outside of chapter 5 of part 7

ITEPA 2003 and therefore in principle subject to income tax on the grant of the option. DT relief is however likely to be available if the employee is resident in a jurisdiction with a DT relief in OECD model form. In particular, the requirement of article 15(2)(c) is met: the remuneration is will not be borne by a permanent establishment which the employer has in the UK. For the remuneration is not borne by the company over whose shares the share option is issued. If anyone, it is the shareholders in that company who bear the burden of the remuneration.

22.41 Who is the employer?

The identity of the employer matters for condition (b) and (c).

The OECD commentary provides:

> 8. Paragraph 2 has given rise to numerous cases of abuse through adoption of the practice known as "international hiring-out of labour". In this system, a local employer wishing to employ foreign labour for one or more periods of less than 183 days recruits through an intermediary established abroad who purports to be the employer and hires the labour out to the employer. The worker thus fulfils prima facie the three conditions laid down by paragraph 2 and may claim exemption from taxation in the country where he is temporarily working. To prevent such abuse, in situations of this type, the term "employer" should be interpreted in the context of paragraph 2. In this respect, it should be noted that the term "employer" is not defined in the Convention but it is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks. In cases of international hiring-out of labour, these functions are to a large extent exercised by the user. In this context, substance should prevail over form, i.e. each case should be examined to see whether the functions of employer were exercised mainly by the intermediary or by the user. It is therefore up to the Contracting States to agree on the situations in which the intermediary does not fulfil the conditions required for him to be considered as the employer within the meaning of paragraph 2. In settling this question, the competent authorities may refer not only to the above-mentioned indications but to a number of circumstances enabling them to establish that the real employer is the user of the labour (and not the foreign intermediary):
>
> — the hirer does not bear the responsibility or risk for the results produced by the employee's work;
> — the authority to instruct the worker lies with the user;
> — the work is performed at a place which is under the control and

responsibility of the user;
— the remuneration to the hirer is calculated on the basis of the time utilised, or there is in other ways a connection between this remuneration and wages received by the employee;
— tools and materials are essentially put at the employee's disposal by the user;
— the number and qualifications of the employees are not solely determined by the hirer.

The DTR Manual provides:

1923 Employment [February 2006]
The third condition for exemption under Article 15(2) is that the remuneration of the employee must not be borne by a permanent establishment or fixed base which the employer has in the UK –see DT1710 onwards and DT219 for general guidance concerning the meaning of these terms.
This condition should be considered carefully in all cases where the employee has not apparently been assigned to work in the UK for a UK-resident company. If an employee has simply been seconded by his overseas employer to work here for a UK-resident company it will not usually be necessary to consider this condition.
A subsidiary company in the UK is not generally a permanent establishment of its overseas parent company (see DT1714). The subsidiary is not in law part of its parent company but is a distinct legal person. A permanent establishment is simply a part of an overseas company which is transplanted in the UK. Customers and employees all contract with the overseas company rather than with a separate legal person in the UK. Company letter-paper often indicates how the UK operations are organised; the registered number and place of registration of a UK company are often given at the head or foot of the paper.
If operations in the UK are carried out through a permanent establishment, it should be assumed in the absence of evidence to the contrary that the cost of remuneration of an employee seconded to the permanent establishment is a deduction in computing the profits of the permanent establishment. This will be the normal basis of allocating costs in accordance with international tax principles. The permanent establishment should therefore be regarded as bearing the cost of that individual's remuneration unless there is evidence that the overseas Head Office continues to pay the employee and the cost is not allocated to the UK permanent establishment for UK tax purposes. A permanent establishment cannot be said to 'bear the remuneration' unless it is charged against its profits without a corresponding credit, for example by

way of a management charge. In doubtful cases advice may be sought from the Inspector dealing with the accounts of the permanent establishment.

Sometimes dealing with the PAYE District may be the first contact which an overseas company has with the UK Revenue and it may not yet have been established whether or not the company has a permanent establishment in the UK. If the company has had no prior contact with the Revenue the Corporation Tax District which would have responsibility for the company (the District dealing with the area where the business premises of the company are located) should be asked to advise whether or not a permanent establishment exists in the UK (see DT1715 in cases of difficulty).

1924 Employment [April 2007]

Refer to Employment Income Technical all claims to the exemption of employment income from UK tax (DT1920 onwards) where

- the tax at stake in that case exceeds £50,000, or
- the company claimed to be the employer is apparently based in a tax haven, or
- difficulty is experienced in applying the guidance at DT1920 onwards in a particular case.

As the instructions in DT410 explain, a claim to exemption under an agreement is a claim to the Board by virtue of Section 788(6) ICTA 1988 and a notice of decision on a claim may not be given by an Inspector. If you reach the point where you are unable to reach agreement with the taxpayer please send the case to Employment Income Technical.

The commentary was changed in 1992. In the absence of the commentary, one might have thought that "employer", being an undefined term, would have its UK law meaning in accordance with article 3(2). For criticisms of this in relation to treaties before the amendments to the commentary, see "Employees and Double Taxation Agreements" [1995] BTR 529; "Debates on Treaties" [1997] BTR 1.

22.41.1 *The 60-day rule*

Tax Bulletin 68 provides:

Non-Residents Working In The UK For Short Periods: The "60-Day" Rule

Most of the UK's double taxation agreements contain a provision which may enable an employee who comes to work here on a short-term basis to be taxed only in his or her home country. An employee must show that he or she fulfils a series of conditions specified in the agreement to make a valid claim to exemption from UK tax. One of those conditions will be that the employee's remuneration must be 'paid by or on behalf of an employer' who is not resident

in the UK. In many cases, it is clear that the employer is the non-resident company for whom the taxpayer was working before he or she came to the UK. In other cases, the employee may have been seconded by his or her overseas employer to work for a UK company, or the overseas employer may carry on a business of hiring out staff to other companies. A formal contract of employment remains with the overseas employer, but the employee works in the business of the UK company, which obtains the benefits and bears any risks in relation to the work undertaken by the employee. In economic terms, this state of affairs is recognised by the overseas employer recharging the cost of the employee's earnings to the UK and the UK company might be described as the 'economic employer'. In such a case, the exemption from UK tax for short-term visitors will not be available. This was explained in Tax Bulletin 17, published in June 1995. However, the position of very short-term visitors caused concern, and Tax Bulletin 25 dealt with this in October 1996. This reproduced a statement by the Financial Secretary to the Treasury (FST) that the Inland Revenue would not consider that a short term business visitor was sufficiently integrated into the business of a UK company for it to be regarded as the employer where:

- the employee concerned is in the UK for less than 60 days in a tax year; and
- that period does not form part of a more substantial period when the taxpayer is present in the UK.

This has become known as the "60-day rule". This article gives further guidance on common situations where it may be an issue.

Does the worker have to be from a country with which we have a full double tax agreement for the 60-day rule to apply?

The 60-day rule is framed in terms of accepting without enquiry that the conditions in a DTA for short-term business visitors to be solely taxed in their country of residence have been satisfied. That exemption, and consequently the 60 day rule, is therefore only relevant if the person is resident in a country with which we have signed a comprehensive double tax agreement. If not, domestic legislation will apply in full.

Is the 60-day exemption available if the employee is on the UK payroll?

No. The FST's statement was made in the context of workers who were paid via a non-resident employer's payroll but whose economic employer might be in the UK.

How do you count the days for the 60-day rule?

It is based on physical presence in the UK in the same way as the 183 days are counted for the purposes of Article 15(2) of the OECD model Tax Convention.

Is the 60 days a fixed limit? For example, an employer has a succession of people who work for him and he bears their wages, but they may be in the UK up to 90 days.

The 60-day rule represents a balance between a loss of tax revenue which may be due to the UK and the compliance costs to both employers and the Revenue of ascertaining and collecting such tax for very short-term visitors. There are no plans for it to be altered. However individuals working in the UK may be exempt under the relevant DTA anyway, for example if their earnings are paid by an overseas company, not recharged in any form to a UK company or permanent establishment and no UK company acts as their employer.

Is the 60-day rule available where the earnings have been recharged to a UK permanent establishment rather than a UK-resident company?
Although not covered in the actual wording of the 1996 statement, the Revenue accepts the 60-day rule should apply in these circumstances also.
How should the phrase "part of a more substantial period" be interpreted?
The aim is to provide consistency:

- Between very short-term workers, regardless of the particular dates involved; and
- Between short-term workers seconded from overseas and the normal workforce of the UK employer.

The most obvious example met is where less than 60 days are worked up to 5th April and less than 60 days after, but the overall period is more than 60 days. In these circumstances, the 60-day exemption will not be available, to be consistent with periods of more than 60 days worked over, say, November to January.
What if there is a gap between two shorter periods of employment?
To consider whether the 60-day period has been exceeded, the following factors may be relevant:

- Is there an expectation that the employee will return to the UK when they depart initially?
- How long is the gap between visits in comparison to the length of those visits?
- How frequently does the employee return to the UK?
- How integral to the business are the duties performed?

It is impossible to give an exact formula that will cover all circumstances. However, the following examples should assist in seeing how the Revenue will approach this question.
Example 1: Alain visits the UK for 35 days in Feb/March 2003, then returns to Austria for a fortnight's holiday, and returns again to the same contract for 40 days in April/May.
The 75 days would be regarded as one period. The gap here is insignificant compared to the two periods either side and liability to UK tax would be consistent with a person who works for 75 days here continuously. As the periods are part of the same contract, the employer would be expected to operate PAYE from day one. If there had been no expectation of returning during the first 35 days we would expect PAYE to be operated only for the second period even though liability to UK tax would exist for both for Alain. This is because the 60 days is an objective test whilst PAYE is based on "reasonable expectation" that payments are liable to UK tax.
Example 2: Beatrice visits the UK for 35 days in Year 1. She returns to Belgium but unexpectedly is asked to return in Year 2, after a 7 month gap, and does so for 40 days.
Each episode in the UK would be regarded as separate periods of less than 60 days. Beatrice's return was unexpected, and after a relatively long gap. So there is no UK liability for either and no PAYE is due.
Example 3: Cedric is the financial controller for a Canadian group. Each year he visits the UK subsidiary for 55-59 days.
Once there is an expectation that this will be the work pattern, the Revenue would

consider that the episodes of work here were part of a more substantial period. A financial controller will be significantly integrated into the business, whether this is of the UK subsidiary or possibly a permanent establishment of the parent company. PAYE will apply from when it is clear that visits will recur as part of a regular and integrated pattern, although Cedric may have to consider whether he is also liable under self assessment to UK tax for an earlier period of work, as for Alain in Example 1. Cedric and the group will then be able to decide the duration and timing of visits to the UK on business grounds rather than for individual tax considerations.

Example 4: Danielle spends 50 days working in UK between 10 April and 15 January, with visits averaging 3 days each. Then from 1 June to 6 October a further 15 days are spent visiting UK for business meetings on the same piece of work.

Although Danielle is taxable from the very start, we would not expect either her or the company to be able to recognise this. However, the Revenue would expect PAYE to be operated in Year 2.

HMRC say:

HMRC were asked to clarify the way in which the economic employer test applies in a number of scenarios in which employment costs are recharged to a UK employer. In each scenario, an individual has a formal employment contract with a person resident outside the UK and is seconded to work in the UK.

The economic employer test is set out in the commentary to Article 15 of the OECD Model Tax Convention on Income and Capital which, subject to certain conditions, enables an overseas employee who comes to the UK to work on a short-term basis to be taxed only in his or her home country. HMRC confirmed that it is not practice to restrict this test for UK resident employers.

This means that, where an employee is present in the UK for less than 60 days and is not on the payroll of a UK resident employer, the 60-day rule set out in Tax Bulletin 68 will normally apply: the individual will not be considered to have an economic employer without any further consideration of the facts being necessary. In other situations, it will be necessary to examine the facts to determine who has the rights on the work produced and bearing the relative responsibility and risks. Where the employee is a resident in another contracting State and is seconded to the UK for a short period, the economic employer will not depend on whether the UK employer is entitled to a Corporation Tax deduction for the remuneration costs: the UK employer might be entitled to a deduction even where they are not the economic employer.

HMRC referred to the recent publication on 21 May 2010 by the OECD of proposed revisions to the Model Treaty Commentary on employment

relationships for the purposes of Article 15.[66]

The minutes of the Joint Forum on Expatriate Tax and NICs record:

> **Short term business visitors**
> With reference to the previous question and answer given in October *(i.e. "With reference to the previous question and answer given in July i.e. 'Some of my UK employees were assigned to a separate foreign legal entity overseas, but continued to hold contracts of employment with the UK Company. Some of those employees subsequently returned to the UK as short term business visitors working for and at the expense of that foreign employer. Can Article 15(2) (b) be satisfied in these situations?' could HMRC:*
> (i) expand the answer to explain the word entity and
> (ii) if an overseas branch of a UK parent company is regarded as an overseas entity.")
> can HMRC further clarify whether a branch of a branch would be considered to satisfy the 60 day rule if in example 2, the overseas employee of an overseas employer comes to work in the UK branch? A branch is simply a place where a company carries out its business and as such a 'branch of a branch' remains a branch of the original company. In the scenario described, an overseas branch of a UK company can not be regarded as the employer. The employer will be the UK comp any regardless of how many branches there may or may not be. The 60 day rule will not therefore apply. [67]

22.42 DTA defence to BiK charge

This section considers whether DTAs may provide a defence to the BiK charge.

It is assumed in this section that although the individual is UK resident,[68] they are treaty-resident in another state ("the foreign state") under the DTA tie-breaker rules. A DTA may well be of assistance in these circumstances.

It is assumed that the foreign state has a DTA with an article in the form of Art. 15 of the OECD Model Treaty; of course the individual treaty will

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66 Joint Expatriate Forum on Tax and NICS: 26 May 2010 Meeting note *http://www.hmrc.gov.uk/consultations/260510-epf-minutes.pdf.*

67 29 January 2014 *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf*

68 Otherwise there is no BiK problem.

need to be reviewed.

To qualify for relief under Art. 15(1) the following conditions must be met.

There must be an employment. A shadow directorship is an employment for UK tax purposes, and it is considered that it counts as an employment for treaty purposes.

The BiK charge must be a tax on "salaries, wages and other similar remuneration." This is the case.

The BiK must be in respect of the employment: it is considered that this condition is satisfied.

Lastly, the employment must be exercised wholly in the foreign state (in which case full relief is applicable) or at least partly in the foreign state (in which partial relief applies). This is more problematic and in typical cases assuming the employment is exercised at all, it will be exercised at least partly in the UK. If that is the case only partial relief is available under article 15(1).

If relief is not available under Art.15(1) we turn to Art.15(2).

In principle this can offer exemption from the charge on benefits in kind, even if the employment is exercised wholly or partly in the UK. The three conditions in (a) to (c) must be met.

> *(a) the recipient is present in the UK for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned*

Whether this condition is met depends on the facts.

> *(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the UK*

The employer is of course the company owning the property. The employer will not in principle be UK resident. In fact the BiK is not in the strict sense "paid" but it is suggested that the word should not be strictly construed and this requirement is satisfied.

> *(c) the remuneration is not borne by a permanent establishment which the employer has in the UK.*

This condition will be met, since the company will not have a permanent establishment (the UK home is not a permanent establishment as defined).

Accordingly individuals who are treaty-resident in a contracting state and present in the UK for less than 183 days can qualify for DT relief under

Art. 15(2).

22.43 DTAs: Directors fees

Article 16 OECD Model provides:

> Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

The OECD commentary provides:

> 1. This Article relates to remuneration received by a resident of a Contracting State, whether an individual or a legal person, in the capacity of a member of a board of directors of a company which is a resident of the other Contracting State. Since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company.
> 1.1 Member countries have generally understood the term "fees and other similar payments" to include benefits in kind received by a person in that person's capacity as a member of the board of directors of a company (e.g. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships).
> 2. A member of the board of directors of a company often also has other functions with the company, e.g. as ordinary employee, adviser, consultant, etc. It is clear that the Article does not apply to remuneration paid to such a person on account of such other functions.
> 3. In some countries organs of companies exist which are similar in function to the board of directors. Contracting States are free to include in bilateral conventions such organs of companies under a provision corresponding to Article 16.

22.44 DT relief: government service

Article 19 OECD model provides:

> 1. a) Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
>
> b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident

of that State who:

(i) is a national of that State; or

(ii) did not become a resident of that State solely for the purpose of rendering the services.

2. a) Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

b) However, such pensions and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.

3. The provisions of Articles 15, 16, 17, and 18 shall apply to salaries, wages, pensions, and other similar remuneration in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

22.45 DT relief: claims

The DTR Manual provides:

1920- Non-residents: Employment [April 2007]

... For years of assessment 1996-97 onwards, claims to exemption from UK tax in respect of employment income are made as part of the taxpayer's self assessment on the claim form attached, depending on the circumstances, to either Help Sheet IR302 (Dual-Residents) or Help Sheet IR304 (Non-Residents - Relief under Double Taxation Agreements). Both forms require the taxpayer to establish the fact of his residence in the other country for the purpose of the agreement (see DT310) and to declare that the relevant provisions of the particular agreement are considered to have been fulfilled. All claims under Article 15(2) should be checked carefully by reference to terms of the agreement and, where appropriate, to the guidance at DT1921 - DT1923, and enquiries raised in suitable cases. See also DT1924 about certain types of cases which must always be referred to Employment Income Technical, before a claim is accepted.

...

CHAPTER TWENTY THREE

PAYE

23.1 PAYE: Introduction

A full discussion of PAYE needs a book to itself. This chapter focuses on matters closest to the themes of this book.

The law is mostly contained in the Income Tax (PAYE) Regulations 2003 (which I call "**the PAYE regulations**").

In outline, the obligation to deduct PAYE is in reg. 21(1) PAYE regulations:

> On making a relevant payment to an employee during a tax year, an employer must deduct or repay tax in accordance with these Regulations by reference to the employee's code, if the employer has one for the employee.

The key term is "relevant payment". "Relevant payment" is a label for a number of rules.

There is the usual cascade of definitions. Subject to some exceptions, not discussed here, reg. 4(1) PAYE regulations provides:

> In these Regulations, any reference (however expressed) to relevant payments means payments of, or on account of, net PAYE income...

"Net" PAYE income is a label to introduce rules for deductions not discussed here.[1]

"PAYE income" is defined in s.683 ITEPA:

> (1) For the purposes of this Act and any other enactment (whenever passed) "PAYE income" for a tax year consists of—

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1 Regulation 3(1) PAYE regulations provides:
"Net PAYE income means PAYE income less any—
(a) allowable pension contributions, and
(b) allowable donations to charity."

(a) any PAYE employment income for the year,
(b) any PAYE pension income for the year, and
(c) any PAYE social security income for the year.

(2) "PAYE employment income" for a tax year means income which consists of—

(a) any taxable earnings from an employment in the year (determined in accordance with section 10(2)),[2] and
(b) any taxable specific income from an employment for the year (determined in accordance with section 10(3)).

23.2 Non-resident and workday relief employees

In three cases it may be unclear how much income is taxable and so PAYE income:

(1) non-resident employees and
(2) employees who qualify for workday relief
(3) Split years.

Section 690 ITEPA provides a clearance mechanism:

(1) This section applies in relation to an employee in a tax year if the employee—

(a) [i] is either non-UK resident for the tax year or
[ii] is UK resident but meets the requirement of section 26A for the tax year, and
(b) works or will work in the UK and also works or is likely to work outside the UK.

(1A) This section also applies in relation to an employee in a tax year if it appears to an officer of Revenue and Customs that—

(a) the tax year is likely to be a split year as respects the employee, and
(b) the employee works or will work in the United Kingdom and also works or is likely to work outside the United Kingdom.

(2) If in relation to an employee to whom this section applies and any tax year it appears to an officer of Revenue and Customs that—

(a) some of the income paid to the employee by the employer[3] is PAYE income, but

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2 See 22.6 (Taxable earnings).

3 Section 690(3)(b) ITEPA provides:
"any reference to a payment made by the employer includes a reference to a payment made by a person acting on behalf of the employer and at the expense of the employer or a person connected with the employer."

(b) some of that income may not be PAYE income,

an officer of Revenue and Customs may, on an application made by the appropriate person,[4] give a direction for determining a proportion of any payment made in that year of, or on account of, income of the employee which is to be treated as PAYE income.

I refer to this as **"a s.690 direction."**

(2A) For the purposes of subsection (2) as it applies in relation to an employee who is UK resident for a tax year but not domiciled in the United Kingdom in that tax year, the officer may treat section 809B of ITA 2007 (remittance basis) as applying to the employee for that year, even if no claim under that section has been made.

HMRC Brief 17/09 explains s.690(2A) ITEPA is to correct an oversight in 2008:

Section 690 ITEPA directions
Prior to April 2008 non-domiciled individuals and not ordinarily resident individuals were automatically taxed on the remittance basis on their foreign employment income. However since April 2008 individuals have to make an annual claim to the remittance basis. Section 690 ITEPA was amended in Finance Act 2008 to reflect this change for not ordinarily resident employees. Prior to April 2008 employers were able to ask for a section 690 direction which permitted them not to apply PAYE to certain employment income paid to not ordinarily resident employees entitled to be taxed on the remittance basis. These rules have been amended to allow this procedure to continue.

23.2.1 *Application for s.690 direction*

Section 690 ITEPA continues:

(4) An application under subsection (2) must provide such information as is available and is relevant to the application.
(5) A direction under subsection (2)—
(a) must specify the employee to whom and the tax year to which it relates,
(b) must be given by notice to the appropriate person, and

4 Section 690(3)(a) defines "appropriate person":
"In this section—
(a) "the appropriate person" means the person designated by the employer for the purposes of this section and, if no person is so designated, the employer..."

(c) may be withdrawn by notice to the appropriate person from a date specified in the notice.

(6) The date so specified may not be earlier than 30 days from the date on which the notice of withdrawal is given.

23.2.2 *Effect of s.690 direction*

Section 690 ITEPA continues:

(7) If—

(a) a direction under subsection (2) has effect in relation to an employee to whom this section applies, and

(b) a payment of, or on account of, the income of the employee is made by the employer in the tax year to which the direction relates,

the proportion of the payment determined in accordance with the direction is to be treated for the purposes of PAYE regulations as a payment of PAYE income of the employee.

23.2.3 *Position in absence of s.690 direction*

Section 690 ITEPA continues:

(8) If in any tax year—

(a) no direction under subsection (2) has effect in relation to an employee to whom this section applies, and

(b) any payment of, or on account of, the income of the employee is made by the employer,

the entire payment is to be treated for the purposes of PAYE regulations as a payment of PAYE income of the employee.

(9) Subsections (7) and (8) are without prejudice to—

(a) any assessment in respect of the income of the employee in question, and

(b) any right to repayment of income tax overpaid and any obligation to pay income tax underpaid.

23.2.4 *HMRC practice*

The PAYE Manual provides:

81545. UK employer's duties [July 2013]

...

The employee is resident/not ordinarily resident or not resident in the UK and works both in and outside the UK

The employer can apply under Section 690 ITEPA 2003 for a direction from HMRC to operate PAYE only on the percentage of the employee's

total earnings that are for work in the UK. This applies to all payments made by the employer including termination payments and share based remuneration.

The Section 690 application is only an estimate of the work done in and outside the UK and the employee should complete an SA return to report the actual position. See PAYE81555 - PAYE81565 on how to handle applications under Section 690 ITEPA 2003.

If an employer does not make an application under Section 690 ITEPA 2003, then unless the employee is within an EP Appendix 6 arrangement (see PAYE81740), they must operate PAYE on all payments made to the employee for work done both in and outside the UK. The employee can claim a repayment of the tax deducted on earnings for work done outside the UK on their SA Return.

You must set up an SA record for an employee who works both in and outside the UK, whether or not a Section 690 application is made.

If the employer provides Tax Equalisation arrangements for the employee, you should refer to PAYE81740.

Cases of doubt or difficulty should be referred to Personal Tax Product & Process, PAYE Technical, Shipley for advice.

...

81555. Applications under Section 690 ITEPA 2003 - Who deals with the application? [September 2010]

Arrivals in the UK

On receipt of an application for a direction under Section 690 ITEPA 2003 you must decide which office is responsible for reviewing the application. Use the following table to determine the office and pass the application to them immediately.

Situation	**Responsible Office**
The employee is an Expat	CAR PTI Manchester Expat Unit
All other employees	The Processing Office for the employee

81560. Applications under Section 690 ITEPA 2003 - reviewing the application [June 2012]

Arrivals in the UK

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

Use the flowchart [not published] to review an application under Section 690. It contains links to a number of draft letters you should use depending on the circumstances of the case. These letters are available on SEES Forms and Letters, in the general subdirectory 'Regulation/Payment letters'.

When an application is accepted, you must take the following action

- Set up an SA record for the employee if there is not one already

- Arrange for an SA return with the non-residence and employment pages to be issued for the year(s) the application covers
- Make an SA note as follows 'Sec690 approval given for [year] for earnings from [employer's name]. PAYE to be operated on [%].'
- If the employee is resident/not ordinarily resident
  - Amend their tax code to remove the basic personal allowance (and blind person's allowance if claimed)
- Place all the Section 690 papers in an SA Post batching range

81565. Applications under Section 690 ITEPA 2003 - At the end of the tax year [January 2012]

The employer must complete the employee's form P14, End of Year Summary, to show only

- The pay on which the employer has operated PAYE (this will include the amount representing the UK duties agreed by HMRC under Section 690 ITEPA and any other taxable pay) and the tax deducted from that pay

The employee should, when completing their SA return enter

- The earnings from their P60 / P45 in box 1 on the Employment page including any cash earnings from that employment that have not been included on the P60 / P45
- The tax deducted from their P60 / P45 in box 2 on the Employment page
- The remainder of their earnings in box 3 on the Employment page including paid earnings overseas from an earlier year which were not liable to UK income tax unless they were remitted to the UK during the Tax Return year
- The amount of their total earnings which relates to work done abroad in box 12 under the section 'Share Scheme and Employment Lump Sum, Compensation and Deduction' on the 'Additional Information Page' (SA101)

No equivalent rule is needed for UK resident non-domiciled employees, whose income is either taxable entirely on the remittance basis or on the arising basis.

23.3 PAYE adjustment to recapture lost personal allowance

RDR1 provides:

> **What should you do if you have UK tax allowances and choose to use the remittance basis?**
>
> 8.9 If you decide during a tax year that you are going to use the remittance basis and you are still getting UK personal allowances

> through the PAYE system, you may not be paying enough UK tax.
> 8.10 If you contact us, we can arrange to amend your tax code to one which does not give relief for personal allowances, thus reducing any potential tax bill arising from you getting the benefit of allowances you are no longer entitled to. Your employer can't do this for you as your tax affairs are confidential between you and HMRC. Until they receive a new tax code from us, your employer will continue to deduct tax from you based on the code we originally issued before you were claiming the remittance basis.

It is hard to imagine anyone wishing to do this. But HMRC say:

> Employers have expressed concern that the P46 (Expat) does not allow them to operate a 0T code (no personal allowance) even where they are aware that the employee will claim the remittance basis or has income in excess of £100K.
> HMRC said that it was not the responsibility of employers to withdraw personal allowances and, if they did so, the New PAYE System (NPS) might reinstate the allowances when the P14 is filed and make a repayment to the individual.
> HMRC said that, if employers agree with their employee that they will claim the remittance basis or if the individual's earnings will exceed £100K, they should request a formal change of code number from the Expat Team. This would ensure that HMRC records mirror those of the employer when the P14 is submitted.
> HMRC confirmed that the Modified PAYE rules in EPM6 allows PAs to be withdrawn from remittance basis users but it would be sensible for Employers to notify the Expat Team of situations where that applies. They agreed to make the necessary changes to the EPM6 agreement to make this clear.[5]

23.4 Repayment of overpaid PAYE not a remittance

The minutes of the Joint Expatriate Forum record:

> HMRC had circulated a note explaining that the existing non-statutory practice could continue whereby remittances arising as a result of repayments of overpaid PAYE to non tax-equalised employees were disregarded. This statement was based on new legal advice and meant

5 Joint Expatriate Forum on Tax and NICs: (May 2010) Meeting Note *http://www.hmrc.gov.uk/consultations/260510-epf-minutes.pdf*.

there was no need to provide for this treatment in primary legislation.[6]

This note is dated 7 October 2011 and provides:

> HMRC's long standing practice in relation to repayments of income tax for employees who remain not ordinarily resident in the UK has been to treat PAYE tax overpaid as not constituting a remittance in cases where:
> - under tax equalisation arrangements it would be refunded to the employer; or
> - the employee instructs HMRC to refund the money to an overseas account.
>
> The practice is however not consistent with the FA 2008 remittance basis legislation.
>
> At a Expats Forum sub group meeting held on 18 May 2011, HMRC confirmed that repayments of tax overpaid to an employer under a tax equalisation arrangement would not constitute income as the employee is contractually entitled to net remuneration and the actual UK taxes due on that remuneration. The repayment of the tax overpaid is in effect a refund of overpaid earnings by employee to employer.
>
> However, for gross paid employees, PAYE repayments represent a part repayment of earnings delivered in the UK and as such a remittance to the UK under section 809L ITA. HMRC agreed to consider the views expressed and how the matter could be resolved. In the meantime, the existing practice would continue until at least 5 April 2012.
>
> The suggestion was made at the subgroup that, if the practice was ultra vires HMRC's management discretion, it should be legislated, possibly as part of the current review of non domiciled taxation.
>
> HMRC has since taken further legal advice on this matter. This has confirmed that the current informal practice can continue as an informal concession. As such, there is no need for any legislative fix.

23.5 Short-term business visitors within DTA: PAYE exemption

The PAYE Manual provides:

> **82000 EP appendix 4: criteria for short term business visitors** [April 2013] The CWG2 Employer Further Guide to PAYE and NICs advises employers that it may be possible to relax strict PAYE requirements for employees on short-term business visits to the UK, and tells employers to contact their HMRC Office.

6 Joint Expatriate Forum on Tax and NICs (October 2011); see *http://www.hmrc.gov.uk/consultations/expat-mins-oct-2011.pdf*.

Short Term Business Visitors

This arrangement provides that PAYE can be disregarded in certain circumstances. If an employer has only one or two employees potentially affected they may like to consider applying for an NT code (see PAYE81625) on an individual basis instead.

Conditions

This arrangement must only be applied where individuals are

- Resident in a country with which the UK has a Double Taxation Agreement under which the Dependent Personal Services / Income from Employment Article (Article 15 or the equivalent) is likely to be competent
- Coming to work in the UK for a UK company or the UK branch of an overseas company
- Expected to stay in the UK for 183 days or less in any twelve month period

Provided that it can be shown that for specifically named employees, the UK company or branch will not in fact ultimately bear the remuneration specified. Where agreement is reached and in all other aspects the employee falls within the guidelines, then that part of the remuneration not ultimately borne by the UK company or branch can fall within this arrangement. See also the three 'Notes: Definitions' below regarding employees receiving some remuneration that is ultimately borne by the company or branch and some which is not.

These arrangements will not apply where the expense of the remuneration is passed on to another UK company or branch and not recharged overseas.

Notes: Definitions

- Where used in this arrangement the term remuneration has its widest possible meaning and includes for example, salary, wages, benefits, allowances and expenses
- Where an employee otherwise falling within this arrangement receives remuneration borne by companies in different countries then
  a. Remuneration not ultimately borne in the UK - falls within this agreement
  b. Remuneration ultimately borne in the UK - does not fall within this agreement unless the HMRC Office has agreed a dispensation for it. It is therefore possible for an employee falling within this arrangement to also have a PAYE liability. If otherwise appropriate this PAYE liability can be met using modified PAYE procedures as described in EP Appendix 6, PAYE82002.
- 'Ultimately borne' means the company finally bearing the cost after all recharging of any nature

Although employee remuneration ultimately borne by the UK Company is not covered by this particular arrangement, the OECD commentary provides examples of situations where the UK Company would not be regarded as the economic employer and treaty exemption may therefore apply. In such cases a separate claim should be made.

Notes: Double Taxation Treaties

- Some Double Taxation Treaties (for example that with The Netherlands) specify 183 days in a tax year. When looking at residents of those countries therefore this is the test to apply and not the 183 days in any twelve month

period now more commonly used
- The Double Taxation Manual (DT1920 to DT1924 inclusive) is relevant to this arrangement and should be consulted initially in cases of doubt
- Full Payment Submissions do not need to be completed for EP Appendix 4 employees

Notes: Method of counting days spent in the UK

...

The method of counting days should follow the OECD commentary 'days of physical presence' method. Under this method, the general principle is that any day during any part of which, however brief, the person is present in the UK counts as a day of presence for the purposes or computing the 183 day period. As such

- Any part of a day, day of arrival, day of departure, and all other days spent in the UK such as Saturdays, Sundays, national holidays, holidays before during and after the period of work, short breaks (training, strikes, lock-out, delay in supplies), days of sickness (unless they prevent the individual from leaving and that individual would otherwise have qualified for the exemption) and death and sickness in the family should be included in the calculation
- Days spent in the UK in transit in the course of a trip between two non-UK points should be excluded from the computation

Days during which the taxpayer is a resident of the UK should not be included in the calculation. The conditions in the treaty are for remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and does not apply to a person who is resident and works in the same State.

For example, if a person is a resident of the UK but is hired by an employer in another State, moves to that State where they become resident and is subsequently sent to work for a short period in the UK by his employer, we would only include days in the UK after the taxpayer became a resident of the other State for the purposes of computing whether they had exceeded 183 days in the UK. Days in the UK when the taxpayer was a resident of the UK should not be included.

Similarly if a non-resident taxpayer is seconded to the UK for a short period by their employer and subsequently moves to and becomes a resident of the UK, days in the UK after they became a resident here should not be taken into account for the purposes of the calculation of the 183 days.

...

General principles of an EP Appendix 4 arrangement

1. It only applies to employees who have not become UK resident for tax purposes or if UK resident, are treaty resident in the treaty partner country
2. In all cases involving short-term assignment of employees to the UK, the employer will put in place some form of internal reporting system to keep as accurate as possible a record of employees visiting the UK on business. It is expected that this system will have the following minimum requirement
    - Employees will periodically report days spent in the UK on business to the central point controlling this arrangement

- Employees should not spend more than 30 days intermittently in the UK in any 12 month period without reporting to that central point

3. All records that are kept under this arrangement are within Regulation 97 IT (Pay As You Earn) Regulations 2003 and so must be retained and produced for inspection
4. Where liability is subsequently found to arise on payments of PAYE income made to an employee the employer will be expected to pay the tax that ought to have been deducted from or otherwise paid in respect of each payment. Late payment of PAYE tax will attract interest in the usual way
5. Should it become apparent that PAYE is not being applied in the case of employees who do not satisfy the relevant criteria, HMRC reserves the right to insist that PAYE be operated strictly for all employees from day 1
6. Any employee who cannot fulfil the conditions set out below should have PAYE operated from day 1
7. The treatment for NICs purposes of employees coming to the UK is covered in the CWG2 Employer Further Guide to PAYE and NICs

The time limits given in EP Appendix 4 are administrative only and are over-ridden by any legislative time limits. For example if a taxpayer needs to complete a Self Assessment return then the normal rules relating to Self Assessment apply.

Visitors to the UK 1 - 30 days

No requirements for either employer or employee to fulfil.

Visitors to the UK 31 - 60 days

For an employee who spends no more than 60 days in the UK during the tax year, PAYE can be disregarded provided it is confirmed that

a. there is no formal contract of employment with the UK employer
b. the 60 days do not form part of a more substantial period. (See DT1922.)

Visitors to the UK 61 - 90 days

For an employee in the UK for not more than 90 days in the tax year, PAYE can be disregarded provided that the employer supplies the information below by 31 May following the end of the tax year

- Full name of employee
- Last known UK and overseas addresses of employee
- Nature of duties undertaken
- Date commenced
- Date ceased
- To which country a tax return covering worldwide income is submitted

And confirms that

a. The UK company does not
    - Ultimately bear the cost of the employee's remuneration
    - Function as the employee's employer during the UK assignment. (See DT1922 for further information)

Visitors to the UK 91 to 150 days

For an employee in the UK for a period of 91 days but not exceeding 150 days in the tax year PAYE can be disregarded provided that

a. All of the information requested for visitors up to 90 days is provided and in addition

b. In the case of non-US citizens and Green Card holders, the employee provides a statement from the overseas Revenue authority confirming residence in the other state for tax purposes during the period in the UK. This statement should be passed to the HMRC Office by 31 May following the end of the relevant overseas tax year. This arrangement is only provisional until the relevant certificate is received

In the case of US citizens it will only be necessary for the employee to provide evidence of continuing residence in the US.

Visitors to the UK 151 to 183 days

Applications will be made on a named individual basis for authority to include the employee in this arrangement. The application will be made as soon as it can reasonably be anticipated that the employee will be present in the UK for more than 150 days. The application will include

a. All of the information requested for visitors up to 90 days and confirmation that the statement from the overseas Revenue authority will follow by the relevant 31 May

b. A statement by the employee giving reasons why he / she considers himself /herself to be treaty resident in the treaty partner country by reference to the appropriate article in the Double Taxation Treaty

Helpsheet HS302 provides more information about dual residence generally and the tests to be applied to determine the country of tax residence.

HMRC will consider the circumstances and will

a. Notify the employer that the individual can be included in the Appendix 4 arrangement, or
b. Authorise code NT and issue a Self Assessment tax return, or
c. Confirm that PAYE should be applied and issue a Self Assessment tax return

23.6 Foreign tax credit relief: PAYE exemption

The PAYE Manual provides:

82001 EP appendix 5: net of foreign tax credit relief [January 2014]

Relaxation on payments of PAYE

This arrangement only applies to employers who are required to deduct foreign tax in addition to UK PAYE from payments being made to employees sent to work abroad. Its aim is to give provisional relief for double taxation to employees who must pay both UK tax and foreign tax from the same payments of earnings.

The CWG2 Employer Further Guide to PAYE and NICs, advises employers to contact HMRC if they have to do this. If they do, HMRC considers the position as set out in PAYE81715, and may authorise the employer to operate the arrangement set out in this appendix.

It is the Employer Technical Team (EP Appendix 5 Application), Customer Operations National Insurance Contributions and Employer Office, Gilbridge House, High Street West, Sunderland, SR1 3HL, who are responsible for authorising the employer to operate these arrangements.

If the employee has to pay foreign tax direct to an overseas Revenue authority

on payments taxed through PAYE, advance DTR can be given through the PAYE code (see PAYE81715).

In many overseas contract situations, where an employee is abroad for less than 6 months no overseas tax is ultimately found to be due. This is because the employee will usually have personal protection under the terms of many Double Taxation Agreements (DTA).

However, it cannot be assumed that DTA protection is available on the basis that the employee works in an overseas country for less than 183 days. The relevant DTA and the other authority should be consulted. In particular, the 183 day protection may not be available where

- The employee works for a resident of the overseas country who functions as their employer; Or
- Their contractual employer has an identifiable `permanent establishment' in the overseas country; Or
- The DTA says so

If these circumstances apply or where no DTA exists, overseas tax is due from day 1. The overseas country may also impose withholding at source obligations on the employer so that they have continuing UK PAYE / NIC responsibilities as well as those arising in the overseas country.

It is in these specific circumstances or where the 183 days period is exceeded but the taxpayer remains UK resident, that we can sanction the relaxation of some PAYE requirements.

The relaxation only applies to UK PAYE that should be deducted from an employee's pay using their UK tax code and UK tax tables. All other PAYE and National Insurance requirements must still be fulfilled by the employer. There can be no question of abandoning PAYE / NIC altogether for the duration of the overseas contract.

You should make it clear to the employer that the relaxation is only being made available here because of the taxing rights of the country concerned and otherwise two amounts of tax would be deducted from the employees gross pay. It should not be used by the employer or agent for any other contract or situation without prior consultation with you. It is not available if an overseas deduction is borne by the employer.

Employers responsibilities under this arrangement

Where you agree the use of this arrangement you must write to the employer to

- Request the name and NINO of each employee included in the arrangement
- Ask the employer to provide a regular update of any changes in the number of employees included. The frequency of these updates must be agreed between you and the employer

Advise the employer that

- For those employees on overseas work in (country name) PAYE/NIC due should be calculated in the normal way
- They must only give credit by this method for foreign tax actually payable on and deducted from the employee's wages and paid to the overseas authority
- Credit is given by reducing the amount of UK PAYE deducted from wages by the amount of foreign tax deducted from gross wages in the same UK tax

year

- Foreign tax will normally be set off against UK PAYE in the same pay period before the employer pays it to the Accounts Office. However, credit can be given retrospectively in the same tax year where pay was double taxed
- The credit available under this agreement is restricted to the amount of UK PAYE deductible from the employees wages (NICs deductions and contributions are not affected in any way)
- Any net UK PAYE tax remaining due is to be returned on the employer's RTI submissions. This net amount will form part of the employer's regular payment and should be paid to the Accounts Office in the normal way with all the NICs due
- Any UK PAYE refunds due during the year because of a change of code number must be restricted to the net UK PAYE deducted from the employee during the year
- The employer and the employee must undertake to provide details of foreign tax that has been refunded

Employee redeployed, no longer overseas

For employees who cease to operate overseas but continue in the same employment in the UK or another location, the employer must

- Submit details of pay and UK tax deducted up to the date of redeployment together with a report of foreign tax credited
- Operate the employees existing code on the Week 1 or Month 1 basis

Employee leaves employment or dies

If an employee who has been given credit under this system leaves the employment, or dies, the employer must should

- Submit the final full payment submission for the employee showing the date of leaving or death as appropriate and showing the code as if it had been operated on a Week1/Month1 basis
- Any P45 issued to a leaver should be completed as if the tax code has been operated on the Week 1 or Month 1 basis, showing the net UK tax deducted. This is to ensure that any new employer does not operate it on a cumulative basis

A statement of the overseas tax deducted, for which credit has been given against UK PAYE, should be issued to the departing employee and it should contain

- The Total Taxable Pay to date
- The Total Taxable Pay subject to UK Tax and foreign tax
- The Total Foreign Tax paid
- The amount of UK PAYE that has been offset by the foreign tax

The employer should keep HMRC up to date with any changes to these arrangements, see 'Notification of employees included in the arrangement' below. So if any employee leaves or dies, this does not mean that we require an in year return immediately. As long as the details above are issued to an employee who leaves, the employer can tell HMRC at the next agreed update or at the year end.

If the employer decides to send HMRC an update when the employee leaves or

dies they can do so. If they do, it should contain the information they have provided to the employee. There is no set format for this information and HMRC does not produce a return. It should be sent to the Edinburgh address quoted under the sub heading 'At the end of the tax year' below.

Action to be taken once the agreement is authorised

Following an agreement to the relaxation of PAYE in accordance with Appendix 5, you must take the following action

- On the employers record, use EBS Function AMEND EMPLOYER NOTES to record that an arrangement under Appendix 5 has been agreed
- The Employers Technical Team will update the database spreadsheet that records these schemes

Notification of employees included in the arrangement

The employer must send details of employees included in this arrangement and keep you up to date with changes to those details on a regular basis (at intervals agreed between you and the employer).

On receipt of these details, you must take the following action to ensure that the taxpayer's liability is reviewed at the end of the year.

In all cases on each employee's record

- Enter a note on Contact History that the employee is included in an arrangement under Appendix 5
- Set the inhibit automatic reconciliation signal on the PAYE Service record for CY and CY+1 (this should be set on the record for every year until the employment ceases)

For redeployments, leavers and deceased cases on receipt of the P45(1) or equivalent on each employee record

- Enter the following note on Contact History 'Total tax to date (enter date of leaving or redeployment) is net of Foreign Tax Credit Relief'
- Update the current year's record to add a Week 1 / Month 1 basis to the latest code on the record

Note: A cumulative code for these cases cannot normally be restored in-year. If you receive a request for a cumulative code or an in-year repayment, you should tell the customer that this is not possible. If they press the matter you should contact Personal Tax Customer, Product & Process, PAYE Technical, Shipley for advice.

At the end of the tax year

The introduction of PAYE reporting in real time does not change the application of Appendix 5, where the employee is liable to pay foreign tax as well as UK PAYE.

Employers should have included any net UK tax deducted on their Full Payment Submissions throughout the year and any errors should have been corrected before the end of the tax year. If not corrected on the last FPS or by 19 April, the employer will have to submit an Earlier Year Update (EYU).

At the end of the tax year the employer should send HMRC a statement showing

- The name and NINO of each employee included in the arrangement
- The amount of income subjected to both PAYE and foreign tax
- The total foreign tax deducted
- The amount of foreign tax deducted and remitted to the overseas authority

which was set off against that employees UK PAYE deductions due (foreign tax credit relief)

The employer should also provide evidence that the foreign tax has been paid. This information should be sent in the first instance to

HMRC, Edinburgh Group, EP Appendix 5 Team, Spur A, Grayfield House, 5 Bankhead Avenue, Edinburgh, EH11 4AE

Action at employer level

When the employer submits details of the foreign tax credit given with the evidence of foreign tax paid for each employee included in the arrangement, Edinburgh will follow their existing guidance and risk assess the cases by checking NPS and SA as appropriate.

Action at employee level

On receipt of details provided by the employer, for each employee you should

- Make a note on Contact History to record the foreign tax credit given by that employer in that year
- Proceed in accordance with the guidance at PAYE93038. ...

HMRC say:

> HMRC has been advised that some software developers have been unable to update their products for EP Appendix 5 but are looking to do so before 6 April 2015. HMRC has therefore decided to extend the period during which employers may operate EP Appendix 5 without compliant software until 6 April 2015. This is a final extension. From 6 April 2015, EP Appendix 5 will only be available where the employer is able to report UK tax paid after the foreign tax credit relief has been deducted in the data items Total Tax to Date and Tax Deducted or Refunded.
>
> Some employers know that their current software will not be updated in 2014-15 and do not intend to change their provider. Those employers may have already made arrangements for employees to apply for tax codes with estimated double taxation relief from 6 April 2014. These employers are encouraged to apply the new tax codes and not revert back to EP Appendix 5 for 2014-15. [7]

23.7 Tax equalisation

The PAYE Manual provides:

> **PAYE82002 - PAYE operation: international employments: EP appendix 6: modified PAYE in tax equalisation cases** [June 2014]

7 29 April 2014
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/327284/140704_Expat_Forum_Minutes_FINAL.pdf

Application for modified PAYE for tax equalised expatriate employees from 6 April 20__

Tax equalisation generally describes an arrangement between an employer (see Note 1) and a foreign national employee who comes to the United Kingdom (UK) to work. Under the terms of an agreement, the employee (see Note 2) is entitled to specified net cash earnings and non-cash benefits. The employer undertakes to meet the UK Income Tax liability arising from the earnings and to ensure that the employee's UK tax affairs will be handled by a professional adviser or by an in-house specialist experienced in tax equalisation issues.

For an employee to be included in an arrangement established under this application, the employer must equalise liability to UK Income Tax on all general earnings subject to the rules in part 2 Chapters 4 and 5 ITEPA applying to employees resident, ordinarily resident or domiciled outside the UK.

An application indicates that the employer agrees to operate PAYE on a gross-up of cash earnings and non-cash benefits for all employees eligible to be included in this arrangement and has undertaken with the employees to pay any residual UK liability on earnings based on each employee's self assessment. Employers should ensure that employees complete their self-assessment returns in accordance with the guidance in Help Sheet IR212.

These arrangements can apply to Real Time Information (RTI) employers as well as non-Real Time Information employers.

Note 1: For the purposes of this application, 'employer' includes a 'relevant person' for whom an employee works in terms of section 689 Income Tax (Earnings and Pensions) Act 2003 (ITEPA).

Note 2: For the purposes of this application, 'employee' includes an 'office holder'.

Note 3: Where the employee is tax equalised on all general earnings but not on specific employment income, for example, on taxable share related events the employee may still be covered by the arrangement as long as all the other conditions are satisfied.

Employer name:……..

Employer address: ……..

Employer PAYE reference: ……..

Calculation of estimated PAYE on tax equalised earnings

1. We will prepare a best estimate of all earnings including cash allowances and non-cash benefits for the year at the beginning of each year, grossed-up for tax purposes and calculate PAYE tax without restriction for the 50 per cent 'overriding limit'. The best estimate will include, where relevant, the annual salary, any cash bonus awards made to 5 April and non-cash benefits provided by a home country employer.
2. We will undertake an in-year review during the period December to April to take account of any material changes, and in particular, to ensure that
   a. Calendar or tax year end bonuses are accounted for
   b. Taxable share related events are accounted for
3. Where we do not equalise liability in respect of awards under 2(b) above
   a. PAYE must be applied in accordance with all relevant statutory provisions

and regulations and

b. In the case of notional payments, where an employee does not make good the due amount within the period of 90 days specified by section 222(1) (c) ITEPA 2003, we will include additional earnings in this arrangement equivalent to the due amount. These additional earnings will be grossed-up for tax purposes.

4. We will update the estimated PAYE calculation during the year to reflect arrivals and departures of employees subject to this application.

5. We will exclude from the estimated PAYE tax calculation contributions we make (employer contributions) to a qualifying overseas pension scheme in respect of an employee who is a relevant migrant member of that scheme. Subject to the conditions specified in paragraph 51 of Schedule 36 to the Finance Act 2004, we will exclude employer contributions to an overseas pension scheme in relation to which the employee received corresponding relief in 2005-06. We will also exclude employer contributions to overseas schemes where the employee is entitled to relief from UK tax under the terms of a Double Taxation Agreement.

6. We will take into account employee contributions to the overseas pension schemes referred to in paragraph 5 where we know the amounts involved and are satisfied that each employee is entitled to relief for contributions as a relevant migrant member or with pre-commencement entitlement to corresponding relief or under the terms of a Double Taxation Agreement.

7. Where we give provisional relief for overseas workdays (apportionment of earnings between UK and non-UK duties for the purposes of sections 15 and 26 ITEPA 2003), based on each employee's workday history or as anticipated by the employees where they join during the tax year, we will withdraw personal allowances, apply code 0T and notify HMRC accordingly. Any tax gross-up will be applied after the earnings have been apportioned between UK and non-UK duties. We will enter code 0T on the payroll record and Full Payment Submissions.

8. Where paragraph 7 does not apply, we will give personal allowances by applying the emergency code on a cumulative basis when calculating PAYE tax. We will enter that code the payroll record and Full Payment Submissions.

9. We will take relief for foreign tax into account in respect of UK residents working abroad where an agreement has been reached with HM Revenue and Customs (HMRC) in accordance with the PAYE Manual EP Appendix 5. We note in particular the requirement that an overseas country imposes a withholding at source obligation on earnings that are subject to PAYE.

10. We will not apply PAYE to the earnings of a tax-equalised employee covered under separate arrangements in EP Appendix 4 of the PAYE Manual. Where it later appears that such earnings are not exempt from UK tax under the terms of the relevant Double Taxation Agreement, we will include the employee in this arrangement and notify HMRC accordingly.

11. We will send one FPS each month no later than the 19th of the month following the end of the tax month. The FPS will show the estimated earnings and income tax calculated in accordance with this agreement. We undertake to pay 1/12th of the estimated PAYE for the tax year each month by the 19th or

22nd of the following month (depending upon the payment method). Where the number of employees covered by this arrangement at any one time is five or fewer, we undertake to pay 3/12ths of the estimated PAYE tax on or before the 19th or 22nd (depending upon the payment method) of July, October, January and April ('the quarterly basis'). If the number of employees covered by this arrangement increases to more than 5 at any one time in the course of a year and is likely to remain at that higher level, we will make payments of estimated PAYE by the 19th or 22nd of each month from the start of the following tax year. If the number of employees covered by this arrangement at any one time reduces to five or fewer in the course of a year and is likely to remain at that lower level, we will make payments of estimated PAYE on the quarterly basis from the start of the following tax year. Late payment penalties under schedule 56 of the Finance Act 2009 will not apply to payments under this arrangement providing that tax is paid at the agreed time. Schedule 56 penalties will be charged if the estimated tax is not paid as specified in this paragraph.

Arrivals and departures

12. We shall submit a Full Payment Submission which will confirm for each employee covered by this agreement

- That the employee is included in a EPM6 agreement
- A relevant starting date
- The length of time the seconded employee intends to work in the UK and if they intend to live here
- If they are from the European Economic area
- A leaving date

The actual leaving date may be entered on the final Full Payment Submission for the year where a month 12 reconciliation is undertaken. In these circumstances, the Irregular Employment Pattern Indicator should be set to keep the record open.

Year end requirements

13. Forms P60 will be given to the employees by 31 May after the end of each tax year. The figure of pay for each employee will comprise all cash payments and non-cash benefits in respect of which PAYE tax has been calculated after grossing-up. The figure of tax will be the total amount of PAYE tax paid under this arrangement in respect of the employee concerned.

14. We accept that due to the inherent nature of these modified arrangements, over and underpayments of tax may arise compared with the amount of tax that would otherwise have been due if normal PAYE procedures had been applied. Provided that the procedures as outlined in these arrangements are followed, interest will not be charged in accordance with the PAYE regulations in respect of any residual income tax liabilities as shown by the employees' tax returns. However, it is accepted that interest will run on any part of the estimated PAYE for a tax year due to have been paid under this agreement which (depending upon the payment method) reaches HMRC after 19 or 22 April, as appropriate, following the end of the tax year.

15. We shall submit in respect of each employee covered by these arrangements a form P11D, or an approved substitute, and associated form P11D(b) by 31 January following the end of the tax year. Where a dispensation has already

been agreed for certain expense items for "local hire" employees, the relevant P11D / substitute will be prepared on the same basis provided the nature of the expense items are the same as those covered by the existing dispensation. We acknowledge that where all statements are not submitted by 31 January following the end of the tax year, penalties under Section 98 TMA 1970 may arise. This is on the basis that the earnings in question ought to have been provided on forms P11D or approved substitutes before 7 July following the end of the tax year.

Submission of employee's self assessment tax return and calculation of tax liability

16. We will have systems and procedures in place to ensure that each employee's self assessment will include actual cash remuneration, all benefits and reimbursed expenses payments not covered by a dispensation and other amounts chargeable to tax as employment income, grossed up on a current year basis. Each employee's tax return will include a note in the notes section of the relevant Employment Page to the effect that the employee is tax equalised and Modified PAYE has been applied.

Payment of residual Income Tax liability

17. We will pay any additional tax found to be due under these arrangements following the submission of the employee's tax return by 31 January following the end of the tax year. Alternatively, if a refund is due, the appropriate repayment claim mandated to us or (if different) to the employee's contractual employer will be submitted. We understand that as a consequence of these arrangements there will be no requirement to make payments on account of tax liabilities. We acknowledge that a tax return for an employee covered by these arrangements should incorporate a claim to cancel payments on account. We further understand that HMRC should not issue Statements of Payments on Account to employees included under these arrangements.

18. We understand that for employees who are not ordinarily resident in the UK, any overpayments of PAYE will not be treated as a remittance of foreign earnings where repayment is mandated to an employer in the UK.

National Insurance Contributions

19. These arrangements do not apply to National Insurance Contributions (NICs). In cases where the employee is liable for Class 1 NICs and taxable benefits are provided that attract Class 1A NICs, NICs must be accounted for in the normal way unless separate arrangements are agreed with HMRC as set out in EP Appendix 7A of the HMRC PAYE Manual.

Statement

20. We acknowledge that HMRC reserve the right to review / cancel these arrangements as a result of changes in the law or should operational difficulties arise or the arrangements are seen to be deficient, for example

- Where significant and / or regular underpayments of income tax on employment income have arisen in respect of employees' self assessment returns and in the opinion of HMRC that tax ought to have been accounted for in the calculation of estimated PAYE provided for under these arrangements
- Where an employer fails to pay tax on time and / or to ensure that returns

and P11Ds are filed on time such that a liability arises to pay interest and / or penalties.

We accept that as a result of a decision to cancel these arrangements, HMRC may require the strict operation of PAYE. Similarly, we reserve the right to cancel these arrangements and adopt the strict operation of PAYE. Cancellation by either party will be confirmed by written notice and will be effective from the following 6 April or an earlier date, as agreed by the parties. If a date cannot be agreed, cancellation will be effective on the earlier of the previously stated 6 April or 3 months from the date when the written notice was given.

Application made by:

Name: ……..……

Capacity: ……..……

Signature: ……

On behalf of (name of employer): ……

Date: ……

Application agreed on behalf of HM Revenue and Customs

Name: ……..

Signature: ……..……..

Date: ……...……..

PAYE82003 - PAYE operation: international employments: EP appendix 7a: modified class 1 and class 1a national insurance contributions (NICs) for expatriate employees subject to an EP appendix 6 agreement [May 2013]

Application for modified NICs for expatriate employees from 6 April 20__

Employer name: ……..

Employer address: ……..

Employer PAYE reference: ……

Part 1 - Scope of agreement

1. This application applies only to those employees who
   a. Are subject to an EP Appendix 6 agreement, and
   b. Are assigned to work in the United Kingdom (UK) from abroad and have an employer or host employer in the UK liable for secondary UK NICs liabilities, and
   c. Pay NICs on earnings in this employment, above the annual upper earnings limit (UEL) for the year, or on earnings at or above the UEL in each earnings period throughout the year. If an employee joins, commences liability part way through an earnings period, or leaves the employment part way through an earnings period, that shall not invalidate the agreement, provided that
      - For employees with monthly earnings periods, NICs are calculated and paid on earnings at or above the UEL in all months other than the month in which the employee joined or left
      - For employees with an annual earnings period, NICs are calculated and paid on earnings to the person's pro-rata annual or annual UEL. (If an employee with an annual earnings period starts after tax week 1 they will have an annual pro-rata earnings period. If a person starts before or during tax week 1 they will have an annual earnings period

irrespective of if and when they leave the employment)

Part 2 - Operation of agreement

2. We will calculate and pay Class 1 NICs on a best estimate of those elements of earnings that are subject to Class 1 NICs. At the beginning of each year, or if liability commences after the beginning of the year, in the month when NICs liability first occurs, we will prepare the best estimate. The best estimate will include all world-wide earnings paid from whatever source, including where relevant, the annual salary, any cash bonus awards made to 5 April, and any non-cash benefits that attract Class 1 NICs liability.

3. In accordance with Part 3 of this agreement, we will calculate and pay Class 1 NICs on all the estimated earnings which are subject to NICs.

4. We shall for each employee, in respect of every tax month estimated earnings are calculated for that employee, complete and maintain a payroll record and include the details about the payment, the National Insurance category letter and NICs data items on a Full Payment Submission (FPS). The FPS must be submitted to Her Majesty's Revenue and Customs (HMRC) no later than the 19th of the month following the end of the tax month.

5. We will undertake an in-year review during the period December to 5 April to take account of any material changes and in particular, will ensure that amounts that are earnings, as defined in sections 3 and 4 of the Social Security Contributions and Benefits Act 1992, which

- Must be included in the computation of a person's earnings when assessing Class 1 NICs, and
- Are bonuses and / or NICs due on amounts which count as employment income in relation to employment-related securities to which sections 698 or 700 of the Income Tax (Earnings and Pensions) Act 2003 applies, for example, share related events

are accounted for.

We will update the Class 1 NICs payable immediately following the review, amend payroll records and

- When completing the next FPS for submission to HMRC, adjust the year to date NICs data items to show the revised values to date, and
- Adjust the next payment to HMRC if too much or too little NICs have been paid.

6. During the year, we will update the estimated Class 1 NICs to be paid to reflect arrivals and departures of employees who are subject to this application, and changes in the scope of these arrangements as they apply to one or more employee.

7. We understand that where we have employees who are not ordinarily resident in the UK and who meet the conditions set out in Tax Bulletin 79 as workers for whom salary can be apportioned between UK and non-UK days, we can initially compute earnings for Class 1 NICs on the basis of an estimate of UK and non-UK workday that we have used for income tax purposes. When we complete our NIC Settlement Return, this initial estimate must be corrected using the statutory NICs rules for non-UK days set out in Tax Bulletin 79 and the correct NICs must be paid before 31 March following the end of the tax year.

Part 3 - Payment of Class 1 NICs to HM Revenue and Customs (HMRC)

9. We undertake to pay to HMRC each month, the Class 1 NICs due on 1/12th of the estimated earnings. These payments will be made each month, by the 19th or 22nd of the following month (depending upon our payment method).

10. Where the number of employees covered by this arrangement at any one time is 5 or fewer, we undertake to pay the Class 1 NICs due on 3/12ths of the total estimated earnings for the tax year, on or before the 19th or 22nd (depending upon the payment method) of July, October, January and April (the quarterly basis).

11. If the number of employees covered by this agreement increases to more than 5 at any one time in the course of the year, and is likely to remain at the higher level, we will make the payments of Class 1 NICs by the 19th or 22nd of each month, from the start of the following year. If the number of employees covered by this agreement at any one time reduces to five or fewer in the course of the year and is likely to remain at the lower level, we will make payments of Class 1 NICs on the quarterly basis, from the start of the following year.

12. If the NICs are paid in accordance with the terms of this agreement, late payment penalties under Schedule 56 of the Finance Act 2009, will not apply to payments under this arrangement. Schedule 56 penalties will be charged if the NICs due on the estimated earnings are not paid as specified in Part 3 of this agreement.

Part 4 - Arrivals and departures

13. We will notify HMRC of our intention to include new arrivals to the UK covered by this agreement. Similarly, we will notify HMRC of our intention to exclude an employee from the agreement in the event of the employee no longer being subject to PAYE under EP Appendix 6. We will make these notifications to HMRC in writing before the end of the relevant tax year.

Part 5 - Interest

15. We accept that due to the inherent nature of these modified arrangements, over and underpayments of Class 1 NICs may arise, compared with the amount of Class 1 NICs that would otherwise have been due if normal NICs procedures had been applied. Provided that the procedures outlined in these arrangements are followed, interest will not be charged in accordance with the NICs regulations in respect of any residual Class 1 NICs liabilities as shown by the employer's 'NIC Settlement Return'. However, it is accepted that interest will run on any part of the NICs due on estimated earnings for a tax year due to have been paid under this agreement, which (depending upon the method of payment) reaches HMRC after 19 or 22 April following the end of the tax year.

16. It is accepted that if the payment of Class 1 NICs, due on estimated earnings payable by 19 or 22 April is paid late, HMRC will charge interest on amounts paid late.

Part 6 - Class 1A NICs

17. We understand that for individuals covered by this agreement we will have until 31st January following the end of the tax year in which to submit our P11D(b). By the normal statutory time of 19 July following the end of the tax year we will make a payment of Class 1A NICs based on a best estimate of Class 1A NICs due. We will calculate and pay to HMRC the correct amount of

Class 1A by 31 March following the end of the tax year. However, we understand that when we make our best estimate of earnings for Class 1 NICs, it is permissible to include non-cash benefits that would statutorily attract a Class 1A NICs charge. Where our best estimate for Class 1 NICs includes payments and benefits that attract Class 1A NICs under the normal statutory provisions, and we have paid Class 1 NICs using that estimate, we are not then required to pay Class 1A NICs by the normal statutory time of 19 July. Where our best estimate of earnings for Class 1 NICs purposes includes non-cash benefits that would normally be subject to Class 1A NICs, we must correct this after the tax year end and pay the right amount of Class 1 NICs and Class 1A NICs using our NIC Settlement Return. The right amount of Class 1A NICs must be paid by 31 March following the end of the tax year.

18. We will submit form P11D(b) at the latest by 31 January following the end of the tax year. The P11D(b) will show the correct benefits for the tax year computed using the statutory rules. We will annotate the P11D(b) 'Appendix 7A' applies.

19. We understand that if we do not pay the Class 1A NICs due by the date set out in this agreement, then regulation 67B of the Social Security (Contributions) Regulations 2001 may apply (late payment penalties).

20. We understand that where the P11D(b) is not submitted by 31 January following the year end, penalties may arise under Regulation 81(1) Social Security (Contributions) Regulations 2001 and that interest under Regulation 76(1) Social Security (Contributions) Regulations 2001, will accrue from the original 19 July statutory date.

We understand that where we submit an incorrect return under the terms of this agreement, penalties may arise under Regulation 81 of the Social Security (Contributions) Regulations 2001

- On the Class 1A NICs due for payment no later than 19July following the end of the year in which benefits were provided; and
- That the earnings in question ought to have been included on forms P11D or approved substitutes and form P11D(b) before 7 July following the end of the tax year.

Part 7 - Payment of residual Class 1 and Class 1A NICs Liability - NIC Settlement Return

21. We accept that where additional Class 1 or Class 1A NICs are found to be due and are paid after 31 March following the end of the tax year, or errors in the NIC Settlement Return are discovered, interest and penalties will be charged in accordance with the legislation.

22. No later than 31 March following the end of the tax year we will carry out an exercise to establish the correct amount of Class 1 and Class 1A NICs due on all the employee's earnings and benefits both from the UK and abroad. We will calculate and pay to HMRC any additional Class 1 NICs and / or Class 1A NICs found to be due under these arrangements by the 31 March following the end of the tax year concerned. Any additional Class 1 or Class 1A NICs will be paid over to HMRC via a 'NIC Settlement Return' (NSR). An NSR will also account for any NICs due on any primary NICs paid on the employees' behalf under these arrangements, unless already accounted for.

23. We will set out in the NSR the correct Class 1 and Class 1A NICs due for the year for each employee covered by this agreement taking into account what has been paid previously under parts 3 and 7 of this agreement. We will send HMRC the NSR no later than 31 March following the end of the tax year in which earnings were paid.

24. We understand that where the employee is social security equalised, the payment of the primary NICs on the 'best estimate' of gross earnings will represent a payment of earnings. Therefore, earnings should be grossed up to take account of these NICs met on the employee's behalf. Where primary NICs are met on behalf of the employee in respect of earnings included in the NSR, the earnings on the return should be grossed up to take account of the primary NICs met on the employee's behalf.

Part 8 - Overpaid Class 1 NICs

25. We understand that if we discover that NICs have been overpaid in relation to the 'best estimate' we can complete the NSR to reflect any secondary (employers) Class 1 or Class 1A NICs overpaid. We can also claim a refund of any primary (employees) Class 1 NICs overpaid on the 'best estimate', but only where:

a. The Class 1 NICs paid by the employer are paid as part of the equalisation process and have not been recovered from the employee's earnings, or
b. The Class 1 NICs have been paid by the employer and recovered from the employee and the employee mandates the repayment to the employer in writing.

26. We understand that, in all other cases, the NSR must be submitted together with a covering letter asking for a refund. This will be passed to HMRC Personal Tax International for processing. We understand that under this agreement, we cannot recover overpayments by deducting the amounts from future payments to HMRC or by offsetting overpayments of primary NICs in respect of one employee against NICs due in respect of another.

Part 9 - Statement

27. We acknowledge that HMRC reserve the right to review / cancel these arrangements as a result of changes in the law, or should operational difficulties arise, or the arrangements are seen to be deficient, for example

- Where significant and/or regular underpayments of Class 1 and Class 1A NICs have arisen in respect of one or more employees and, in the opinion of HMRC, the Class 1 and Class 1A NICs ought to have been accounted for in the calculation of the estimated Class 1 and Class 1A NICs provided for under these arrangements
- Where an employer fails to pay the Class 1 or Class 1A NICs on time and/or to ensure that returns are filed on time, such that a liability arises to pay interest and/or penalties.

28. We accept that as a result of a decision to cancel these arrangements, HMRC will require the strict operation of the payment of Class 1 and Class 1A NICs. Similarly, we reserve the right to cancel these arrangements and adopt the strict operation of Class 1 and Class 1A NICs.

29. We agree that a separate employer record will be opened with HMRC for this scheme in the name '[Company Name] (Appendix 7A)' under which we will

submit the NSR.

30. Cancellation by either party will be confirmed by written notice and will be effective from the following 6 April or an earlier date, as agreed by the parties. If a date cannot be agreed, cancellation will be effective on the earlier of the aforementioned 6 April or 3 months from the date when the written notice was given.

Application made by:

Name: ……..……

Capacity: ……

Signature: ……

On behalf of (name of employer): ……

Date: ……

Application agreed on behalf of HM Revenue and Customs

Name: ……..

Signature: ……..

Date: ……..

PAYE82004 - PAYE operation: international employments: EP appendix 7b: modified class 1 national insurance contributions (NICs) for employees assigned from the United Kingdom (UK) to work overseas [May 2013]

Application for modified NICs for expatriate employees from 6 April 20__

Employer name: ……..

Employer address: ……..

Employer PAYE reference: ……..

Part 1 - Scope of agreement

1. This application applies only to those employees who

a. Are employed by a UK employer and are assigned to work abroad for a period of limited duration, but for more than a complete tax year, and

b. Have an ongoing liability to UK National Insurance contributions (NICs) whilst abroad; and

c. Earn above the upper earnings limit (UEL) in every earnings period throughout the tax year. (I understand that it shall not invalidate this agreement if an employee earns less than the UEL in the pay period they join the company, or in the pay period in which they leave, if in all other pay periods during the year, the UEL is exceeded. However, in the case of employees with annual pay periods, covered by the agreement, their earnings must exceed the annual UEL); and

d. Not liable to UK tax on their earnings from employment; and

e. Receive some earnings and benefits derived from the employment from sources other than the UK employer.

Part 2 - Operation of agreement

2. We will calculate and pay Class 1 NICs on a best estimate of those elements of earnings that are subject to Class 1 NICs. At the beginning of each year, or if liability starts after the beginning of the year, in the month when NICs liability first occurs, we will prepare the best estimate. The best estimate will include all world-wide earnings paid from whatever source, including where relevant, annual salary, any cash bonus awards made to 5 April, and any non-cash benefits that attract Class 1 NICs liability.

3. We shall for every payment of estimated earnings calculated for each employee, complete and maintain a payroll record and include the details about the payment, the National Insurance category letter and NICs data items on a Full Payment Submission (FPS). The FPS must be submitted to Her Majesty's Revenue and Customs (HMRC) on or before the payment of regular earnings by the UK employer or no later than the 19th of the month following the end of the tax month where all earnings are paid by the overseas employer.

4. We will undertake an in-year review during the period December to 5 April to take account of any material changes and in particular, will ensure that amounts that are earnings, as defined in sections 3 and 4 of the Social Security Contributions and Benefits Act 1992, which

- Must be included in the computation of a person's earnings when assessing Class 1 NICs, and
- Are bonuses and / or NICs due on amounts which count as employment income in relation to employment-related securities to which sections 698 or 700 of the Income Tax (Earnings and Pensions) Act 2003 applies, for example, share related events

are accounted for.

We will update the Class 1 NICs payable immediately following the review and amend payroll records and

- When completing the next FPS for submission to HMRC, adjust the year to date NICs data items to show the revised values to date, and
- Adjust the next payment to HMRC if too much or too little NICs have been paid

Part 3 - Payment of Class 1 NICs to Her Majesty's Revenue and Customs

5. We undertake to pay to HMRC each month, the Class 1 NICs due on 1/12th of the total estimated earnings for the tax year. These payments will be made each month by the 19th or 22nd of the following month (depending upon our payment method).

6. Where the number of employees covered by this arrangement at any one time is 5 or fewer, we undertake to pay the Class 1 NICs due on 3/12ths of the total estimated earnings for the tax year, on or before the 19th or 22nd (depending upon the payment method) of July, October, January and April (the quarterly basis).

7. If the number of employees covered by this agreement increases to more than 5 at any one time in the course of the year, and is likely to remain at the higher level, we will make payments of estimated Class 1 NICs by the 19th or 22nd of each month from the start of the following year. If the number of employees covered by this agreement at any one time reduces to five or fewer in the course of the year, and is likely to remain at the lower level, we will make payments of estimated Class 1 NICs on the quarterly basis from the start of the following year.

8. If the NICs are paid in accordance with the terms of this agreement, late payment penalties under Schedule 56 of the Finance Act 2009, will not apply to payments under this arrangement. Schedule 56 penalties will be charged if the NICs due on the estimated earnings are not paid as specified in Parts 2 and 3 of this agreement.

Part 4 - Arrivals and departures

9. We will notify HMRC of our intention to include any new employees entering the agreement by providing details of the employees' departures from the UK. Similarly we will notify HMRC of our intention to exclude an employee from the agreement by providing details of the employee's return to the UK. We will make these notifications to HMRC in writing by the end of the relevant tax year.

10. We accept that in cases where an employee is repatriated to the UK before he/she has been overseas for a complete tax year and, as a result, his/her general earnings from the employment become chargeable to UK Income Tax, this agreement will no longer apply to that employee. In such cases, we will cease to use estimates in respect of all earnings paid and benefits received after the employee has returned to the UK, and use the statutory basis of calculating and returning both Class 1 and Class 1A NICs. We will carry out an exercise before the end of the tax year, to establish the correct amount of the earnings in the period covered by our earlier estimate.

For these employees we will include on a Full Payment Submission for every payment of earnings subject to Class 1 NICs paid after the employee returns to the UK and the NICs data items relating to each payment, on or before each payment is made to HMRC. For these same employees, no later than the 19th April following the end of the tax year we will

- Record the correct earnings and NICs details for the period before the employee returned to the UK on that employee's payroll records, and
- Send a Full Payment Submission to HMRC to adjust the year to date NICs totals for each category letter to show the correct details for the year.

Forms P60 will be given to the employees by 31 May after the end of each tax year.

If the correct figures for Class 1 NICs exceed our earlier estimates, we will pay the balance to HMRC with our final payment for the year. Where Class 1A NICs becomes payable, we will make a P11D(b) return and pay Class 1A by 19 July following the end of the tax year.

Part 5 - Employer annual return

11. Forms P60 will be given to the employees by 31 May after the end of each tax year.

Where an employee leaves the UK part way through a tax year, we will

- Calculate Class 1A NICs payable to the date the employee left the UK
- Send HMRC a P11D(b) by the 19 July following the end of the tax year, and (For 2012-13 and later years, this concession will be withdrawn and so the P11D(b) filing date will be 6 July)
- Pay HMRC any Class 1A NICs due by 19 July following the end of the tax year

Part 6 - Interest

12. We accept that, due to the inherent nature of the modified arrangements, over and underpayments of Class 1 NICs may arise compared with the amount of Class 1 NICs that would otherwise have been due if normal NICs procedures had been applied. Provided that the procedures outlined in these arrangements are followed, interest will not be charged in accordance with the NICs

regulations in respect of any residual Class 1 NICs liabilities as shown by the employer's 'NIC Settlement Return' - See Part 8. However, it is accepted that interest will run on any part of the NICs due on the estimated earnings to have been paid under this agreement which (depending upon the method of payment) reaches HMRC after the 19 or 22 of April following the end of the tax year.

13. It is accepted that if the payment of Class 1 NICs, due on estimated earnings payable by 19 or 22 April, is paid late, HMRC will charge interest on amounts paid late.

Part 7 - Impact of HMRC dispensation

14. We accept that the terms of a dispensation will not apply to employees who do not have a 'taxable employment' as defined in Part 2 of the Income Taxes (Earnings and Pensions) Act 2003. Therefore, the 'best estimate' will reflect the total amount of earnings liable to Class 1 NICs taking into account any payments that can be disregarded from Class 1 earnings under the provisions of Regulation 25 and Schedule 3 of the Social Security (Contributions) Regulations 2001.

Part 8 - Class 1A NICs

15. With the exception of paragraph 12 of this agreement, we understand that any benefits provided to employees covered by this agreement will not fall to be chargeable to income tax under ITEPA as 'general earnings', therefore, liability for Class 1A NICs will not arise.

Part 9 - Payment of residual Class 1 NICs liability - NIC Settlement Return

16. No later than 31 March following the end of the tax year we will carry out an exercise to establish the correct amount of Class 1 NICs due on all the employee's earnings, both from the UK and from abroad. We will calculate and pay to HMRC Class 1 NICs on the difference between the correct figures for the year and those figures that we submitted to HMRC on our Employer Annual Return. Payment of the Class 1 NICs will be made by 31 March following the end of the tax year concerned. Any additional Class 1 NICs payable will be shown on our 'NIC Settlement Return' (NSR).

17. We will set out in the NSR the correct Class 1 NICs due for the year for each employee covered by this agreement taking into account what has been paid previously under parts 3 and 7 of this agreement. We will send HMRC the NSR no later than 31 March following the end of the tax year in which earnings were paid.

18. We accept that where the additional Class 1 NICs found to be due are paid after 31 March following the end of the tax year, or errors in the NSR are discovered, interest and penalties will be charged in accordance with legislation.

Part 10 - Overpaid Class 1 NICs

19. We understand that, if we discover that Class 1 NICs have been overpaid in relation to the 'best estimate', we can complete the NSR to reflect any secondary (employers) Class 1 NICs overpaid. We can also claim a refund of any primary (employees) Class 1 NICs overpaid on the best estimate but only where

a. The Class 1 NICs were paid by the employer and have not been recovered from the employee, or
b. The Class 1 NICs are paid by the employer and recovered from the

employee, and then only if the employee mandates the repayment to the employer in writing.

20. We understand that, to claim the overpayment, the NSR must be submitted together with an application for a refund. This will be passed to HMRC Payment Reconciliation in the National Insurance Contributions and Employer Office for processing. We understand that under this agreement, we cannot recover overpayments by deducting the amounts from future payments to HMRC or offsetting overpayments in respect of one employee against underpayments in respect of another employee.

Part 11 - Statement

21. We acknowledge that HMRC reserve the right to review / cancel these arrangements as a result of changes in the law, or should operational difficulties arise, or the arrangements are seen to be deficient, for example, where

- Significant and/or regular underpayments of Class 1 NICs have arisen in respect of one or more employees and, in the opinion of HMRC, the Class 1 NICs ought to have been accounted for in the calculation of the estimated Class 1 NICs provided for under these arrangements
- An employer fails to pay the Class 1 NICs on time and/or to ensure that returns are filed on time such that a liability arises to pay interest and/or penalties.

22. We accept that, if a decision is made by HMRC to cancel these arrangements, HMRC will require the strict operation of the payment of Class 1 NICs. Similarly, we reserve the right to cancel these arrangements and adopt the strict operation of Class 1 NICs.

23. We agree that a separate employer record will be opened with HMRC for this scheme in the name '[Company Name] (Appendix 7B)' under which we shall submit the NSR.

24. Cancellation by either party will be confirmed by written notice and will be effective from the following 6 April, or such earlier date as is agreed by the parties. If a date cannot be agreed, cancellation will be effective on the earlier of the aforementioned 6 April or 3 months from the date when the written notice was given.

Application made by:
Name: ……
Capacity: ……..……
Signature: ……
On behalf of (name of employer): .....……
Date: .....……
Application agreed on behalf of HM Revenue and Customs
Name: ……..
Signature: ……..
Date: ……..

CHAPTER TWENTY FOUR

PENSION INCOME

24.1 Pension Income: Introduction

The taxation of pensions requires a book to itself.[1] In this chapter I focus the matters closest to the themes of this book.

The legislation is in part 9 ITEPA. After the usual outline in accordance with the principles of plain English drafting, there follows a cascade of definitions which need to be considered briefly.

24.1.1 *"Pension income"*

This term is defined in s.566(2) ITEPA:

> "Pension income" means the pensions, annuities and income of other types to which the provisions listed in subsection (4) apply.
> This definition applies for the purposes of the Tax Acts.

Section 566(4) sets out 13 categories of income:

These are the provisions referred to in subsection (2)—

Provision	Income	Chapter (of this Part)
Section 569	UK pensions	Chapter 3
Section 573	Foreign pensions	Chapter 4
Section 577	UK social security pensions	Chapter 5
Section 579A	Pensions under registered pension schemes	Chapter 5A
Section 609	Annuities for the benefit of dependants	Chapter 10
Section 610	Annuities under sponsored superannuation schemes	Chapter 10
Section 611	Annuities in recognition of another's services	Chapter 10
Section 615	Certain overseas government pensions paid in the UK	Chapter 11
Section 619	The House of Commons Members' Fund	Chapter 12
Section 629	Pre-1973 pensions paid under OPA 1973	Chapter 14
Section 633	Voluntary annual payments	Chapter 15
Section 636B	Pensions treated as arising from payment of trivial commutation lump sums and winding-up lump sums under registered pension schemes:	Chapter 15A

1 And indeed such a book has been written: Hardy, *Pensions Taxation* (1st ed, 2014).

Section 636C	Pensions treated as arising from payment of trivial commutation lump sum death benefits and winding-up lump sum death benefits under registered pension schemes:	Chapter 15A

Three of these categories are discussed here, those in chapters 3, 4, and 11, which I describe as UK pension, foreign pensions, and commonwealth government pensions.

24.1.2 *"Taxable pension income" and "Net taxable pension income"*

These terms are defined in s.567 ITEPA. "Net" taxable pension income brings in rules for deductions, not discussed here. "Taxable" pension income is a label which brings in a number of rules, for in the various situations where the statute desires to bring pension income into charge it provides that it is "taxable".

24.2 UK pension

Section 569 ITEPA provides:

> (1) This section applies to any pension[2] paid by or on behalf of a person who is in the UK.
> (2) But this section does not apply to a pension if any provision of Chapters 5 to 14 of this Part applies to it.

I refer to this as "**a UK pension**". Section 571 ITEPA provides:

> If section 569 applies, the taxable pension income for a tax year is the full amount of the pension accruing in that year irrespective of when any amount is actually paid.

Thus a UK pension is taxed on an arising basis.

24.3 Foreign pension

Section 573 ITEPA provides:

> (1) This section applies to any pension[3] paid by or on behalf of a

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2 "Pension" for the taxation of UK pensions is defined in 570 ITEPA. The definition (perhaps for historic reasons) is different from the definition which applies for foreign pensions.

3 "Pension" for the taxation of foreign pensions is defined in 574 ITEPA. The definition (perhaps for historic reasons) is different from the definition which applies for UK pensions.

> person who is outside the UK to a person who is resident in the UK.
> (2) But this section does not apply to a pension if any provision of Chapters 5 to 14 of this Part applies to it.

I refer to this as **"a foreign pension"**.

Section 575(1) ITEPA provides:

> (1) [a] If section 573 applies, the taxable pension income for a tax year is the full amount of the pension income arising in the tax year,
> [b] but subject to subsections (1A)[split years] (2) [10% deduction] and (3) [remittance basis].

An arising basis taxpayer is allowed a 10% deduction from foreign pensions: s.575(2) ITEPA provides:

> [a] The full amount of the pension income arising in the tax year or, as the case may be, the UK part of the tax year is to be calculated on the basis that the pension is 90% of its actual amount,
> [b] unless as a result of subsection (3) the pension income is charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).

The wording is somewhat unmathematical but the meaning is clear. The 10% deduction was introduced when the remittance basis on foreign pensions was abolished (except for foreign domiciliaries) in 1974. It is difficult to see a good reason for it but presumably this was a political douceur to ease the restriction to the remittance basis, and which has survived ever since. The deduction does not apply to a remittance basis taxpayer whose pension is taxed on the remittance basis. One relief was thought to suffice; on the face of it that seems fair enough, though one might argue whether it is EU law compliant.[4] The individual may always choose to be taxed under an arising basis.

Section 575(3) ITEPA provides:

> That pension income is treated as relevant foreign income for the purposes of Chapters 2 and 3 of Part 8 of [ITTOIA] (relevant foreign income: remittance basis and deductions and reliefs).

The significance of treating the income as RFI is that the income can qualify for the remittance basis.

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4 See 60.8.14 (Option to be treated as resident).

24.3.1 *Split year*

Section 575(1A) ITEPA provides:

> [a] If the person liable for the tax under this Part is an individual and the tax year is a split year as respects that individual, the taxable pension income for the tax year is the full amount of the pension income arising in the UK part of the year,
> [b] subject to subsections (2) [the 10% reduction] and (3) [the remittance basis] and section 576A [temporary non-residents].

24.4 Commonwealth government pensions

24.4.1 *"Commonwealth government pension"*

Section 615 ITEPA provides:

> (1) This section applies to a pension if conditions A, B and C are met.
> (2) Condition A is that the pension—
> (a) is payable—
> (i) to a person who has been employed in overseas government service, or
> (ii) to the widow, widower, surviving civil partner, child, relative or dependant of a person who has been employed in overseas government service, and
> (b) is payable in respect of that service.
> (3) Condition B is that the pension—
> (a) is payable in the UK, and
> (b) is payable to a person who is resident in the UK.
> (4) Condition C is that the pension is payable by or on behalf of the government of—
> (a) a country which forms part of Her Majesty's dominions,
> (b) any other country which is for the time being mentioned in Schedule 3 to the British Nationality Act 1981, or
> (c) any territory under Her Majesty's protection.
> (5) But condition C is not met if the pension is payable out of the public revenue of the UK or Northern Ireland.
> (6) In condition A the references to a person being employed in overseas government service are to the person being employed outside the UK—
> (a) in the service of the Crown, or
> (b) in service under the government of a country or territory which falls within subsection (4).
> (7) In this Chapter "pension" includes a pension which is paid

voluntarily or is capable of being discontinued.

The EI Manual provides:

> **74006. Certain overseas government pensions paid in the UK** [February 2006] ...
> ***Her Majesty's dominions***
> The Dependant Territories are:
> Anguilla, Bermuda, British Antarctic Territory, British Indian Ocean Territory, British Virgin Islands, Cayman Islands, Falkland Islands, Gibraltar, Montserrat, Pitcairn, Henderson, Ducie and Oeno Islands, St Helena, St Helena Dependencies (Ascension Island, Tristan da Cunha), South Georgia and South Sandwich Islands, Turks and Caicos Islands
> ***Countries listed in Schedule 3 BNA 1981***
> Antigua and Barbuda, Australia, The Bahamas, Bangladesh, Barbados, Belize, Botswana, Brunei, Canada, Republic of Cyprus, Dominica, Fiji, The Gambia, Ghana, Grenada, Guyana, India, Jamaica, Kenya, Kiribati, Lesotho, Malawi, Malaysia, Maldives, Malta, Mauritius, Namibia, Nauru, New Zealand, Nigeria, Pakistan, Papua New Guinea, Saint Christopher and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Seychelles, Sierra Leone, Singapore, Solomon Islands, South Africa, Sri Lanka, Swaziland, Tanzania, Tonga, Trinidad and Tobago, Tuvalu, Uganda, Vanuatu, Western Samoa, Zambia, Zimbabwe.
> ***Territories under Her Majesty's protection***
> There are no longer any protectorates or protected states. ...

I refer to pensions within this definition as "commonwealth government pensions" (though that is not a wholly accurate label).

24.4.2 *Taxation of commonwealth government pensions*

Section 616 ITEPA provides:

> If section 615 applies, the taxable pension income for a tax year is the full amount of the pension accruing in that year irrespective of when any amount is actually paid.

Section 617 ITEPA provides for the 10% deduction:

> A deduction of 10% is allowed from an amount of taxable pension income determined under section 616 (see section 567).

The remittance basis is not applicable, perhaps because the pensions are "payable within the UK" and so regarded as received here.

24.5 Double Taxation relief for pension income

Article 18 OECD Model Convention provides:

> Subject to the provisions of paragraph 2 of Article 19 [government service], pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

Some pre-OECD model treaties confer relief only if the income is subject to tax in the foreign state; see 59.17 ("Subject to tax").

24.5.1 *Rationale for residence taxation*

Why does the OECD model opt for residence taxation rather than source taxation? The OECD commentary provides:

> 1. [1] According to this Article, pensions paid in respect of private employment are taxable only in the State of residence of the recipient. Various policy and administrative considerations support the principle that the taxing right with respect to this type of pension, and other similar remuneration, should be left to the State of residence.
> [2] For instance, the State of residence of the recipient of a pension is in a better position than any other State to take into account the recipient's overall ability to pay tax, which mostly depends on worldwide income and personal circumstances such as family responsibilities. This solution also avoids imposing on the recipient of this type of pension the administrative burden of having to comply with tax obligations in States other than that recipient's State of residence.

The arguments at [2] are invalid as they apply equally to every type of income, not just pensions. But the commentary later gives a better reason, the old difficulty of identifying the location of the source:

> 19. ... alternative provisions under which there is either exclusive or limited source taxation rights with respect to pensions require a determination of the State of source of pensions. Since a mere reference to a pension "arising in" a Contracting State could be construed as meaning either a pension paid by a fund established in that State or a pension derived from work performed in a State, States using such wording should clarify how it should be interpreted and applied.
> 19.1 Conceptually, the State of source might be considered to be the State in which the fund is established, the State where the relevant work has been performed or the State where deductions have been claimed. Each of these approaches would raise difficulties in the case of

> individuals who work in more than one State, change residence during their career or derive pensions from funds established in a State other than that in which they have worked. For example, many individuals now spend significant parts of their careers outside the State in which their pension funds are established and from which their pension benefits are ultimately paid. In such a case, treating the State in which the fund is established as the State of source would seem difficult to justify. The alternative of considering as the State of source the State where the work has been performed or deductions claimed would address that issue but would raise administrative difficulties for both taxpayers and tax authorities, particularly in the case of individuals who have worked in many States during their career, since it would create the possibility of different parts of the same pension having different States of source.

The OECD model offers the pragmatic solution, but it is not surprising that there is a wide variety of provisions in actual treaties. Some possibilities are discussed in the OECD commentary, but that is not set out here.

24.5.2 *"Pensions and other similar remuneration"*

The OECD commentary provides:

> 3. The types of payment that are covered by the Article include not only pensions directly paid to former employees but also to other beneficiaries (e.g. surviving spouses, companions or children of the employees) and other similar payments, such as annuities, paid in respect of past employment. The Article also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19.

24.5.3 *One-off payments*

The OECD commentary provides:

> 4. Various payments may be made to an employee following cessation of employment. Whether or not such payments fall under the Article will be determined by the nature of the payments, having regard to the facts and circumstances in which they are made, as explained in the following two paragraphs.
> 5. While the word "pension", under the ordinary meaning of the word, covers only periodic payments, the words "other similar remuneration" are broad enough to cover non-periodic payments. For instance, a lump-sum payment in lieu of periodic pension payments that is made on or after cessation of employment may fall within the Article.

24.5.4 *"Pension income or employment income?"*

The OECD commentary provides:

> 6. Whether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact. For example, if it is shown that the consideration for the payment is the commutation of the pension or the compensation for a reduced pension then the payment may be characterised as "other similar remuneration" falling under the Article. This would be the case where a person was entitled to elect upon retirement between the payment of a pension or a lump-sum computed either by reference to the total amount of the contributions or to the amount of pension to which that person would otherwise be entitled under the rules in force for the pension scheme. The source of the payment is an important factor; payments made from a pension scheme would normally be covered by the Article. Other factors which could assist in determining whether a payment or series of payments fall under the Article include: whether a payment is made on or after the cessation of the employment giving rise to the payment, whether the recipient continues working, whether the recipient has reached the normal age of retirement with respect to that particular type of employment, the status of other recipients who qualify for the same type of lump-sum payment and whether the recipient is simultaneously eligible for other pension benefits. Reimbursement of pension contributions (e.g. after temporary employment) does not constitute "other similar remuneration" under Article 18. Where cases of difficulty arise in the taxation of such payments, the Contracting States should solve the matter by recourse to the provisions of Article 25 [mutual agreement].

24.5.5 *Social security income*

The OECD commentary provides:

> 24. Depending on the circumstances, social security payments can fall under this Article as "pensions and other similar remuneration in consideration of past employment", under Article 19 as "pension[s] paid by, or out of funds created by, a Contracting State [...] in respect of services rendered to that State..." or under Article 21 as "items of income [...] not dealt with in the foregoing Articles". Social security pensions fall under this Article when they are paid in consideration of past employment, unless paragraph 2 of Article 19 applies (see below). A social security pension may be said to be "in consideration of past employment" if employment is a condition for that pension. For instance,

this will be the case where, under the relevant social security scheme:
— the amount of the pension is determined on the basis of either or both the period of employment and the employment income so that years when the individual was not employed do not give rise to pension benefits,
— the amount of the pension is determined on the basis of contributions to the scheme that are made under the condition of employment and in relation to the period of employment, or
— the amount of the pension is determined on the basis of the period of employment and either or both the contributions to the scheme and the investment income of the scheme.

25. Paragraph 2 of Article 19 will apply to a social security pension that would fall within Article 18 except for the fact that the past employment in consideration of which it is paid constituted services rendered to a State or a political subdivision or a local authority thereof, other than services referred to in paragraph 3 of Article 19.

26. Social security payments that do not fall within Articles 18 or 19 fall within Article 21. This would be the case, for instance, for payments made to self-employed persons as well as a pension purely based on resources, on age or disability which would be paid regardless of past employment or factors related to past employment (such as years of employment or contributions made during employment).

24.5.6 *"In consideration of past employment"*

The OECD commentary provides:

3... The Article only applies, however, to payments that are in consideration of past employment; it would therefore not apply, for example, to an annuity acquired directly by the annuitant from capital that has not been funded from an employment pension scheme. The Article applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could nevertheless constitute a "pension or other similar remuneration" (the tax mismatch that could arise in such a situation is discussed below)...

7. Since the Article applies only to pensions and other similar remuneration that are paid in consideration for past employment, it does not cover other pensions such as those that are paid with respect to previous independent personal services. Some States, however, extend the scope of the Article to cover all types of pensions, including Government pensions; States wishing to do so are free to agree bilaterally to include provisions to that effect.

24.6 UK/Australia DTA

Article 17(1) of the UK/Australia Convention provides:

> Pensions (including government pensions) and annuities paid to a resident of a Contracting State shall be taxable only in that State.

The Australian Revenue have given two rulings concerning compensation payments.

> **Income tax: are periodic workers' compensation payments made by Comcare, 'pensions' for purposes of the pensions articles in Australia's double taxation agreements?**
> 1. Yes. The term 'pension' is not defined in any of the DTAs and therefore takes the meaning it has under domestic law. A pension is defined in the Macquarie Dictionary as '1. a fixed periodical payment made in consideration of past services, injury or loss sustained, merit, poverty etc. 2. an allowance or annuity.' The meaning of the term 'pension' was considered by Hill J. in the Federal Court in *Tubemakers of Aust Ltd v FC of T* 93 ATC 4207. His Honour concluded that the essential characteristic of a pension is only that there be periodical payments. Payments made by Comcare under [a statutory compensation scheme] are fixed periodical payments made in consideration of injury or loss of wages. They are therefore pensions within the ordinary meaning of that term and fall within the operation of the Pensions Article in Australia's DTAs.
> 2. Under Australia's DTAs, pensions paid by the Australian Government are generally included in the Pensions Article and are taxable only in the country of residence of the recipient. Although, in some DTAs, government pensions paid in respect of services rendered to that government are dealt with under the Government Services Article rather than the Pensions Article, this does not affect the treatment of Comcare payments made under section 19. This is because the Comcare payments are made in consideration of injury or loss of wages and not for past services to the Government.[5]

The second ruling is as follows:

> **Facts** A non-resident individual (the taxpayer) who is a UK resident for the purposes of the [Australia] UK Convention, received loss of earnings

5 TD 93/151
http://law.ato.gov.au/atolaw/view.htm?docid=TXD/TD93151/NAT/ATO/00001

payments from Australia as a result of injury suffered in a transport accident in the State of Victoria.
The payments comprised weekly statutory compensation payments [under a statutory compensation scheme]... for loss of income due to the injury.
The payments are calculated by reference to the recipient's pre-accident earnings.
Reasons for Decision
[The ruling cites art.17 of the DTA and continues:] Therefore, pensions paid from Australia to an individual who is a resident of the UK shall be taxable only in the UK.
Article 3(3) of the UK Convention provides that any term not defined in the Convention shall, unless the context requires otherwise, have the meaning it has under the domestic laws in respect of the taxes to which the Convention applies.[6] The term 'pension' is not defined in the UK Convention or in Australia's domestic taxation law.
[The statement referred to the authorities cited in Taxation Determination TD 93/151 and continued:]
The loss of earnings payments made under [the statutory compensation scheme] have the essential characteristic of a 'pension' as per Hill J. in *Tubemakers* and fall within the Macquarie dictionary definition of 'pension' as they are fixed periodic payments made in consideration of injury or loss sustained. Accordingly, the periodic compensation payments made to the taxpayer ... are a 'pension' for the purposes of the Pension Article of the UK Convention.
Therefore, the Pension Article applies to give the UK, as the country of residence of the taxpayer, sole taxing rights over the compensation payments.[7]

It is different if the OECD model wording is used, which only applies to pensions "in consideration of past employment".

24.7 US/UK DTA

24.7.1 *"Pension scheme"*

Article 3(1)(o) of the US/UK DTA defines "pension scheme":

> the term "pension scheme" means any plan, scheme, fund, trust or other

6 Author's footnote: this is OECD model form; see 57.11 (Undefined terms have domestic law meanings).

7 ATO ID 2008/145.

arrangement established in a Contracting State which is—
(i) generally exempt from income taxation in that State; and
(ii) operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements.

The DTA Exchange of Notes provides:

With reference to sub-paragraph (o) of paragraph 1 of Article 3 (General definitions)—
it is understood that pension schemes shall include the following and any identical or substantially similar schemes which are established pursuant to legislation introduced after the date of signature of the Convention—
(a) under the law of the United Kingdom,
[i] employment-related arrangements (other than a social security scheme) approved as retirement benefit schemes for the purposes of Chapter I of Part XIV of ICTA 1988, and
[ii] personal pension schemes approved under Chapter IV of Part XIV of that Act; and
(b) under the law of the United States,
[i] qualified plans under section 401(a) of the Internal Revenue Code,
[ii] individual retirement plans (including
[A] individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k),
[B] individual retirement accounts,
[C] individual retirement annuities,
[D] section 408(p) accounts, and Roth IRAs under section 408A),
[iii] section 403(a) qualified annuity plans, and
[iv] section 403(b) plans.

The requirement that a pension fund must be "established in" a treaty state requires some nexus between the pension fund and the state, but what that nexus is not stated.

The Tribunal has held that the world bank pension scheme was not "established in" the US:

105. ... the contracting parties meant by the phrase 'established in' a Contracting State the concept of being established under and in conformity with the relevant Contracting State's tax legislation relating to pension schemes.
106. This provides a sensible and workable definition in accordance

> with what we discern as the purpose of the provision, which is to recognise the special categories of pension scheme to which the Contracting States have chosen to give exemption from income taxation under their respective domestic laws because they are schemes operated principally to administer or provide pension or retirement benefits, etc. The exemption from income taxation in the USA which the SRP enjoys does not, we are satisfied, arise from its status as a pension scheme, but from the relevantly unconnected privileges and indemnities enjoyed by the World Bank....
>
> 108. We do not accept that the SRP has a sufficient legal nexus with the USA to support the case that it is 'established in' the USA for relevant purposes. This conclusion follows from our finding above that a US court would not have jurisdiction to exercise primary supervision over the administration of the SRP by virtue of the 'safe harbor' provisions or otherwise....
>
> 110. We do not accept that the purpose of the exemption under article 17(1)(b) of the DTA is to provide equal treatment for pensioners resident in either Contracting State with regard to the taxation of pension income. It is, as we discern it, to give exemption in both Contracting States to pension income which the parties to the DTA have chosen to exempt from income taxation under their respective domestic laws because they are schemes operated principally to administer or provide pension or retirement benefits, etc.[8]

The Australian Revenue takes a more formal approach on whether a fund is "established in Australia" for the purposes of Australian legislation:

> 100. ... there appears to be no case law which provides guidance on the location of the establishment of a superannuation fund. In the absence of such guidance, it is considered that a superannuation fund will be established in Australia when the initial contribution that establishes the fund is paid to and accepted by the trustee in Australia.[9] It is not necessary that the deed for the fund is signed and executed in Australia. Whether the initial contribution to establish the fund occurred in Australia is a question of fact which is determined by reference to the circumstances of each case.

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8 *Macklin v HMRC* [2014] SFTD 290. The position will need to be reviewed when the case is final.

9 Footnote original: Those superannuation schemes that are established by or under the law of the Commonwealth, or of a State or Territory - see paragraph (a) of the definition of 'public sector superannuation scheme' in section 10 of the SISA - are established in Australia.

101. If there is a situation where the initial contribution to establish the fund occurred outside Australia, notwithstanding that one or more of the signatories executed the deed in Australia, the fund will not be established in Australia.[10]

The DT Manual provides:

19876B. Pension Contribution [September 2011]
The term "pension scheme" is defined for the purposes of the treaty at Article 3(1)(o). This means that Treaty benefits are for approved schemes only. As section 615 ICTA 1988 schemes, which are UK established trusts for non-residents, are not approved they do not come within the definition of "pension scheme" in Article 3(1)(o) because they are not "generally exempt from income taxation in that State". They are therefore not included in the list in the Exchange of Notes.
So called US section 401(k) plans are included within the definition of a pension scheme as they are within the definition of a pension scheme in Article 3(1)(o) because they are a type of section 401(a) plan.

24.7.2 *Pension taxed in residence state*

Article 17(1) of the US/UK DTA provides:

(1) (a) Pensions and other similar remuneration beneficially owned by a resident of a Contracting State shall be taxable only in that State.

The DTA Exchange of Notes provides:—

With reference to paragraph 1 of Article 17 ... it is understood that a payment shall be treated as a pension or other similar remuneration under paragraph 1 of Article 17 if it is a payment under a pension scheme as defined in sub-paragraph (o) of paragraph 1 of Article 3 (General definitions) of the Convention.

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10 Taxation Ruling TR 2008/9, "Income tax: meaning of 'Australian superannuation fund' in subsection 295-95(2) of the Income Tax Assessment Act 1997" *http://law.ato.gov.au/atolaw/view.htm?DocID=TXR/TR20089/NAT/ATO/00001&PiT=99991231235958*

24.7.3 *Mutual recognition of pension tax exemption*

Article 17(1) of the US/UK DTA continues:

> (b) Notwithstanding sub-paragraph (a) of this paragraph, the amount of any such pension or remuneration paid from a pension scheme established in the other Contracting State that would be exempt from taxation in that other State if the beneficial owner were a resident thereof shall be exempt from taxation in the first-mentioned State.

To make it easier to follow which state is which, this could be paraphrased:

> (b) ... the amount of any such pension or remuneration paid from a pension scheme established in [the USA] that would be exempt from taxation in [the USA] if the beneficial owner were a resident [of the USA] shall be exempt from taxation in [the UK].

The US Department of the Treasury Technical Explanation of the Convention[11] provides:

> ... Thus, for example, a distribution from a U.S. "Roth IRA" to a U.K. resident would be exempt from tax in the United Kingdom to the same extent the distribution would be exempt from tax in the United States if it were distributed to a U.S. resident. The same is true with respect to distributions from a traditional IRA to the extent that the distribution represents a return of non-deductible contributions. Similarly, if the distribution were not subject to tax when it was "rolled over" into another U.S. IRA (but not, for example, to a U.K. pension scheme), then the distribution would be exempt from tax in the United Kingdom.

24.7.4 *Savings clause*

The US Department of the Treasury Technical Explanation of the Convention[12] provides:

> Subparagraph 1(a) is subject to the saving clause of paragraph 4 of Article 1 (General Scope)[13] while subparagraph 1(b) is not, by reason of the exception in subparagraph 5(a) of Article 1. Thus, a U.S. citizen who is a resident of the United Kingdom and receives a pension will be subject to U.S. tax on the payment, notwithstanding the rules in those

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11 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

12 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

13 See 59.15.1 (US/UK DTA: Savings clause).

> paragraphs that give the State of residence of the recipient the exclusive taxing right. However, a U.S. citizen who receives a distribution from a pension scheme established in the United Kingdom will be taxable on only the portion of the pension distribution that is taxable in the United Kingdom.
>
> Paragraphs 2 and 4 of Article 17 also are subject to the saving clause. Accordingly, a U.S. citizen who is a resident of the United Kingdom will be subject to U.S. tax on a lump-sum distribution from a pension scheme or an annuity, notwithstanding the rules in those paragraphs that give exclusive taxation rights to the State of source or residence, as the case may be. Paragraphs 3 and 5 are exceptions to the saving clause. Accordingly, a U.S. citizen who is a resident of the United Kingdom will not be subject to U.S. tax on any U.S. social security benefits, child support payments or alimony.

24.7.5 *Lump Sums*

Article 17(2) of the US/UK DTA continues:

> Notwithstanding the provisions of paragraph 1 of this Article, a lump-sum payment derived from a pension scheme established in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in the first-mentioned State.

It may be easier to keep track of this by identifying the states expressly. In the case of a UK resident:

> ... a lump-sum payment derived from a pension scheme established in [the USA] and beneficially owned by a resident of [the UK] shall be taxable only in [the USA].

In the case of a US resident:

> ... a lump-sum payment derived from a pension scheme established in [the UK] and beneficially owned by a resident of [the USA] shall be taxable only in [the UK].

The US Department of the Treasury Technical Explanation of the Convention[14] provides:

> Paragraph 2 is intended to deal with a particular type of double non-taxation that arose under the prior Convention because the United Kingdom does not tax lump-sum distributions from pension funds. Under

14 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

> the prior Convention, a lump-sum payment was treated in the same way as any other pension, and was taxable only in the country of residence of the beneficial owner. Accordingly, a person who anticipated receiving a lump-sum distribution from a U.S. pension scheme with respect to employment in the United States could avoid U.S. withholding tax on the distribution by establishing residence in the United Kingdom for the year in which he received the distribution. The person would not be subject to tax in either the United States or the United Kingdom with respect to the lump-sum distribution, resulting in a significant windfall.
> Paragraph 2 prevents this unanticipated benefit by providing that, notwithstanding the exclusive residence-country taxation of paragraph 1, any lump-sum payment derived by a resident of a Contracting State from a pension scheme established in the other Contracting State shall be taxable in that other State.

The US Department of the Treasury Technical Explanation of the Convention[15] provides:

> Paragraphs 2 and 4 of Article 17 also are subject to the saving clause. Accordingly, a U.S. citizen who is a resident of the United Kingdom will be subject to U.S. tax on a lump-sum distribution from a pension scheme or an annuity, notwithstanding the rules in those paragraphs that give exclusive taxation rights to the State of source or residence, as the case may be.

The DTR Manual provides:

> **19876A. Pensions from 2003** [September 2011]
> ***Lump Sums***
> Under the old Agreement, a lump-sum payment from a pension scheme was taxable only in the country of residence. So if an individual moved from the US to the UK before receiving a lump sum from a US pension scheme, they would be taxable on the lump sum neither in the US (because of the treaty) nor in the UK (which does not tax lump sums anyway).
> The new provision prevents this occurring by providing that a lump-sum payment derived by a resident of one State from a pension scheme established in the other State shall be taxable only in that other State.
> The provision preserves the exemption from income tax of a lump sum relevant benefit where it is paid by a UK approved pension scheme to a beneficial owner who is a US resident. However, Article 1(4) will apply

15 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

in respect of US citizens as the provisions of Article 17(2) are not amongst those listed at Article 1(5). So the US are able to tax lump sums received by US citizens from UK schemes.

The minutes of the Joint Forum on Expatriate Tax and NICs provides:

UK tax charges and transfers to US

Question: It is common practice for funds to be transferred between US pension schemes, particularly from a 401(k) to an IRA (individual retirement account). Although it is not necessarily a requirement, most people transfer their pension savings when they move employment.

Article 18(1) of the UK/US double taxation convention provides: "Where an individual who is a reside nt of a Contracting State is a member or beneficiary of, or participant in, a pension scheme established in the other Contract ing State, income earned by the pension scheme may be taxed as income of that individual only when, and, subject to paragraphs 1 and 2 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) of this Convention, to the extent that, it is paid to, or fo r the benefit of, that individual from the pension scheme (and not transferred to another pension scheme)."

Where Article 18(1) is otherwise in point, is it HMRC's position that any unauthorised payments charge applies to the whole of the UK tax- relieved contributions deemed to be transferred to the IRA, treating those as transferred in priority to any fund income, or does Article 18(1) somehow confer total or partial exemption from this charge (if so, how)? The cumulative rate of charge on UK tax-relieved contributions (unauthorised payment charge and surcharge) is 55%, which is more than the tax relief originally given on the contributions. Does this mean that part of the tax represents a charge on fund growth, which would be prevented by Article 18(1) if the treaty is allowed to have any application to Schedule 34 Finance Act 2004 charges? Or is Article 17 the provision that would relate to a transfer from a 401(k) to an IRA?

HMRC answer: The provisions of the UK/US double taxation convention will not apply where both the individual and the pension scheme are in the US. Where a member of a US pension scheme is resident in the UK and receives UK tax relief on their pension savings t hat part of their pension savings will be subject to the provisions of Schedule 34 Finance Act 2004 (the member payment provisions). If a transfer is made between a 401(k) and an IRA and the IRA is not a qualifying recognised overseas pension scheme (QROPS), the transfer will be an unauthorised payment. Any tax charge will be on the UK element of the pension savings and not to the investment growth in relation to the contributions. The wording of Article 18 refers to "income earned by the pension scheme" (in this case the US

401(k)). However, the inco me earned by the pension scheme would not be subject to UK tax charges. We do not see a transfer between pension schemes as being within Article 17 of the UK/US double taxation convention.[16]

24.8 US/UK DTA Pension Contributions

24.8.1 *Income accruing to pension schemes*

Article 18 of the US/UK DTA provides:

> (1) Where an individual who is a resident of a Contracting State is a member or beneficiary of, or participant in, a pension scheme established in the other Contracting State, income earned by the pension scheme may be taxed as income of that individual only when, and, subject to paragraphs 1 and 2 of Article 17 (Pensions, social security, annuities, alimony, and child support) of this Convention, to the extent that, it is paid to, or for the benefit of, that individual from the pension scheme (and not transferred to another pension scheme).

The US Department of the Treasury Technical Explanation of the Convention[17] provides:

> Paragraph 1 provides that if a resident of a Contracting State participates in a pension scheme established in the other Contracting State, the State of residence will not tax the income of the pension scheme with respect to that resident until a distribution is made from the pension scheme. Thus, for example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in the United Kingdom, paragraph 1 prevents the United Kingdom from taxing currently the plan's earnings and accretions with respect to that individual. When the resident receives a distribution from the pension scheme, that distribution may be subject to tax in the State of residence, subject to paragraphs 1 and 2 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support).

The US Department of the Treasury Technical Explanation of the Convention[18] provides:

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16 29 January 2014 *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302475/140326_Expats_Forum_Jan_14_Minutes_FINAL.pdf*

17 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

18 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

> Paragraph 1 is not subject to the saving clause of paragraph 4 of Article 1 (General Scope) by reason of the exception in subparagraph 5(a) of Article 1. Accordingly, a U.S. citizen who is a resident of the United Kingdom will not be subject to tax in the United States on the earnings and accretions of a U.K. pension fund with respect to that U.S. citizen.

The DTR Manual provides:

> **19876A. Pensions from 2003** [September 2011]
> ***IRAs***
> ...An IRA is a trust (or similar arrangement known as a custodial account) set up for the exclusive benefit of the taxpayer and, on his death, nominated beneficiaries, which satisfies certain conditions imposed by United States tax law. Contributions to an IRA are tax deductible in the United States and the funds can be invested in a wide range of investments. IRA funds can be withdrawn at any time, but if withdrawals are made before the taxpayer reaches the age of 59½ he must pay an additional penalty tax of 10% unless he is disabled.
> ...
> ***IRAs: Year 2003/04 et seq.***
> ... The new Agreement ... will mean that no liability will arise until it would have done so under US tax law. Under US law, this will be when distributions are made. As indicated above, this will generally not be before age 59½ but must be before age 70½. The important point to note is that income will no longer be assessable in the UK on the basis of income arising within the IRA.. Any case of doubt or difficulty should be referred to HMRC, Customs & International, Tax Treaty Team.

The taxation of the pension scheme itself is outside the scope of this book, but note that the term "person" is, unusually, defined in the DTA to include pension schemes and employee benefit trusts and arrangements.

24.8.2 *Relief for contribution to pension scheme*

Article 18 of the US/UK DTA provides:

> (2) Where an individual who is a member or beneficiary of, or participant in, a pension scheme established in a Contracting State exercises an employment or self-employment in the other Contracting State—
>
> (a) contributions paid by or on behalf of that individual to the pension scheme during the period that he exercises an employment or self-employment in the other State shall be deductible (or excludable) in computing his taxable income in that other State; and

(b) any benefits accrued under the pension scheme, or contributions made to the pension scheme by or on behalf of the individual's employer, during that period shall not be treated as part of the employee's taxable income and any such contributions shall be allowed as a deduction in computing the business profits of his employer in that other State.

The reliefs available under this paragraph shall not exceed the reliefs that would be allowed by the other State to residents of that State for contributions to, or benefits accrued under, a pension scheme established in that State.

The US Department of the Treasury Technical Explanation of the Convention[19] provides:

> Paragraph 2 provides certain benefits with respect to cross-border contributions to a pension scheme, subject to the limitations of paragraphs 3 and 4 of the Article. It is irrelevant for purposes of paragraph 2 whether the participant establishes residence in the State where the individual renders services (the "host State"). The benefits provided in paragraph 2 are similar to the benefits the U.S. Model provides with respect to contributions.
>
> Subparagraph (a) of paragraph 2 allows an individual who exercises employment or self-employment in a Contracting State to deduct or exclude from income in that Contracting State contributions made by or on behalf of the individual during the period of employment or self-employment to a pension scheme established in the other Contracting State. Thus, for example, if a participant in a U.S. qualified plan goes to work in the United Kingdom, the participant may deduct or exclude from income in the United Kingdom contributions to the U.S. qualified plan made while the participant works in the United Kingdom. Subparagraph (a), however, applies only to the extent of the relief allowed by the host State (e.g., the United Kingdom in the example) for contributions to a pension scheme established in that State.
>
> Subparagraph (b) of paragraph 2 provides that, in the case of employment, accrued benefits and contributions by or on behalf of the individual's employer, during the period of employment in the host State, will not be treated as taxable income to the employee in that State. Subparagraph (b) also allows the employer a deduction in computing business profits in the host State for contributions to the plan. For example, if a participant in a U.S. qualified plan goes to work in the United Kingdom, the participant's

19 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

> employer may deduct from its business profits in the United Kingdom contributions to the U.S. qualified plan for the benefit of the employee while the employee renders services in the United Kingdom.
> As in the case of subparagraph (a), subparagraph (b) applies only to the extent of the relief allowed by the host State for contributions to pension schemes established in that State. Therefore, where the United States is the host State, the exclusion of employee contributions from the employee's income under this paragraph is limited to elective contributions not in excess of the amount specified in section 402(g). Deduction of employer contributions is subject to the limitations of sections 415 and 404. The section 404 limitation on deductions is calculated as if the individual were the only employee covered by the plan.

The US Department of the Treasury Technical Explanation of the Convention[20] provides:

> Paragraph 2 is not subject to the saving clause by reason of subparagraph 5(b) of Article 1. Accordingly, the benefits of paragraph 2 will be available to residents of the United States who are not citizens of the United States nor admitted for permanent resident ("green card" holders) in the United States.

The DT Manual provides:

> **19876B. Pension Contribution** [September 2011]
> ...It is a feature of several UK treaties from 2003 onwards that pension contributions made in one country are recognised for tax purposes in the other.
> The general premise of these is that if a member of a pension scheme established in one country goes to work (as an employee or in a self-employed capacity) in the other country, the state of residence will not tax the scheme member on income earned by the scheme unless it is paid to him (or for his benefit). Nor will tax be payable if income is transferred to another pension scheme until the benefits are actually received.
> Under the new Agreement, contributions to the scheme by that member (or those paid on his behalf) will be tax-deductible in the state of residence. In the same way, benefits accrued under the scheme, or employer contributions to the scheme, will not be treated as part of his taxable income and those contributions will be tax-deductible for the

20 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

employer. The reliefs available cannot exceed those allowed by the state of residence for contributions of the same amount to a scheme established in the state of residence.

The conditions for getting the relief are as follows

- contributions were made by or on behalf of the individual or (in the case of an employee) his employer to the pension scheme (or to a similar scheme for which it was substituted) before the individual began to exercise an employment or self-employment in the other contracting state, and
- the competent authority of the other State agrees that the pension scheme generally corresponds to a pension scheme established in that other State.

Where someone comes to work in the UK we will regard the first condition as having been met if the individual was a member of the US scheme before beginning to exercise an employment or self-employment in the UK.

The types of scheme that would be accepted as "generally corresponding" are those listed in the Exchange of Notes.

24.8.3 *Restriction on pension contribution relief*

Article 18 of the US/UK DTA provides:

> (3) The provisions of paragraph 2 of this Article shall not apply unless—
>
> (a) contributions by or on behalf of the individual, or by or on behalf of the individual's employer, to the pension scheme (or to another similar pension scheme for which the first-mentioned pension scheme was substituted) were made before the individual began to exercise an employment or self-employment in the other State; and
>
> (b) the competent authority of the other State has agreed that the pension scheme generally corresponds to a pension scheme established in that other State.

The DTA Exchange of Notes provides:

> With reference to sub-paragraph (b) of paragraph 3 and sub-paragraph (d) of paragraph 5 of Article 18 (Pension schemes)—
>
> it is understood that the pension schemes listed with respect to a Contracting State in this exchange of notes in connection with sub-paragraph (o) of paragraph 1 of Article 3 (General definitions) shall generally correspond to the pension schemes listed in this exchange of notes with respect to the other Contracting State.

The US Department of the Treasury Technical Explanation of the

Convention[21] provides:

> Paragraph 3 limits the availability of benefits under paragraph 2. Under subparagraph (a) of paragraph 3, paragraph 2 does not apply to contributions to a pension scheme unless the participant already was contributing to the scheme, or his employer already was contributing to the scheme with respect to that individual, before the individual began exercising employment in the State where the services are performed (the "host State"). This condition would be met if either the employee or the employer was contributing to a scheme that was replaced by the scheme to which he is contributing. The rule regarding successor schemes would apply if, for example, the employer has been taken over by a company that replaces the existing scheme with its own scheme, rolling membership in the old scheme over into the new scheme.
> In addition, under subparagraph (b) of paragraph 3, the competent authority of the host State must determine that the recognized plan to which a contribution is made in the other Contracting State generally corresponds to the plan in the host State. According to the notes, it is understood for this purpose that U.S. pension schemes eligible for the benefits of paragraph 2 include qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k)), individual retirement accounts, individual retirement annuities, section 408(p) accounts and Roth IRAs under section 408A), section 403(a) qualified annuity plans, and section 403(b) plans.

24.8.4 *Interaction of pension contribution relief and with remittance basis*

Article 18 of the US/UK DTA provides:

> (4) Where, under sub-paragraph (a) of paragraph 2 of this Article, contributions to a pension scheme are deductible (or excludable) in computing an individual's taxable income in a Contracting State and, under the laws in force in that State, the individual is subject to tax in that State, in respect of income, profits or gains, by reference to the amount thereof which is remitted to or received in that State and not by reference to the full amount thereof, then the relief that would otherwise be available to that individual under that sub-paragraph in respect of such contributions shall be reduced to an amount that bears the same proportion to that relief as the amount of the income, profits or gains in respect of which the individual is subject to tax in that State bears to the

21 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

amount of the income, profits or gains in respect of which he would be subject to tax if he were so subject in respect of the full amount thereof and not only in respect of the amount remitted to or received in that State.

The US Department of the Treasury Technical Explanation of the Convention[22] provides:

Paragraph 4 limits the availability of benefits under paragraph 2 of this article. Paragraph 4 provides a special rule in cases where income dealt with by the Convention is taxable to a resident of a Contracting State only if and to the extent it is remitted to or received by that person. In such cases, paragraph 4 reduces proportionately the deduction or exclusion of contributions to a pension scheme under subparagraph (a) of paragraph 2 based upon the amount of income subject to tax in the State of residence. Although this rule is written in bilateral fashion, it presently applies to residents of the United Kingdom only, because the United States does not tax on a remittance basis. Paragraph 4 would apply, for example, if a U.S. citizen resident in the United Kingdom earns income in the United States that is not subject to tax in the United Kingdom because the income is not remitted to the United Kingdom. In this case, paragraph 4 would reduce proportionately the amount of any deduction or exclusion allowed in the United Kingdom to the U.S. citizen by subparagraph (a) of paragraph 2 for contributions to a U.S. pension scheme.

The DT Manual provides:

19876B. Pension Contribution [September 2011]
...Relief will be restricted where contributions to a pension scheme are deductible or excludable in computing a person's taxable income in the host country if he is subject to tax there not on his total income but only on amounts remitted to that country. Relief is available only on a corresponding proportion of the pension contributions.

An example

Individual's total income, profits and gains	£100,000
Income, profits and gains remitted to the UK	£90,000
Individual's contributions to US pension scheme	£5,000

Contributions deductible in computing individual's UK taxable income - £4,500 (i.e. 90% of individual's total contributions).

22 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

24.8.5 *Cross border pension contribution relief*

Article 18 of the US/UK DTA provides:

> (5)(a) Where a citizen of the United States who is a resident of the United Kingdom exercises an employment in the United Kingdom the income from which is taxable in the United Kingdom and is borne by an employer who is a resident of the United Kingdom or by a permanent establishment situated in the United Kingdom, and the individual is a member or beneficiary of, or participant in, a pension scheme established in the United Kingdom,
>
> (i) contributions paid by or on behalf of that individual to the pension scheme during the period that he exercises the employment in the United Kingdom, and that are attributable to the employment, shall be deductible (or excludable) in computing his taxable income in the United States; and
>
> (ii) any benefits accrued under the pension scheme, or contributions made to the pension scheme by or on behalf of the individual's employer, during that period, and that are attributable to the employment, shall not be treated as part of the employee's taxable income in computing his taxable income in the United States.
>
> This paragraph shall apply only to the extent that the contributions or benefits qualify for tax relief in the United Kingdom.
>
> (b) The reliefs available under this paragraph shall not exceed the reliefs that would be allowed by the United States to its residents for contributions to, or benefits accrued under, a generally corresponding pension scheme established in the United States.
>
> (c) For purposes of determining an individual's eligibility to participate in and receive tax benefits with respect to a pension scheme established in the United States, contributions made to, or benefits accrued under, a pension scheme established in the United Kingdom shall be treated as contributions or benefits under a generally corresponding pension scheme established in the United States to the extent reliefs are available to the individual under this paragraph.
>
> (d) This paragraph shall not apply unless the competent authority of the United States has agreed that the pension scheme generally corresponds to a pension scheme established in the United States.

The US Department of the Treasury Technical Explanation of the

Convention[23] provides:

> Paragraph 5 generally provides U.S. tax treatment for certain contributions by or on behalf of U.S. citizens resident in the United Kingdom to pension schemes established in the United Kingdom that is comparable to the treatment that would be provided for contributions to U.S. schemes. Under subparagraph (a) of paragraph 5, a U.S. citizen resident in the United Kingdom may exclude or deduct for U.S. tax purposes certain contributions to a pension scheme established in the United Kingdom. Qualifying contributions generally include contributions made during the period the U.S. citizen exercises an employment in the United Kingdom if expenses of the employment are borne by a U.K. employer or U.K. permanent establishment. Similarly, with respect to the U.S. citizen's participation in the U.K. pension scheme, accrued benefits and contributions during that period generally are not treated as taxable income in the United States.
>
> The U.S. tax benefit allowed by paragraph 5, however, is limited to the lesser of the amount of relief allowed for contributions and benefits under a pension scheme established in the United Kingdom and, under subparagraph (b), the amount of relief that would be allowed for contributions and benefits under a generally corresponding pension scheme established in the United States.
>
> Subparagraph (c) provides that the benefits an individual obtains under paragraph 5 are counted when determining that individual's eligibility for benefits under a pension scheme established in the United States. Thus, for example, contributions to a U.K. pension scheme may be counted in determining whether the individual has exceeded the annual limitation on contributions to an individual retirement account.
>
> Under subparagraph (d), paragraph 5 does not apply to pension contributions and benefits unless the competent authority of the United States has agreed that the pension scheme established in the United Kingdom generally corresponds to a pension scheme established in the United States. The notes provide that certain pension schemes have been determined to "generally correspond" to schemes in the other country. Since paragraph 5 applies only with respect to persons employed by a U.K. employer or U.K. permanent establishment, however, the relevant U.K. plans are those that correspond to employer plans in the United States. Accordingly, it applies with respect to retirement benefit schemes for the purpose of Chapter I of Part XIV of the Income and Corporation Taxes Act 1988.

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23 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

The US Department of the Treasury Technical Explanation of the Convention[24] provides:

> Paragraph 5 is not subject to the saving clause of paragraph 4 of Article 1 by reason of the exception in subparagraph 5(a) of Article 1. Accordingly, U.S. citizens who are resident in the United Kingdom will receive the benefits provided by paragraph 5 with respect to contributions made to pension schemes established in the United Kingdom.

24.9 Canadian RRSP and RRIF

The DT Manual provides:

> **DT4617 Withdrawals from Canadian RRSPs/RRIFs** [Jan 2012]
> Canadian Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs)
> Where a UK resident makes a lump sum withdrawal from an RRSP or an RRIF, Canada imposes a 25 per cent withholding tax. No tax credit relief is allowable in the United Kingdom in respect of the tax withheld, however, because the Canadian tax is imposed upon the lump sum withdrawal (which does not itself give rise to a tax charge in the United Kingdom), whereas any UK tax charge is on the disposal of assets held within the Plan or Fund to enable the lump sum to be withdrawn (and no tax is levied on the disposal of fund assets in Canada). The Elimination of Double Taxation Article (Article 21) obliges the United Kingdom to give credit for Canadian tax paid only against UK tax computed by reference to the same profits, income or chargeable gains by reference to which the Canadian tax is computed. Since no UK tax is computed by reference to the subject of Canadian tax (that is, the withdrawal), no tax credit relief is allowable. Similarly, where the disposal of fund assets to facilitate a withdrawal gives rise to a UK tax charge, no tax credit relief is allowable since the disposal does not attract a tax charge in Canada.

24 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

CHAPTER TWENTY FIVE

DISCRETIONARY TRUSTS: INCOME TAX

25.1 Discretionary trusts: Introduction

This chapter is concerned with the income taxation of discretionary trusts. The topic requires a book to itself. This chapter focuses on the matters closest to the theme of this work but it is necessary to review the general rules to understand these matters in their context.

The starting point is to appreciate that a receipt from a discretionary trust may be:

(1) income ("an income distribution" or "an income receipt") or

(2) capital ("a capital distribution")

in the hands of the recipient.

I use the term **"discretionary income payment"** to refer to a payment made from a trust to a beneficiary at the discretion of trustees, which is income (not capital) in the hands of the beneficiary. The statutory term is "discretionary payment" (it being assumed, though not expressly stated, that the payment is an income distribution).

In outline, there are three tiers of IT charges.

Tier (1): Charge on trustees on the receipt of income

At this tier it is necessary to distinguish resident and non-resident trustees:

(a) UK resident trustees are charged on all their income

(b) Non-resident trustees are charged on UK source income only.

Tier (2): Charge on trustees on making a discretionary income payment

At this tier it is also necessary to distinguish resident and non-resident trustees:

(a) UK resident trustees pay this charge.

(b) Non-resident trustees do not pay this charge.

Tier (3): Charge on beneficiaries on receiving a discretionary income payment

At this tier it is necessary to distinguish resident and non-resident beneficiaries:

(a) UK resident beneficiaries: charge on all trust income
(b) Non-resident beneficiaries: charge on UK source trust income (ie UK resident trusts) only.

Two sets of tax credits (more or less) eliminate the triple taxation which would otherwise result.

(1) Tax paid at tier (1) enters a "tax pool" and is allowed as a credit for the tax at tier (2) so that no additional tax may be paid at tier (2). I refer to this as **"the trustees tax pool credit"**.
(2) The tax at tier (2) is a credit for the tax at tier (3), and beneficiaries who are not top rate taxpayers or who are entitled to some reliefs may reclaim this tax. I refer to this as **"the beneficiary's tax credit"**.

Where the trustees tax pool credit fails to provide relief, there are further statutory and concessionary reliefs.

Section 462 ITA provides an overview of the layout of the legislation:

> (1) This Part [part 9 ITA] sets out special rules about settlements and trustees.
> (2) Chapter 2 contains general provision about settlements and trustees, for example, definitions of expressions relating to settlements.
> (3) Chapter 3 provides for income tax to be charged at the dividend trust rate or at the trust rate on certain amounts included in the net income of the trustees of a settlement.
> (4) Chapter 4 provides—
> (a) for expenses of the trustees of a settlement to be set against the trustees' trust rate income (see section 463(2)), and
> (b) consequentially, for the amount of the trust rate income to be reduced.
> (5) Chapter 5 qualifies section 479 (which is in Chapter 3) in the case of the trustees of an approved share incentive plan.
> (6) Chapter 6 provides that the first slice of the trust rate income of the trustees of a settlement is not to be charged at the dividend trust rate or at the trust rate.
> (7) Chapter 7 deals with the treatment of payments made by the trustees of a settlement in the exercise of a discretion ...

In this chapter when I refer to a trust, I am referring to a discretionary trust, and assume that the trust is not settlor-interested (or if it is, that s.624 does not apply).

25.1.1 *Cross references*

The following topics are considered elsewhere:
14.2 (Location of source of income: Territorial scope of IT)
14.9 (Split years: savings & investment & miscellaneous income).
I do not consider the vexed topic of trustees expenses (chapters 4 and 8), share incentive plans (chapter 5) or the standard rate band, which gives relief for the first (small) slice of income (chapter 6). I do not consider the position of corporate beneficiaries.

25.2 Tier 1: Charge on trustees on receipt of income

There are special rules, primarily dealing with the rates of tax on trusts. However the income tax charge itself arises under the usual charging provisions: there is no special charging provision for trusts. Accordingly:
(1) UK trustees are subject to tax on all their income
(2) Non-resident trustees are subject to tax on UK source income (except so far as non-residents income tax relief is available).
The trustees can qualify for the usual reliefs. Insofar as non-resident trustees qualify for reliefs, the position is straightforward, but tax relief for UK trustees (for instance DT relief[1]) affects the tax pool credit system, which therefore has to be supplemented with further reliefs.

25.2.1 *Accumulated or discretionary income*

The TSE Manual provides a rough summary:

> **3011 Amount of trust income chargeable** [September 2011]
> Trustees are chargeable at the basic rate on trust income without any deduction for trust management expenses.
> **Accumulation or discretionary trust**
> If the trust is within ITA/S479, the trustees are liable to tax at the special trust rates. These are the dividend trust rate in respect of dividend type income and the trust rate in respect of other income. TSEM3019 explains which trusts are within ITA/S479.
> The amount of trust income chargeable at the special trust rates is the gross trust income, minus the total of:
> [a] income which before distribution ranks as the income, for tax purposes, of a person other than the trustees

1 See 25.12 (Are discretionary trusts "beneficial owners" for DTA purposes?).

[b] for years to and including 2005-06 only income which is treated, for any purposes of the Taxes Act, as that of the settlor (from 6 April 2006 the exemption for settlor-interested settlements to the special trust rates no longer applies) and
[c] allowable trust management expenses (TSEM8300+).

Section 479 ITA provides:

(1) This section applies if—
(a) accumulated or discretionary income arises to the trustees of a settlement, and
(b) the income does not arise under a trust established for charitable purposes only.
(2) Income tax is charged on the income at the rates referred to in this section instead of at the rates which would otherwise apply (for which see Chapter 2 of Part 2 (rates at which income tax is charged)).
(3) Income tax is charged on the income at the dividend trust rate so far as the income is dividend income.
(4) Otherwise, income tax is charged on the income at the trust rate.

The rates are the top income tax rates (the Blair/Brown administration disapproved of trusts and the coalition administration have not changed the policy). For 2013/14, s.9 ITA provides:

(1) The trust rate is 45%.
(2) The dividend trust rate is 37.5%.

The key term is "accumulated or discretionary income". Section 480 ITA provides:

(1) Income is accumulated or discretionary income so far as—
(a) it must be accumulated, or
(b) it is payable at the discretion of the trustees or any other person,
and it is not excluded by subsection (3).
(2) The cases covered by subsection (1)(b) include cases where the trustees have, or any other person has, any discretion over one or more of the following matters—
(a) whether, or the extent to which, the income is to be accumulated,
(b) the persons to whom the income is to be paid, and
(c) how much of the income is to be paid to any person.

This covers common form discretionary trusts.

25.2.2 *Exception for settlor-interested trusts*

Section 480 continues with 3 exceptions of which only the first is relevant here. Section 480(3) ITA provides:

> Income is excluded for the purposes of subsection (1) so far as—
> (a) before being distributed, it is the income of any person other than the trustees...

I would have thought that this applies to the income of settlor-interested trusts, so far as s.624 ITTOIA applies, but HMRC do not agree: see TSE Manual 3011set out above, at para [b].

25.2.3 *Other trust income taxed at top rates*

Section 481 ITA provides:

> (1) This section applies if—
> (a) the trustees of a settlement are liable for income tax on an amount of a type set out in section 482,
> (b) the trustees are not trustees of a unit trust scheme, and
> (c) the amount is not income arising under a trust established for charitable purposes only.
> (2) Income tax is charged on the amount at one of the rates referred to in this section instead of at the rate which would otherwise apply (for which see Chapter 2 of Part 2 (rates at which income tax is charged)). This is subject to subsection (5).
> (3) If the amount is within Type 1 as set out in section 482, income tax is charged on the amount at the dividend trust rate.
> (4) Otherwise, income tax is charged on the amount at the trust rate.

This applies to all trusts, IIP as well as discretionary, but it is convenient to deal with it here. Section 481 continues with 4 exceptions:

> (5) Income tax is not to be charged as mentioned in subsection (2) so far as the amount—
> (a) is accumulated or discretionary income,
> (b) would be accumulated or discretionary income apart from section 480(3)(a) or (c), or
> (c) is income from property within subsection (6).
> (6) Property is within this subsection if it is held for the purposes of a superannuation fund to which section 615(3) of ICTA (superannuation funds relating to undertakings outside the UK) applies.

Section 482 ITA specifies 11 types of income, mostly fairly exotic

categories, which constitute capital for trust purposes but income for tax purposes:

The types of amount referred to in section 481 are as follows.

Type 1: Purchase of own shares

A payment—

(a) which is made to the trustees or to which the trustees are entitled, and

(b) which is made by way of qualifying distribution by a company on the redemption, repayment or purchase of shares in the company or on the purchase of rights to acquire such shares.

Type 2: Accrued income profits

Accrued income profits treated as made by the trustees under section 628(5) or 630(2) [ITA].

Type 3: Offshore income gains

Income treated as arising to the trustees under regulation 17 of the Offshore Funds (Tax) Regulations 2009.

Type 4: Employee share ownership trusts

Income which the trustees are treated as receiving under section 68(2) or 71(4) of FA 1989 (which relate to employee share ownership trusts).

Type 5: Lease premiums

A sum to which Chapter 4 of Part 3 of ITTOIA 2005 (which provides for certain amounts to be treated as receipts of a property business) applies.

Type 6: Deeply discounted securities

A profit in relation to which the trustees are liable for income tax under section 429 of ITTOIA 2005 (profits from deeply discounted securities).

Type 7: Life insurance gains

A gain in relation to which the trustees are liable for income tax under section 467 of ITTOIA 2005 (gains from contracts for life insurance etc), other than a gain to which subsection (7) of that section applies.

Type 8: Transactions in deposits

A profit or gain in relation to which the trustees are liable for income tax under section 554 of ITTOIA 2005 (transactions in deposits).

Type 9: Futures & options

A profit or gain—

(a) in relation to which the trustees are liable for income tax under section 557 of ITTOIA 2005 (disposals of futures and options), and

(b) which does not meet any of conditions A to C in section 568 of ITTOIA 2005.

Type 10: Foreign dividend coupons

Proceeds in relation to which the trustees are liable for income tax under section 573 of ITTOIA 2005 (sales of foreign dividend coupons).

Type 11: Transactions in land

Income treated as arising to the trustees under Chapter 3 of Part 13 of this Act [ITA] (tax avoidance: transactions in land).

25.3 Tier 3: Discretionary income payment: Charge on beneficiary

Section 683(1) ITTOIA imposes the tax charge on discretionary income payments:

> Income tax is charged under this Chapter on annual payments that are not charged to income tax under or as a result of any other provision of this Act or any other Act. ...

"Annual payment" is an opaque technical term: it is a label for a category (or set of categories) of income, the meaning of which is discussed in a large and in parts difficult body of case law.[2] It is not necessary to discuss that here, as it is well established that income payments from discretionary trusts are annual payments and so are charged under this section.

25.3.1 *Beneficiary a remittance basis taxpayer*

Section 684 ITTOIA provides:

> (1) Tax is charged under this Chapter on the full amount of the annual payments arising in the tax year.

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2 Section 683(3) ITTOIA provides one statutory rule: "The frequency with which payments are made is ignored in determining whether they are annual payments for the purposes of this Chapter."
ITTOIA EN explains: Subsection (3) rewrites "or whether the same is received and payable half-yearly or at any shorter or more distant periods".

(2) Subsection (1) is subject to Part 8 (foreign income: special rules).

This brings in the ITA remittance basis if the discretionary income payments have a foreign source.

25.3.2 *Discretionary trust payment: What is the source?*

Where the trust is a common form discretionary trust, and a beneficiary receives trust income in the exercise of the trustees' discretion, the trust is the source (not the underlying trust assets):

> A discretionary trust ... is not transparent. No beneficiary is entitled unless and until the trustees exercise their discretion in his or her favour, and the trustees' exercise of discretion is regarded as ... creating a new source of income...[3]

The beneficiary's income is categorised as annual payments (regardless of the type of income received by the trustees). HMRC agree. The TSE Manual provides:

> **3756. Individual beneficiary receives discretionary income payment from a resident trust: trust not settlor-interested** [August

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3 *Memec v IRC* 71 TC 77 (HC) at p.95. The same point was made in *IRC v Berrill* 55 TC 429 at p.444.

For a dissenting view, see Venables, "*Memec v IRC* and the Source of Discretionary Income Payments from Trusts" PTPR (1999) Vol. 7 p.87, accessible *http://www.khpplc.co.uk/reviews*; Venables, *Non-Resident Trusts*, (8th ed., 2000), 16.3 (Taxation of Beneficiary):

"Where there are discretionary trusts of income ...and the trustees distribute income in the exercise of their discretion, the taxability of the recipient beneficiary is a matter of some controversy. My own opinion is that in exercising their discretion the trustees simply perfect the settlor's gift so that the position at the end of the day is the same as if the trust instrument had expressly provided that the beneficiary should receive the income. Thus, the income which the beneficiary receives is the same income as that which the trustees received, the beneficiary's source is the same as the trustees' source and any tax paid by the trustees is to be treated as having been paid on account of the beneficiary."

Before 1973 this view was (I think) generally held though the point was not formally decided. This was assumed to be correct in *Drummond v Collins* 6 TC 525 though the point was not directly considered. However the FA 1973, imposing the additional rate of tax (now chapter 7 part 9 ITA), clearly assumes that a discretionary trust is a separate source, and so provides a statutory basis (if needed) to support the view that discretionary trusts are not transparent. Venables raised the argument in the Court of Appeal in *Memec*, but it was not addressed: 77 TC at p.111.

> 2013]
> In the case of trusts or settlements that are not settor-interested a discretionary income payment is treated as an amount that is net of tax at the trust rate. The beneficiary's income is the net amount grossed at the trust rate. It carries tax credit at that rate. It is available for relief or repayment.
> The gross amount is an annual payment. It is a new source of income, usually not identified with the underlying trust income. *Cunard's Trustees v IRC* (27 TC 122) supported the view that when the trustees exercised their discretion, a new source of income came into existence.
> ...

If a discretionary trust becomes interest in possession in form, the trustees' discretion over income in principle comes to an end and the source has ceased: *IRC v Berrill* at p.444. But the cessation of a source is not now significant for tax purposes.

Memec also considers annuities:

> Similarly, the rights of an annuitant under a trust are regarded as a source of income distinct from that of the underlying trust investments.[4]

However annuities are not now found, so this is of academic interest only.

25.3.3 *Discretionary trust payment: Location of source*

Where the trust is the source, how does one decide its location? There are (as usual) a variety of possible connecting factors, including: the residence of the trustees, the country in whose courts the trust will be enforced, the place where the discretion is exercised. It is suggested that trustee residence is the deciding factor, and this is consistent with s.493(1)(b) ITA. HMRC agree. Normally all these factors will point the same way so the issue will not arise.

25.3.4 *Time income arises*

The TSE Manual provides:

> **3759. Beneficiary receives discretionary income payment from a resident trust: when payment made** [August 2013]
> For tax purposes the beneficiary receives a payment on
> • The date the trustees made the payment or

4 See too *R v Special Comrs ex p. Shaftesbury Homes & Arethusa Training Ship* 8 TC 367; *Inchyra v Jennings* 42 TC 388.

- The date the beneficiary became legally entitled to require the trustees to pay over the income. This could be when the payment indefeasibly vested, following the trustees' resolution.

Tax cases: *Cunard's Trustees v IRC* 27 TC 122

25.3.5 *Entering discretionary trust income in beneficiary's tax return*

Income from non-resident trusts is entered in box 41 of the Foreign pages of the tax return, SA106 (2013/14): the side note to this box refers to "discretionary income from non-resident trusts".

HMRC Helpsheet 262 (2013/14) provides:

> If you have received a discretionary payment from the non-UK resident trust, enter all of the income in box 41 ... [5]

For UK resident trusts, the income is entered in box 1 of the Trusts etc pages, SA107 (2013/14).

25.4 Beneficiaries tax credit

25.4.1 *UK resident trusts*

The tax credit is in s.494 ITA, which is introduced by s.493 ITA:

> (1) Sections 494 and 495 apply for income tax purposes if—
> (a) in a tax year the trustees of a settlement make an annual payment to a person ('the beneficiary') in the exercise of a discretion (whether exercisable by the trustees or any other person),
> (b) the trustees are UK resident for the tax year, and
> (c) condition A or condition B is met.

The usual case is condition A. Section 493(2) ITA provides:

> Condition A is that what is paid to the beneficiary is, only because of the payment, income of the beneficiary for income tax or corporation tax purposes. 'Income' does not include employment income.

Condition B relates to payments to minor children of the settlor,[6] a topic not considered here.

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5 The helpsheet continues: "... unless the situation mentioned in the next paragraph applies" The next paragraph refers to the special rules for settlor-interested trusts; see 27.7.2 (Relief for non-settlor-beneficiary).

6 Section 494(3) ITA provides: "Condition B is that the payment is treated for income tax purposes as the income of a settlor under section 629 of ITTOIA 2005 (income paid to relevant children of settlor)."

Section 494 ITA provides the beneficiaries tax credit and grossing up. Grossing up comes first:

> (1) The discretionary payment is treated as if it were made after the deduction of a sum representing income tax at the trust rate on the grossed up amount of the discretionary payment.
> (2) The grossed up amount of the discretionary payment is the actual amount of the discretionary payment grossed up by reference to the trust rate.

Then the beneficiaries tax credit:

> (3) The person mentioned in subsection (4) is treated as having paid income tax of an amount equal to the sum deducted as mentioned in subsection (1).
> (4) That person is—
> (a) if condition A in section 493 is met, the beneficiary, and
> (b) if condition B in section 493 is met, the settlor.

Condition B (payments to minor children of the settlor) is not considered here.

25.4.2 *Non-resident trusts*

The beneficiary's tax credit (along with the tier 2 charge on trustees) only apply if the trustees are UK resident: s.493(1)(b) ITA.

EN ITA Change 89 provides:

> This change makes it explicit that the Chapter dealing with the taxation of discretionary payments by trustees applies only to payments made and tax suffered while the trustees are UK resident.
> ... section 493 contains the condition that it only applies to UK resident trustees. It follows that where a payment is made by non-UK resident trustees:
> - the payment does not carry any tax credit in the hands of the beneficiary; and
> - the trustees are not liable for any tax in respect of the payment.
>
> As a corollary to the provisions of section 687 of ICTA not applying to non-UK resident trustees, tax only enters the trustees' tax pool if it is tax suffered on income arising while the trustees are UK resident - see section 497.
> This change does not affect the operation of ESC B18, which enables UK resident beneficiaries who receive discretionary payments to have a credit for the tax paid by non-UK resident trustees on UK source income.

25.5 Tier 2: Charge on trustees making discretionary income payment

Section 496 ITA provides the charge on trustees:

> (1) Income tax is charged for a tax year if—
>
> (a) in the tax year the trustees of a settlement make payments as a result of which income tax is treated as having been paid under section 494, and
>
> (b) amount A is greater than amount B.
>
> (2) Amount A is the total amount of the income tax treated under section 494 as having been paid.
>
> (3) Amount B is the amount of the trustees' tax pool available for the tax year (see section 497).
>
> (4) The amount of the tax charged under this section is equal to the difference between amounts A and B.
>
> (5) The trustees are liable for the tax.

25.6 Trustees tax pool credit

Section 497(1) ITA deals with the trustees' tax pool:

> Take the following steps to calculate the amount of the trustees' tax pool available for a tax year ('the current tax year').
>
> This is subject to subsections (2) and (3).
>
> *Step 1* Take the amount of the trustees' tax pool available for the previous tax year and deduct from that amount (but not so that it goes below nil)—
>
> (a) the total amount of income tax treated under section 494 as having been paid as a result of payments made by the trustees in the previous tax year, and
>
> (b) the amount to which the trustees are entitled under section 496B in respect of the previous tax year.
>
> *Step 2* Add together all amounts of income tax for which the trustees are liable for the current tax year and which are of a type set out in section 498.
>
> *Step 3* Add the sum calculated at Step 2 to the amount resulting from Step 1.

Section 497(2)(3) ITA deal with the special cases of immigrant trusts and new trusts:

> (2) If the trustees were non-UK resident for the previous tax year, references in subsection (1) to the previous tax year are to be read as references to the last tax year prior to the current tax year for which the

trustees were UK resident.
(3) If—
(a) the current tax year is the tax year during which the settlement is established, or
(b) the trustees have been UK resident for no tax year prior to the current tax year,
ignore Steps 1 and 3 and, accordingly, the trustees' tax pool available for the current tax year is the sum calculated at Step 2.

Section 498 ITA provides the list of types of income which qualify fall within the tax pool. It is in short all the tax paid by the trustees. In full detail:

(1) The types of amount referred to at Step 2 in section 497 are as follows.
Type 1 The amount of any tax on income (other than income of a kind mentioned below in relation to Type 2, 3 or 3A) charged at the dividend trust rate or at the trust rate.
Type 2 The amount of tax at the nominal rate on any income which is—
(a) chargeable under Chapter 3 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies),
(b) chargeable under Chapter 5 of that Part (stock dividends from UK resident companies), or
(c) chargeable under Chapter 6 of that Part (release of loan to participator in close company),
and on which tax is charged at the dividend trust rate as a result of section 479.
Type 3 The amount of tax at the nominal rate on any income on which tax is charged at the dividend trust rate as a result of section 481.
Type 3A The amount of tax at the nominal rate on any amount in respect of which—
(a) the trustees are liable to income tax under section 467 of ITTOIA 2005 (gains from contracts for life insurance etc),
(b) the trustees are liable to income tax at the trust rate by virtue of section 482 above, and
(c) tax at the basic rate is treated as having been paid by virtue of section 530 of ITTOIA 2005 (life insurance).
Type 4 The amount of any tax on income on which tax is charged at the basic rate …2 as a result of section 491.
Type 5 The amount of tax on any income determined in accordance with section 26 of FA 2005 (special tax treatment for trusts for the benefit of vulnerable persons).
(2) In relation to Types 2 and 3, references to the nominal rate are

references to a rate equal to the difference between the dividend trust rate and the dividend ordinary rate.

(2A) In relation to Type 3A, the reference to the nominal rate is a reference to a rate equal to the difference between the trust rate and the basic rate.

(3) In relation to Types 1 to 4, references to income do not include income the tax on which is reduced in accordance with section 26 of FA 2005.

25.6.1 *Effect of trustees DT relief on tax pool*

The TSE Manual provides:

3670 Discretionary trust [June 2009]

These instructions apply to taxed overseas income received by a discretionary or accumulation trust. The trustees can claim double taxation relief in respect of overseas tax that qualifies for relief. The trustee's marginal rate is the rate applicable to trusts, or where it applies, the dividend trust rate. INTM367780+ onwards has instructions about calculating relief.

A paying agent may have allowed provisional tax credit relief on overseas income. The computation of double taxation relief must reflect this.

Tax pool

The Section 687 ICTA 1988 tax pool must contain only UK tax paid or suffered by deduction. It must not include UK tax covered by credit for overseas tax.

Section 687(3)(a) ICTA 1988 effectively withdraws the double taxation relief when the trustees make a discretionary payment to a beneficiary.

25.6.2 *Transitional rule for pre-2008 income*

ITA 2007 Sch 2 para 104 provides:

(1) Section 497 applies with the following modifications in relation to the trustees of a settlement established prior to the tax year 2007–08 if the current tax year is the tax year 2007–08.

(2) It also so applies if—

(a) the current tax year is a tax year subsequent to the tax year 2007–08, and

(b) the trustees have been UK resident for no tax year prior to the current tax year or the last tax year prior to the current tax year for which they were UK resident is a tax year prior to the tax year 2007–08.

(3) It applies as if in subsection (1) for Step 1 there were substituted—

'Step 1
Take the amount of the trustees' final section 687(3) tax pool and deduct from that amount (but not so that it goes below nil) the total of all tax (if any) treated under section 687(2)(a) of ICTA as being paid as a result of payments made by the trustees in the tax year 2006–07.
'The amount of the trustees' final section 687(3) tax pool' is the total amount—

(a) available to the trustees under section 687(3) of ICTA for setting against tax assessable on them under section 687(2)(b) of that Act for the tax year 2006–07, or

(b) which would have been so available had tax been so assessable.'

(4) It applies as if subsections (2) and (3) were omitted.

25.7 HMRC example

The TSE Manual provides an example:

3024 The tax pool - trustees calculate maximum discretionary payment [September 2011]
In this example, in the tax year 2010-2011 a trustee of a discretionary trust receives a net dividend of £1,350 (tax credit £150. The trustee is chargeable at 42.5%, which is partly covered by the 10% non-payable tax credit.

Description		
Dividend received	£1,350	
Plus non-payable tax credit	£150	
Gross income	£1,500	
Tax at 10% on first £1,000 (standard rate band)		£100
Tax at 42.5% on the remainder £500×42.5%		£212.50
Total tax		£312.50
Less non-payable tax credit		- £150
Tax payable by trustee - goes into tax pool		£162.50
Net income after tax		£1187.50

The trustee now has net income of £1,187.50 (net dividend of £1,350 less tax paid of £162.50). Only £162.50 of the total tax goes into the tax pool because the £150 dividend tax credit is not payable.
If the trustee pays the net income of £1,187.50 to the beneficiary, the tax credit of 50% on that net payment is £1,187.50 (gross amount of £2,375 at 50%). But if the tax pool has nothing brought forward from the previous year and there is no other income on which tax has been paid, the tax pool of £162.50 will not cover the tax credit of £1,187.50 on the payment made. Under Section 496 the trustee would have to pay £1,187.50 less £162.50 = £1,025, bur there are no funds available.

Instead, the trustees can calculate the maximum amount of discretionary payment as follows:-

Description		
Net income after tax		£1,187.50
Add tax in tax pool		£162.50
Total amount to cover payment to beneficiary & tax credit @50%		£1,350.00
Tax credit at 50%	£ 675.00	£675.00
Less tax paid in tax pool		£162.50
Additional tax to be paid by trustee		£512.50
Net payment to beneficiary	£ 675.00	

The beneficiary is paid net income of £675 with a tax credit of £675, which is equivalent to gross income of £1,350 with tax credit at 50%. The trustee pays a total of £675 tax to HMRC, £162.50 tax on the dividend received and the additional £512.50 under Section 496. So if the trustee is relying on the dividend income to fund both the payment to the beneficiary and the additional tax there are sufficient funds to release only 50% of the actual dividend, that is £1,350×50% = £675.

HMRC offer an online tax pool calculator to do the computations, in simple cases.[7]

25.8 Payment from discretionary trust: Income or capital receipt?

The question whether a trust distribution is an "annual payment" (ie, income) or not (ie, capital) matters for many purposes. In particular:

(1) The IT charge on a beneficiary receiving the distribution (tier 3) only applies if the distribution is income.
(2) The IT charge on trustees making the distribution (tier 2) only applies if the distribution is income.
(3) Section 87 and s.731 only apply if the distribution is capital.[8]

The position depends on the terms of the power under which the payment is made.

25.8.1 *Power over income*

A common form discretionary trust[9] provides this type of power over trust

7 *http://www.hmrc.gov.uk/tools/trusts/calculator.htm*.

8 See 30.11 (S.731 capital condition); 51.6.5 (Payment in form of income (un)taxed on remittence basis).

9 For a discussion of the drafting, see Kessler, *Drafting Trusts & Will Trusts* (12th ed., 2014), Chap 15 (Discretionary Trusts).

income:

> The Trustees may pay or apply the trust income to or for the benefit of any Beneficiaries, as the Trustees think fit.

If trustees receive income and make a payment under such a power, the receipt is income and not capital. This has never been doubted.

25.8.2 *Power over capital*

A common form discretionary trust also provides this type of power over trust capital:

> The Trustees may pay or apply the capital of the Trust Fund to or for the advancement or benefit of any Beneficiary.

If trustees make a payment under such a power the receipt is capital and not income. This is still the case even if:

(1) the payments are made to satisfy an "income purpose", eg maintenance of a beneficiary; and
(2) the payments are recurrent (eg annual or even monthly).

This follows from *Stevenson v Wishart*.[10]

25.8.3 *Accumulated income paid out as capital*

Suppose:

(1) trustees accumulate income and add it to capital; and
(2) the trustees pay that capital to a beneficiary in exercise of a power like that in para 25.8.2 (Power over capital).

The receipt is still capital and not income. This follows from *Stevenson v Wishart.* In that case the distributions which HMRC sought to tax as income represented original trust capital and not accumulated income. It is considered that this makes no difference. *Stevenson v Wishart* is authority for the proposition that the income/capital question is governed by the terms of the power concerned.[11]

---

10 59 TC 740. The judgment of Knox J is clearer on this point than the Court of Appeal; this view is adopted in *Pierce v Wood* [2010] WTLR 253 at [29] "An appointment or advance of trust capital, in exercise of a power over capital, even if it were to meet an income need of the beneficiary, is normally a capital receipt in the beneficiary's hands."

11 Provisions such as ss.631(1)(2) and 633 ITTOIA assume this is correct (deeming payments out of accumulated income to be treated as income).

It might be different in an extreme case, where for tax planning reasons there was an arrangement under which:

(1) income was accumulated;

(2) the trustees pay that capital to a beneficiary (by exercise of a common form power of advancement or appointment) shortly afterwards.

HMRC would have an attractive argument that the receipt should be regarded as income under general principles (or under the GAAR but it would not be necessary to rely on that).

In practice it should be possible to avoid this by ensuring that advances of capital are not neatly identifiable with accumulated income.

25.8.4 *HMRC view*

HMRC agree with the views set out above. The TSE Manual provides:

> **TSEM3781 - Trust income and gains: beneficiaries: payment from trust capital - normally capital in beneficiary's hands** [Aug 2013]
> A payment made out of trust capital including
> - accumulated income
> - a capital receipt that is deemed to be income for tax purposes
>
> is normally regarded as capital of the beneficiary and so is not taxable. This view was supported in the case of *Stevenson v Wishart* (59 TC 740).
> Where
> - there is no pre-existing interest in income, or
> - the payment is made under an interest in capital that is separate from an interest in income
>
> payments out of trust capital constitute capital in the hands of the recipient.
> Examples that illustrate the normal rule are:
> - Anthony has no interest in income at all. But the trustees may advance capital to or for him at their discretion. Payments are capital and not taxable on him.
> - Barbara has a discretionary interest in income. The trustees may also advance capital to or for her at their discretion. Payments are capital and not taxable on her.
> - Carina has an annuity of £10,000 and in addition, the trustees have the power to apply capital at their discretion for her benefit. Payments are capital and not taxable on her.

The Manual notes three exceptional cases:

TSEM3783 - Trust income and gains: beneficiaries: payment from trust capital - exceptions to normal rule [Aug 2013]
There are certain circumstances in which payments from trust capital are treated as income of the beneficiary. They are:
[1] express gift of an annuity (TSEM3784)
[2] payments to supplement or augment an income interest (TSEM3785)
[3] compensation for loss of income (where beneficiary entitled to compensation) (TSEM3786)

Exceptions [1] and [3] are of specialist interest and not considered here. The Manual explains the second exception in this way:

TSEM3785 - Trust income and gains: beneficiaries: payment from trust capital - exceptions to normal rule - payment to supplement or augment income [Aug 2013]
The cases of *Cunard's Trustees v IRC* (27 TC 122) and *Brodie v IRC* (17 TC 432) established that where there is a pre-existing income interest (whether in the form of an annuity or interest in possession) payments out of trust capital to supplement or augment income constitute income in the hands of the recipient.
Where the beneficiary has a pre-existing annual income entitlement, and the trustees can or have to supplement or augment the trust income out of capital:
- if they can use capital in this way, i.e. it is discretionary, ITA/S494 will apply
- if they have to use capital in this way, the annual payments treatment will apply.

Example:
Dilwar lives rent-free in trust property. The deed provides for income to be used to pay rates and other property expenses, while the rest of income is to be used for his benefit. If the income is insufficient, the trustees are empowered to use capital at discretion to keep the beneficiary at same level of comfort as in the past. Dilwar has a pre-existing income entitlement, so the payment from capital is treated as income in his hands. ITA/S494 applies to the capital payments.
Elena has an annuity of £10,000 a year. If the trust income is less than £10,000, the trustees have to make up the shortfall from trust capital. Elena has a pre-existing income entitlement, so the payment from capital is treated as income in her hands. The whole £10,000 is taxable as income and the annual payments treatment applies.

25.8.5 *Accumulated income paid out as income under s.31 TA 1925*

The Manual considers the special case of a payment of trust capital under s.31(2) Trustee Act 1925. In order to follow this, it is necessary to set out the terms of s.31. The section is somewhat intricate, and I set out the relevant parts as they normally apply:

> (1) Where any property is held by trustees in trust for any person for any interest whatsoever, whether vested or contingent, then, subject to any prior interests or charges affecting that property—
>
> (i) during the infancy of any such person, if his interest so long continues, the trustees may, at their sole discretion, pay to his parent or guardian, if any, or otherwise apply for or towards his maintenance, education, or benefit, the whole or such part, if any, of the income of that property as may, in all the circumstances, be reasonable,...
>
> Provided that, in deciding whether the whole or any part of the income of the property is during a minority to be paid or applied for the purposes aforesaid, the trustees shall have regard to the age of the infant and his requirements and generally to the circumstances of the case, and in particular to what other income, if any, is applicable for the same purposes; and where trustees have notice that the income of more than one fund is applicable for those purposes, then, so far as practicable, unless the entire income of the funds is paid or applied as aforesaid or the court otherwise directs, a proportionate part only of the income of each fund shall be so paid or applied.
>
> (2) During the infancy of any such person, if his interest so long continues, the trustees shall accumulate all the residue of that income ... and shall hold those accumulations as follows ...
>
> (ii) In any other case the trustees shall, ... hold the accumulations as an accretion to the capital of the property from which such accumulations arose, and as one fund with such capital for all purposes, ...
>
> but the trustees may, at any time during the infancy of such person if his interest so long continues, apply those accumulations, or any part thereof, as if they were income arising in the then current year.

The Manual argues that a payment under s.31(2) is a capital receipt:

> **TSEM3782 - Trust income and gains: beneficiaries: payment from trust capital - normally capital in beneficiary's hands - S31 Trustee Act 1925** [Aug 2013]
>
> The concluding words of Section 31(2) Trustee Act 1925 allow the

> trustees to apply accumulations 'as if they were income arising'.
> These words do not have the effect of de-capitalising the accumulations concerned. Once accumulated income is forever capitalised. Where such accumulations have been released the money must therefore have been received by the beneficiary as capital. The phrase 'as if they were income arising in the then current year' should be regarded as simply meaning that the trustees are bound by the proviso to Section 31(1), just in the same way as they would be if they were deciding whether or not to release current income to or for the benefit of the minor.
> When paid by virtue of this provision the payment is capital in the beneficiary's hands, so it would not fall within ITA/Ss493-494, i.e. there is no tax credit to the beneficiary. Such a payment may be subject to the application of ITTOIA/S629 to charge the amount as income of the settlor - see TSEM4300+.

The payment of a sum under s.31(2) TA 1925 seems to me a clear case of an income receipt, under the principle of *Cunard's Trustees* to which HMRC refer in the Manual passage set out above. HMRC are correct to say that the accumulated income is capitalised, ie it becomes and remains capital in the hands of the trustees. But that does not answer the question as it is clear that a payment out of trust capital may still constitute income in the hands of the beneficiaries. The important point is that the terms of the relevant provision of the settlement link the payment with an income interest of a beneficiary. See the comment of Knox J in *Stevenson v Wishart* 59 TC 740 at p.757D.

It might perhaps be clearer if the trust accounts recorded an "Accumulated Income Fund" (instead of recording accumulated income as increasing the capital fund). However, this makes no difference.

Perhaps HMRC will reconsider following the repeal of the proviso in the Inheritance and Trustees' Powers Act 2014.

The view that the receipt is a capital receipt will more often favour HMRC, but sometimes it will favour the taxpayer. The taxpayer cannot be criticised for adopting HMRC's official view when it suits them.

It has been said that two Special Commissioners decisions from the 1970s have held that the exercise of the s.31(2) power did not have the effect of making the payments income in the hands of the beneficiary.[12] But unreported special commissioner decisions cannot be cited as

12 Sheasby, "Accumulations of Income" [2000] TACT Review issue 11 accessible *http://www.trustees.org.uk/review-index/Trusts-Accumulations-of-income.php*

precedents.[13]

25.8.6 *Accumulated income paid out as income under express power*

A common form discretionary trust generally has express powers similar to s.31 but without the proviso. This allows trustees to accumulate income, adding it to trust capital, and typically gives the trustees power "to apply the accumulations as if they were income arising in the then current year".

If trustees make a payment out of trust capital under such a power it is considered that the receipt is an income receipt of the beneficiary.

25.9 Discretionary trusts treated as transparent to allow beneficiary reliefs

In some cases discretionary trusts are treated as transparent in order to confer some relief.

25.9.1 *DT relief for UK resident discretionary trust*

Section 111 TIOPA provides:

> **When payment to beneficiary treated as arising from foreign source**
> (1) Subsection (6) applies if each of conditions A to D is met.
> (2) Condition A is that a payment is made by trustees of a settlement.
> (3) Condition B is that income tax is treated under section 494 of ITA 2007 (treatment of discretionary payments by trustees) as having been paid in relation to the payment.

This restricts the relief to UK resident trusts.[14]

> (4) Condition C is that the income arising under the settlement includes taxed overseas income.[15]
> (5) Condition D is that the trustees certify—
> (a) that the payment is one made out of income consisting of, or including, taxed overseas income of an amount, and from a source, stated in the certificate, and
> (b) that the amount of taxed overseas income arose to the trustees not earlier than 6 years before the end of the tax year in which

13 See *Ardmore v HMRC* [2014] UKFTT 453 (TC) at [9] - [23].

14 See 25.4 (Beneficiaries tax credit).

15 This term is defined in s.111(7) TIOPA: "In this section "taxed overseas income", in relation to a settlement, means income in respect of which the trustees are entitled to credit under this Part for tax under the law of a territory outside the UK."

the payment is made.

Where these conditions are satisfied, s.111(6) TIOPA provides the relief:

> The person to whom the payment is made may claim that the payment, up to the certified amount, is to be treated for the purposes of this Part [Part 2 TIOPA headed Double Taxation Relief] as income received by the person—
>
> (a) from the certified source, and
>
> (b) in the tax year in which the payment is made.

The TSE Manual provides:

> **3675. Relief for overseas tax: expenses of discretionary trust** [February 2006]
>
> If trustees are claiming relief for overseas tax they will usually regard expenses as paid out of UK income. This means they can certify the overseas income to the beneficiaries under s.809 ICTA (TSEM3680).
>
> They may sometimes regard expenses as paid from overseas income. This could be because there is not sufficient UK income to cover the expenses. Or maybe certification is not advantageous to the beneficiary. Trustees cannot certify, under s.809, the overseas income they set against the expenses.
>
> **3680. Trustee's certificate of overseas taxed income** [February 2006]
>
> The income of a discretionary or accumulation trust may include overseas taxed income. The trustees can certify that discretionary payments they made to beneficiaries included income from the taxed overseas sources. The certificate must state how much of the payment refers to the overseas income. Trustees issue the certificates under the provisions of s.809(1)(b) ICTA. There is no prescribed wording for the certificate.
>
> Limits of the amounts certified
>
> The trustees must ensure that:
>
> - the amounts they certify do not exceed the gross equivalent of the payments they made
> - the gross amounts they certify do not exceed, in the aggregate, the gross income they received.
>
> Trustees can accumulate, for future certification, overseas income that they have not paid out. Income ceases to be available for certification six years after the start of the tax year in which it arose.
>
> **3685. Relief for overseas tax: mixed trust** [February 2006]
>
> A mixed trust has both a discretionary interest and an interest in possession.
>
> The trustees may claim double taxation relief in respect of overseas tax

that qualifies for relief. The instructions at TSEM3655 apply to income that the beneficiary is entitled to receive. The instructions at TSEM3670 apply to the balance of the income.

25.9.2 *Concessionary relief for UK resident trust*

ESC B18 provides:

> **UK resident trusts**
> A beneficiary may receive from trustees a payment to which [what is now s.494(1) ITA] applies.[16] Where that payment is made out of the income of the trustees in respect of which, had it been received directly, the beneficiary would—
> [1] have been entitled to exemption in respect of FOTRA securities issued in accordance with [what is now s.714 ITTOIA]; or
> [2] have been entitled to relief under the terms of a double taxation agreement; or
> [3] not have been chargeable to UK tax because of their not resident and/or not ordinarily resident status
> the beneficiary may claim that exemption or relief or, where the beneficiary would not have been chargeable, repayment of the tax treated as deducted from the payment (or an appropriate proportion of it).
> For this purpose, the payment will be treated as having been made rateably out of all sources of income arising to the trustees on a last in first out basis.

There are three distinct classes of reliefs here:
(1) Relief for interest on FOTRA securities (beneficiary not resident)
(2) DT relief (beneficiary treaty-resident outside the UK)[17]
(3) Exemptions for non-resident beneficiary

ESC B18 goes on to specify the conditions for the relief:

> Relief or exemption, as appropriate, will be granted to the extent that the payment is out of income which arose to the trustees not earlier than six years before the end of the year of assessment in which the payment was made, provided the trustees—
> [1] have made trust returns giving details of all sources of trust income and payments made to beneficiaries for each and every year for which

16 This reference restricts the relief to UK resident trusts. See 25.4 (Beneficiaries tax credit).

17 But s.111 TIOPA covers this.

they are required, and
[2] have paid all tax due, and any interest, surcharges and penalties arising; and
[3] keep available for inspection any relevant tax certificates.
Relief or exemption, as appropriate, will be granted to the beneficiary on a claim made within five years and ten months of the end of the year of assessment in which the beneficiary received the payment from the trustees.

The INT Manual expands on B18 and provides a worked example. The Manual is not up to date, and in example tax rates are those before the increase to the 50% rate in 2010/11; I omit text referring to the position before 2004.

367790. What methods of relief are available on discretionary payments from UK resident trustees [April 2007]
The way in which relief is calculated will depend on the terms of the treaty under which relief is claimed.

- Under an "other income" article which does not exclude payments from trusts, relief is given in full....
- Where there is no other income article or the article excludes trust income, relief is given by "looking through" to the underlying sources of the income. The way in which we "look through" is determined by Extra Statutory Concession (ESC) B18
- Because payments are made at the discretion of trustees, it is not possible to allow relief at source to a beneficiary of a discretionary trust.

...
367820. Extra Statutory Concession B18 [April 2007]
Under ESC/B18, income underlying a discretionary payment is treated as arising from the sources of income received by the trustees in the tax year that the payment is made. Income is considered as arising rateably from the sources of income. By rateably we mean the beneficiary's payment contains the same proportion of each strand of income as the total received by the trustees.
If there is not enough income arising in the year the payment is made to fund all of the payments made by the trustees (that is, if the trustees are drawing on accumulations – that is, income received by trustees in excess of payments out of trust income – made in previous years) we need to apply the proportions of trustees' income from the year(s) in which the accumulations were made. This is known as "spreading back" (see INTM367910).
367830. ESC/B18 and dividends taxed at the dividend trust rate [April 2007]
When the Schedule F trust rate (now the dividend trust rate) was introduced in 1999/2000 at 25%, the wording of ESC/B18 was revised to exclude the element of tax credit included in that tax. For example, where trustees receive a dividend of £90, with a tax credit of £10, their liability is £15 (that is, £25 less £10 tax credit). However, when applying a beneficiary's share of dividends to a dividend article of a treaty, the tax credit is excluded from the calculation. Therefore for

the purposes of ESC/B18, the 'gross' to which the restriction in the dividend article is applied is £90, the tax £15, and the net £75.

A dividend article with a 15% restriction would apply to the dividend element underlying a beneficiary's distribution as follows:

- Restriction: £90 × 15% = £13.50
- Tax £15 less restriction £13.50 = £1.50

367840. ESC/B18 and trustees' tax returns [April 2007]

It is a condition of ESC/B18 that in order to allow a beneficiary's claim to repayment, the trustees must have made their tax return for the year of the distribution, and paid over any tax due to HMRC.

It is therefore possible that a beneficiary's claim form can be received before the conditions of ESC/B18 are satisfied.

367850. ESC/B18 and Self Assessment [April 2007]

As the conditions for relief under ESC/B18 include actions by trustees, we do not consider a claim as being valid until these actions have been carried out. We cannot accept that the beneficiary has made a valid claim until the trustees have met the conditions set out in ESC/B18.

In practical terms this means that a beneficiary's claim is not valid until the trustees have sent in their tax return for the year in which the distribution was made and paid any tax due.

367860. Dealing with claims by non-resident beneficiaries of UK discretionary trusts under ESC/B18 [April 2007]

How to identify a repayment claim

The claim will usually be supported by a tax certificate on form R185, or an equivalent certificate prepared by the payer, showing tax deducted from the payment at 40%...

If the tax certificate is missing, the schedule will show that tax on the income is at 40% ...

Exceptionally, you may receive a claim on a payment from a UK discretionary trust where tax is not shown as having been paid at the Rate Applicable to Trusts (see INTM367950).

Procedure

You will need to request the trust file (the UTR for this should be quoted on the tax certificate) together with the trustees' tax return for the year of the distribution and all earlier years in date for time limit purposes during the year of distribution (you will need these if a 'spreadback' calculation is necessary).

You will need to advise the claimant or their agent that you have requested information from the trust's tax office to enable you to deal with the claim.

367870. Calculating relief due under ESC/B18 [April 2007]

When the trust file is received the information concerning trust income and distributions provided by the trustees in their returns is extracted and used to calculate the relief due to the beneficiary.

Due to the complexity of the calculations, a computer program is used to apportion the trust income to the beneficiary's share.

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

If necessary a calculation can be made manually (INTM367890).

367880. How to manually calculate relief due under ESC/B18 [April 2007]
Although the apportionment of the income will normally be performed using a computer program, if necessary the calculation can be performed manually, as follows:
1. Deduct any expenses and other obligations, for example Trust Management Expenses (see INTM367920) and annuities (see INTM367770), from the income received by the trustees.
2. For each income source (after deductions at 1 above) calculate the net amount available for distribution, that is the amount after deduction of tax at the rate applicable to trusts or the dividend trust rate as appropriate.
3. Calculate the total net distribution made to the discretionary beneficiaries.
4. Check that the total net distribution made to the discretionary beneficiaries is less than (or equal to) the total net available for distribution. If it is greater than the total net available for distribution, you will need to apply a 'spreadback' calculation (see INTM367910).
5. Allocate the net amount of each source of income arising to the trustees to the beneficiary's net distribution, by the following formula (each source of income must be treated separately because of the different tax rates to which the trust income is subjected):

(a ÷ b) × c =beneficiary's share of income source, where

- a = net income from source
- b = total income available to distribute
- c = beneficiary's net distribution

6. Calculate the beneficiary's gross share of each income source by reference to ESC/B18. For UK dividends the calculation for 2004–05 onwards is

(a ÷ 67.5) × 90 = beneficiary's gross share of dividends for the purposes of ESC/B18, where

- a = beneficiary's share of dividends

...
For other income (including foreign dividends) the calculation for 2004–05 onwards is

(a ÷ 60) × 100 = beneficiary's gross share of dividends for the purposes of ESC/B18, where

- a = beneficiary's share of income

...
7. Calculate the tax applying to each income source under ESC/B18 by deducting the net (calculated at 4) from the gross (calculated at 5).
8. Calculate the repayment due by reference to the relevant treaty articles, and/or UK legislation allowing relief to non-residents. Where repayment is restricted under a double taxation agreement, calculate the amount to restrict as a percentage of the ESC/B18 gross (calculated at 5) and deduct it from the tax (calculated at 6).

367890. T applications and claims: Non-resident beneficiaries of UK trusts [April 2007]
Example of a Manual calculation under ESC/B18
In the tax year 2004–2005 a trust had income from the sources shown below (gross except for dividends paid). The trustees made net distributions of £1000

each to one beneficiary in Canada (who has made a claim to us) and to one beneficiary in the UK. [Trust income is:]

- UK dividends paid £1292
- UK interest £1000
- Rents £500
- Foreign dividends £880
- Foreign interest £1000

Trustees net management expenses were £500

First, deduct trust management expenses from dividends: 1292 less 500 = 792

Then calculate income available for distribution:

Dividends	792
plus (tax credit at one ninth of the dividend)	88
less (dividend trust rate 25%)	(220)
	660
Interest	1000
less (tax at rate applicable to trusts 34%)	(340)
	660
Rents	500
less (tax at rate applicable to trusts 34%)	(170)
	330
Foreign dividends	880
less (tax at dividend trust rate 25%)	(220)
	660
Foreign interest	1000
less (tax at rate applicable to trusts 34%)	(340)
	660

Total available for distribution: 2970

Distribution: (2 × 1000) = 2000; this is less than the total available for distribution, so no spreadback required

Allocation to beneficiary:

Dividends: (660 ÷ 2970) × 1000 = 222.22
Interest: (660 ÷ 2970) × 1000 = 222.22
Rents: (330 ÷ 2970) × 1000 = 111.11
Foreign dividends: (660 ÷ 2970) × 1000 = 222.22
Foreign interest: (660 ÷ 2970) × 1000 = 222.22

Grossing up and deducting net to find tax attributable under ESC/B18:

Dividends: (222.22 ÷ 75) × 90 = 266.66 – 222.22 = tax 44.44
Interest: (222.22 ÷ 66) × 100 = 336.70 – 222.22 = tax 114.48

Rents: (there is actually no need to calculate this, as there is no relief, but the calculation would be as follows)

(111.11 ÷ 66) × 100 = 168.35 – 111.11 = tax 57.24
Foreign dividends: (222.22 ÷ 66) × 100 = 336.70 – 222.22 = tax 114.48
Foreign interest: (222.22 ÷ 66) × 100 = 336.70 – 222.22 = tax 114.48

Calculating the repayment due

In this example the claimant is claiming under the Double Taxation Convention with Canada on dividends and interest, and under UK legislation applying to non-residents on foreign income. Under the treaty there is a 15% restriction on dividends and a 10% restriction on interest.

Dividends: Gross 266.64 × 15% = 40 restriction	Tax 44.44 less 40 =	4.44
Interest: Gross 336.70 × 10% = 33.67 restriction	Tax 114.48 less 33.67 =	81.21
Foreign dividends: Gross 336.70	Tax	114.48
Foreign interest: Gross 336.70	Tax	114.48
Total repayment		314.61

This text has been withheld because of exemptions in the Freedom of Information Act 2000.

367900. Notes on types of underlying income in a discretionary trust [April 2007]

UK dividends: includes stock dividends.

UK interest

Dividends and interest are the most common types of income that you will see in discretionary trusts. With the exception of UK dividends, all of the tax associated with a particular source is considered for the purposes of ESC/B18 to be tax on that source. You may also see:

- Foreign income: relief is given under domestic legislation. Although foreign dividends are taxed in the hands of the trustees at the dividend trust rate of 32.5% ... the beneficiary is treated as having been taxed at 40% ....
- Rental income: there are no double taxation agreements that allow relief to individuals on rental income. No repayment is due on any part of the tax applicable to rental income.
- Accrued income: income returned under the 'accrued income' scheme cannot be relieved under double taxation agreements.
- Royalties: these are unusual in discretionary trusts. Relief is given at the appropriate agreement rate.
- FOTRA securities: you may be considering relief under an agreement which has an interest article that restricts relief. However, income shown on the trust return as interest may be derived from FOTRA securities on which full relief is available to non-residents. As there is no indication in the trust return that income is derived from FOTRA securities, you will not usually be able to consider repayment on this as a separate source from interest. However, if there is any indication of the amount of FOTRA securities in the papers submitted with the return, or in figures originating from the trustees and provided by the claimant or their agent, you should use these to allow relief on the FOTRA securities.

367910. What happens if the total net distributed in a year exceeds the total net available for distribution ('overdistribution') [April 2007]

It the trustees have distributed more money in one year than is available to distribute from the income received in that year, you will need to analyse the balance from undistributed income arising in earlier years.

This is known as a 'spreadback' calculation. The income arising in earlier years

can be analysed using the trust report program.
When spreading back we start with the most recent year in which income has been accumulated. If the trustees have over-distributed in earlier years we may have already made a spreadback calculation and used income accumulated in an earlier year. It is important that we do not use that accumulation again in the current spreadback. You cannot go back more than six years before the year in which the distribution was made. So if the trustees have made an excess distribution in 2003/04 you can only go back to 1998/99. But you only go back to accumulations made in that year if you have used up all the income accumulated in 2002/03, then 2001/02 and so on. The residence position of the beneficiary in the year(s) that the income was accumulated is not relevant.

25.9.3 *Confidentiality*

The INT Manual provides:

> **367630. Claims by non-resident beneficiaries of non-resident discretionary trusts** [April 2007]
> ...
> *Confidentiality when advising a beneficiary or agent about a payment*
> A beneficiary of a discretionary trust has no rights against the income of the trust. Trustees may favour one potential beneficiary rather than another. Therefore, to provide information to a beneficiary about the income of a trust that you have used to calculate relief due under ESC/B18 will infringe the confidentiality of the trustees.
> Because of this we cannot provide a breakdown of the underlying income comprising the repayment. The claimant (and their agent) only has a right to the final figure of the repayment we have calculated. However, if the beneficiary obtains the written permission of a trustee we can release information concerning the underlying trust income.
> Sometimes a trustee will act as the nominated agent of the beneficiary. In that case you can release details of the computation to the trustee without seeking further written permission. If you are providing this information, you will need to show a full calculation. If the original apportionment of income was calculated using the computer program, you will need to make a full Manual calculation (see INTM367890).

It is a strange state of affairs where a taxpayer is not entitled to know how his tax is computed, or whether it is correctly computed. No doubt a tribunal would order disclosure in an appropriate case.

25.9.4 *Disclosure of ESC B18 claim on tax return*

HMRC say:

> It is a stand-alone claim and does not affect how the beneficiary

completes his or her Self Assessment tax return.[18]

I think the point is that there is no box in the tax return for the figures to be entered.

25.10 ESC B18 relief for non-resident trust

ESC B18 provides:

> **Non-resident trusts**
> A similar concession will operate where a beneficiary receives a payment from discretionary trustees which is not within [what is now s.494(1) ITA] (ie where non-resident trustees exercise their discretion outside the UK).
> [1] Where a non-resident beneficiary receives such a payment out of income of the trustees in respect of which, had it been received directly, it would have been chargeable to UK tax, then the beneficiary—
> [a] may claim relief under s.278 ICTA (personal reliefs for certain non-residents); and
> [b] may be treated as receiving that payment from a UK resident trust but claim credit only for UK tax actually paid by the trustees on income out of which the payment is made.
> [c] The beneficiary may also claim exemption from tax in respect of FOTRA securities issued in accordance with [what is now s.714 ITTOIA] to the extent that the payment is regarded as including interest from such securities.
> [2] A UK beneficiary of a non-resident trust may claim appropriate credit for tax actually paid by the trustees on the income out of which the payment is made as if the payments out of UK income were from a UK resident trust and within s.687(1) ICTA.

There are three distinct sets of reliefs here:

(1) Personal reliefs for non-resident beneficiaries.
(2) Credit for tax paid by the trust as if the trust were UK resident; this only applies if the trust chooses to comply with UK tax requirements ie it pays trust rate tax on UK source income.
(3) Relief for interest on FOTRA securities: I suspect that this is in practice academic, though strictly it applies if:
    (a) the trust receives income from FOTRA securities;
    (b) the trustees are outside the FOTRA exemption for trustees;[19]

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18 "HMRC Residency: Non-resident trusts" *http://www.hmrc.gov.uk/cnr/nr_trusts.htm*.

19 Because there are UK beneficiaries: see 19.6.2 (Discretionary trust).

(c) the income is paid to a beneficiary who is not UK resident and so is within the FOTRA exemption; and
(d) the trust complies with UK tax requirements.

ESC B18 goes on to specify the conditions for the relief, which are similar to the conditions for UK resident trusts:

> This treatment will only be available where the trustees—
> – have made trust returns giving details of all sources of trust income and payments made to beneficiaries for each and every year for which they are required; and
> – have paid all tax due and any interest, surcharges and penalties arising; and
> – keep available for inspection any relevant tax certificates.
>
> Relief or exemption, as appropriate, will be granted to the beneficiary on a claim made within five years and ten months of the end of the year of assessment in which the beneficiary received the payment from the trustees.
>
> No credit will be given for UK tax treated as paid on income received by the trustees which would not be available for set off under s 687(2) if that section applied, and that tax is not repayable (for example on dividends). However, such tax is not taken into account in calculating the gross income treated as taxable on the beneficiary under this concession.

25.10.1 *Who makes the claim?*

After considering the case of a settlor-interested trust[20] the International Manual continues:

> **339550. Claims by non-resident trustees of discretionary trusts** [December 2011]
>
> You may receive a claim or application from non-resident trustees of a discretionary trust. ...
>
> ***What to do if one or more beneficiaries of the trust has a residential address in the UK***
>
> If the completed form 4467(trustee)/FD shows any beneficiaries with UK residential addresses, Specialist Personal Tax, PT International Advisory will refer the papers to Specialist PT, Trusts & Estates, who will consider whether the trustees will need to make UK tax returns.
>
> ***What to do if all of the beneficiaries are resident in the same country as the trustees and the settlor of the trust is excluded from benefit***

20 See 59.4.3 (Settlor treaty-resident outside UK).

If all of the beneficiaries of the trust are resident in the same country as the trustees and the settlor of the trust is excluded from benefit, you can allow relief to the trustees.

25.11 UK trust - non resident beneficiary: DT relief

25.11.1 *DTAs with OECD model "other income" article*

SP 3/86 provides:

> **Payments to a non-resident from UK discretionary trusts or UK estates during the administration period: double taxation relief**
> **Introduction**
> 1 This statement explains how relief from UK tax under double taxation agreements will be given in respect of payments made to a non-resident [from] a UK discretionary trust or a UK estate.
> **Background**
> ***Discretionary trusts***
> 2 Generally speaking, a non-resident beneficiary receiving payments from a UK discretionary trust is not entitled to repayment of the tax paid by the trustees on the trust income. However, under concession B18 (which embodies a longstanding practice) HMRC 'looks through' the trust income to the underlying component parts of that income. The purpose of this 'looking through' is to allow the recipient of the income any relief that would have been available to him under the Taxes Acts had the income come to him direct instead of through the trustees.
> 3 Where the beneficiary is resident in a country with which the UK has a double taxation agreement, further relief under the 'looking through' principle may be due. Thus, for example, if the agreement provides for a withholding rate on interest of 15% and interest liable to UK tax formed part of the trust income which had suffered tax at 40% (ie the rate applicable to trusts) then, under the 'looking through' principle, the beneficiary would be repaid the amount of tax suffered in excess of the withholding rate, in this case 25%.
> 4 Some of the UK's double taxation agreements include an 'other income' Article. The purpose of this Article is to determine in which country income not expressly dealt with elsewhere in the agreement should be taxed. In the UK's agreement the article sometimes gives sole taxing rights in respect of such income to the recipient's country of residence.

It is in fact standard OECD model form to give sole taxing rights in respect of such income to the recipient's country of residence. OECD Model Article 21(1) provides:

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

This wording would apply to income from a discretionary trust.

> 5 It has been the practice of HMRC to apply the 'looking through' principle to all cases where relief in respect of the discretionary payment was sought and to refuse claims where full repayment of UK tax was claimed under the provision of [the] 'other income' Article in the agreement.
> [Para 6 deals with estates: see 79.18 (Non-resident beneficiary of UK estate: DT relief).]
> **Change of practice**
> 7 Following a review of their practice in these two areas, HMRC have accepted that if a payment made by trustees out of a UK discretionary trust falls to be treated as a net amount in accordance with TA 1988 s 687(2) [now s.494 ITA], the 'looking through' principle is not appropriate where the beneficiary is resident in a country with which the UK has a double taxation agreement and the 'other income' Article gives sole taxing rights in respect of such income to that country. (This will usually be the case where income from trusts is not specifically excluded from the Article.) This means that tax paid by the trustees in respect of the discretionary payment will be repayable to the beneficiary, provided that any conditions set out in the 'other income' Article are met. For example, the recipient may be required to show that he is subject to tax on the income in his country of residence.
> 8 [This deals with estates]
> 9 Where the 'other income' Article does not give sole taxing rights to the country of residence in respect of the trust or estate income or there is no double taxation agreement with the country concerned, the existing 'looking through' practice will continue to be applied where it is to the advantage of the beneficiary.

The DTAs which confer relief under the "other income" article on discretionary payments made by UK resident trustees are mostly the older generation of treaties. I think the reason is that before 1973, discretionary trusts were regarded as transparent, so distributed income of discretionary trust was not regarded as falling under the "other income" article.[21] DTAs made from the 1980's onwards usually exclude trust and estate income

21 See 25.3.2 (Discretionary trust payment: what is the source?).

from the "other income" article.

The International Manual sets out a list of the countries whose DTAs provide relief for discretionary payments made by UK resident trustees. It is not however up to date and for convenience I divide it into two parts:

> **INTM367800 - DT applications and claims: Non-resident beneficiaries of UK trusts** [April 2007]
> **DTAs where relief is available under the 'other income' article on discretionary payments made by UK resident trustees**
> The DTTs which currently confer relief under the "other income" article on discretionary payments made by UK resident trustees are:

Austria	Kenya
Bosnia Herzegovina*	Montenegro*
Portugal	Morocco
Romania	Namibia
Croatia*	Serbia*
Egypt	Sudan
Ivory Coast	Swaziland
Israel	Tunisia
Jamaica	Zambia

* Bosnia-Herzegovina, Croatia, Montenegro, Serbia: relief is given under the terms of the old UK/Yugoslavia DTT: see SP 3/07.

In the following former USSR states, DTT relief ceased in 2002: Armenia, Belarus, Georgia, Kyrgyzstan, Lithuania, Moldova, Tajikistan, Turkmenistan; see SP 4/01 [2002] STI 32.

The following countries are still mentioned in the INT Manual list but should be deleted following new treaties (date of treaty in brackets):

Barbados (2012)
Hungary (2011).
France (2008)
Germany (2010)
Macedonia (2007)
Poland (2006)
Slovenia (2007)
South Africa (2002)
Spain (2013, in force 12 June 2014)

25.11.2 *DTAs with restrictions on "other income" article*

UK DTAs from the 1980's onwards mostly exclude trust and estate

income from the "other income" article. Art 23(1) of the France/UK DTA is typical:

> Items of income beneficially owned by a resident of a Contracting State, wherever arising, which are not dealt with in the foregoing Articles of this Convention, *other than income paid out of trusts or the estates of deceased persons in the course of administration,* shall be taxable only in that State.

This leaves relief to be claimed under ESC B18.[22]

Interestingly, the UK/Germany treaty (2010) deals with the point expressly.[23] Article 21 provides:

> 1) Items of income beneficially owned by a resident of a Contracting State, wherever arising, which are not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
> 2) Notwithstanding the provisions of paragraph 1, the following provisions shall apply with respect to income paid out of trusts or the estates of deceased persons in the course of administration:
> Where such income is paid to a beneficiary who is a resident of Germany by trustees or personal representatives who are residents of the UK out of income received by those trustees or personal representatives which would, if those trustees or personal representatives had been residents of Germany, have fallen within other Articles of this Convention, the beneficiary shall be treated as having received an amount of the income received by the trustees or personal representatives corresponding to the income received by him and any tax paid by the trustees or personal representatives on that amount shall be treated as having been paid by the beneficiary.

Why? Presumably the German authorities do not like German residents to be taxed by law and untaxed by HMRC extra-statutory concessions

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22 The US/UK DTA has this exclusion and the Exchange of Notes on that DTA comments:"With reference to paragraph 1 of Article 22 (Other income) - it is understood that the purpose of the exclusion from the paragraph for income paid out of trusts or the estates of deceased persons in the course of administration is to allow a recipient of such income the relief that would have been available to him under the provisions of the Convention had they received the income direct instead of through the trust or estate." More accurately, the purpose is to prevent the recipient of such income from receiving *more than* the relief that would have been available to a person under the provisions of the Convention and ESC B18 had they received the income direct instead of through the trust or estate. But it comes to the same thing.

23 Barbados (2012) is the same, so perhaps this will be the new standard form.

such as ESC B18 and A14. Those who believe that tax law should be statutory and not concessionary will say: quite right too.

It is curious that the programme to legislate ESCs, which has legislated many trivial ESCs, has not covered the important ESC B18. No explanation has been given, so it is tempting to speculate. Perhaps it has been filed as too difficult; perhaps HMRC are planning changes to the law; perhaps legislation will come eventually.

In the USA/UK DTA the treaty excludes trust and estate income in the standard wording, and point is dealt with by the DTA Exchange of Notes:

> With reference to paragraph 1 of Article 22 (Other income)—
> it is understood that the purpose of the exclusion from the paragraph for income paid out of trusts or the estates of deceased persons in the course of administration is to allow a recipient of such income the relief that would have been available to him under the provisions of the Convention had he received the income direct instead of through the trust or estate.

25.12 Are discretionary trusts "beneficial owners" for DTA purposes?

25.12.1 *Meaning(s) of "beneficial ownership"*

The expression "beneficial ownership" has (at least) three possible meanings:

(1) The English property law/trust law meaning, where it is contrasted with bare legal ownership and is (more or less) synonymous with equitable ownership.[24]

(2) An international tax law meaning, in the context of DTAs.

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24 For this meaning, see 62.6 ("Beneficial ownership" of FOTRA securities).
This is not of course to say that "beneficial ownership" in an English statute always has the the English law meaning: the context governs the sense. The CG Manual offers an example of a case where "beneficial" was used in a tax statute with a wider, DTA-style meaning. The former s.210(2) TCGA provided an exemption on the disposal of a life policy with (in short) an exception where the person making the disposal was "not the original beneficial owner". But trustees qualified for the exemption as they were the "beneficial owner" for this purpose:

> "**69055 Exemption for second hand policies: Disposals before 9 April 2003** [February 2010]
> ... Where trustees took out a life insurance policy ... it could be accepted that they were the beneficial owners of the policy within the old s.210(2) TCGA."

(3) A meaning (or set of meanings) in the context of money laundering.[25]
These are all quite distinct and discussion of the meaning in one context has almost no relevance in other contexts. It would have been better to have three distinct expressions, but the usages are now too well established to alter that, and the context will generally show which meaning is intended.

A full discussion would require three long chapters.

25.12.2 *Discretionary trusts: Beneficial owners for DTA purposes*

Relief under DTAs is frequently limited to the beneficial owner.

It is clear that the trustees are the "beneficial owner" of income of a discretionary trust in the DTA sense and so can qualify for DT relief.

The OECD are at present consulting on a revised commentary which will make this clearer. The proposed commentary is as follows (the point is made in the footnote but the entire passage is important):

> **Commentary on Article 10 (Dividends)**
> 12. The requirement of beneficial owner was introduced in paragraph 1 of Article 10 to clarify the meaning of the words "paid ... to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was paid direct to a resident of a State with which the State of source had concluded a convention.

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25 See (1) reg.6 Money Laundering Regulations 2007 (Meaning of beneficial owner). This is too long to set out in full, but it includes "the class of persons in whose main interest the trust is set up or operates."
(2) The Glossary to the Financial Action Task Force's 40 Recommendations defines beneficial owner as: "the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement." See *http://www.fatf-gafi.org/media/fatf/documents/FATF%20Standards%20-%2040%20Recommendations%20rc.pdf*
(3) OECD "Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes", (2001) *http://www.oecd.org/dataoecd/0/3/43703185.pdf*, p.14 has a related definition: In this Report, "beneficial ownership" refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder."

12.1 Since the term "beneficial owner" was added to address potential difficulties arising from the use of the words "paid to … a resident" in paragraph 1, it was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term "beneficial owner" is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries[26]), rather, it should be understood in its context, in particular in relation to the words "paid … to a resident", and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

12.12 Where an item of income is paid to a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

12.3 [This paragraph deals with the controversial topic of conduit companies, and need not be set out here.]

12.4 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the recipient of the dividend is not the "beneficial owner" because that recipient's right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation must be related to the payment received; it would therefore not include contractual or legal obligations unrelated to the payment received even if those obligations could effectively result in the recipient using the payment received to satisfy those obligations. Examples of such unrelated obligations are those unrelated obligations that the recipient may have as a debtor or as a party to financial transactions or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs 6.8 to 6.34 of the Commentary on Article 1. Where the recipient of a dividend does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another

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26 [Footnote original] For example, where the trustees of a discretionary trust do not distribute dividends earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer), could constitute the beneficial owners of such income for the purposes of Article 10 0 even if they are not the beneficial owners under the relevant trust law.

> person, the recipient is the "beneficial owner" of that dividend. It should also be noted that Article 10 refers to the beneficial owner of a dividend as opposed to the owner of the shares, which may be different in some cases. ...[27]

See too OECD Commentary on OECD model article 11, para 9-11.

See Wheeler, *The Missing Keystone of Income Tax Treaties* (2012) para 2.4.3 (Beneficial ownership); OECD, "Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles" (2009) Annex 1: Background Regarding the Meaning of "Beneficial Owner" in Tax Treaties;[28] Avery Jones et al, "The Origins of Concepts and Expressions used in the OECD Model" [2006] BTR 695 at p.747; Prebble, "Trusts and Double Taxation Agreements" ejournal of Tax Research (2004) vol 2 no 2 p192;[29]. "Beneficial Ownership and the OECD Model" [2001] BTR 27.

25.13 Scots trusts and Scots beneficiaries (from 2016)

HMRC say:

> 45. Income from discretionary and accumulation trusts is distributed to beneficiaries at the discretion of the trustees. The trustees of UK resident trusts are currently charged on their income at the trusts tax rate (50 per cent - this will fall to 45 per cent in 2013-14) or dividend trust rate (42.5 per cent - this will fall to 37.5 per cent in 2013-14). The beneficiaries' income is treated as being received net of tax at the trust rate, so they currently receive a tax credit of 50 per cent.
>
> 46. Income flowing through these trusts loses its character - in other words, irrespective of whether the income arising to the trust was savings or non-savings income all the income would be treated as non-savings income in the hands of the beneficiaries. Income payments from discretionary trusts will therefore be liable at the Scottish rate when paid to Scottish beneficiaries.
>
> 47. In broad terms the trustees of non-resident discretionary trusts are only liable to income tax at the trust rate on the UK source income that they receive. They are not liable to UK income tax on foreign source income although they may be liable to tax on this income in the overseas jurisdiction. Discretionary income distributions from non-UK resident

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27 OECD, *OECD Model Tax Convention: Revised Proposals Concerning The Meaning of "Beneficial Owner" In Articles 10, 11 and 12* (2012) accessible *http://www.oecd.org/ctp/treaties/Beneficialownership.pdf.*

28 Accessible *http://www.oecd.org/dataoecd/34/26/41974553.pdf*

29 Accessible *http://www.atax.unsw.edu.au/ejtr/content/issues/previous/paper3_v2n2.pdf*

trusts are treated as untaxed income of the beneficiary irrespective of whether the trustees have suffered tax on the trust income. The beneficiary may if certain conditions are met claim credit for some of the tax paid by the trustees. Such income should be included by Scottish taxpayer beneficiaries as part of their total income in the normal way, and this would be liable at the Scottish rate of income tax. This would be consistent with the current tax treatment and simple to administer (!).[30]

30 HMRC, "Clarifying the Scope of the Scottish Rate of Income Tax Technical Note" (May 2012).

CHAPTER TWENTY SIX

IIP TRUSTS: INCOME TAX

26.1 Introduction and terminology

This chapter considers the income taxation of interest in possession trusts (**"IIP trusts"**), that is, in short, trusts where the income is paid to a beneficiary. I call that beneficiary **"the life tenant"**; HMRC use the term "IIP beneficiary" which is more accurate, but perhaps more opaque. The trustees may be called **"IIP trustees"**.

26.2 Taxation of IIP trustees

Trustees are in principle subject to tax on income arising to them if it is UK source income or if they are UK resident. This applies even to trustees of transparent IIP trusts. There are however a number of exceptions for trustees of IIP trusts as exemptions for life tenants enure for the benefit of the trustees.

26.2.1 *Income mandated to life tenant*

The TSE Manual provides:

> **3040. Trust income mandated to a beneficiary** [March 2013]
> Trustees of interest in possession trusts (IIPs) (TSEM1564) exclude from the Trust and Estate Tax Returns income mandated to beneficiaries. The beneficiaries include this on their personal returns.
> This practice has been extended to trustees of settlor interested trusts (TSEM4000+) where the settlor (or the settlor's spouse or civil partner) is also an IIP beneficiary and the trust income is mandated to them.[1]

The TSE Manual later expands on this:

> **3763. Trust income and gains: beneficiary entitled to trust income - mandated income** [August 2013]

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1 On this point see 27.8 (Taxation of trustees of settlor-interested trust).

Sometimes the trustees mandate trust income to a beneficiary. If the trustees mandate income to a beneficiary, it means that the beneficiary receives it and the trustees do not. So in such a case there is no statutory basis (see TSEM3761) for taxing the trustees as being in receipt of the income. The beneficiary both receives the income and is entitled to it. The trustees exclude the income from the Trust and Estate Tax Return, even if it is untaxed. The beneficiary's trust income is

- a share of the net taxed income as calculated on normal basis, and
- the gross amount of untaxed income directly chargeable on him.

The beneficiary (or, where the settlor has retained an interest, the settlor) includes the income on his personal return.

9310. Ownership and income tax: income tax principles - receiving or entitled to [July 2011]

There is specific tax legislation in ITTOIA 2005 saying who is liable for tax on income:

S271 for rental income

S371 for interest

S385 for dividends and other distributions

S581 for income from intellectual property, for example royalties.

For rent, interest and income from intellectual property the legislation says that the person liable for income tax is the person receiving or entitled to the income. For dividends and other distributions the legislation says the person liable for income tax is the person to whom the distribution is made or is treated as made, or the person receiving or entitled to the distribution. Further detail about particular types of income from property is given in TSEM9900.

The 'receiving' basis enables you to tax the person in receipt of the income, even if you cannot trace the person entitled to it. But ultimately you want to tax the person who is entitled. For example, in an interest in possession trust (TSEM1105), the trustees are initially taxable on the trust income because they receive it. But the IIP beneficiary is ultimately taxable on the trust income because he or she is entitled to it. So you tax the beneficiary on the income on the 'entitled' basis, and give credit for any tax paid by the trustees who received it.

In sum, for the purpose of taxation of income, you want to establish who is 'entitled to' the income.

26.2.2 *Life tenant non-resident*

The taxation of UK trustees of an IIP trust (assuming they have not mandated the income to a life tenant) is affected by the residence of the life tenant. TSE Manual provides:

3160. Resident trustees with trust income from abroad: beneficiary is not resident [February 2011]
These instructions apply only if the beneficiary has an absolute interest in trust income (TSEM6204). This includes a life tenant and an annuitant.
The trustees' income tax liability is based on the beneficiary's residence position. Trustees are not chargeable in respect of the share of income from abroad payable to the non-resident beneficiary. They exclude it from the Trust and Estate Tax Return. [See] *Williams v Singer* 7 TC 387

26.2.3 *Life tenant remittance basis taxpayer*

The taxation of UK trustees of an IIP trust (assuming they have not mandated the income to the life tenant) similarly depends on whether the life tenant is a remittance basis taxpayer. TSE Manual provides:

3165. Resident trustees with trust income from abroad: beneficiary is resident but not domiciled [April 2010]
These instructions apply only if the beneficiary has an absolute interest in trust income (TSEM6204). This includes a life tenant and an annuitant.
The trustee' income tax liability is based on the beneficiary's domicile. The beneficiary must make a claim for any year that the remittance basis is to apply.
If in any year the beneficiary claims the remittance basis the trustees' liability on the share of income from abroad payable to the beneficiary is limited to the amount remitted to the UK. Trustees exclude from the Trust and Estate Tax Return any such overseas income that is not remitted to the UK.
If in any year the beneficiary does not claim the remittance basis the trustees are assessable on the amount arising.
[See] *Williams v Singer & others* 7 TC 387
3170. Resident trustees with trust income from abroad - beneficiary is resident but not ordinarily resident [April 2011]
These instructions apply only if the beneficiary:
- has an absolute interest in trust income (TSEM6204). This includes a life tenant and an annuitant;
- is a citizen of the Commonwealth or the Republic of Ireland.[2]

The trustees' income tax liability is based on the beneficiary's not

2 The Manual is out of date here: the requirement to be a citizen of the Commonwealth or the Republic of Ireland does not apply from 2005/06.

ordinarily resident status.
The beneficiary must make a claim for any year that the remittance basis is to apply.
If in any year the beneficiary claims the remittance basis the trustees' liability on the share of other income from abroad payable to the beneficiary is limited to the amount remitted to the UK. Trustees exclude from the Trust and Estate Tax Return any such overseas income that is not remitted to the UK.
If in any year the beneficiary does not claim the remittance basis the trustees are assessable on the amount arising.
[See] *Williams v Singer & others* 7 TC 387

Form SA904(Notes) Notes on Trusts & Estate Foreign for the year ended 5 April 2013 directs:

If the beneficiary(ies) of the trust has an absolute interest in the trust (including a life tenant) and it is known that they will make a claim to be taxed on the remittance basis, include on page TF 2 (not page TF 1) only amounts of foreign income that have been 'remitted'.
Add up all the dividends and distributions from overseas sources included in column E on Page TF 2. Use the 'Additional information' box 4.39 on page TF 5 to make the following declaration.
The amount in box 4.4 on Page TF 2 includes a total of £ (x) in dividends and distributions from overseas sources.

The reason for this is that where dividend income is taxed on a remittance basis the rate of tax on trustees is the basic rate and not the dividend ordinary rate. Section 14 ITA provides:

(1) Income tax is charged at the dividend ordinary rate on the income of persons other than individuals which—
(a) is dividend income,
(b) would otherwise be charged at the basic rate, and
(c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).

This is consistent with the statutory rules for the taxation of individuals: see 46.4 (Rates of tax on dividend income). It is somewhat impractical for trustees to know whether income has been remitted.

What if income is remitted in a year after receipt? In practice I expect tax is paid by the life tenant and such income is not entered on the trust tax return.

26.2.4 *Life tenant entitled to tax credit relief*

The TSE Manual provides:

> **3655. Relief for overseas tax: Beneficiary entitled to trust income** [June 2009]
> These instructions apply to taxed overseas trust income that is treated as a beneficiary's income as it arises.
> The trustees can claim, and receive, tax credit relief on behalf of the beneficiary. The amount is based on the beneficiary's marginal rate and residence status. INTM367730+ onwards has instructions about tax credit relief.
> If the trustees do not claim relief, the overseas income chargeable is the net amount after deduction of overseas tax.
> A paying agent may have allowed provisional tax credit relief on overseas income. If that provisional relief is excessive, the beneficiary accounts for the excessive relief.

The Manual continues with a comment on annuities, but that is so rare in practice it is not set out here.

26.3 Taxation of life tenant

26.3.1 *What is source of income of beneficiary?*

The life tenant is of course subject to tax on income received from the trust if it is UK source income or if the life tenant is UK resident. For this purpose it is necessary to identify the source. The choice is between:

(1) regarding the trust as the source of trust income; or
(2) regarding the trust assets as the source, in which case one "looks through" the trust and it is described as "transparent".[3]

The answer depends on the terms of the trust, construed in accordance with the proper law of the trust.

Similar issues arise for unit trust income, see 39.1 (Unit Trusts – Introduction).

For the position where the life tenant pays the income (eg pays interest or rent to the trustees) see 30.4.7 (Interest-bearing loan to life tenant).

26.3.2 *England and other "Baker" jurisdictions*

The source of the life tenant's income is the underlying trust assets (not

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3 See 84.2 ("Transparent" and "opaque").

the trust) if, under the terms of the trust, construed in accordance with the proper law of the trust, the beneficiary is entitled to the income of each trust asset as it arises. This is the case for a standard form interest in possession trust governed by English law.[4] In other words, an IIP trust is transparent for IT purposes.

Rather surprisingly, this applies even if the life interest is subject to an annuity: *Nelson v Adamson* 24 TC 36. But in practice annuities are not used so the point is of academic interest only.

For completeness: it has been suggested, tentatively and *obiter,* that this does not apply to trading income, at least for the purposes of DTAs;[5] however there is no sound basis for that distinction and the correct view is that the transparency principle applies generally.

It is possible to draft an English law trust so that under the terms of the trust the beneficiary is not entitled to a proprietary interest in the income as it arises, but merely has the right to call on the trustees to transfer to them a sum equal to the net income.[6] Then the trust (not the underlying assets) will be the source. In practice this is not normally done.[7]

26.3.3 *New York and other "Garland" jurisdictions*

Common form interest in possession type trusts governed by some foreign trust laws do not give the beneficiary the right to income as it arises, but only the right to recover a sum from the trustees. The right is *in personam* not *in rem*. In this case the trust is not transparent and the beneficiary's income is classified as an annual payment (regardless of the type of income arising to the trustee).[8]

This is so even if the beneficiary is described as "life tenant" and is, in

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4 *Baker v Archer-Shee* 11 TC 749. This issue has given rise to academic debate ever since the House of Lords reached its 3:2 decision in *Baker.* See Waters, "The Nature of the Trust Beneficiary's Interest" (1967) 45 Can Bar Rev 219; Schabe, "The Trust Conduit Principle: A Foundationless Theory?" [1999] Journal of Australian Taxation 17, accessible *http://www.austlii.edu.au/au/journals/JATax/1999/17.html.*

5 *R (oao Huitson) v HMRC* [2010] STC 715 at [54]. The point was not considered on appeal, see [2011] STC 1860.

6 *R v Special Comrs ex p Shaftesbury House & Arethusa Training Ship* 8 TC 367 appears to be an example. But that case was decided before *Baker*, and it should be decided differently now.

7 Except perhaps unit trusts: see 39.3 (Unauthorised unit trust: foreign trustees).

8 *Garland v Archer Shee* 15 TC 693.

economic reality, in the same position as a life tenant under an English law trust. In this respect, a *Garland* trust is like an English law estate of a deceased person, not an English law trust.

26.3.4 *Scots trusts*

A liferent (the Scottish term for a life interest) under a Scots trust in common form is not transparent.[9]

This has been reversed for UK resident Scots trusts; s.464 ITA provides:

> (1) This section applies if—
>
> (a) income arises to trustees under a trust having effect under the law of Scotland,
>
> (b) the trustees are UK resident, and
>
> (c) a beneficiary under the trust ("B") would have an equitable right in possession to the income if the trust had effect under the law of England and Wales.
>
> (2) B is treated for income tax purposes as having an equitable right in possession to the income (even though B has no such right under the law of Scotland).

It is difficult to see why the statutory rule only applies to UK resident trusts. It is difficult to see why it applies to Scotland and no other *Garland* jurisdictions. The reason is that it is not part of a coherent regime for the taxation of trusts but a late Finance Bill amendment to deal with a narrow domestic anomaly.[10] In practice it will not often matter.

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9 "There is no difference between the law of Scotland as regards the beneficiary's rights and the law which is admitted in the record to be the law of the State of New York;" "the right of property in the estate of the trust is vested in the trustees to the exclusion of any competing property, and the right of the beneficiary, ... as under the law of New York, is merely a right *in personam* against the trustees to enforce their performance of the trust." *Inland Revenue v Clark's Trustees* [1939] SC 11 at p.24 accessible *http://www.kessler.co.uk/tfd-archive* approved *Leedale v Lewis* 56 TC 501 at p.538. See too Scottish Law Commission, *Discussion Paper on the Nature and the Constitution of Trusts* para 2.5:

> "The beneficiary has a … right to compel the trustee to administer the trust funds in accordance with the provisions of the declaration of trust. This is a personal right. It is axiomatic that in Scots law the beneficiaries do not have a real right or a quasi-real right in the trust property. They have no proprietary interest in the trust fund."

Scottish Law Commission 2006 accessible *http://www.scotlawcom.gov.uk*.

10 See Discussion Paper on Apportionment of Receipts and Outgoings para 4.5, Scottish Law Commission, 2003, accessible *http://www.scotlawcom.gov.uk/download_file/view/49/*.

One can create a transparent Scots law trust with appropriate wording.[11]

26.3.5 *Commentary*

The UK rules strictly require one to ask whether every trust jurisdiction is:
(1) a *Baker* jurisdiction (where the life tenant of a standard form IIP trust has a right to income as it arises); or
(2) a *Garland* jurisdiction (where the life tenant only has a right against the trustee).

That is a somewhat metaphysical question as it is difficult to pin down any practical consequence (other than tax) which arises from the answer.

The distinction between *Baker* and *Garland* trusts should be abolished. It has no economic substance and precious little legal basis. It is to a large extent undone by concession. This could easily be done by extending s.464 ITA to apply to all *Garland* trusts.

26.4 Beneficiary's credit for tax paid by trustees

26.4.1 *Income taxed on trustees or taxed at source*

The TSE Manual provides:

> **3764. Beneficiary entitled to trust income - grossing up** [August 2013]
> If the trustees receive income that is taxed at source, or if they pay tax on it under self assessment, the beneficiary will receive a net amount. But he or she is entitled to the gross amount. Consequently he or she is taxable on the gross amount.
> For example, the trustees have gross bank interest of £1,000 on which tax is deducted at source £200.They pay £800 to the beneficiary. The beneficiary is entitled to the gross amount £1,000, and is taxable on that amount.
> **3765. Beneficiary entitled to trust income - credit for trustees' tax** [August 2013]
> If the trustees have paid tax or have received income with tax taken off, the beneficiary is given credit for that tax.
> For example, in 2009-10 the trustees have gross rental income of £2,000 on which they pay tax £400. They pay £1,600 to the beneficiary. The beneficiary is entitled to the gross amount £2,000, and is taxable on that

11 "Scottish Trust beneficiaries are not entitled to specific items of trust property *unless that is expressly provided for in the Trust Deed*." Discussion Paper on Apportionment of Receipts and Outgoings para 4.5.

amount. He or she is given credit for the £400 tax paid by the trustees. If the beneficiary is a higher rate taxpayer, he or she will have further tax to pay see example in TSEM3766. If the beneficiary is a non-taxpayer, he or she may claim a repayment.

The beneficiary is given credit for trustees' tax only if the beneficiary is taxable on the same item. If the IIP trustees receive an amount that is capital in trust law and deemed to be income for tax purposes (see TSEM3201 and TSEM3768), the beneficiary is not given credit for the trustees' tax. The IIP beneficiary would not be entitled to such a receipt, as it would not be trust income, and would not be taxable on the receipt...

3766. Beneficiary entitled to trust income - grossing up and credit for trustees' tax example [August 2013][12]

An IIP trust where the Settlements legislation does not apply (see TSEM3765) receives income in 2009-2010: rental income £2,000 and bank interest £800 (basic rate tax of £200 deducted at source).

Trustee's position

	Rent	interest
gross income	2,000	1,000
tax due	400	200
net income	1,600	800

The trustee receives credit for the tax deducted at source from the bank interest (£200) so has to pay £220 tax.[13]

Beneficiary's position (***Beneficiary is a higher rate taxpayer***)[14]

	Rent	interest
net income (as above)	1,600	800
grossed up (@ 20%)	2,000	1,000
Beneficiary is a higher rate taxpayer		
tax at 40%	800	400
less credit	-400	-200
further tax to pay	400	200

For an example involving TMEs, see TSEM8345-8350.

3767. Beneficiary entitled to trust income - form R185 (Trust Income) [August 2013]

In the example in TSEM3766 the entries on the form R185 (Trust Income) given by the trustees to the beneficiary would be:

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12 [Author's footnote] I have slightly altered the wording of the examples to enhance clarity.

13 [Author's footnote] The correct figure is £200.

14 [Author's footnote] If the beneficiary is a basic rate taxpayer, there is no further tax due.

	Net amount	tax paid
Box 3 non-savings income	£1600	£400
Box 4 savings income	£800	£200

The beneficiary uses the information on form R185 (Trust Income) to make his or her tax return or to claim repayment.

26.4.2 *Mandated income*

The TSE Manual provides:

> **3763. Beneficiary entitled to trust income - mandated income** [August 2013]
> Sometimes the trustees mandate trust income to a beneficiary. If the trustees mandate income to a beneficiary, it means that the beneficiary receives it and the trustees do not. So in such a case there is no statutory basis (see TSEM3761) for taxing the trustees as being in receipt of the income. The beneficiary both receives the income and is entitled to it. The trustees exclude the income from the Trust and Estate Tax Return, even if it is untaxed. The beneficiary's trust income is
> - a share of the net taxed income as calculated on normal basis, and
> - the gross amount of untaxed income directly chargeable on him.
>
> The beneficiary (or, where the settlor has retained an interest, the settlor) includes the income on his personal return.

26.5 Trustees expenses

26.5.1 *Deduction for trustees*

The TSE Manual provides:

> **8310. IIP trustees: basic rate, etc tax** [April 2011]
> In taxing the trustees of an IIP trust at rates up to basic rate, the usual deductions against various sources of income (e.g. deductions to arrive at net trading profit or rental income) are allowed. But the trustees do not get relief at those rates of tax for any 'trustees' expenses' whatsoever. The tax case of *Aikin v Macdonald's Trustees* (3 TC 306 -1894), concerned with income remitted to the UK from abroad, confirmed the general principle that trust management expenses are not to be taken into account in arriving at the measure of taxable income of the trustees. The case found that the full amount of income received in the UK was taxable without any deduction in respect of expenses incurred in this country in managing the trust. As Lord McLaren said, 'the only kind of deductions allowed is expenditure incurred in earning the profits, there is no deduction under any circumstances allowable for expenditure

incurred in managing profits which have already been earned and reduced into money' (p309).

8315. IIP trustees: deemed income [April 2011]

Unlike the trustees of accumulation/discretionary trusts, the trustees of IIP trusts are not normally chargeable to the special trust rates. Consequently there is generally no equivalent question of allowing TMEs against the special trust rates - but see 'Practical considerations' below.

For IIP trusts, there are certain items that are capital in trust law but deemed to be income for tax purposes, and are also taxable at the special trust rates. (See TSEM3201.)

...

From 6 April 2007 Section 484 ITA provides for all the deemed income items in ITA/482, now including accrued income, to be given relief for allowable TMEs

Practical considerations

In practice, if an IIP trust incurs allowable TMEs, they will reduce the beneficiary's entitlement to trust income and will not normally be taken into account for the trustees' deemed income purposes. A capital receipt would normally not find its way into the hands of an IIP beneficiary, as it would not be trust income. So, the fact that the trustees were liable to the special trust rates on certain receipts would have no direct effect on the income beneficiary, and Section 484 ITA TMEs would not come into question. But if there is a high enough level of allowable income expenses such that they reduce the IIP beneficiary's entitlement to nil, and at the same time there is deemed income taxable on the trustees at the special trust rates, excess income expenses could be used against the trust rate income.

26.5.2 *Deduction for life tenant*

The TSE Manual provides:

8320. IIP beneficiaries: case law [April 2011]

There is case law in *Murray v CIR* (11 TC 133), *MacFarlane v CIR* (14 TC 540), and *CIR v Dewar* (16 TC 93-94). A beneficiary with an absolute interest in income (for example a life tenant) is entitled to the amount arising to the trustees that is available after any management and administration expenses etc. of the trustees have been provided for. Consequently the beneficiary is taxable on the net amount - *CIR v Hamilton of Dalzell (Lord)* (10 TC 406).

8325. IIP beneficiaries: TMEs not a tax deduction [December 2011]

In an IIP trust, the income beneficiary is entitled to the income as it

arises out of trust assets, with the exception of any part of that income that is properly paid away on trust expenses and some other items (see TSEM3761A). TMEs are considered as part of establishing what net income the beneficiary is entitled to in law. That entitlement then provides the measure on which to tax the beneficiary. So, 'allowable' TMEs for an IIP beneficiary do not constitute a tax deduction or a tax relief, because they represent sums of money that the beneficiary was not entitled to in the first place.

8330. IIP beneficiaries: tax law [April 2011]

ITA Sections 499 to 503 provide generally for the IIP beneficiary's income to be reduced by allowable TMEs for tax purposes.

ITA Sections 501 and 502 provide for relief for allowable TMEs for non-resident IIP beneficiaries.

Section 500 ITA provides:

(1) Expenses of the trustees can be used to reduce the beneficiary's income for income tax purposes only so far as—

(a) the expenses are incurred by the trustees in the current tax year or in an earlier tax year, and

(b) as a result of the expenses being chargeable to income as mentioned in subsection (2) or (3), the beneficiary's entitlement to the beneficiary's income is reduced by reference to the expenses.

"Chargeable to income tax" is defined in s.500 ITA:

(2) Expenses are chargeable to income for the purposes of subsection (1)(b) if they are chargeable to income by the trustees under a term of the settlement (subject to any overriding law which prevents the expenses from being so chargeable).

(3) Expenses are also chargeable to income for the purposes of subsection (1)(b) if they—

(a) are not chargeable to income by the trustees under a term of the settlement, but

(b) are chargeable to income by the trustees in accordance with any law (subject to any overriding term of the settlement which prevents the expenses from being so chargeable).

Section 500(4) ITA prevents double counting (for the avoidance of doubt):

Expenses cannot be used to reduce the beneficiary's income for income tax purposes so far as they are expenses which have fallen, or may fall, to be taken into account for the purpose of calculating the trustees' liability to income tax for any tax year.

26.5.3 *Non-resident beneficiaries*

Section 501 ITA provides:

> (1) This section applies if—
>
> (a) expenses of the trustees are to be used to reduce the beneficiary's income for income tax purposes, and
>
> (b) a proportion of the beneficiary's income is untaxed income (see section 502).
>
> (2) A proportion of those expenses is not to be so used.
>
> (3) That proportion is the same as the proportion of the beneficiary's income which is untaxed income.
>
> (4) In subsection (3) the references to the beneficiary's income and untaxed income do not, in either case, include so much (if any) of that income as is equal to the amount of income tax, or of any foreign tax, for which the trustees are liable on that income.
>
> (5) "Foreign tax" means any tax which—
>
> (a) is of a similar character to income tax, and
>
> (b) is imposed by the laws of a territory outside the UK.

Section 502 ITA provides a commonsense definition of "untaxed income":

> (1) For the purposes of section 501 the beneficiary's income is untaxed income so far as the beneficiary is not liable to income tax on it wholly or partly because the beneficiary—
>
> (a) has been non-UK resident, or
>
> (b) has been treated as resident in a territory outside the United Kingdom under double taxation arrangements.
>
> (2) If the income tax charged on the beneficiary for the beneficiary's income is limited under Chapter 1 of Part 14 (limits on liability to income tax of non-UK residents), the untaxed income includes so much of the beneficiary's income which is disregarded income (within the meaning of that Chapter) except so far as the disregarded income is within subsection (3).
>
> (3) The disregarded income is within this subsection so far as—
>
> (a) sums representing income tax have been deducted from the income,
>
> (b) sums representing income tax have been treated as deducted from or paid in respect of the income, or
>
> (c) there are tax credits in respect of the income.

Against which income does one set expenses? This question did not arise when all types of income were taxed at the same rates. Now we need s.503 ITA which provides the answer:

(1) This section applies if the beneficiary's income is to be reduced for income tax purposes by expenses of the trustees.
(2) The beneficiary's income is to be reduced in the following order—
first, reduce dividend income within subsection (3) (if any),
second, reduce dividend income not within that subsection (if any),
third, reduce savings income (if any), and
fourth, reduce other income (if any).
(3) Income is within this subsection so far as it is—
(a) chargeable under Chapter 3 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies),
(b) chargeable under Chapter 5 of that Part (stock dividends from UK resident companies), or
(c) chargeable under Chapter 6 of that Part (release of loan to participator in close company).
(4) If the trustees are liable for income tax charged on a component of the beneficiary's income at a particular rate, then any reduction of that component is to be made in accordance with the steps set out in subsection (5).
(5) Here are the steps.
Step 1 Deduct from the component the amount of income tax charged on it at the particular rate for which the trustees are liable.
Step 2 Take the result from Step 1 and reduce it (but not below nil) by the amount of the trustees' expenses so far as they have not already been used to reduce other components of the beneficiary's income.
Step 3 Take the result from Step 2 and gross it up by reference to the particular rate. The result is the reduced amount of the component of the beneficiary's income.

ITA change 91 provides:

Change 91: Settlements: trustees' expenses reducing beneficiary's income: sections 500, 503 and Schedule 1 (section 646A of ITTOIA)
This change makes explicit some of the rules about the way expenses incurred by trustees in connection with income to which a beneficiary is entitled reduce the amount of the beneficiary's income for tax purposes.
There are only two provisions in ICTA that concern the tax treatment of expenses in relation to income to which a beneficiary is entitled before it is distributed (where the beneficiary is regarded as having an interest in possession). These are:

- section 689A, which deals with the disregard of some expenses in the case of a non-resident beneficiary; and
- section 689B, which concerns the order in which expenses reduce the beneficiary's income.

While there are additional provisions in section 686(2AA) of ICTA that give some rules on the treatment of trustees' expenses in relation to accumulation or discretionary income, there is no corresponding provision for interest in possession trusts. The practices that have become established and which are reflected in these sections are based on the principle that the income of a beneficiary is the income arising to the trustees so far as the beneficiary is entitled to it.

There are two ways in which this principle operates.

First, if the trustees' expenses are chargeable to income under a provision of the settlement, then irrespective of whether they would be so chargeable in the absence of that provision, the expenses are to be taken into account. This is subject to the existence of any law that in a particular case (for example by way of a court order) overrides the provision in the trust deed.

This is different from the rule that operates in relation to accumulated or discretionary income where the terms of the settlement are to be ignored, and from what it appears that section 689A of ICTA provides for in this context.

If the deed is silent on whether a particular expense is chargeable to income then the expense is taken into account if it would be chargeable to income under general trust law.

These rules are reflected in section 500. They mean that an expense is allowable if it is chargeable to income under the trust deed, even if it would be chargeable to capital under general trust law. Conversely, in cases where general trust law would require an expense to be charged to income, but the trust deed charges it to capital, then the change means that the expense is not allowable.

The second area concerns how trustees' expenses are taken into account in such cases.

The expenses do not affect the amount of income on which the trustees are chargeable to tax, but operate to reduce the amount of the beneficiary's income. It is not that the beneficiary gets relief for the expenses as such; it is simply that the beneficiary is not entitled to the income used to pay the expenses. So, the beneficiary's income (as reduced by allowable expenses) is grossed up at the normal rate appropriate to that income to arrive at the gross amount which is to be treated as part of the beneficiary's total income.

This is not set out in the source legislation but, based on the decision in *CIR v Lord Hamilton of Dalzell* (1926), 10 TC 406 CS, it is the accepted way that expenses are taken into account. Section 503 reflects this.

This change also provides rules about cases where the trustees' expenses exceed a beneficiary's income. Section 500(1) applies in relation to the tax year in which the beneficiary's entitlement to income is reduced, whether the expense was incurred in that tax year or an earlier tax year. The reference to an earlier tax year means that the section covers cases where the trustees' expenses in an earlier tax year exceed the income in that earlier year and so the trustees are

carrying forward the excess.
This change is in principle adverse to some taxpayers and favourable to others. But it is expected to have no practical effect as it is in line with current practice.

The TSE Manual continues:

8335. IIP beneficiaries: tax law: Section 500 ITA [April 2011]
Section 500 provides that if, as a result of the expense being chargeable to income it reduces the beneficiary's entitlement to income, it reduces the measure of the beneficiary's income for tax purposes.
An expense can reduce the beneficiary's entitlement in two ways:
If it is chargeable to income under general trust law and there is no specific provision about the expense in the trust deed.
If it is chargeable to income under the trust deed, whether it is chargeable to income or capital in general trust law.
In cases where general trust law would require an expense to be charged to income, but the trust deed charges it to capital, the expense is not allowable, as it does not reduce the beneficiary's entitlement to income
In sum:

- if an expense is properly chargeable to capital in general trust law, but charged to income under the trust deed, the expense is allowed;
- if an expense is properly chargeable to income in general trust law, but charged to capital under the trust deed, the expense is not allowed.

The legislation for interest in possession trusts specifies that one must give priority to the provisions of the trust deed over general trust law when establishing whether the expense is an allowable trust management expense for tax purposes. In practical terms the provisions result in the IIP beneficiary being taxed on his or her entitlement to income.
8340. IIP beneficiaries: trust deed [April 2011]
The IIP beneficiary is taxed on the income of the trust net expenses properly chargeable to income.
'Properly chargeable to income' in the IIP trust context means properly chargeable to income under all four sources of trust law referred to in TSEM8020. By contrast with discretionary trusts, where Section 484 ITA specifically excludes provisions in the trust deed, this term for IIP beneficiaries includes expenses whose final incidence falls on income by virtue of the terms of the trust deed - Section 500(2) ITA.
So if an IIP trust deed allows the trustees to pay what are normally capital expenses out of income, those expenses reduce the measure of the beneficiary's income. If an IIP trust deed allows trustees to pay what are in general trust law income expenses out of capital, again the trust deed has priority over general trust law, and consequently the IIP beneficiary's income is not reduced by such expenses.

In the absence of a specific provision in the trust deed, general trust law applies. If the trustees pay expenses out of income that are properly chargeable to capital in general trust law, then the IIP beneficiary is taxable on the amount of income used to pay the expenses, even though he or she does not receive it.

8345. IIP beneficiaries: measure of income: net and gross amounts [April 2011]

Tax is charged on the beneficiary's entitlement. The beneficiary receives

- income net of tax and income expenses including TMEs (that receipt referred to below as 'the net amount'), but is actually entitled to
- the untaxed amount of the income, net of income expenses including TMEs (that entitlement referred to below as 'the gross amount').

So the net amount is grossed up at the appropriate tax rates to arrive at the amount included in the beneficiary's income for income tax purposes.

Example

Trustees income is £1,000; allowable TMEs are £250, income tax due is £200 (£1,000 at 20%).

The 'net amount' is £550

The 'gross amount' is £687.50 (£550 grossed up × 100 ÷ 80).

8350. IIP beneficiaries: measure of income: tax paid by trustees [April 2011]

The income tax paid by the trustees on that part of the income used for TMEs and other items excluded from the IIP beneficiary's entitlement is not part of the beneficiary's entitlement, because the income out of which the tax is paid is not part of the beneficiary's entitlement. But the rest of the tax paid by trustees represents income to which the IIP beneficiary is entitled.

The beneficiary is given credit for the tax already paid by the trustees (or deducted at source) on the amount included in the beneficiary's income for income tax purposes. That credit, i.e. tax already paid on the income to which the beneficiary is entitled, will necessarily be represented by the difference between the gross amount and the net amount as described in TSEM8345.

8355. IIP beneficiaries: Section 500 ITA: basis of allowance [April 2011]

Section 500(1)(a) ITA provides that allowable TMEs are allowed on the 'incurred' basis. So the beneficiary's entitlement in any tax year is income arising less allowable TMEs incurred.

Section 500 provides for unused allowable TMEs incurred in an earlier year to be used against the current tax year. In a year where allowable TMEs incurred exceed income arising the beneficiary's income entitlement will be nil. The excess allowable TMEs will be taken into account in later year/s.

For an expense to be properly chargeable to income in trust law the trustees must have authority to put the final burden of that expense on the income fund. Which fund they use to pay it out of temporarily is not relevant.

In a year where there is not enough income, trustees may borrow from capital to pay income expenses, and in the next year reimburse capital from income.

If an expense is properly chargeable to income, but the trustees pay all or part of it from trust capital in year 1 because there is no income or not enough income that year, the beneficiary's net income in year 1 will be reduced to nil. If in year 2 the trustees reimburse capital from income, that amount will be allowable against the beneficiary's income for tax purposes in year 2.

Example

Year 1, trust income £1,000, allowable TMEs £2,000.

Trustees pay £1,000 TMEs out of income, and £1,000 out of capital. Beneficiary's taxable income £1,000 less TMEs £1,000 = nil.

Year 2, trust income £3,000, allowable TMEs £1,000.

Trustees pay £1,000 TMEs of current year out of income, and reimburse capital £1,000 for income expenses of previous year.

Beneficiary's taxable income £3,000 less £2,000 = £1,000.

8360. IIP beneficiaries: tax law: order of set-off [April 2011]

Section 503(2) ITA provides the order of set-off for TMEs to reduce the income of an IIP beneficiary. The order of set-off of TMEs in an IIP beneficiary's tax calculation is the same as for accumulation/discretionary trustees (TSEM8250). But there is no grossing up of expenses as there is for accumulation/ discretionary trustees.

8365. IIP beneficiaries: tax law: order of set-off [June 2011]

Example

An IIP trust receives income in 2010-11:

rental income £1,000

bank interest £800 (basic rate tax of £200 has been deducted at source).

Trustee pays TMEs properly chargeable to income of £250.

Trustee's position

	Rent	Interest
Gross income	£1,000	£1,000
Tax due	£200	£200
Net income	£800	£800

The trustee receives credit for the tax deducted at source from the bank interest (£200) so has to pay £200 tax on the rent. TMEs do not affect the trustee's position.

Beneficiary's position

	Rent	interest
Net income (as above)	£800	£800
Minus TMEs (set first against savings income)		(£250)
	£800	£550
grossed up (@ 20%)	£1,000	£687.50

8370. IIP beneficiaries: tax law: form R185 (Trust Income) [April 2011]

In the example in TSEM8365 the entries on the form R185 (Trust Income) given by the trustees to the beneficiary would be:

	Net amount	Tax paid
Box 3 non-savings income	£800.00	£200.00
Box 4 savings income	£550.00	£137.50

The beneficiary uses the information on form R185(Trust Income) to make his or her tax return or to claim repayment.

8375. IIP beneficiaries: mandated income [April 2011]

Where trustees mandate income (see TSEM3762) and the beneficiary pays TMEs that are properly chargeable to income, such a beneficiary may set the TMEs against income chargeable at higher rate only. This practice of charging such income at no higher than the basic rate necessarily follows from the case law propositions that

- there is no income tax relief at basic rate for income used to meet TMEs (see TSEM8310)
- although an IIP beneficiary receives income mandated to him, to the extent that it is used to meet expenses properly borne by income it is not a part of his entitlement (see TSEM8325).

26.6 Scots trusts (from 2016)

HMRC say:

> 41. [Trust residence] is already a complex area and the Government wishes to avoid additional complexity. The introduction of "Scottish resident" trusts and estates would add another layer of complications for trustees and personal representatives. The Government therefore proposes that trusts should retain their current (UK or non-UK) residence status and be taxed at UK rates where appropriate.
>
> 42. Trusts and deceased estates are not generally affected by the Scottish rate of income tax. Income arising to trusts will not be chargeable to the Scottish rate, which applies only to individuals. A body of trustees (on whom liability for tax due on trust income falls), is treated as a single 'person' for tax purposes, and is not an individual. Neither is the personal representative of the deceased acting in an individual capacity.
>
> 43. However, trust or estate income arising to or received by an individual Scottish beneficiary would be chargeable to the Scottish rate. There are a number of different types of trust though and there are implications in relation to the Scottish rate when income is paid out to beneficiaries. These would be treated in the following ways.
>
> ...
>
> *Deceased Estates and Interest in Possession Trusts*
>
> 48. A UK-resident Interest in Possession (IIP) trust is one where the beneficiary has a legal right to the trust income as it arises. Under Scots law the beneficiaries have no such right to the income as it arises, but

they do have rights which they can enforce against the trustees to ensure that the trust purposes are carried out, and trustees have an obligation to account to the beneficiaries. Despite these differences in trust law, section 464 of ITA ensures consistency of treatment across the UK for tax purposes. Prior to making a payment to the beneficiary, the trustee is required to pay tax at the UK basic rate of tax.

49. Personal representatives dealing with estates of deceased persons will not be liable at the Scottish rate of income tax on income arising during or at the end of the administration of the estate. When paying income from the residue of a deceased estate to the beneficiary they will similarly have paid basic rate tax on that income.

50. In either case, the beneficiary could be receiving non-savings income which has borne tax at the basic rate. Currently beneficiaries liable at the basic rate of tax may have no need to do anything further - they would not need to submit a tax return merely to report the IIP or residuary estate income because there would be no additional tax to pay (although some basic rate IIP beneficiaries may feel it worthwhile to reclaim tax in cases where the trustees have borne expenses out of the income to which the beneficiary is entitled). Beneficiaries liable to tax at the higher or additional rates will have further tax to pay and will be required to complete tax returns.

51. If the Scottish and UK rates were to diverge, this would cause a potential difficulty for Scottish taxpayer beneficiaries whose marginal rate of tax is the Scottish basic rate of income tax and who receive some income under the deduction of tax at the UK basic rate. If, for example, the Scottish main rates of income tax were higher than the main UK rates then, strictly, they will have a further small liability. This would need to be collected via PAYE coding adjustments or through Self Assessment. Few of these beneficiaries will currently complete a tax return so it would be a significant exercise to identify them and adjust tax codes to collect the income. The costs of collecting these small amounts would often outweigh the amount collected. If the divergence in tax rate were reversed there would be similar issues for beneficiaries wanting to reclaim overpayments.

52. Since savings income will still be charged at the UK rates of income tax this would only be a problem at the moment for non-savings income, such as income from rented properties. Income paid through an IIP trust or deceased estate will therefore be excluded from a charge under the Scottish rate of income tax - in other words the UK rates should always apply to such income. Beneficiaries whose marginal rate of tax is derived from the Scottish basic rate of income tax would have no further liability in relation to the income received in respect of which the

trustees or personal representatives had paid basic rate tax.

53. With non-UK resident interest in possession trusts the issues are different as the trustees will only be liable to UK income tax on UK source income and that income will not be subject to the trust rate. The trustees will not be liable to UK income tax on any foreign income that they receive. It should also be noted that the beneficiary's right to income under foreign law in respect of interest in possession trusts can differ from that described above for UK trusts and consequently the treatment of the income in the hands of the beneficiary can differ. In some foreign law jurisdictions the beneficiaries are entitled to their appropriate share of each item of trust income when it arises to the trustees. These are known as Baker type trusts. In such circumstances the beneficiaries are chargeable on their share of trust income. If the trust income has borne UK tax it is treated as taxed income of the beneficiaries and each beneficiary's share is income that has been taxed at whatever rate of tax it has borne. Once the Scottish rate is introduced, this income will be taxed at the beneficiary's appropriate tax rate - if they are a Scottish taxpayer, they will therefore pay tax at the Scottish rate on non-savings income from the trust.

54. Under some other foreign law jurisdictions beneficiaries of interest in possession trusts are entitled only to their appropriate share of the net trust income that remains after the trustees have paid trust expenses; these are referred to as Garland type trusts. The beneficiaries are chargeable on the arising basis by reference to the income receivable by them from the trust. This applies whether or not it was paid out by the trustees. The income is treated as a new source of income and will be returned by the beneficiary as untaxed foreign income. If the beneficiary is a Scottish taxpayer, they will therefore pay tax at the appropriate Scottish main rate on this income.

55. If trustees have already paid UK or foreign tax on the trust income, the beneficiary can claim relief for this tax, subject to certain conditions being met. This must be outside of their Self Assessment return though.

56. Once the Scottish rate is introduced, such claims would be able to be set against tax charged at the Scottish main rates, in the same way as is currently allowed.

Settlor interested trusts

57. Settlor interested trusts are trusts where the settlor (the person who put funds into the trust), or certain family members, can benefit from the trust. The trustees are required to pay tax at the appropriate rate. The settlor will be liable at their marginal rate, although they will receive a tax credit for the tax paid by the trustees.

58. Income in the hands of the settlor will continue to be charged at their

marginal rate - therefore, if the settlor is a Scottish taxpayer, this income will be chargeable at the Scottish main rates. This will also be the case if there is an offshore structure and the transferor or beneficiary are assessable to tax under the Transfer of Assets legislation at sections 720 and 731 of ITA.[15]

26.7 DT reliefs

In relation to trusts, three states may be concerned:
(1) The state where the income arises
(2) The state where the trustees are resident
(3) The state where the beneficiary is resident

In this book I only consider the matter from a UK perspective: it will be necessary to consider foreign law viewpoints but that is outside the scope of this book.

In this chapter "beneficial ownership" is used in the treaty sense.[16]

26.7.1 *Reliefs where beneficial ownership of income is required*

Article 10 OECD model convention provides:

> 1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
> b) 15 per cent of the gross amount of the dividends in all other cases.

Thus relief for UK dividends requires that the beneficial owner of the dividends is treaty-resident in the foreign jurisdiction.

Article 11 OECD model convention provides:

> 1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

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15 HMRC, "Clarifying the Scope of the Scottish Rate of Income Tax Technical Note" (May 2012).

16 See 25.12.1 (Meaning(s) of "beneficial ownership").

> 2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

Thus relief for UK interest similarly requires that the beneficial owner of the interest is treaty-resident in the foreign jurisdiction.

Article 12(1) OECD model convention provides:

> Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

Thus relief for UK royalties similarly requires that the beneficial owner of the royalties is treaty-resident in the foreign jurisdiction.

In some treaties beneficial ownership is added as a requirement even where it is not in the OECD model.

26.7.2 *Baker trusts*

In the case of Baker trusts, for the purposes of DT reliefs:

(1) The trust is transparent ie the underlying trust income is regarded as the income of the beneficiary.

(2) The life tenant is the beneficial owner of the trust income payable to the life tenant. So if the trust receives (say) interest income, the income of the beneficiary is classified as interest, and if the beneficiary is treaty-resident in a treaty jurisdiction with an article providing exemption from UK source interest, the income qualifies for this DT relief.

(3) The trustees (if otherwise taxable) qualify for DT relief to the extent that the beneficiary qualifies for the relief. This is another case of the trustees enjoying reliefs applicable to life tenants.

(4) The position is different for a receipt which is income for tax purposes and capital for trust law purposes: in that case the trustees are the beneficial owner of the income.

HMRC agree. International Manual provides:

> **339540. Baker and Garland Trusts** [December 2011]
>
> ...
>
> ***Baker trusts***
>
> Where 'Baker' applies, you cannot treat the trustees as being beneficial owners of a trust's income as it arises. Instead it is the beneficiaries who

are the beneficial owners.

That is correct. The Manual continues:

> Strictly, each beneficiary should claim in his or her own right.

This is not strictly correct. A trustee could claim indirect DT relief in a case where a beneficiary failed to do so. But nothing turns on that since HMRC do not apply what they identify as the strict law:

> In practice it is acceptable to allow relief to the trustees, provided that you can be satisfied that the beneficiaries are entitled to relief under the same double taxation agreement as that under which the trustees have claimed. If this is not the case you may allow partial relief to the trustees by reference to the percentage of the interests that are relievable under the same DTA as the trustees. The beneficiaries who are not resident in the same country as the trustees will need to make their own claims against the income distributed to them.

26.7.3 *Garland trusts*

In the case of *Garland* trusts, for the purposes of DT reliefs:

(1) The trustee is the beneficial owner of the trust income.

(2) The income of the beneficiary will qualify for DT relief under the "other income" article in the OECD model form (but not under the UK preferred form): see 25.11 (UK trust - non resident beneficiary: DT relief).

(3) Point (2) would cause great difficulties. However by concession HMRC will regard a *Garland* trust as transparent *Baker* trust for DT purposes. I refer to this as "**the Garland concession"**.

International Manual provides:

> **339540. Baker and Garland Trusts** [December 2011]
>
> **...**
>
> ***Garland trusts***
>
> Where 'Garland' applies, you can, for the purposes of the double taxation agreement, treat the trustees as the beneficial owners of trust income as it arises and allow relief. This treatment is given because we consider that the beneficiary's right to income from the trust is against the trustees, rather than in the underlying assets held in trust. However, you should still establish the identity and residence of the beneficiaries. If any beneficiary is in the UK you should notify their tax office.

International Manual provides:

166030. Garland trusts [September 2011]
In the case of income of a non-discretionary foreign trust of the type considered in the case of *Garland v Archer Shee* 15 TC 693, the beneficiaries are not concerned with the source of the trust income and whether or not it has borne UK tax. It is the practice to allow relief to beneficiaries, other than annuitants, in respect of the proportion of the income assessable as foreign income which is regarded as being derived from trust income which has borne United Kingdom tax. It is a condition of the relief that the amount of the income for higher rate purposes is to be treated as the sum of the amount assessable and the amount of tax on a grossed up basis which is applicable to the part of the assessment on which relief has been given.
Submit the first claim from a beneficiary for this relief to the Offshore Personal Tax Team (part of Charity, Assets & Residence), before admitting the claim.
166040. Foreign tax [February 2006]
Where foreign tax has been paid on trust income (including, in the case of dividends, any underlying tax where, exceptionally credit for such tax is due under the terms of an agreement – see INTM164410), it is the practice, in the case of a trust of a type referred to in INTM166030, to allow credit relief to beneficiaries, other than annuitants, for that foreign tax. Credit relief is given in the same way and to the same extent as if each beneficiary were entitled to his proportionate share of the underlying investments of the trust.

26.8 Baker or Garland trust jurisdiction?

The English courts assume that foreign trust jurisdictions apply English law principles in the absence of evidence to the contrary. But the Scottish courts will, I expect, assume Scots law principles, in the absence of evidence, with the opposite result. In practice HMRC have helpfully published a list which would constitute evidence on which (in the absence of other evidence) a tribunal should be expected to rely.[17] This list only represents the HMRC view and could be challenged on the basis of expert evidence. The list assumes the trust has standard form wording. It is in principle possible to draft a non-transparent trust in a *Baker* jurisdiction. It may be possible to draft a transparent trust in a *Garland* jurisdiction by using non-standard wording.

The HMRC list is as follows. The endnotes are my own.

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17 Accessible *http://www.hmrc.gov.uk/cnr/nr_trusts.htm#lctable.*

Argentina	No Trust Law
Australia[1]	
New South Wales	Baker
Queensland	Baker
South Australia	Baker
Victoria	Baker
Western Australia	Baker
Bahamas	Baker
Barbados	Baker
Belgium	No Trust Law
Belize	Baker
Canada[2]	
British Columbia	Baker
Nova Scotia	Baker
Ontario	Baker
Saskatchewan	Baker
Quebec[3]	Garland
Cayman Islands	Baker
Denmark	Garland
Egypt	Baker
Estonia	Baker
Fiji	Baker
France[4]	No Trust Law
Ghana	Baker
Gibraltar	Baker
Guernsey	Baker
Guyana	Baker
Hong Kong	Baker
Hungary	Baker
India[5]	Garland
Ireland, Republic of[6]	Baker
Isle of Man	Baker
Italy[7]	No Trust Law
Japan	No Trust Law
Jersey[8]	Baker
Kenya	Baker
Latvia	Baker
Liechtenstein	Garland[9]
Lithuania	Baker
Luxembourg	Baker
Malaysia	Baker
Malawi	Baker
Malta[10]	No Trust Law
Monaco	No Trust Law
Montserrat	Baker
Namibia	Garland
Netherlands	No Trust Law[11]
New Hebrides	Baker
New Zealand	Baker
Nigeria	Baker
Norway	Garland
St Helena	Baker
St Vincent	Baker
Singapore	Baker
South Africa[12]	Garland
South Yemen	Baker
Spain	No Trust Law
Sri Lanka	Baker
Sweden	Garland
Trinidad & Tobago	Baker
Uganda	Baker
USA[13]	
New York	Garland
Minnesota	Garland
Montana	Garland
North Dakota	Garland
South Dakota	Garland
Wisconsin	Garland
All other states[14]	Baker
Zambia	Baker
Zimbabwe	Garland

1 The list omits Tasmania, Northern Territory and Australian Capital Territory. It is considered that these are *Baker* jurisdictions.

2 This seems correct: see *Minister of National Revenue* [1956] SCR 49 especially [1953] Ex CR 292 at p.297, accessible *http://www.kessler.co.uk/tfd-archive* The list of Canadian jurisdictions omits Alberta, Manitoba, New Brunswick, Newfoundland and Labrador, Northwest Territories, Nunavut, Prince Edward Island and Yukon. It is suggested that these are the same as the other Canadian common law jurisdictions, i.e. *Baker* jurisdictions.

3 This seems well founded in Art. 1261 Code Civil Québec: "Le patrimoine fiduciaire, formé des biens transférés en fiducie, constitue un patrimoine d'affectation autonome et distinct de celui du constituant, du fiduciaire ou du bénéficiaire, sur lequel aucun d'entre eux n'a de droit réel." [The trust patrimony, consisting of the property transferred to the trust, constitutes a patrimony by appropriation, autonomous and distinct from that of the settlor, trustee or beneficiary *and in which none of them has any real right*]. See also Gretton, "Trusts without Equity" ICLQ 49, No.3 (July 2000).

4 France was omitted (accidentally?) from the version of the list published 1 April 2008, but the comment in the earlier version of the list is printed here as it is correct.

5 *Duncan's Executors v Adamson* (1935) 14 ATC 22 so held. This seems soundly based on s.3 [India] Trusts Act 1882: "The 'beneficial interest' or 'interest' of the beneficiary is his right against the trustee as owner of the trust-property."

6 The list omits Northern Ireland: this is a *Baker* jurisdiction.

7 This is wrong: Italy does have a trust law.

8 Harriet Brown agrees: see *Jersey Law of Trusts* (4th ed., 2013), 2.52.

9 It is not clear whether HMRC are referring to a Stiftung or a Treuhandschaften; see 84.8 (Foundation: Stiftung); 84.11 (Liechtenstein Treuunternehmen).

10 This is wrong: Malta does have a trust law.

11 This is wrong: The Netherlands does have a trust law.

12 Honoré agrees: *South African Law of Trusts*, (5th ed., 2002), para 349.

13 New York was (rather implausibly) found to be a *Garland* jurisdiction in *Garland v Archer-Shee* 15 TC 693. The finding of fact in *Garland* was also made in *Timpson's Executors v Yerbury* 20 TC 155 at p.157, and was accepted as common ground in *Astor v Perry* 19 TC 255. See "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, 2004 p.46 accessible on *http://www.kessler.co.uk/tfd-archive* for contrary views as to US law. Since foreign law is a question of fact, a court would not be bound by those decisions, but in practice they are not likely to be challenged.

14 This may not be correct for all the other states. In particular, Ohio and New Jersey have been found to be *Garland* jurisdictions. See *The Marchioness of Ormond v Brown* 17 TC 333 at p.341, *Kelly v Rogers* 19 TC 692 at p.696. But see the above footnote. In *Lawson v Rolfe* 46 TC 199 it was common ground that California was a *Baker* jurisdiction.

CHAPTER TWENTY SEVEN

SETTLOR-INTERESTED TRUSTS

27.1 Settlor-interested trusts: Introduction

Chapter 5 Part 5 ITTOIA contains a code of anti-avoidance provisions known as the Settlement Provisions. A full discussion would need a book to itself. This chapter focusses on the matters closest to the theme of this book.

The most important of the settlement provisions is s.624(1) ITTOIA which provides:

> Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone if it arises—
>
> (a) during the life of the settlor, and
>
> (b) from property in which the settlor has an interest.

I refer to income which is treated as the settlor's income under this section as **"s.624 income"**.

27.1.1 *Cross-references*

The following topics are considered elsewhere:

46.5 (Settlor-interested trust: rates of tax on settlor)
59.4 (DT reliefs: s.624 ITTOIA)
80.1 (Who is the settlor?)
80.2 (Definitions of "settlement")
81.2 (Two or more settlors of settlor-interested trust: IT).

For specialist types of income accruing to settlor-interested trusts, see:

- Chargeable event gain: see 33.8
- Offshore income gain: see 35.8.2 (UK resident settlor-interested trust) and 35.10.1 (Non-resident settlor-interested trust)
- Accrued income profits: see 37.1 (Accrued income profits: Introduction)

- Deeply discounted security income: see 37.13.1 (UK resident settlor-interested trust) and 38.11 (Non-resident trust).

This chapter considers the IT rules. For CGT see 50.1 (Gains of non-resident settlor-interested trusts).

27.2 Meaning of "income arising under a settlement"

Section 648(1) ITTOIA provides:

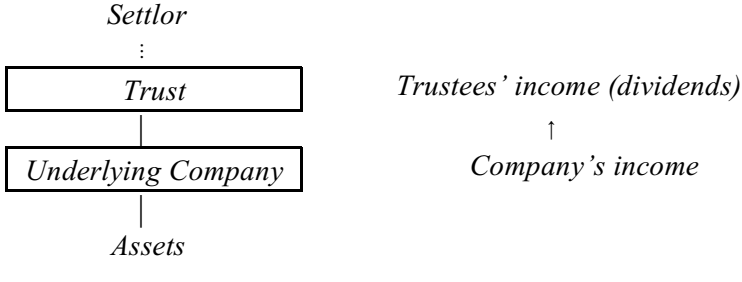
> References in this Chapter to income arising under a settlement include— [1]
>
> (a) any income chargeable to income tax by deduction or otherwise, and
>
> (b) any income which would have been so chargeable if it had been received in the UK by a person domiciled and resident there.

The points made in 28.13 (Capital receipts deemed to be income) and 28.14 (The amount of income of person abroad) apply also for the purposes of ascertaining what is the "income arising under a settlement".

The income may be deemed to be the income of the settlor under s.624 even if the settlor is paying the income (eg if the settlor pays rent or interest to a settlor interested discretionary trust).[2]

27.2.1 *Income of company, unit trust or partnership held by trustees*

Suppose a settlor-interested trust holds an underlying company, thus:



The trustees' income is "income arising under a settlement" and taxed under s.624.

The company's income is not "income arising under the settlement" and

---

1 The context suggests this is an exhaustive definition, ie the word "include" really means "mean".

2 See *Ang v Parrish* 53 TC 304. But it is different if the settlor is also life tenant; see 30.4.7 (Interest-bearing loan to life tenant).

not within the scope of s.624. This follows from the repeal by Sch 17 FA 1989 of s.681(2)(b) ICTA (which formerly brought company income into the scope of that expression).[3] This was assumed to be correct without argument in the film star case *Mills v IRC*.[4]

Where (as a matter of fact) the trust and the company constitute one arrangement, one might have thought at first sight that both the company income and the trustees income (dividends) could be described as income arising under the settlement-arrangement. But the context shows that only the trustees' income should be regarded as "income arising under the settlement" for the purposes of the IT settlement provisions. The background is explained in the first film star case, *Crossland v Hawkins*:

> The heavy incidence of Surtax [now higher rate income tax] on large incomes has for some time led artistes and others in the world of entertainment to adopt the device of forming a limited company which they control, and giving the company, by means of a service agreement, the right to their services. In return the company pays the artiste some modest salary. The company then hires the artiste out to whomsoever requires his services and itself obtains the consideration for them. ... In this way Surtax on the whole of the artiste's earnings is reduced to Surtax on the salary he gets from the company plus such dividend as is distributed to him; and when eventually the company is wound up the accumulated reserves of past years will come to him as capital.[5]
>
> All this is perfectly legitimate and indeed, in the case of persons whose high earnings may be short-lived, understandable. ... The present appeal is not concerned with that scheme, but it may be useful to bear its existence in mind.[6]

If the company is UK resident, it is within the scope of corporation tax and

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3 This was part of the repeal of the close company apportionment provisions.

4 For the film star cases, see 80.18 (Provision of services).

5 If winding up the company now, one would need to consider chapter 4 part 13 ITA (sale of occupation income).
At the time of *Crossland v Hawkins* there were close company apportionment rules, but they were not so harsh. The Court explained: "From its profits the company must distribute a reasonable dividend if it is to avoid Surtax on the whole of its profits - see Section 245 of the Income Tax Act, 1952 - but it is allowed to make such reserves as are required for the maintenance and development of the business; and where the business depends on the fortunes of a particular artiste these reserves may be considerable."

6 39 TC 493 at p.502.

the CTA provides a further reason why the settlement provisions do not apply. Section 3(1) CTA 2009 provides:

> The provisions of the Income Tax Acts relating to the charge to income tax do not apply to income of a company if—
> (a) the company is UK resident, or
> (b) the company is not UK resident and the income is within its chargeable profits as defined by section 19.

Section 624 is a "provision of the income tax acts relating to the charge of income tax" so it does not apply to income of a UK resident company.

This makes good sense, because if the profits are subject to corporation tax, HMRC do not need the settlement provisions. This view is also supported by CTA 2009 EN:

> **Clause 3: Exclusion of charge to income tax**
> 46. This clause ensures that income of a company within the charge to corporation tax is not chargeable to income tax as well as corporation tax. It is based on section 6(2) of ICTA.

This argument was put in *IRC v Levy* but the judge expressed no view.[7]

It is considered that income of a unit trust held by trustees is similarly not "income arising under a settlement" (unless the unit trust is transparent in which case the income arises to the trustees).

It is suggested that the position is different where trustees have an interest in a partnership. Insofar as income is distributed by the partnership to the trust it obviously constitutes income arising under the settlement. But even if income is retained by the partnership, it is still income of the trustees since partnership income is regarded as accruing to the partners.

Income of a non-resident company or unit trust which is not "income arising under a settlement" may fall within s.720 ITA.

27.2.2 *Income of life tenant (not the settlor)*

Income payable under the trust to a life tenant is "income arising under a settlement". Admittedly, such income is usually regarded for tax purposes as the income of the life tenant, not of the trustees.[8] But that is not

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7 56 TC 58 at [87]. HMRC's answer was to rely on s.9 ICTA 1988, but I cannot see how that helps.

8 See 26.3 (Taxation of life tenant).

relevant, because:

(1) the expression is "income arising under a settlement", not "income accruing to trustees"; and

(2) "settlement" is very widely defined: see 80.2.3 (Settlement-arrangement definition of settlement).

This can be seen to be the case by considering a trust made by S, revocable by S, under which income is payable to B for life. It could hardly be argued that such income falls outside the scope of s.624 ITTOIA.

27.2.3 *Income of life tenant settlor*

Where the settlor has an interest in possession, trust income actually received by the settlor is not within s.624 ITTOIA. It is subject to income tax under general principles. But from 2006/07 the rates of tax are the same in either case,[9] so the issue does not now arise.[10]

27.2.4 *Property business income*

Property Income Manual 1045 discusses how one calculates property income for the purposes of the settlement provisions:

> **1045. Life interest trusts** [October 2011]
> *Trusts and the settlor - losses*
> ... Various special provisions may apply to trusts and to those who set them up (the 'settlor'). In particular, there is a rule to prevent tax avoidance which can treat trust income as being, for tax purposes, the income of the settlor. Such income is taxed on the settlor under s.619(1) ITTOIA. Where the income is property income, the normal property income rules apply in calculating the income. (S.623 ITTOIA).

This is correct. It follows that interest paid by the trustees is in principle deductible in computing the quantum of property income for s.624 purposes.

27.2.5 *Property business losses*

The Property Income Manual then considers the treatment of losses:

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9 See 46.5 (Settlor-interested trust: rates of tax on settlor).

10 The point was discussed in the 4th ed. of this book at 11.4.3. Trust income not received by the life tenant settlor is within s.624 ITTOIA. That applies to income used for trust expenses and income for tax purposes which is capital for trust law purposes.

1045. Life interest trusts [October 2011]
Trusts and the settlor - losses
The more common case is where the trustees carry on the rental business but the settlor is caught by Section 619(1). Under these circumstances the settlor can't set any trust rental business losses against personal rental business income.
Similarly the settlor can't merge personal rental business losses and the trust rental business profits which are deemed to be the settlor's income and charged under Section 619(1). Thus:

- Where the trustees have a rental business loss and the settlor has a personal rental business profit, the trust loss is carried forward and the settlor is taxed on their personal rental business profit; the amount of the trustees' rental business profit charged on the settlor in the following year under Section 619(1) will be reduced by the trust loss carried forward.
- Where the trustees have a rental business profit and the settlor has a personal rental business loss, the settlor is taxed on the trust rental business profit under Section 619(1); the settlor's personal rental business loss can't be merged with the trust profit; but, as a separate matter, the settlor may in some cases be able to set a personal rental business loss sideways against other income, including any Section 619(1) income deemed to arise from the trustees' rental business; see PIM 4205.

The position is different where the taxpayer is:

- the settlor; and
- the life tenant; and
- carries on the rental business.

Under these circumstances the settlor can merge their personal property losses with the deemed income from the trust and vice versa.

This is thought to be correct. See too 16.4 (Losses of overseas property business).

27.2.6 *Trustee expenses*

Section 624(1A) ITTOIA provides:

> If the settlement is a trust, expenses of the trustees are not to be used to reduce the income of the settlor.

ITA EN provides:

> 3323.New subsection (1A) makes it explicit that trustees' expenses are not taken into account in measuring the income of a settlor under section

> 624 of ITTOIA. This follows from the fact that it is the income arising that is deemed to be the settlor's and the income arising is the gross amount out of which the trustees may pay expenses.

This is important because if s.624 does not apply, expenses do reduce the income of the life tenant.[11]

27.2.7 *Settlor's deductions and reliefs*

Section 623 ITTOIA provides:

> For the purpose of calculating liability to tax under this Chapter (but for no other purpose), a settlor shall be allowed the same deductions and reliefs as if any amount treated under this Chapter as income of the settlor had actually been received by the settlor.

As far as I can see, this is not needed (except perhaps for the avoidance of doubt). Deductions and reliefs should be available in any event under general principles. There are no deductions or reliefs which would otherwise be disallowed on the basis that the settlor did not actually receive the income arising under the settlement. Perhaps that may not have been the case in 1938 when the provision was first introduced. If so, the provision survives mainly for historical reasons, and, perhaps, for the avoidance of doubt.

27.2.8 *Income arising under the settlement must be identifiable*

Section 624 assumes that one can *identify* the amount of income which arises under the settlement. If that identification is not possible then it is considered that s.624 does not operate.[12] In straightforward cases this is not a problem. The issue tends to arise where there are two settlors; see 81.4.2 (Beneficial loans, guarantees, payments of trust expenses).

27.3 Meaning(s) of "settlor-interested"

27.3.1 *The concepts of "settlor-interested"*

The term "settlor-interested", first coined in the FA 2000, is used in connection with various provisions of which the most important are:
(1) The IT settlor-interested trust rules(discussed in this chapter).

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11 See 26.5 (Trustees expenses).

12 The same point applies to the ToA provisions; see 28.7.2 (Income arising must be identifiable).

(2) The CGT settlor-interested trust rules.[13]

Consistent with the patchwork nature of UK tax, these provisions have significant differences, though they share a common framework. "Settlor-interested" is a convenient label, but not a wholly accurate one.

27.3.2 *"Settlor-interested" for IT purposes*

Section 625(1) ITTOIA provides:

> A settlor is treated for the purposes of section 624 as having an interest in property if there are any circumstances in which the property or any related[14] property—
>
> (a) is payable to the settlor or the settlor's spouse or civil partner,
>
> (b) is applicable for the benefit of the settlor or the settlor's spouse or civil partner, or
>
> (c) will, or may, become so payable or applicable.

Sections 625 - 628 ITTOIA contain about a dozen complex exceptions which are not discussed here as they are not relevant to the themes of this book. In practice the settlor and spouse are usually expressly included as beneficiaries or expressly excluded.[15]

27.3.3 *Beneficial loan or guarantee*

Beneficial loans and guarantees to trustees potentially raise three distinct questions, so far as the settlor-interested trust are concerned:[16]

(1) Is the lender/guarantor a settlor by virtue of the loan/guarantee? (This question generally arises only if the lender/guarantor is not the original settlor, though it could also arise if one had to consider whether the settlor has provided additional property and so tainted the

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13 See 50.4 (Settlor-interested condition). Other examples, not discussed in this book, are s.169F TCGA (restriction of holdover relief for settlor-interested trusts); Sch 4A TCGA (disposal of interest in settlor-interested trusts). In addition, "power to enjoy" for s.720 ITA is a similar concept, with a different label. GWR is a comparable but not identical concept.

14 "Related property" is defined in s.625(5) ITTOIA:

> In this section "related property", in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income from it.

15 For further discussion see Kessler, *Drafting Trusts and Will Trusts* (12th ed., 2014), Chapter 13 (Settlor exclusion and default clauses).

16 For other issues raised by loans to trustees, see 52.1.1 (Cross references).

settlement).
(2) If so, what property has the lender/guarantor provided?
(3) Does the lender/guarantor have an interest in the trust property by virtue of the loan/guarantee? (This question does not arise if the lender/guarantor already has an interest in the trust property.)

It is necessary to distinguish between loans which are (1) interest-free (2) beneficial but not interest-free, eg, at low interest; and (3) commercial loans. Guarantees are not the same as loans, but the issues overlap, so I also consider them in this section.

There are many possible permutations, which makes an exposition rather more difficult.

To start with the simplest case: suppose the settlor lends interest-free to a trust from which he or she is otherwise excluded. The HMRC view is that the trust is settlor-interested as the settlor may benefit by repayment of the loan:

> In *Jenkins v IRC* (26 TC 265) the Court of Appeal found that the making of an interest-free loan brought the settlement into what is now [s.624]. In the *Jenkins* case, the dispute was about whether certain income received by the trustees of the settlement could be assessed on the settlor under the provisions of FA 1938 s38(4). That provision contained an extended definition of retaining an interest in income that is in similar terms to the definition [in s.624].
>
> The effect of the decision in *Jenkins* was that a settlor who has made an interest-free loan to his/her trust has brought himself or herself within the scope of s38(4), and by implication [s.624] (albeit that there would be no charge unless income actually arose to the trustees).[17]

The contrary is faintly arguable[18] but for practical purposes this should be accepted as correct.

The same applies if the settlor lends on terms which are beneficial but not interest-free, eg at a low rate of interest. However a settlor (if otherwise excluded) has no interest if the loan is on commercial terms, as

---

17 Letter from HMRC to the Association of British Insurers, September 2004, accessible *http://www.kessler.co.uk/tfd-archive*. For other issues arising on settlor loans to trusts, see 27.11 (Settlor receives capital sum) and 29.11 (Transferor receives capital sum).

18 The point was conceded in *Jenkins v IRC* 26 TC 265 but the concession was held to be correct in *Wachtel v IRC* 46 TC 543. So the issue remains (just) arguable in the Court of Appeal.

repayment of such a loan is not a benefit.

If someone other than the original settlor lends interest-free to a trust, the loan makes the lender a settlor.[19] There is then a trust with two settlors, the original settlor and the lender. The lender will be within the scope of s.624 on the income originating from the lender, if one can identify it.[20]

If someone other than the original settlor lends on terms which are beneficial but not interest-free, eg at a low rate of interest, the loan still makes the lender a settlor. However the lender will not be within the scope of s.624 unless one can identify the income originating from the lender, which is not usually the case.[21]

If the settlor ("the guarantor") guarantees a loan or other obligation of the trustees, the trust is not settlor-interested (assuming the settlor is otherwise excluded). A guarantor's claim against a solvent trust would only arise if the trustees failed to meet their primary contractual obligations and the words "in any circumstance whatsoever" do not extend to a breach of contract of that kind.

If someone other than the settlor gives a guarantee, the guarantor would not fall within s.624, unless:

(1) one could identify the income originating from the guarantor (which is not usually the case) and
(2) the guarantor had an interest in that income under the trust (the existence of the guarantee alone does not constitute an interest).

27.3.4 *Meaning of "spouse/civil partner" in settlor-interested trust provision*

Section 625(4) ITTOIA gives the expression "spouse/civil partner" an artificial and slightly narrow meaning:

> In subsection (1) "the settlor's spouse or civil partner" does not include—
>
> (a) a spouse or civil partner from whom the settlor is separated under an order of a court or a separation agreement,
> (b) a spouse or civil partner from whom the settlor is separated where the separation is likely to be permanent,
> (c) the widow or widower or surviving civil partner of the settlor, or

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19 A person who is not otherwise a settlor in principle becomes a settlor by virtue of making an interest-free loan: see 80.19 (Interest-free or back-to-back loan).

20 See 81.4.2 (Beneficial loans, guarantees, payments of trust expenses).

21 See 81.4 (Multiple settlors: cases where apportionment not possible).

(d) a person to whom the settlor is not married but may later marry or a person of whom the settlor is not a civil partner but of whom the settlor may later be a civil partner.

The ToA provisions and the s.86 provisions do not contain the same provision, which is anomalous, but that is the patchwork nature of UK tax. Fortunately it does not often matter.

For the general meaning of spouse, see App 1.3 ("Spouse" and related expressions).

27.3.5 *Settlor interested in part of trust fund*

The IT settlor-interested trust provisions only apply to income from property in which the settlor has an interest. So if the settlor is excluded from part of the trust fund, the IT provisions do not apply to that part. HMRC agree. The TSE Manual provides:

> **TSEM4200 settlor retains an interest** [January 2011]
> **...Settlement only partially settlor-interested**
> Where the settlor has retained a clearly defined interest in a distinct part of the settlement, for example in one fund forming part of a trust, only a corresponding part of the income is caught. In other cases of a settlor retaining a partial interest in a trust, you should submit the case to HMRC Trusts & Estates Technical Edinburgh for advice.

The TSE Manual provides:

> **TSEM4513 - Tax paid by trustees where trust is not wholly settlor interested** [December 2011]
> Trust is partially settlor interested
> The income tax paid by trustees for a tax year may be paid partly on income attributable to a settlor and partly on income from property from which a settlor is excluded from benefit. The tax paid on income attributable to the settlor does not enter the tax pool - see TSEM4512. Tax paid on other income enters the tax pool in the normal way - see TSEM3756 onwards,
> **Example**
> A settles property into the A discretionary settlement. The settlement consists of two funds.
> Fund A contains a house which is let and a block of shares in A plc.
> Fund B contains a block of shares in B plc.
> Under the terms of the settlement the settlor and any spouse or civil partner of the settlor are excluded from benefiting from Fund B.
> In 2009-2010 the income of the trustees (and tax paid on that income) is

as follows:

Fund A		*Tax due from trustees*	
Rental Income	£10,000	£1,000 @ 20%	£200
		£9,000 @40%	£3,600
Dividend Income	£ 5,000	£5,000 @ 32.5% (of which 10% satisfied by tax credit)	£1,625
Tax paid			£5,425

The settlor is given credit for the tax paid on the income attributable to the settlor - £5,425. Where the tax paid by the trustees exceeds the settlor's own income tax liability the tax (excluding the £500 non payable tax credit attached to the dividends) may be repaid to the settlor.

Fund B			
Dividend Income	£15,000	£15,000 @ 32.5% (of which 10% satisfied by tax credit)	£4,875
Tax paid			£4,875

As the settlor is excluded from benefiting from Fund B, this tax is not available to the settlor. The normal rules apply and £3375 of the tax paid (4875 less 1500 non payable tax credit attached to the dividends) enters the tax pool.

27.3.6 *Settlement ceasing to be settlor-interested*

If the settlor originally had an interest in trust property but is later excluded (together with the settlor's spouse) then s.624 ITTOIA ceases to apply to income arising after the date of the exclusion.[22]

If the settlor is excluded from part of the trust fund, then they are within the scope of s.624 only on the income arising from the part in which they still have an interest.

The TSE Manual provides:

> **TSEM4513 - Tax paid by trustees where trust is not wholly settlor interested** [December 2011]
>
> **... Trust ceases to be, or becomes, settlor interested**
>
> A trust may cease to be settlor interested part way through a tax year, for example when the settlor dies. Similarly, a trust may become settlor interested part way through a tax year, for example the settlor may marry or enter into a civil partnership with an existing beneficiary of the trust. Where this happens the tax paid by the trustees should be apportioned on a time basis so the part is available to cover the settlor's liability and the other part dealt with in the normal way.

22 Contrast 29.5 (Section 721 Condition A (power to enjoy).

Example
In 2009-2010 the income of the trustees (and tax paid on that income) is as follows:

		Tax due from trustees	
Savings Income	£10,000	1,000 @ 20%	£200
		9,000 @ 40%	£3,600
Tax paid			£3,800

The settlor of the trust dies on 5 January 2010. The trust ceases to be settlor interested on that date because Section 624 ITTOIA applies only to income arising under a settlement during the life on the settlor.
The settlor is taxed on £7,500 and is given credit for £2,850 (75% of £3,800).
The balance of the tax, £950 goes into the tax pool.

27.3.7 *Transfer to new settlement*

If the trust fund is transferred to a new settlement from which the settlor is not excluded, then s.624(1) ITTOIA continues to apply. The original settlor is the settlor of the new trust.[23]

If the entire trust fund is transferred to a new trust from which the settlor (and spouse) are excluded then s.624 ceases to apply, and if they are excluded from part, it ceases to apply in part.

27.4 Section 624 remittance basis

Section 648 ITTOIA provides a relief which I call "**the s.624 remittance basis**".

The legislation uses the clumsy but effective drafting technique of restricting the definition of "income arising under a settlement". That term is defined in a commonsense way in s.648(1)[24] and s.648(3) then provides:

> And if, for a tax year, section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the settlor, references in this Chapter to income arising under a settlement include in relation to any relevant foreign income arising under the settlement in that tax year only such of it as is remitted to the UK (in that tax year or any subsequent tax year) in circumstances such that, if the settlor remitted it, the settlor would be chargeable to income tax.
> (4) See Chapter A1 of Part 14 of ITA 2007 for the meaning of "remitted

23 See 80.8 (Transfer from trust A to trust B by exercise of trustees' power).
24 See 27.2 (Meaning of "income arising under a settlement").

> to the UK" etc.

This applies to "relevant foreign income" arising under the settlement. The drafter has overlooked the definition of RFI, which means foreign income of a UK resident. Foreign source income of non-resident trustees is not RFI.[25] Taken literally, s.648(3) would never apply to income of non-resident trustees. But the context shows that "relevant foreign income" means income which would be RFI if received by a UK resident.

Section 648(5) provides a timing provision:

> Where subsection (3) applies the remitted income is treated for the purposes of this Chapter as arising under the settlement in the tax year in which it is remitted.

In short, foreign income qualifies in principle for the s.624 remittance basis if it is not remitted to the UK.

The charge under s.648(5) arises if two conditions are satisfied:

(1) The income "is remitted to the UK".
(2) The circumstances are "such that, if the settlor remitted it, the settlor would be chargeable to income tax".

In practice this mainly concerns settlor-interested discretionary trusts. Income of a trust where the settlor has an interest in possession is in principle outside the scope of s.624,[26] though s.624 could apply to a receipt which was income for tax purposes but capital for trust purposes.

27.4.1 *Transitional rule for pre-2008 settlor-interested trust income*

In the following discussion I use the term **"pre-2008 s.624 income"** to mean foreign income arising under a settlor-interested settlement before 6 April 2008, which

(1) fell within s.624 ITTOIA, but
(2) qualified for relief under s.648(3) ITTOIA, the s.624 remittance basis (which in earlier editions of this work I called "the foreign domicile defence").

There was no tax charge when the income arose if it was not received in the UK.

Para 86(4) Sch 7 FA 2008 provides (so far as relevant):

> ... in relation to an individual's income ... for the tax year 2007–08 or

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25 See 10.3.1 (Relevant foreign income).

26 See 27.2.3 (Income of life tenant settlor).

> any earlier tax year, section 809L has effect as if the references to a relevant person were to the individual.

The point is that there is a taxable remittance of pre-2008 s.624 income only if it is received/used/enjoyed by the settlor in the UK. Receipt (etc) by a relevant person does not count.[27]

For this purpose it is necessary to decide whether s.624 income is income of the individual for the tax year 2007/08 or before. The timing rule in s.624(5) might treat pre-2008 income as post-2008 income and so disapply the transitional relief. Para 86(4A), inserted with retrospective effect by the FA 2009, deals with this:

> For the purposes of sub-paragraph (4), section 648(2) to (5) of ITTOIA 2005 (and corresponding earlier enactments) do not apply (so that relevant foreign income which arose under a settlement in the tax year 2007-08 or any earlier tax year is to be treated as income for the tax year in which it arose).

The RDR Manual provides:

> **31490 Relevant persons and foreign income and gains arising to a settlement before 6 April 2008** [March 2011]
> *Background*
> As explained in RDRM31480 s.809L ITA has introduced the concept of 'relevant person' RDRM33030 which, broadly, provides that a taxable remittance will occur when foreign income or gains are brought into or otherwise used in the UK by relevant persons.
> Where a settlor creates a settlement and retains an interest in the property in that settlement the income arising to the trust is treated, for income tax purposes, as the income of the settlor alone under s624 ITTOIA. This is the case even where the trust income is paid to someone other than the settlor. Refer to RDRM33590 Settlements: Chapter 5 Part 5 ITTOIA.
> Where a settlor claims to use the remittance basis, section 648 provides for the trust income to be treated as arising in the year in which it is remitted. Because of the narrower definition of remittance which applied before 6 April 2008 this would produce an inequitable result where relevant foreign income that arose to a settlement before 6 April 2008 is remitted and becomes chargeable on the settlor after 6 April 2008.
> *Transition*
> The transitional rule provides that in establishing whether there has been

27 See 11.9 (Relevant person transitional rule: for pre-2008/09 income and gains).

> a remittance of an individual's income and gains for 2007-08 or any earlier year Conditions A and B, Condition C and Condition D at s.809L ITA (refer to RDRM33020 Meaning of Remittance) are applied as if references to 'relevant person' are to the individual.
> For the purpose of applying this transitional rule only, that is, for the purpose of determining whether there is any benefit under the provisions of paragraph 86(4) only the income is treated as arising in the year that it arose to the settlement.
> *Effect*
> This means that income arising under a settlement in tax years prior to 5 April 2008 but which is remitted after 6 April 2008 is not treated as remitted by the settlor unless it has been brought to, received by or used in the UK for his benefit.

I had previously thought that under the pre-2008 rules, there was taxable remittance if the trustees of a settlor-interested trust brought s.624 income into the UK - even though the settlor was never actually entitled to the income. However HMRC presumably did not agree, as that is not now the position for pre-2008 s.624 income. There is a remittance only if the settlor actually becomes entitled to the pre-2008 income and brings/receives/uses it in the UK.

27.4.2 *Post-2008 trust income*

For post-2008 trust income, the usual ITA remittance basis applies, so the s.624 income is treated as remitted if it is brought/received/used in the UK by any relevant person (including the trustees).

27.5 S.624 remittance basis planning

Practical ways of avoiding the s.624 remittance basis charge are as follows:

(1) Give the settlor an interest in possession, so trust income is taxed on the RFI remittance basis, and is outside s.624.[28]
(2) The trustees do not remit any trust funds to the UK and if the trustees pay the income in any form to the settlor, the settlor does not remit that income.
(3) The trustees segregate trust income and trust capital and remit trust capital, not trust income. There is no charge under the s.624

28 See 27.2.3 (Income of life tenant settlor).

remittance basis if trustees remit to the UK a sum which is not income arising under the settlement.

27.6 Non-resident settlor

The legislation again uses the clumsy but effective drafting technique of restricting the definition of "income arising under a settlement". That term is defined in a commonsense way in s.648(1)[29] and s.648(2) then continues:

> But if, in a tax year, the settlor is not UK resident, references in this Chapter to income arising under a settlement do not include income arising under the settlement in that tax year in respect of which the settlor, if actually entitled to it, would not be chargeable to income tax by deduction or otherwise because of not being UK resident.

Where the settlor is non-resident, UK source trust income is within the scope of s.624, but foreign income is not.[30] Contrast s.720 ITA which does not apply at all unless the transferor is resident.

27.6.1 *UK resident trust, non-resident settlor*

The trustees are taxed in full on foreign source income. This prevents s.624 applying where it might benefit the taxpayer.

However the settlor is taxed on UK source income. This is beneficial if the settlor's marginal rate is less than the top rate of income tax, or if non-residents income tax relief applies.[31]

27.6.2 *Non-resident trust, non-resident settlor*

Neither the trustees nor the settlor are taxed on foreign source income.

The settlor is taxed on UK source income. This is beneficial if the settlor's marginal rate is less than the top rate of income tax, or if the circumstances are that non-residents income tax relief is available to the settlor and not to the trustees, which could happen because of the UK beneficiary rule.[32]

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29 See 27.2 (Meaning of "income arising under a settlement").

30 This is clear on the words of the section, but if authority is needed, see *IRC v Countess of Kenmare* 37 TC 383.

31 See 42.1 (Non-residents IT relief).

32 See 42.1 (Non-residents IT relief).

27.6.3 *Remittance of trust income*

It does not matter for the non-resident settlor if trust income is remitted.

Suppose:-

(1) Income arises to the trustees of a settlor-interested trust while the settlor is non-resident (**"non-resident period income"**).

(2) The income is remitted by the trustees when the settlor is resident and a remittance basis taxpayer.

Section 648 ITTOIA provides:

> (3) And if, for a tax year, section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the settlor, references in this Chapter to income arising under a settlement include in relation to any relevant foreign income arising under the settlement in that tax year only such of it as is remitted to the UK (in that tax year or any subsequent tax year) in circumstances such that, if the settlor remitted it, the settlor would be chargeable to income tax...
>
> (5) Where subsection (3) applies the remitted income is treated for the purposes of this Chapter as arising under the settlement in the tax year in which it is remitted.

It may seem at first sight that the non-resident period income is caught as it is treated under s.648(5) as arising in the year of remittance. That is however, not the case, for two reasons:

(1) The circumstances are not "such that, if the settlor remitted the non-resident period income, the settlor would be chargeable to IT". Unless the settlor is UK resident when the income arises, the settlor would not be taxed on it when remitted later, even if it had been the settlor's income all along.

(2) Non-resident period income is not "income arising under the settlement" by virtue of s.648(2).

The result is sensible and consistent with rule that income of an individual arising during a non-resident period is not taxable if remitted during a resident period.[33]

27.7 Taxation of beneficiaries of settlor-interested trust

If income of a settlor-interested trust is paid to a beneficiary there could in principle be a double charge to tax:

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33 See 10.20 (RFI/gains arising when non-resident, remitted when resident).

(1) The settlor is taxed under s.624.
(2) The beneficiary could be taxed under normal trust tax principles.

Section 685A ITTOIA avoids the double charge by giving relief to the beneficiary; hence I refer to this as **"s.624 beneficiary relief"**.

For completion of tax returns when this relief applies, see 25.3.5 (Entering discretionary trust income in beneficiary's tax return).

27.7.1 *Conditions for relief*

Section 685A(1) ITTOIA provides:

> This section applies if—
> (a) a person receives an annual payment in respect of income from the trustees of a settlement,
> (b) the payment is made in the exercise of a discretion (whether of the trustees of the settlement or any other person), and
> (c) a settlor is charged to tax under section 619(1) on the income arising to the trustees of the settlement (whether in the current year of assessment or in a previous year of assessment) out of which the annual payment is made.

A settlor is not charged to tax (within the meaning of (c)) if the s.624 remittance basis applies and the income is (un)taxed under the remittance basis. Where that relief applies, s.624 beneficiary relief is disapplied.

Section 685A(2) ITTOIA provides:

> This section applies only in respect of that proportion of the annual payment which corresponds to the proportion of the total income arising to the trustees of the settlement in respect of which a settlor is chargeable to tax under section 619(1).

Section 685A(2) may apply where:
(1) A settlement is partly settlor-interested (because there are two settlors or the only settlor is partly excluded).
(2) A non-resident settlor is charged on part of the trust income (UK source income only).
(3) A remittance basis taxpayer settlor is charged on part of the trust income (UK source and remitted income only).

27.7.2 *Relief for non-settlor-beneficiary*

Section 685A(3) ITTOIA provides relief for the beneficiary in the form of a tax credit:

> If and in so far as this section applies, the recipient of the annual payment shall be treated for the purposes of this Chapter as having paid income tax at the additional rate in respect of the annual payment.

Section 685A(4) ITTOIA prevents the beneficiary from using the tax credit except against the charge on the trust income:

> But—
>
> (a) tax which the recipient is treated by virtue of this section as having paid is not repayable,
>
> (b) tax which the recipient is treated by virtue of this section as having paid may not be taken into account in relation to a tax liability of the recipient in respect of any other income of his...

EN FB 2008 provides:

> 7. The income of a 'settlor-interested' trust is deemed, for the purposes of income tax, to be the settlor's income as it arises.
> 8. In non settlor-interested discretionary trusts, where income payments are made to beneficiaries, the income constitutes a new source, and is taxed on the beneficiary. The tax paid by trustees is available to the beneficiaries in the form of a tax credit.
> 9 . In a settlor-interested trust, an income payment to a beneficiary is still a new source of income taxable in the beneficiary's hands. However the tax paid by the trustees of such trusts is treated as paid on behalf of the settlor. Because the settlor has already been taxed on the whole amount, charging the beneficiary to additional tax would result in a form of double taxation.
> 10. Section 685A ITTOIA 2005 provides that income paid by trustees of a settlor-interested trust to (non-settlor) beneficiaries comes with a non-repayable 'notional' tax credit equal to the higher rate of tax (currently 40 per cent) which covers all the tax liability on that income.

The TSE Manual provides:

> **4570 Payments to beneficiary other than the settlor** [December 2011]
> ... For 2006-07 onwards the law provides that discretionary payments to the beneficiary are treated as though the beneficiary had paid tax at the higher rate (see TSEM3755). The amount of the actual payment (it is not grossed up) should be shown in the beneficiary's return and it is included in the calculation of that person's total income. The tax credit ensures the beneficiary has no further liability in respect of the payment but it is ring-fenced so that no part of it can be repaid or set against liability arising from any other income of the beneficiary.

Section 685A(5A)(5B) ITTOIA provide:

> (5A) If the recipient of the annual payment is treated by subsection (3) as having paid income tax in respect of the annual payment, the amount of the payment is treated as the highest part of the recipient's total income for all income tax purposes except the purposes of sections 535 to 537 (gains from contracts for life insurance etc: top slicing relief).
> (5B) See section 1012 of ITA 2007 (relationship between highest part rules) for the relationship between—
> (a) the rule in subsection (5A), and
> (b) other rules requiring particular income to be treated as the highest part of a person's income.

EN FB 2008 explains subsections (5A)(5B):

> 10. Section 685A ITTOIA 2005 provides that income paid by trustees of a settlor-interested trust to (non-settlor) beneficiaries comes with a non-repayable 'notional' tax credit equal to the higher rate of tax (currently 40 per cent) which covers all the tax liability on that income.
> 11. However, under current statutory ordering rules income from a trust is charged before savings and/or dividend income. The result is that a beneficiary of such a trust who also has savings and/or dividend income may find that the non-trust income is pushed into higher rates so that more tax is due overall.
> 12. The measure amends this ordering rule, so that income from a settlor-interested trust is treated within section 1012 ITA 2007 as one of the highest slices of income instead of being treated as part of the lowest slice.
> 13. The amending legislation backdates the correct position to 6 April 2006 to ensure that those affected are not disadvantaged by the omission.

The problem arose because the relief takes the form of a non-repayable tax credit rather than an exemption for the trust distribution (which comes to the same thing but seems simpler). The reason for that drafting technique is not clear to me.

Two points arise from this which ought to raise serious questions about the rule of law in relation to the UK tax system. First the tax system is so complex that it took two years for the error in the FA 2006 to be noticed. (I confess I did not notice it myself.) Secondly, the error was corrected by casual retrospective legislation.

Section 685A(6) ITTOIA confers relief for the charge on trustees making

the trust distribution:[34]

> Sections 494 and 495 of ITA shall not apply in relation to an annual payment if and in so far as this section applies.

27.7.3 *Relief for settlor-beneficiary*

Section 685A(5) ITTOIA provides:

> If the recipient of the annual payment is a settlor in relation to the settlement, if and in so far as this section applies the annual payment shall not be treated as his income for the purposes of the Income Tax Acts (and subsection (3) does not apply).

The TSE Manual provides:

> **4570 Payments to the settlor** [December 2011]
> Where you tax the settlor on the income arising to the trust, discretionary payments out of the trust to the settlor are not further taxable. For years up to and including 2005-06 the phrase in Section 687(1) 'but would not be his income if it were not made to him' means Section 687 does not apply to payments that fall to be treated as the income of the settlor under Section 624 ITTOIA. For 2006/07 onwards discretionary payments made by the trustees to the settlor are taken out of charge by Section 685A(5) ITTOIA.

The legislation distinguishes between non-settlor beneficiaries and the settlor. In the one case the beneficiaries are given a credit, and in the latter case the income is exempt. At first sight this seems strange, but a reason will emerge.

The payment is not a capital payment for s.87 purposes: see 51.6.5 (Payment in form of income (un)taxed on remittance basis).

27.7.4 *Taxation of life tenant (not settlor) of settlor-interested trust*

Suppose a settlor-interested settlement under which a beneficiary ("B", not the settlor) has an interest in possession. Section 624 beneficiary relief only applies to discretionary trusts. But if a trust confers an interest in possession (not on the settlor) then no relief is needed: the life tenant is not taxable as the trust income is the income of the settlor and of the settlor alone, so that B cannot be taxable on it.

B is in principle taxable on income not within s.624, that is, income

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34 See 25.5 (Tier 2: Charge on trustees making discretionary income payment).

within the s.624 non-residence defence or s.624 remittance basis.

27.8 Taxation of trustees of settlor-interested trust

If s.624 applies, the trust income is the income of the settlor "and of the settlor alone". So one might think then the trustees are not subject to tax. However s.646(8) ITTOIA provides:

> Nothing in sections 624 to 632 is to be read as excluding a charge to tax on the trustees as persons by whom any income is received.

Thus:

(1) The trustees enter the income in their return and pay tax (including tax at the trust rate, if a discretionary trust).
(2) The settlor enters the income on his or her return, and (allowing a credit for the tax paid by the trustees) pays further tax or reclaims tax.

Malcolm Gunn describes these rules as "quite frankly ridiculous"[35] and the reader will probably agree; but there it is. It is suggested that trustees should be liable only if the settlor fails to pay (IHT liability rules offer a precedent).

The problem is mainly for discretionary trusts. For IIP settlor-interested trusts, the trustees are similarly liable, but two factors mitigate the severity of the rule:

(1) In general trustees are liable at the basic rate (or the dividend ordinary rate) only; and that liability may be covered by deduction at source (or a tax credit).
(2) Mandating income can avoid the liability. HMRC Trusts and Estates Newsletter (December 2010) provides:

> **Trusts and Estates - mandated income of settlor-interested trusts**
> ... Step 1 of the Trust and Estate Tax Return (SA900 page 2) does not require a full return to be made, nor income tax to be paid, where all income is mandated to an IIP beneficiary.[36] However, that practice does not currently apply where the trust is settlor interested. Following a review of that practice, HMRC has concluded that where income is mandated to an IIP beneficiary of a settlor-interested trust there is no statutory basis for taxing the trustees as being in receipt of the income. The settlor is taxed on any income (or income from property) in which he or she has a retained interest...

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35 Gunn, "Tax Charge Doubled!" Taxation 22 Feb 2007.

36 See 26.2.1 (Income mandated to life tenant).

> HMRC will no longer require a fully completed return from trustees of settlor interested trusts in respect of income that is mandated to an IIP beneficiary.[37]

A discretionary trust which wishes to distribute all income to a beneficiary (typically, but not necessarily, the settlor) may consider creating a non-estate IIP and mandating the income to the life tenant,[38] in order to avoid the administrative costs of annual tax returns.

27.9 Settlor indemnity and tax repayment

Section 646(1) ITTOIA provides:

> A settlor is entitled to recover from—
> (a) any trustee, or
> (b) any other person to whom the income is payable in connection with the settlement,
> the amount of any tax paid by the settlor which became chargeable on the settlor under section 624 or 629.

Conversely if the trustees pay tax which the settlor reclaims, the tax must be paid back to the trustees. Section 646 ITTOIA provides:

> (5) The settlor must pay an amount equal to the repayment to—
> (a) the trustee, or
> (b) the other person to whom the income is payable by virtue of or as a result of the settlement.
> (6) If there are two or more such persons, the amount must be apportioned among them as the case may require.

For the tax implications see 30.4.10 (Reimbursement of tax under statutory indemnity); 30.22 (Relevant income used to pay expenses) and 80.24 (Failure to exercise right of reimbursement).

27.10 Sections 624 and 720: comparison

Sections 624 ITTOIA and 720 ITA cover some similar ground. For a full comparison one would need to read all the relevant chapters in this book. It may be helpful to summarise the major differences:

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37 *http://www.hmrc.gov.uk/cto/newsletter-april11.pdf* accepting the argument in Malcolm Gunn's article.

38 Or indeed to anyone else, at the direction of the life tenant.

Section 624	**Section 720**
Applies to trusts	Applies to non-resident trusts *and companies*
No motive defence	Motive defence
Settlor indemnity	No indemnity for transferor
Applies generally	Applies to resident transferor

The rates of tax are slightly different, a (probably accidental) result of the FA 2006.[39]

Section 624 has priority over s.720: see 29.15 (Interaction with s.624 (and other anti-avoidance provisions?)).

27.11 Settlor receives capital sum

Section 633 ITTOIA provides:

> (1) Any capital sum paid directly or indirectly in any tax year by the trustees of a settlement to the settlor is treated for income tax purposes as follows.
> (2) The sum is treated as the income of the settlor for the tax year so far as the amount of the sum falls within the amount of income available up to the end of the year.

Section 634 ITTOIA defines "capital sum" and "sums paid to the settlor", but is not sufficiently important to discuss in full here.[40]

The key term is "available income." Section 635 ITTOIA provides the definition:

> (1) For the purposes of section 633 the amount of income available up to the end of any tax year is, in relation to any capital sum paid as mentioned in subsection (1) of that section by the trustees of a settlement, calculated as follows.
> (2) Add together the amount of income arising under the settlement in that year and any previous year which has not been distributed.
> (3) Deduct from that figure—
> (a) the amount of that income taken into account under section 633 in relation to that sum in any previous year or years,
> (b) the amount of that income taken into account under section 633 in relation to any other capital sums paid to the settlor in any

39 See 46.5 (Settlor-interested trust: rates of tax on settlor).

40 The definition of capital sum is the same as for the transfer of asset rules; see 29.12.2 ("Capital sum"). The definition of paid to the settlor is discussed in the context of s.87: see 51.7 (Receipt from the trustees).

year before that sum was paid,

(c) any income arising under the settlement in that year or any previous year which has been treated as income of the settlor under section 624 or 629 ...

Section 633 is generally irrelevant to settlor-interested trusts. The trust income will fall into one of two categories:

(1) It will be treated as accruing to the settlor under s.624, or

(2) (if the s.624 remittance basis applies or the settlor is non-resident) it will not be "income arising under the settlement".

In either case there is no "available income".

Section 633 is (in short) intended to catch capital sums paid to the settlor from a trust which is not settlor-interested. Accordingly I shall not discuss the section further here. Where such payments are in point, see too 29.11 (Transferor receives capital sum).

27.12 Interaction of s.624 and s.37 TCGA

Section 37(1) TCGA deals with the relationship between IT and CGT:

> There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth
> [a] charged to income tax as income of, or
> [b] taken into account as a receipt in computing income or profits or gains or losses of,
> the person making the disposal for the purposes of the Income Tax Acts…

Thus IT has priority over CGT.

The section does not work when s.624 applies as the income is treated for IT purposes as income of the settlor and not the trustees! HMRC suggest a creative application of s.32 TMA may solve the problem. CG Manual para 14304 provides:

> **14304. Sums chargeable as income** [February 2006]
> This exclusion does not apply to … situations where the income in question is not treated as the income of the person making the disposal. Typically this is a case of a settlor interested trust where the income is taxed on the settlor. If in this situation the settlor is assessable to both income tax and capital gains tax then relief may be available under s.32 TMA 1970.

Suppose a settlor-interested discretionary trust. Income accrues to the

trustees. The settlor pays income tax. What stops the trustees realising a chargeable gain, on which the trustees may be chargeable if UK resident, or which may be s.2(2) amounts if the trust is not UK resident? Ths solution does not lie in s.32 TMA as it is not the case that the settlor is assessable to both IT and CGT. There is nothing obvious to stop the trustees realising a chargeable gain. But no-one suggests that there is a charge. The solution must be in a general implied rule that receipts of an income nature are not within the scope of CGT.

27.13 Corporate settlor

It is possible (though not usual[41]) for a company to make a settlement (in the settlement-arrangement sense).

Section 627(4) ITTOIA provides:

> The rule in section 624(1) does not apply in relation to income which—
> (a) arises under a settlement, and
> (b) originates from any settlor who was not an individual.

This provisions was introduced in 2012. EN FA 2012 provides:

> The purpose of the amendments to the settlements legislation is to confirm that income arising under a settlement is treated as that of the settlor only where the settlor is an individual. The proposed changes would close avoidance schemes that seek to exploit the settlements legislation by using corporate settlors of 'interest in possession' settlor-interested trusts to try to avoid income tax at higher or additional rates which would otherwise be due on dividends paid by a subsidiary of the corporate settlor. The amendments would ensure that the relevant provisions do not apply to settlors who are not individuals and hence that the income would not be treated as that of the settlor in those situations.

Even before 2012, the correct view was that s.624 did not apply to a corporate settlor.[42] It is helpful to have clarified the law, even if the reason for the change was to stop a tax avoidance scheme which did not work.

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41 See 80.34 (Pension trusts and employee benefit trusts).

42 The point is now of historic interest only; but see the 10th edition of this work para 24.16 (Corporate Settlor); Kessler & Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013), para 20.2.2 (Loans by company) (online version *http://www.taxationofcharities.co.uk*).

27.14 Tax return: disclosure of s.624 income

The trustees may inform the settlor of the s.624 income by completing form R185(Settlor) (Statement of trust income chargeable on settlor).

The settlor reports s.624 income in boxes 7-14 of form SA107 (Trusts etc) 2013/14. SA107 Notes (2013/14) provides:

> **Income arising to trustees of a trust or settlement**
> **Boxes 7 to 12**
> Copy the figures from form R185(Settlor). If you have not been provided with one you may need to ask the trustees of the trust or settlement for the information to go in boxes 7 to 12. Use the appropriate box according to the rate of tax taken off by the trustees. You get credit for tax paid by the trustees.
> Do not enter foreign income in these boxes – use the Foreign pages instead.
> If you are both the settlor and the beneficiary of a non-discretionary settlor-interested trust, the amount of your entitlement as beneficiary may be less than the total trust income because the trustees have used some of the income to pay the trust management expenses. But as a settlor you are taxable on all the income so you must enter the total trust income in boxes 7 to 12.
> **Income arising from a non-trust settlement**
> **Boxes 9, 13 and 14**
> If you are taxable as settlor on income arising to another person in a non-trust settlement or arrangement, enter dividend type income in box 9, non-savings income in box 13 and savings income in box 14. Helpsheet 270 Trusts and settlements – income treated as the settlor's explains more about this and will help you to work out these amounts. If, exceptionally, tax has been deducted from the income, enter it in box 7 or box 8. If the income is foreign, use the Foreign pages.

See Rance, "Settlor-interested settlements and how to report income", Taxation 16 January 2014 p.14.

CHAPTER TWENTY EIGHT

TRANSFER OF ASSETS ABROAD: INTRODUCTION

28.1 ToA: Introduction

Non-resident trusts and companies pay no UK tax on foreign income. A non-resident company may pay less tax on UK income. These rules present an obvious means of income tax avoidance. HMRC's first answer to this is Chapter 2 Part 13 ITA, entitled "Transfer of assets abroad" (**"the ToA provisions"**).

There are two main charging provisions:

(1) **"The s.720 charge"** on the transferor; the ToA guidance calls this "the income charge".[1]

(2) **"The s.731 charge"** on individuals (other than the transferor) who receive benefits; the ToA guidance calls this "the benefits charge".

This chapter considers the requirements these charges have in common. The next two chapters consider them individually.

The 2013/14 edition of this work grumbled about the absence of HMRC guidance.[2] Be careful what to wish for! In 2013 HMRC published 150

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1 There is a third charging provision in s.727 ITA but that is is only a minor supplement to s.720. Some commentators regard the charge on enjoyment condition C as a separate charge, in which case there are said to be four charging provisions; but I prefer to classify that as a sub-rule of the s.720 charge.

2 at para 28.1: "the discussion of the provisions in International Manual 600000 contains almost nothing significant, but thirty eight paragraphs are withheld "because of exemptions in the Freedom of Information Act 2000". Information is withheld if disclosure would be likely to prejudice the collection of tax. No doubt parts of the withheld text identify tax avoidance possibilities or procedures to detect evasion and are correctly withheld. I expect that the bulk of the withheld text is simply a discussion of the law. Disclosure only prejudices tax collection if one takes the view that uncertainty in the scope of anti-avoidance law is desirable. This is constitutionally wrong. The principle of legal certainty is an important aspect of the

pages of draft guidance **("ToA draft guidance")** which will be inserted into the International Manual.[3] I set out relevant passages in this book. As a result, the 5 chapters dealing with this topic have increased from 285 pages in the last edition to about 350 pages in the present edition. The most difficult issues are hardly addressed and every important statement is qualified by words such as *normally, generally, likely, usually, broadly, depending on,* etc. Overall, I do not think public knowledge of the provisions is much improved. Perhaps it was naive to expect otherwise. But recognising the difficulty and the importance of the subject, HMRC have set up a working group to review the guidance. The optimistic reader may hope for the best.

In 2009 HMRC published guidance on the ITA remittance basis rules as they apply to the ToA provisions. This is headed TAH (presumably for Transfer of Assets Handbook). Perhaps it will eventually be incorporated into the rest of the ToA guidance.

The ToA provisions are expressed in mandatory terms, and do not only apply at the option of HMRC. This view was rightly accepted by HMRC (despite the irritation of the judge) in *Anson v HMRC*.[4] What is source for the goose is source for the gander.

28.2 "Relevant transfer"

The key concept is "relevant transfer". The ToA charges only apply if a relevant transfer occurs. Section 716(1) ITA provides:

> A transfer is a relevant transfer for the purposes of this Chapter if—
> (a) it is a transfer of assets, and
> (b) as a result of—
> (i) the transfer,
> (ii) one or more associated operations, or
> (iii) the transfer and one or more associated operations,

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rule of law. (That is the reason why the Manuals are published.) It is also pragmatically wrong. Legal certainty is in the interest of HMRC as well as private citizens. If HMRC are not prepared to state their view then private citizens must do as best they can. They can hardly be guilty of neglect if they form wrong views in this difficult area in which HMRC are themselves not prepared to comment, and this is likely to lead to loss of tax."

3 *https://www.gov.uk/government/consultations/reform-of-an-anti-avoidance-provision-transfer-of-assets-abroad*

4 [2012] STC 1014 at [18]. For the difficulties which would arise on any other view, see 32.48 (Can an individual disclaim the motive defence?).

income becomes payable to a person abroad.

This sets out the following basic conditions:
(1) *A transfer of assets*.
(2) *Income becomes payable to person abroad*.
(3) *Causation*: Condition (2) is caused by (i) the transfer, or (ii) associated operations, or (iii) both. I refer to this as "**the relevant transfer causation conditions (i), (ii) and (iii)**", or together "**the relevant transfer causation conditions**".

These basic conditions are the subject of this chapter. However the fact that there is a relevant transfer is not sufficient in itself to cause a tax charge. The further conditions in the various charging sections must be satisfied. These are considered in the next two chapters.

28.3 A "transfer" of "assets"

Section 717(a) ITA provides:

> In this Chapter—
> (a) "assets" includes property or rights of any kind

Section 716(2) ITA provides:

> In this Chapter "transfer", in relation to rights, includes the creation of the rights.

If two parties enter into a contract there are *two* transfers of assets as both parties acquire rights.

In *Brackett v Chater*[5] T entered into a contract of employment with an offshore company. Rights under a contract of employment are an "asset". Entering into a contract of employment is a "transfer". T had power to enjoy the income of the company (which was held on trusts under which T was interested) so T was taxed on all income accruing to the company as a result of the transfer.

If B borrows from L there are two transfers of assets, for B acquires the money borrowed and L acquires the benefit of the debt. If L is non-resident, then the interest is income accruing to a person abroad.

Note that there may be a "transfer of assets" in circumstances where there is no individual who is the "transferor".

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5 60 TC 134.

28.4 Person abroad

Section 718(1) ITA provides:

> In this Chapter "person abroad" means—
> (a) a person who is resident outside the UK, or
> (b) an individual who is domiciled outside the UK.

28.4.1 *UK resident foreign incorporated company*

A UK resident foreign incorporated company is not a person abroad. For the law before 2012/13, see the 2013/14 edition of this work para 28.4.1.

28.4.2 *Non-resident company with UK PE*

A non-resident company with a UK permanent establishment is subject to corporation tax on its PE income.[6] Section 3(1) CTA 2009 provides:

> The provisions of the Income Tax Acts relating to the charge to income tax do not apply to income of a company if—
> (a) the company is UK resident, or
> (b) the company is not UK resident and the income is within its chargeable profits as defined by section 19.

It is considered that s.720 and s.731 are "provisions of the income tax acts relating to the charge of income tax" so they do not apply to PE income of a non-resident company.

This makes good sense, because if the profits are subject to corporation tax, HMRC do not need the ToA provisions. This view is also supported by CTA 2009 EN:

> **Clause 3: Exclusion of charge to income tax**
> 46. This clause ensures that income of a company within the charge to corporation tax is not chargeable to income tax as well as corporation tax. It is based on section 6(2) of ICTA.

This argument was put in *IRC v Levy* but the judge expressed no view.[7] In practice the point may never arise, as it would be unusual for a company within the ToA rules to have a UK PE.

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6 See 86.1 (Why does permanent establishment matter?).

7 56 TC 58 at [87]. HMRC's answer was to rely on s.9 ICTA 1988, but I cannot see how that helps.

28.4.3 *"Resident outside the UK"*

In practice this expression has not given rise to much difficulty, but there are some interesting possible questions here. Tax statutes usually refer to a person as being "resident in the UK" or "not resident in the UK" and those are well understood expressions, usually with an express definition. "Resident outside the UK" is unusual[8] and not quite the same as "not resident in the UK".

It is suggested that:

(1) A person who is not UK resident must be resident outside the UK.[9]

(2) A person who is UK resident but also resident in another state[10] - a kind of dual residence - will be resident outside the UK.

Section 718(2) ITA provides:

> For the purposes of this Chapter, the following persons are treated as resident outside the UK–
>
> (b) the person treated as non-UK resident under section 475(3) (trustees of settlements),[11] and
>
> (c) persons treated as non-UK resident under section 834(4) (personal representatives).

This is needed because the statutory definitions which determine that trustees (and PRs) are "not resident" in the UK do not (or at least do not expressly) determine that those trustees (or PRs) are "resident outside the UK." It might perhaps have been argued that trustees who are not resident in the UK are not resident anywhere, so they are not "resident outside the UK."

The corporate residence provisions in ss13-18 CTA 2009 only apply for the purposes of Corporation Tax and so do not specifically apply for the

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8 Another example is s.721(1) ITEPA which defines "foreign employer" as "an individual, partnership or body of persons resident outside the UK and not resident in the UK."

9 Contrast *UCL v Newman* The Times, 8 January 1986 accessible *http://www.kessler.co.uk/tfd-archive*. This concerned "a rather aimless drifter who has spent his time ... "bumming" around Europe. He had never really settled anywhere." Mr Newman was not ordinarily resident in any specific state; but he was *ordinarily resident in the EU* as all his time was spend in one member state or another.

10 Most statutory residence definitions do not expressly apply to determine whether a person is resident in a foreign state, so we must muddle through without them.

11 See 5.4 (Trustee residence for income tax and CGT).

definition of "person abroad".

28.5 Income "becomes payable" to person abroad

The condition here is that income becomes payable to a non-resident or foreign domiciled person (the person abroad).

This condition is satisfied where the transfer is to a UK resident and domiciled person who later becomes non-resident or foreign domiciled.[12]

In *Latilla v IRC*[13] a partnership share was transferred to a company abroad which received its share of the partnership profits. It was argued that trading profits could not be described as income *payable* to the company. Trading "income" is the result of a computation in trading accounts. The gross receipts of the trade (or indeed gross rents of a property business) are not the income. The House of Lords rejected this argument and held that there was no difference between trading income and other types of income.[14] It seems surprising today that this technicality was thought arguable, so far has the pendulum swung from literal to purposive construction.

Suppose T transfers money to a person abroad, and the person abroad uses the funds to repay a debt. In principle, no income arises to the person abroad as a result of the transfer, so the transfer does not satisfy the transfer of asset provisions.[15]

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12 *Congreve v IRC* 30 TC 163 (a gift to a company which became non-resident), approved on this point in *IRC v Willoughby* 70 TC 57.

13 25 TC 107. I mention for completeness only that this was followed in *Brackett v Chater* 60 TC 134 & 639.

14 The same argument had been rejected in *IRC v Thompson (Receiver for Debenture Holders of John A Wood*) 20 TC 422 at p.429: "[The taxpayer's argument] was that "income" in that Rule meant the balance of profits and gains, and that the Receiver in receiving the money of the Company as it came in from time to time was not receiving the balance of profits and gains, and that therefore he was not the person who received within the meaning of that Rule. But there appears to me to be nothing in that contention. The Receiver in fact receives the proceeds of all the assets of the Company, whether they are capital or whether they are income, and in receiving the proceeds of assets which are income assets he receives the income within the meaning of that Rule."

15 The example is based on the facts of *Fynn v IRC* 37 TC 629 where the Revenue did not argue that s.720 applied, presumably, because they accepted this view was correct. Instead the Revenue argued s.727 applied: see 29.12.3 ("Connected with any relevant transaction").

28.5.1 *Transfer from one person abroad to another*

Suppose assets are transferred from one person abroad to another, eg from offshore trustees to an offshore company. Can one argue that there is no relevant transfer because one cannot say that income *becomes* payable to a person abroad? It was payable to a person abroad even before the transfer! The argument is linguistically possible, but the context shows that it is wrong. If the argument was right then a transfer by a non-resident or foreign domiciled transferor would never be a relevant transfer, which is certainly not the case.

28.6 Situs of transferred assets

The heading "transfer of assets abroad" might suggest a requirement that UK situate assets must become non-UK situate, but that is obviously not the case. After all the creation of rights may be a transfer of assets, and newly created assets are not situate anywhere before the transfer.

HMRC agree. The ToA draft guidance provides:

> **INTM600280 Where are assets located and does it matter?**
> The location of assets either before or after a transfer does not affect the application of the provisions if one of the required outcomes of a transfer is present. ...
> The heading of Chapter 2 Part 13 ITA is 'Transfer of Assets Abroad' but in fact there is nothing within the legislation itself requiring that assets have to be located outside the UK or moved from the UK abroad. In his decision in the case of *IRC v Willoughby* (70 TC 57) at page 81 the Special Commissioner appears to share this view, saying, 'In my opinion, and I so hold, this language [what was section 739(1) ICTA] may be satisfied whether the assets are transferred from the UK to outside the UK, or being outside the UK they are transferred to a person outside the UK'.

The taxpayer in *Willoughby* wisely abandoned this argument on appeal.

28.7 Transfer for full consideration

A relevant transfer may be made for full consideration and need have no element of "bounty" or gratuitous intent. (Contrast the settlement provisions.)[16] HMRC agree. The ToA draft guidance provides:

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16 See 80.2.3 (Settlement-arrangement definition of settlement).

> **INTM600240 Relevant Transaction: What is a transfer?**
> ... The fact that an individual may receive a payment or consideration in full for a movement of some form of property from one person to another does not preclude that action from being a transfer for the purposes of the transfer of assets rules.

28.7.1 *Purchase of asset from person abroad*

Suppose T buys an asset from a person abroad for cash ("the purchase price"). At first glance, the payment of the cash purchase price is a relevant transfer. The payment is a transfer of assets; as a result of the payment, income (from the cash) will normally accrue to the person abroad. However, it is suggested that this is not the case if:

(1) the asset would otherwise have yielded income to the person abroad;[17]

(2) the purchase price does not exceed the value of the asset.

In these circumstances, the person abroad acquires the income of the cash purchase price T transfers to them, but T loses the income from the asset which they sell to T. If the two (broadly) cancel each other out, it cannot be said that any "income becomes payable" to the person abroad. If that is right, the transfer of asset conditions are not satisfied every time someone sells an asset to (or buys an asset from) a non-resident person. That would be a sensible result. If T sells assets to an offshore trust, say, or to an offshore company, it would be surprising if T's only defence to ToA was the motive defence.[18]

28.7.2 *Income arising must be identifiable*

The provisions assume that one can *identify* the amount of income which arises to the person abroad as a result of the transfer. If that identification is not possible then the ToA provisions do not - indeed cannot - operate.

John Avery Jones raises this question:

> What about buying a ticket from a foreign airline, buying a meal or paying for a hotel room when abroad? There is a transfer of assets and

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17 The position would be different if T transfers assets to an offshore company in consideration of an issue of shares or debentures, or a life policy.

18 In such cases T would often have "power to enjoy". Unless this is right, there is double taxation. T may be liable under s.720 for income tax on the income arising from the asset sold to the person abroad. T is also liable to income tax on income arising from the proceeds which T receives on the sale of the same asset.
If my view is wrong, then the motive defence should be generously applied in cases of a sale for full consideration.

> it is clear that "income becoming payable" includes the receipt of sums which form part of the recipient's trading profits. Oh, and there is my IFA subscription, my subscription to *European Taxation*, my purchase of that overpriced new edition of *OECD Model Tax Convention*, and the new edition of *Klaus Vogel on Double Taxation Conventions* direct from the publisher. Foreign entities all of them. I expect if I think for a moment I shall think of lots more. What about my (foreign) car? Did I buy it from an agent for the manufacturer or from a UK subsidiary, and does it make any difference anyway?[19]

These payments are all transfers of assets, as a result of which (additional) trading[20] income in principle becomes payable to the person abroad. But none of these transfers are relevant transfers because one cannot identify the amount of income which becomes payable as a result of them.[21]

The question whether one can identify the income which arises to the person abroad as a result of a transfer sometimes overlaps with the question whether one can identify a transferor. In *IRC v Pratt* 57 TC 1 where a company made a transfer, the taxpayers were held not to be transferors because one could not identify income arising to the person abroad from what each individual taxpayer had contributed or done.[22] But the two questions are in principle distinct. An individual who subscribes for shares in (say) Microsoft Inc is clearly a transferor, but one cannot identify what income becomes payable to Microsoft as a result of that transfer, so the ToA provisions do not apply.

28.7.3 *Deposit in offshore bank account*

If T deposits money with a bank, the trading receipts of the bank are increased, though that may be reduced or almost cancelled by the interest the bank pays to T. There is still a profit overall, if the bank is profitable, but that element of profit cannot be identified. The deposit is a transfer of assets but it is not a relevant transfer because one cannot identify the income which becomes payable as a result of it.

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19 [1998] BTR 392.

20 Except in the case of the purchase of the foreign car from a UK subsidiary, where the income arising to the person abroad would be the dividend (if any) from the subsidiary.

21 Of course in practice considerations of materiality might also arise.

22 See 29.3.2 (Transfer procured by individual).

28.7.4 *Transfer for issue of shares or debentures*

Suppose T transfers an asset to a foreign company in exchange for the issue of shares or debentures in that company (set up for the purpose and wholly owned by a trust or structure set up by T). This may well be transfer for full consideration. It is nevertheless a relevant transfer. Indeed it is the archetypal ToA situation. Tax avoidance arrangements set up in the 1920s and 1930s typically involved the transfer of assets to a Canadian company in consideration of debentures issued by that company.

Contrast the position if T subscribes for shares or debentures in (say) a large quoted foreign company or collective investment scheme. This is not a relevant transfer as one cannot identify the income which arises as a result of the transfer.

28.7.5 *Transfer for issue of bond or life insurance policy*

The same applies if T subscribes for a bond or life insurance policy from a large foreign institution. One cannot normally identify the income arising to the institution as a result of the transfer so this is not a relevant transfer. However, if the transfer is linked to particular investments actually made by the institution (as is usually the case for a personal portfolio bond), it would in principle be possible to identify the income, and there would be a relevant transfer.

28.7.6 *HMRC view*

EN FB 2006 states:

> [1] The [ToA] provisions do not affect an individual's personal direct offshore investments. They only apply where an individual is able to enjoy income in a form that would otherwise be non-taxable (or subject to a lower rate of taxation), and there is a purpose to avoid UK tax.
> [2] So the legislation would not apply where, for example,
> [a] a UK resident invests directly in an offshore bank account or
> [b] buys shares in a company quoted on an overseas stock exchange,
> because the income arising from such investments remains liable to UK tax in the usual way.[23]

23 EN to s.79, para 63.

Example [a] is the person who invests[24] in an offshore bank account. That person makes a transfer of assets to a person abroad (the bank). It is broadly[25] true that the income from such investments (ie bank interest) "remains liable to tax in the usual way". But while this explains why HMRC do not wish to apply s.720 ITA, it does not actually offer any defence to the provisions.[26] (This fact is relevant to the motive defence, but it would be surprising if the only defence to s.720 was the motive defence.)[27] The true reason is that one cannot identify any income of the bank which becomes payable as a result of the transfer, so the transfer is not a relevant transfer.

Example [b] is the person who buys shares on an overseas stock exchange. The example is misconceived and perhaps the less one says about it the better. But in brief: a person who buys shares does not make a relevant transfer, unless the vendor is abroad; and the fact that the shares are "quoted on an overseas stock exchange", like the flowers that bloom in the spring, has nothing to do with the case. If the vendor is abroad (perhaps the EN assumes this) the transfer is not a relevant transfer for the reason set out above.

Whatever one thinks of the reasoning of the EN, it does appear that the conclusions reached in this section would generally be acceptable to HMRC.

28.8 Income accruing to person abroad: Causation conditions

There is not a relevant transfer merely because there has been a transfer of assets and income has become payable to a person abroad. The income must become so payable as a result of the transfer (or associated operations). The test is one of causation.

28.8.1 *Purchase of secondhand company by individual*

Suppose T (UK resident) buys the shares of an already existing non-

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24 A loan or deposit in a bank account may not be an "investment" in the strict sense of the term, but the EN is not using the term "invest" in its strict sense.

25 It is not strictly true that income from an offshore bank account remains liable to UK tax "in the usual way". A remittance basis taxpayer may invest in a foreign account to qualify for the remittance basis. An arising basis taxpayer obtains the tax advantage that tax is not deducted at source, and DT relief may apply.

26 See 29.4 (Must the transferor avoid or intend to avoid IT?).

27 No-one expects the depositor to claim the motive defence in their tax return.

resident company ("**a secondhand company**"). Assume the company owns assets. That purchase involves a transfer of assets by T – payment of the purchase price[28] – is described in the following discussion as "**the purchase price transfer**".

It is the case that income accrues to a person abroad (the company). However, it cannot be said that the income became payable to the company as a result of the purchase price transfer. The company merely continues to receive the income from its own assets, as it did before, and is not in any way affected by the change in ownership of its shares. Thus if the vendor is UK resident and domiciled, the purchase price transfer is not a relevant transfer.

Now suppose T purchases the shares from a person abroad. In that case the purchase price transfer may be a relevant transfer because the vendor may invest the proceeds of sale and receive income as a result of that transfer. However, the income arising as a result of the purchase price transfer would be the income accruing to the vendor, not the company's income.

In these cases there will have been (at least) one other transfer of assets, the transfer of assets to the secondhand company (eg on a subscription for the company's shares). I call this "**the company funds transfer**". The company funds transfer is a relevant transfer. If T is the transferor of that transfer then T will in principle be within s.720 and taxed on the secondhand company's income.[29] If T is not the transferor, T may be subject to tax under s.731 if T receives benefits (unless the company funds transfer qualifies for the motive defence).

The secondhand company may later make a relevant transfer.[30] If T procures that transfer, T is its transferor.

28.8.2 *Purchase of secondhand company by holding company*

Now suppose:

(1) T transfers assets to H Ltd, an offshore company ("**the H transfer**").

(2) H uses its funds to purchase a secondhand company ("**the purchase**

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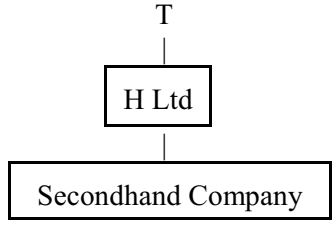
28 The sale in fact involves two transfers of assets: payment of the purchase price to the vendor and transfer of the shares to T.

29 As to whether T is the transferor, see 29.3 (Who is the transferor?).

30 For instance, a transfer to a non-resident subsidiary. A straightforward sale of assets by the company may not be a relevant transfer because no income becomes payable. See 28.7.1 (Purchase of asset from person abroad).

price transfer").

Thus the position is:



A similar analysis applies:

(1) The H transfer is in principle a relevant transfer. However, no income arises to a person abroad as a result of that transfer.[31]

(2) The purchase price transfer is not a relevant transfer. No income accrues to a person abroad as a result of that transfer. Income does arise to the secondhand company, but not as a result of the H transfer or the purchase price transfer.

Suppose H Ltd then provides additional funds for the secondhand company, directly or indirectly. It appears then that the secondhand company will receive income as a result of the H transfer[32] and T will be subject to tax under s.720 on the income accruing to the secondhand company from the additional funds, if that income can be identified.

28.9 Associated operation: Definition

Section 719(1) ITA provides just about the widest definition the drafter could devise:

> In this Chapter "associated operation", in relation to a transfer of assets, means an operation of any kind effected by any person in relation to—
>
> (a) any of the assets transferred,
>
> (b) any assets directly or indirectly representing[33] any of the assets

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31 Assume no income accrues to H (the secondhand company does not pay a dividend).

32 Together with an associated operation (the provision of funds by H).

33 "Representing" is defined in s.717(b) ITA:

> "references to assets representing any assets, income or accumulations of income include references to—
>
> (i) shares in or obligations of any company to which the assets, income or accumulations are or have been transferred, or
>
> (ii) obligations of any other person to whom the assets, income or accumulations are or have been transferred."
>
> Thus if (1) T transfers assets to a company and (2) T transfers the shares in the

transferred,

(c) the income arising from any assets within para (a) or (b), or

(d) any assets directly or indirectly representing the accumulations of income arising from any assets within para (a) or (b).

I refer to items (a) to (d) as **"the assets transferred"**.

An associated operation does not exist in isolation, it exists in relation to a transfer. I refer to that as being associated with the transfer. There are two requirements:

(1) It must be an "operation".

(2) It must be "effected in relation to" the assets transferred by the transfer.

The term "associated operations" is also used in the IHTA. However the definition is different, so only limited assistance can be drawn from IHT cases.

28.9.1 *"Operation"*

"Operation" is (rightly) not defined but is clearly a word of wide import. It includes a company becoming non-resident.[34] It does not include death, but that does not matter because it does include the act of making a will.[35]

In *Herdman v IRC* 45 TC 394 there was a sale (ie transfer) of assets to an Irish company. The company then "accumulated" income and "managed" its assets so as to be able to repay a loan to the transferor. These were held to be "operations" by most of the judges but this is obiter and difficult to accept. Unlike IHT, operation does not include an omission. A company does not "accumulate" income (in the legal sense). If "management" is an operation then everything is an operation (all assets must be "managed") and the expression makes no sense. Lords Pearce and Reid (more judiciously) left open the question of whether these were "operations".

---

company to another person, the second transfer is an associated operation in relation to the first. This would not have been clear without the definition.

34 *Congreve v IRC* 30 TC 163.

35 *Bambridge v IRC* 36 TC 313. This case contains Harman's aphorism: "Death, as we know, is an awfully big adventure, but even the Crown admits that it is not an associated operation." More analytically, death is not an associated operation as it is not "effected by a person in relation to assets".

28.9.2 *Effected "by any person"*

The ToA draft guidance provides:

> **INTM600300 Relevant Transaction: Associated operations**
> ... An operation effected by someone other than the transferor can be an associated operation as the legislation states it can be effected by any person. This is demonstrated in a number of tax cases. *Corbett's Executrices v IRC* 25 TC 305 involved the transfer of an interest in an estate to a UK resident company which subsequently sold some of the investments transferred to a company resident overseas. It was held that the transfer to the overseas company was associated with the transfer to the UK resident company. In *Herdman v IRC* 45 TC 394 it was held that following a transfer to a company the accumulation of income by that company and the management of the assets transferred was an operation associated with the original transfer.

28.9.3 *"Effected in relation to" the assets transferred*

In *Fynn v IRC*:[36]

(1) In 1948 T transferred assets to an Irish company ("the original transfer").
(2) In 1952 T lent money to the company ("the 1952 loan").

The 1952 loan was not an associated operation in relation to the original transfer, because it was not effected "in relation to" the assets transferred by the original transfer.

In *Carvill v IRC*:[37]

(1) T transferred assets to a Bermudian company (B Ltd) in exchange for shares, and so became a majority shareholder in B Ltd ("the original transfer").
(2) T became a 100% shareholder in B Ltd by (a) purchasing shares and (b) B Ltd purchasing its own shares.
(3) B Ltd entered into arrangements to remunerate T via a personal services company and a brokerage sharing agreement.

Steps (2) and (3) were not associated operations, as they were not effected in relation to the assets transferred by the original transfer.

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36 37 TC 629.
37 [2000] STC (SCD) 143 at [80]-[85], 75 TC 477 (Special Commissioners).

28.9.4 *Associated operation preceding the transfer*

Section 719(2) ITA provides:

> It does not matter whether the operation is effected before, after, or at the same time as the transfer.

This provision (introduced in 2006) gives statutory effect to the view formerly expressed in RI 201.[38] I cannot think of a practical case where it would matter and would be grateful to any reader who could explain why HMRC thought this point was worth legislating for.

28.9.5 *Is mere historical association enough?*

On a simply reading of the definition, an operation can be associated with an earlier transfer even if the two were not part of any plan and many years apart. Suppose:

(1) A transfers an asset to B (who is UK resident) in 1970; and
(2) B transfers the asset in the year 2010 to an offshore trust under which A may benefit.

On a simple reading, B's disposition is an associated operation in relation to A's transfer even though:

(1) they are not part of a single arrangement;
(2) A is unaware of B's disposition;
(3) B's disposition is itself a relevant transfer;
(4) one or both transfers is a sale on arm's length terms.

The same would apply if A's transfer was made in 1870 or 1670. Indeed, anyone who purchases or disposes of an estate in English land is only effecting the most recent operation of a series of associated operations (dispositions of the land) which may perhaps be traced back to the Norman Conquest if not before, and only a lack of records prevents one tracing the sequence of associated operations to the dawn of civilisation. In fact this simple reading cannot be right, for reasons given below.

28.10 Significance of associated operations

It is never enough to establish that there is an associated operation in

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38 "... an associated operation does not necessarily have to take place after a transfer of assets. A transaction undertaken 'in relation to' a transfer of assets can precede the transfer."
That seemed right. The FA 2006 gave no thought to transitional provisions but in the circumstances it does not matter.

relation to a transfer. This is just the first step. One must then go on to ask what (if anything) follows. The term "associated operations" is used in the definition of "relevant transfer"[39] and it is used in the definition of "relevant transaction"; s.715(1) ITA provides:

> A transaction is a relevant transaction for the purposes of this Chapter if it is—
>
> (a) a relevant transfer, or
>
> (b) an associated operation.

The existence of associated operations is therefore relevant to the following:

(1) *Section 716 ITA*: Income becomes payable to person abroad as a result of transfer and/or associated operations.[40]

(2) *Section 721 ITA*: Individual has "power to enjoy" as a result of transfer and/or associated operations.

(3) *Section 729 ITA*: Individual receives capital sum connected with any relevant transaction.

(4) *Section 732 ITA*: Individual receives a benefit as a result of the transfer or associated operations.[41]

(5) *Section 733 ITA*: "Relevant income" is income which can as a result of the transfer or associated operations be used for providing a benefit.[42]

(6) *Motive defence*: All relevant transactions must satisfy the conditions of the motive defence.[43]

The ToA draft guidance provides:

> **INTM600300 Relevant Transaction: Associated operations**
>
> ... The same associated operations do not have to be taken into account in every context where it is necessary to consider 'associated operations'. For example, a transfer together with an associated operation may result in income becoming payable to a person abroad, but it may be a quite different associated operation in relation to a transfer that results in the power to enjoy that income.

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39 See 28.2 ("Relevant transfer").

40 See 28.11 (Person abroad receives income as indirect consequence of transfer).

41 See 30.8 (Benefit causation condition).

42 See 30.31 (Is income of company held by a trust relevant income?).

43 See 32.39 (Associated operations and motive defence before 5 December 2005) and 32.40 (Transfer and associated operations both after 4 December 2005).

28.11 Person abroad receives income as indirect consequence of transfer

28.11.1 *Transfer from A to B followed by transfer from B to person abroad*

Suppose:

(1) In 1970 A transfers an asset to B (who is a UK resident individual) ("A's transfer").
(2) In 2000 B transfers the asset to an offshore trust ("B's trust") under which A may benefit ("B's transfer").
(3) A's transfer and B's transfer are not part of a single arrangement and A is unaware of B's transfer.

B's transfer is obviously a relevant transfer. The question is whether A's transfer is a relevant transfer.

It may be helpful to recap the definition. Section 716(1) ITA provides:

> A transfer is a relevant transfer for the purposes of this Chapter if—
> (a) it is a transfer of assets, and
> (b) as a result of—
> (i) the transfer,
> (ii) one or more associated operations, or
> (iii) the transfer and one or more associated operations,
> income becomes payable to a person abroad.

I refer to (i) to (iii) as "causation conditions (i) to (iii)".

A's transfer meets condition (a): it is a transfer of assets. Income becomes payable to a person abroad. Causation condition (i) is not satisfied, that is, it is not as a result of A's transfer alone that income has become payable to the offshore trustees. However, B's transfer is at first sight an "associated operation" in relation to A's transfer. It seems at first sight that causation condition (ii) is satisfied: income becomes payable to the trustees as a result of the associated operation (B's transfer); so A's transfer is a "relevant transfer" and A is taxable under s.720 on the income of B's trust! This clearly cannot be right; but why not? The motive defence is not a satisfactory solution to this problem:[44] one must conclude that A's transfer is not a relevant transfer, that is, it does not satisfy causation condition (ii) or (iii). How do we reach this result?

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44 The motive defence could not help if either A's transfer or B's transfer was made for tax avoidance reasons; or even if B's transfer was innocent but A was unable to prove it: see 32.39 (Associated operations and motive defence before 5 December 2005).

28.11.2 *Position before 2007/08*

Before 2007/08 the ToA provisions applied a more limited causation test. They only applied to:

> transfer of assets *by virtue or in consequence* of which, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled outside the UK.

This applied causation condition (i) and (iii) but not causation condition (ii).

In the 5th edition of this book I said:[45]

> ... the key to making sense of "associated operations" everywhere in the ToA provisions rests on the concept of causation. In the example above, although income accrues to the offshore trustees, it does not do so "in consequence" of A's transfer *in conjunction* with B's transfer. The only cause is B's transfer.
>
> But for A's transfer, B's transfer would not have happened, and so income would not become payable to the person abroad. However, causation in law (and indeed in ordinary English usage) does not apply a simple "but for" test. B's transfer as an independent act will "break the chain of causation". That is, the reference to words of causation requires one to identify the real or effective or operative cause of the fact that income accrues to a person abroad (which in this case is B's transfer). There must be "sufficient causal connection."

So I concluded:

> Although the statutory words are different, it is suggested that the appropriate test is the "clean break" test, i.e. is A a settlor of B's trust, did A provide the property indirectly?

28.11.3 *Position from 2007/08*

Unfortunately the key which allowed the reader to make sense of the provisions was discarded in the tax law rewrite.[46] I infer that HMRC found causation an inconvenience, so they relaxed it, by adding causation condition (ii). But no consideration was given to the consequences. The

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45 5th edition, para 14.11. Footnotes omitted.

46 The rewrite team might say that s.742(1A) ICTA (introduced in 2006) made this change. That was arguably not the correct view of that provision, but it does not now matter.

result is a gap which the courts will have to fill up as best they can. It continues to be the case, in the example above, that A *cannot* be the transferor and within s.720. But on what grounds can one reach that result? Something must be read into the statutory wording.

One solution is to say that there can only be one transferor; since B is clearly a transferor, A is not to be regarded as transferor. This has some support in *Vestey* 54 TC 503.

The best solution, now the key to understanding associated operation rules, is to say that an operation cannot be associated with a transfer unless the transfer and the operation are "put in train" by one person. Mere historic association is not enough to constitute "associated operations" for the purposes of the Act. There must be something more.[47] In an ideal world, Parliament should have identified that "something more" and not leave the job of constructing workable legislation to the courts. But there it is. It is suggested that the test for associated operations is the "clean break" test, ie is A a settlor of B's trust, did A provide the property indirectly?[48] If not, the operations are not associated.

This view is supported in *Corbett*:

> The interval during which the beneficiaries were thinking out their "associated operations" could not make any difference to the legal conclusion, *unless the Special Commissioners had found as a fact that it negatived the "conjunction" or association between the two operations* - the transfer to and the transfer by Woodgate.[49]

28.11.4 *Transfer to UK trust followed by migration of trust before 6 April 2006*

Suppose:

(1) In 1970, A transfers assets to a discretionary trust with UK trustees ("A's transfer");

(2) In 2000, the UK trustees appoint foreign trustees in their place and transfer the trust assets to them ("the appointment of foreign

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47 Contrast the approach to "disposition by associated operations" in *IRC v Brandenburg* [1982] STC 555, where Special Commissioners added a gloss that a disposition made by associated operations (for IHT purposes) must be "put in train" by one person: see Venables, "Gifts by Associated Operations" 5 PTPR 11, accessible *http://www.khpplc.co.uk/reviews*

48 See 80.4 (Gift from A to B followed by gift to trust by B).

49 25 TC 305 at p.394.

trustees").

The appointment of foreign trustees is a relevant transfer. (The appointment of foreign trustees involves a transfer of assets, as a result of which income accrues to the non-resident trustees.) The question is whether A's transfer does likewise. That is, is it a relevant transfer?

A's transfer alone does not satisfy causation condition (i). Income becomes payable to a person abroad. But causation condition (i) is not satisfied because it is not as a result of A's transfer alone that income has become payable to the offshore trustees. However, the appointment of foreign trustees is an "associated operation" in relation to A's transfer. Before the ITA 2007, the question was whether A's transfer in conjunction with the associated operation together satisfied the causation condition. It is considered that it was as a result of the transfer in conjunction with the associated operation that the income accrued to the foreign trustees. This was so even if the appointment was not envisaged at the time of the transfer to the original settlement. With the current wording, the literal reading is that A's transfer is a "relevant transfer". This is simply because the appointment of foreign trustees is an associated operation, and income becomes payable to a person abroad as a result of that operation; causation condition (ii) is satisfied. Although some gloss is required to make the section work, in other cases, as discussed above, that gloss is not likely to alter the result in this case.[50]

28.11.5 *Transfer to trust followed by transfer from trust to offshore company*

This is in principle the same as 28.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006). This applies whether the transfer by the trustees is gratuitous or in exchange for shares, debentures or an offshore life policy. But if the investment is for wholly commercial

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50 The position in 28.11.1 (Transfer from A to B followed by transfer from B to person abroad) is different. There B's transfer is independent in a way that trustees are not, because trustees are constrained by the fiduciary nature of their powers.
This view is also supported by obiter dicta in *Congreve v IRC* 30 TC 163. This concerned a gift to a UK company which became non-resident. This was a relevant transfer without the association operations rule. See 28.5 (Income "becomes payable" to person abroad). But the House of Lords also held (at p.206) that the company becoming non-resident was an associated operation; and (by inference) income arose to the company abroad as a result of the transfer and associated operation.
HMRC would have further arguments, if necessary, based on *Muir v Muir* [1943] AC 468.

reasons, it may be argued that is not the case and so the income of the underlying company is not within the ToA provisions, but this requires the Courts to read words into the statute, and the case for doing so here is not strong enough.

28.11.6 *Transfer to company followed by migration of company*

This is a relevant transfer even without the associated operations rules.[51]

28.11.7 *Transfer to UK trust followed by migration of trust from 6 April 2006*

Suppose the facts of 28.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006), but assume the migration occurred after 6 April 2006. The trust is deemed to be a single person. The analysis is therefore different. The appointment of foreign trustees does not involve any transfer. Instead the analysis is the same as 28.11.6 (Transfer to company followed by migration of company). The end result is the same, though the route to that destination is different.

28.12 Income of person abroad

The concept of "income of the person abroad" is relevant for several purposes of the ToA provisions:

(1) There is a relevant transfer only if "income becomes payable" to a person abroad. If *no* such income becomes payable then there is no relevant transfer and the ToA provisions cannot come into effect.

(2) The *identity* of the income payable to the person abroad as a result of the transfer is relevant:
   (a) for s.720 ITA, as one must ask whether the transferor has power to enjoy that income;
   (b) for s.731 ITA, as one must ask whether that income can be used to benefit an individual.

(3) The *amount* of income payable to the person abroad as a result of the transfer is relevant as ascertaining that amount is the first step in computing the amount on which tax is charged under s.720 or relevant income for s.731.

28.13 Capital receipts deemed to be income

The transfer of asset rules refer to "income". This means "income for

51 See above footnote

income tax purposes" which is a different concept from "income for trust law purposes" or "income for accountancy law purposes".

The ToA draft guidance provides:

> **INTM600400 Income becomes payable to person abroad: Income**
> ... As well as items that are specifically treated as income there are also items treated as income for some income tax purposes but which may not be income of a person abroad for the purpose of transfer of assets. In considering whether any item is income it is relevant to consider its character in the hands of the person who actually receives it. In the absence of a specific provision that identifies a particular item as income for all UK tax purposes or specifically for the purpose of the transfer of assets legislation, if it is not income in the hands of the person abroad who actually receives it then it is unlikely to be income for the purpose of transfer of assets....

28.13.1 *Dividends, etc*

Section 383 ITTOIA provides:

> (1) Income tax is charged on dividends and other distributions of a UK resident company.
> (2) For income tax purposes such dividends and other distributions are to be treated as income.
> (3) For the purposes of subsection (2), it does not matter that those dividends and other distributions are capital apart from that subsection.

This applies for the purposes of the ToA provisions and s.624 ITTOIA, so the distribution on a purchase of own shares, for instance, is income for those purposes[52] even though it is a capital receipt for trust law purposes. Likewise income deemed to accrue on a stock dividend under s.410 ITTOIA and a gain deemed to be income under s.688 ITA (transactions in land). But HMRC do not agree. The ToA draft guidance provides:

> **INTM601160 the income charge: what is the measure of income: stock or scrip dividends**
> Where an individual owns shares in a UK resident company that makes a stock or scrip dividend payment (see CTM17005), in respect of those shares, that individual is treated for UK income tax as having received an amount of income equal to the appropriate amount in cash. The amount is however only regarded as the income of the individual and is

52 This is assumed to be the case in the drafting of s.482 ITA.

not regarded as income for all purposes of the Taxes Acts. Thus if the person abroad is, for example, a company, that stock dividend from a UK company would not on the face of it be income in the company's hands. As such it would not be taken into account as income that becomes payable to a person abroad for the purposes of transfer of assets.

The position for a stock dividend from a foreign company may however be different. The provisions relating to stock dividends in Chapter 5 Part 4 ITTOIA only apply in respect of stock dividends from UK companies. In considering such an item received from a foreign company regard would need to be taken of the relevant foreign law as well as the character in the hands of the receiver. If it is not income in the hands of the person abroad or otherwise specifically treated as income it will fall outside the transfer of assets provisions.

On gains from offshore funds: see 35.10 (OIG arising to non-resident trust). On gains from life policies see 33.7 (Non-resident trusts and companies) and 33.7.2 (Non-resident company or institution).

28.14 The amount of income of person abroad

This section considers the amount of the income arising to the person abroad as a result of the transfer and associated operations.

28.14.1 *Dividend income of person abroad: Net or grossed up?*

In order to follow the discussion one needs to bear in mind the usual rules for taxing a UK dividend.[53] In short, a UK resident or EEA national receives a tax credit and the dividend is grossed up. For instance:

Dividend £1,000 **("net amount")**
Tax credit (one ninth) £111
Dividend plus tax credit £1,111 **("gross amount")**

A person abroad who is not resident in the EU is not normally entitled to a tax credit and the income is not grossed up.

For s.720 purposes, it is considered that dividend income should be grossed up: see 46.6 (Rates of tax on transferor within s.720 ITA).

For s.731 purposes:

(1) If the person abroad was not entitled to a tax credit, the amount of a

53 See 20.2 (Income from UK resident company). References in this section to dividends also include other company distributions.

dividend would be the net amount.

(2) If the person abroad was entitled to a tax credit the amount of a dividend would be the gross amount. However, the relevant income is only the amount which can be applied for the benefit of any person so the amount of relevant income is the net amount.

HMRC agree. The ToA draft guidance provides:

> **INTM601240 what is the measure of income: dividends**
> Income tax is charged on dividends and other distributions from UK companies under section 383 ITTOIA 2005. If the income of the person abroad is dividend income it is unlikely that the person abroad will be entitled to a tax credit on the dividend and the amount included in the accounts is likely to be the net dividend. Where the income charge applies to this see (INTM602520)
> In arriving at the amount of UK source dividends to be taken into account in the amount of income charge, the net dividend should be grossed up by reference to the tax credit and the gross dividend taken into account. Such income is treated as arising to the individual, and being ordinarily resident in the UK, would be entitled to the tax credit.
> ...
> **INTM602520 Deductions and reliefs**
> If the income of person abroad is UK source dividends, the dividends would have to be grossed up before allocating the tax credit. For years up to and including 1998-99 the recipient of the distribution was entitled to a tax credit equal to such proportion of the amount or value of the distribution as corresponded to the rate of advance corporation tax in force for the financial year in which the distribution was made. Dividends for subsequent years carry a notional tax credit. This treatment would not normally apply to non-resident shareholders, but if the income is notionally treated (for example under the income charge provisions) as that of a UK resident, the same consequences follow as for an actual recipient.
> Where the income of the person abroad is foreign source dividends there would not normally be a tax credit available. However from 2008-09 section 397A ITTOIA 2005 provides for tax credits in respect of distributions from non-UK resident companies. Where the distributions are treated under any of the provisions of the Taxes Acts as the income of a person other than the recipient then that person is treated as receiving it This means that where the income charge under the transfer of assets provisions is in point a tax credit of 1/9th of the amount or value of the grossed up distribution is available to persons holding less

> than 10% of the share capital of the company concerned, and subject to certain other conditions within that legislation. ...
> As far as the benefits charge is concerned no tax credits are available either in respect of UK or of foreign source dividends of a person abroad. However the amount of relevant income will be the net dividend after any tax charge.

28.14.2 *Deduction of administration costs against investment income*

In *Chetwode v IRC* 51 TC 647 an offshore company received dividends and interest of about £3,000 per annum. The transferor was taxed on the gross amount of that income, without deduction for (i) investment advisory fees, (ii) management fees, (iii) safekeeping charges, (iv) security handling fees and bank charges, (v) registered office and executive office fees, totalling about £1,000 per annum. The approach of *Chetwode* was that s.720 should be construed so as to put the transferor in the same position as if he had retained the assets himself. Had he done so he could not have deducted these investment costs for the purposes of calculating his income. So there was no deduction for s.720 purposes. This is consistent with s.624.[54]

HMRC allowed deductions in respect of estimates of such costs of collecting the investment income as would have been incurred had the investment income been instead received by the transferor in person. This was calculated (how?) at about £20 per year. There is no statement on whether this concessionary practice still obtains but it is (perhaps) worth claiming it to see.

For s.731 purposes expenses will be deducted in computing relevant income.

28.14.3 *Trading income and trading losses of person abroad*

It was accepted in *Chetwode* that trading income of the person abroad is calculated by setting trading receipts against trading expenses.[55] The case does not discuss whether trading income is calculated:

(1) by accountancy principles, under which statutory non-deduction provisions such as s.34 or s.45 ITTOIA would not apply, and depreciation would in principle be allowed; or

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54 See 27.2.6 (Trustee expenses).

55 See at p.687 "In the case of a trade, it is necessary to strike a balance, in respect of a period, before any taxable "income" arises."

(2) by tax principles applicable to calculating trading profits.

The approach of *Chetwode* suggests that the second is the correct view.

HMRC agree. The ToA draft guidance provides:

> **INTM601120 the income charge: trading companies**
> The income of a trading company which is to be taken into account for the purposes of the income charge is generally the balance of profits that would be chargeable to tax in the UK. Therefore in arriving at this amount regard should be had to the provisions in Part 2 ITTOIA 2005. It may be that deductions are claimed in respect of emoluments paid by a company to the individual who is subject to the income charge. If a deduction is allowable under 'normal principles' as above then, although the amount within the income charge is effectively reduced, emoluments are within the direct income tax charging rules.

Profits are computed on a current year basis[56] but that does not much matter after the abolition of the preceding year basis (which used to apply to trading income).

For losses, RI 201 provides:

> The Revenue's practice is only to allow trading losses to be carried forward and set against future trading profits. They cannot be offset against investment income of the same, previous or future years.[57]

The ToA draft guidance makes the same point:

> **INTM601120 the income charge: trading companies**
> ...In circumstances where an offshore company's trading expenses exceed its income the result will be a loss. The transfer of assets provisions are charging provisions only and, specifically, charge income treated as being that of the individual. There is no provision for treating such a loss as that of the individual.
> However it is HMRC's practice to allow an offshore company's trading losses to be carried forward and to be set off against the future profits of the company. They cannot be offset against the company's investment income of the same, previous or future years. ...

For s.731, losses will be deducted in computing relevant income if paid out of relevant income. There is no group relief.

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56 *Vestey v IRC* 54 TC at p.528 (Special Commissioners).

57 This is consistent with the position for property income losses. See 27.2.5 (Property business losses).

28.14.4 *Property income of person abroad*

The rules for measuring property income are the same as for the settlement provisions; see 27.2.4 (Property Business Income). Transfer pricing may also need consideration here.

The ToA draft guidance provides:

> **INTM601280 what is the measure of income: income from property**
> Where there is rental income, any profits should be arrived at in accordance with the rules in Part 3 ITTOIA 2005 [and Part 4 Corporation Tax Act 2009?].

28.14.5 *Loan relationship and Forex income*

Since income is computed on IT principles, "income" does not include profits computed under loan relationship or Forex rules which apply for the purposes of corporation tax and not for IT purposes. This is so even if the person abroad is a company.

HMRC agree. The ToA draft guidance provides:

> **INTM601120 the income charge: trading companies**
> It should be noted that forex and loan relationship rules apply for Corporation Tax purposes only.

28.14.6 *Exchange rate profits/losses*

The ToA draft guidance provides:

> **INTM601260 what is the measure of income: profit on exchange**
> If the accounts of a person abroad show a profit on exchange, this should not be treated as income of the person abroad for the purposes of the income charge. The profit usually derives from a difference between the exchange rates in force when the income is credited in the accounts of the person abroad and the rates ruling:
> - when that income is actually remitted to the person abroad, or
> - if not remitted, at the date to which the accounts are made up.
>
> The income as it arises to the person abroad is to be deemed to be that of the individual (*Chetwode v IRC*, 51 TC 647) and we are therefore concerned only with the exchange rates in force at the time when the income is receivable by the person abroad. A profit on exchange is merely a book-keeping entry necessary to ensure that the cash position of the person abroad tallies with the income actually remitted, or which could be remitted at the date at which the accounts are made up.

> On the same basis, any loss on exchange should not reduce the income of person abroad in arriving at the income charge.

28.15 ToA EU law defence

28.15.1 *EC infringement proceedings*

In 2011 the European Commission formally requested the UK to amend the ToA provisions and s.13 TCGA.[58] The request took the form of reasoned opinions, the second step of the infringement procedure.[59] The text of the reasoned opinions was not published, but an EC press release provided the main details:

> The first infringement relates to the UK's "transfer of assets abroad" legislation. Under this legislation, if a UK resident individual invests in a company by transferring assets to it, and if this company is incorporated and managed in another Member State, then the investor is subject to tax on the income generated by the company to which he/she contributed the assets. However, if the same individual invested the same assets in a UK company, only the company itself would be liable for tax.

The EC analysis was as follows:

> In both cases, the Commission considers there to be discrimination, seeing as investments outside the UK are taxed more heavily than domestic investments. The difference in tax treatment between domestic and cross-border transactions restricts two fundamental principles of the EU's Single Market, namely of the freedom of establishment and the free movement of capital ....
> The Commission is of the opinion that both restrictions are disproportionate, in the sense that they go beyond what is reasonably necessary in order to prevent abuse or tax avoidance and any other requirements of public interest.[60]

The ToA rules (unlike s.13 TCGA) have no *de minimis* exception so the provisions potentially fall within the free movement of capital and not just freedom of establishment. This is significant in relation to non-EU states.

In response Parliament enacted s.742A ITA; I refer to this as **"the EU law defence"** (or where comparing it to other EU law defences, "the ToA EU law defence").

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58 See 35.15 (EU law compliance).

59 Art.258 TFEU.

60 IP/11/158, 16 February 2011. The CIOT had lobbied the EC to take this step.

The background can be traced through HMRC consultation and response documents[61] but these are now mainly of historic interest.

28.15.2 *The EU law defence*

Section 742A(1) ITA provides:

> Subsection (2) applies for the purpose of determining the liability of an individual to tax under this Chapter by reference to a relevant transaction if—
>
> (a) the transaction is effected on or after 6 April 2012, and
>
> (b) conditions A and B are met.

I refer to **"EU law conditions A and B"**.

Assuming these conditions are satisfied, s.742A(2) ITA provides the relief:

> Income is to be left out of account so far as the individual satisfies an officer of HMRC that it is attributable to the transaction.

The EU law defence shares some common features with the ToA motive defence, so the following issues are considered elsewhere:
32.45 (Tax return: Disclosure of motive or EU law defence claim).
32.47 (Appeals).
32.48 (Can an individual disclaim the motive or EU law defence?).

28.15.3 *Attribution of income*

The EU law defence requires one to ascertain what income is attributable to the transaction. Suppose:

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61 HMRC, "Reform of two anti-avoidance provisions (i) the attribution of gains to members of closely controlled non-resident companies, and (ii) the transfer of assets abroad" (July 2012).
HMRC, "Reform of two anti-avoidance provisions: (i) the attribution of gains to members of closely controlled non-resident companies, and (ii) transfer of assets abroad Summary of Responses" (December 2012)
https://www.gov.uk/government/consultations/reform-of-an-anti-avoidance-provision-transfer-of-assets-abroad
HMRC, "Reform of an anti-avoidance provision: Transfer of Assets Abroad" (July 2013) *http://www.hmrc.gov.uk/budget-updates/11dec12/774-776.pdf*
HMRC, "Reform of an anti-avoidance provision: Transfer of Assets Abroad Outcome of Consultation" (December 2013)
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/267976/Transfer_of_assets_outcome_of_consultation.pdf

(1) Before 2012, T makes a transfer of assets to non-resident company within s.720.
(2) After 2012, the company uses the funds in a transaction which meets EU law conditions A and B, and which generates income. For instance:
  (a) the company buys and sells (in a trading transaction).
  (b) the company acquires income producing assets.

It is suggested that the income is attributable to the post-2012 transaction.

28.15.4 *EU law condition B: Genuine transaction*

It is convenient to deal first with EU law condition B.

Section 742A(5) ITA provides:

> Condition B is that the individual satisfies an officer of Revenue and Customs that, viewed objectively, the transaction must be considered to be a genuine transaction having regard to any arrangements under which it is effected and any other relevant circumstances.

The requirement is that the transaction must be "genuine". The rest is just verbiage.

"Genuine" is best regarded as a label for a complex set of rules. In order for a transaction to qualify as genuine:

(1) (a) The transaction must meet the arm's length requirement in s.742A(6); or
  (b) The transaction must meet the non-arm's length requirement in s.742A(11).

(2) The transaction must meet the commercial substance requirement in s.742A(8).

These rules are expressed to be "without prejudice to the generality of subsection (3)(a) or (5)" so the transaction must also be "genuine" in the ordinary meaning of the word. The word "genuine" has various meanings,[62] but none of them make sense here so it is suggested that a transaction which meets these conditions is "genuine".

28.15.5 *"Genuine": Arm's length requirement*

Section 742A(6) ITA provides:

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62 In a legal context, the meanings are primarily: (1) not a sham; (2) not tax avoidance (3) an intensifier; see 32.17.3 ("Genuine").

> Without prejudice to the generality of subsection (3)(a) or (5), in order for the transaction to be considered to be a genuine transaction the transaction must not—
>
> (a) be on terms other than those that would have been made between persons not connected with each other dealing at arm's length, or
>
> (b) be a transaction that would not have been entered into between such persons so dealing,
>
> having regard to any arrangements under which the transaction is effected and any other relevant circumstances.

I refer to this as **"the arm's length requirement"**.

The wording is derived from s.738(3) ITA; for discussion see 32.6.2 (Arm's length requirement).

28.15.6 *"Genuine": Non-arm's length transactions*

Section 742A(11) ITA provides:

> Subsection (6) does not apply if—
>
> (a) the relevant transfer is made by an individual who makes it wholly—
>
> (i) for personal reasons (and not commercial reasons), and
>
> (ii) for the personal benefit (and not the commercial benefit) of other individuals, and
>
> (b) [i] no consideration is given (directly or indirectly) for the relevant transfer or otherwise for any benefit received by any individual mentioned in paragraph (a)(ii), and
>
> [ii] all assets and income falling within subsection (12) are dealt with accordingly.

It is difficult to see what the legislation is trying to stop here. In practice straightforward gifts to trusts will qualify. EN FB 2013 offers this case as its sole example (though even that is expressed tentatively – note the *may*):

> This may be the case where, for example, an individual settles assets into a non-resident trust for the benefit of his family.

This would not apply if trustees or a company make the relevant transfer. It would not apply if there were some consideration as opposed to nil consideration. But why? The legislation seems disproportionate here, which would be another basis for saying that it is not EU law compliant.

28.15.7 *Assets within subsection (12)*

The expression "assets and income falling within subsection (12)" is used:
(1) In the non-arm's length transaction test (above); and
(2) In the commercial substance requirement (below).
Section 742A(12) ITA provides:

> The assets and income falling within this subsection are—
> (a) any of the assets transferred by the relevant transfer;
> (b) any assets directly or indirectly representing any of the assets transferred;
> (c) any income arising from any assets within paragraph (a) or (b);
> (d) any assets directly or indirectly representing the accumulations of income arising from any assets within paragraph (a) or (b).

The drafting is taken from the definition of associated operation: see 28.9 (Associated operation: definition).
Section 742A(13) ITA provides:

> In subsections (11) and (12) references to the relevant transfer are to—
> (a) if the transaction mentioned in subsection (1) is a relevant transfer, the transfer, or
> (b) if the transaction so mentioned is an associated operation, the relevant transfer to which it relates.

28.15.8 *"Genuine": Commercial substance requirement*

Section 742A(7)(8) ITA must be read together to follow the sense:

> (7) [a] Subsection (8) applies if any asset or income falling within subsection (12)
> [b] is used for the purposes of, or is received in the course of, activities carried on in a territory outside the UK
> [c] by a person ("the relevant person")
> [d] through a business establishment which the relevant person has in that territory.
> (8) Without prejudice to the generality of subsection (3)(a) or (5), in order for the transaction to be considered to be a genuine transaction the activities mentioned in subsection (7) must consist of the provision by the relevant person of goods or services to others on a commercial basis and involve—

(a) the use of staff[63] in numbers, and with competence and authority,
(b) the use of premises and equipment, and
(c) the addition of economic value, by the relevant person, to those to whom the goods or services are provided,

commensurate with the size and nature of those activities.

I refer to this as **"the commercial substance requirement"**.

"Goods and services" should be construed widely to include letting of property or the licensing of intellectual property rights. Otherwise the provision would not be EU law compliant.

The wording is derived from the ECJ judgment in *Cadbury Sweppes*: see 60.5.3 (Justification). There is not much guidance on how much is needed to be commensurate. *Columbus Container Services* offers an example of a case where there was sufficient commercial substance. The Advocate General said:

> 180. ...[the] court should, in particular, determine whether, during the tax year in question, Columbus continued to meet all the conditions applying to coordination centres ... including ... requirements concerning the level of employment in Belgium.[64]
>
> 181. ... I do not think that the fact that an establishment such as Columbus devotes its activities to holding and managing capital and may, where necessary, make financial investments in other member states, can be decisive as regards finding that a purely artificial arrangement exists, in so far as that establishment does not engage in actual economic activities in the host member state.
>
> 182. Not only are financial activities excluded in principle from the freedoms of movement, it cannot be totally ruled out that capital investments will be made by an establishment like Columbus for its partners in the host member state or, at least, through financial or banking intermediaries established in Belgium.[65]
>
> 183. I consider that these circumstances, combined with an actual physical establishment in the host member state, are sufficient to rule out the existence of a purely artificial arrangement.[66]

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63 Section 742A(9) ITA defines "staff" widely: "In subsection (8)(a) "staff" means employees, agents or contractors of the relevant person."

64 [Footnote original] Co-ordination centres must employ in Belgium the equivalent of at least ten full-time staff once they have been in business for two years.

65 I wonder if something has gone wrong in the translation of this paragraph.

66 [2008] STC 2554.

28.15.9 *"Business establishment"*

Section 742A(10) ITA provides:

> To determine if a person has a "business establishment" in a territory outside the UK, apply sections 1141, 1142(1) and 1143 of CTA 2010 as if in those provisions—
>
> (a) references to a company were to a person, and
>
> (b) references to a permanent establishment were to a business establishment.

In short, "business establishment" means the same as (in my terminology) a UK-law PE. See 86.2 (Meaning(s) of "permanent establishment").

In Parliament, David Gauke (Exchequer Secretary to the Treasury) said:

> The legislation does not distinguish between trading and investment activities as such. It specifies that if there is an overseas business establishment the activities must consist of the provisions of goods or services on a commercial basis. The threshold for commercial activity can be met by an investment or holding company that provides services, as well as a trading entity. If unusually an investment or holding company does not carry out its activities though an overseas business establishment, a transaction may still be genuine, and the activities will not be subject to the test in subsections (7) and (8) of proposed new section 742A, but will be subject to the rest of the proposed new section and will be exempted if genuine. That means that it will always be possible for an investment or holding company to be exempt in accordance with EU law, if the overall arrangements are genuine and serve EU treaty aims.[67]

28.15.10 *Partial relief*

Section 742A ITA provides:

> (14) Subsection (15) applies if—
>
> (a) subsection (2) would apply in relation to a transaction but for the individual being unable to satisfy an officer of Revenue and Customs for the purposes of condition B that the transaction meets the requirements set out in subsection (6), but
>
> (b) the individual does satisfy an officer of Revenue and Customs

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67 Public Bill Committee 21 May 2013 *http://www.publications.parliament.uk/pa/cm201314/cmpublic/financeno2/130521/pm/130521s01.htm*

that those requirements are met in relation to a part of the transaction.

(15) Subsection (2) applies as if the reference to the transaction were to that part of the transaction.

28.15.11 *EU law condition A*

Section 742A(3) ITA provides:

> Condition A is that—
>
> (a) were, viewed objectively, the transaction to be considered to be a genuine transaction having regard to any arrangements under which it is effected and any other relevant circumstances, and
>
> (b) were the individual to be liable to tax under this Chapter by reference to the transaction,
>
> the individual's liability to tax would, in contravention of a relevant treaty provision, constitute an unjustified and disproportionate restriction on a freedom protected under that relevant treaty provision.

The hypotheses in 742A(3)(a)(b) add nothing:

(a) Para (a) repeats EU law defence condition B.

(b) If there is no liability (para (b)) then the EU law defence is not needed.

So condition A amounts to the condition that:

> the individual's liability to tax [under the ToA provisions] would, in contravention of a relevant treaty provision, constitute an unjustified and disproportionate restriction on a freedom protected under that relevant treaty provision.

The relevant treaty is TFEU or the EEA agreement.[68] For the EU law, see 60.1 (EU law and UK taxation – Introduction).

The ToA draft guidance provides:

> **INTM603160 Genuine transactions exemption: Examples**
> Creating an establishment overseas, whether or not the activities are carried on by a company, will attract exemption provided the activities

68 Section 742A(4) ITA provides: "In subsection (3) "relevant treaty provision" means—

(a) Title II or IV of Part Three of the TFEU,

(b) Part II or III of the EEA agreement, or

(c) the provision of any subsequent treaty replacing a provision mentioned in paragraph (a) or (b)."

are genuinely commercial and transactions take place at arm's length. But HMRC will examine the arrangements to ensure that, for example, they do not in reality reflect a UK establishment which is fronted by the foreign arrangements. Where activities do take place both overseas and in the UK, the UK activities will not fall within the exemption, as the arrangements in this respect would constitute artificial profit shifting and an abuse.

For the purpose of determining where activities take place, the principles of profit attribution will be applied, having regard to actual situation of assets which generate profit, where key decisions are taken, where key decision making persons habitually reside, and where decisions are truly taken.

Assets managed abroad

The offshore funds legislation in Part 8 of TIOPA 2010 is designed to charge offshore income gains and prevent the avoidance of tax on income accruing. The Transfer of Assets provisions, among other things, prevent this legislation being circumvented through the transfer of assets into the hands of a manager based offshore. Although the overseas management activity may itself be rewarded on an arm's length basis, this does not mean that returns on the assets will escape UK tax where the conditions of the Transfer of Assets provisions are satisfied. There will be a movement of capital but in order to benefit from the engagement of freedom of movement of capital it will be necessary to demonstrate that the purpose of the freedom is served. The purpose of freedom of movement of capital is to secure its effective allocation, and that requires a link to the place of investment and not simply seeking to balance return and risk as a manager normally does according to instructions given. In order to engage the freedom it will be necessary to demonstrate that the beneficiary has influence over the disposition of the capital in a particular State in contrast merely to arranging for its management offshore.

28.15.12 *Commencement of EU law defence*

Para 9(2) Sch 10 FA 2013 provides:

> The amendments made by paragraphs 3 to 8 above have effect for the tax year 2012-13 and subsequent tax years.

The relief applies retrospectively to 2012/13.

Section 736(2A) ITA provides:

> The exemption given by section 742A applies only in the case of a relevant transaction effected on or after 6 April 2012.

The same rule is imposed by s.742A(1)(a) ITA. Thus what matters is the date of the transaction, not the date that the income arises.

This seems a strange commencement rule, as taxpayers can still rely on EU law in relation to pre-2012 transactions. When UK law is amended to become EU-law compliant, the amendment is usually made prospectively, leaving taxpayers to pursue EU law remedies for earlier years, but one might have expected the new law to apply to income from 2012, not to transactions from 2012.

28.15.13 *Is the current law EU compliant?*

In February 2014 the CIOT asked the EC to pursue its complaint on the grounds that the rules are still not EU law compliant. The CIOT's main complaint is EU law condition B (genuine transaction). If condition A is met, there is necessarily a breach of EU law and it is a breach of EU law, to specify any further conditions which have to be satisfied as a defence to the ToA code. The EC has not withdrawn its complaint so the issue is ongoing. Further changes to the ToA rules can be expected.

28.15.14 *EU law defence: Commentary*

It is melancholic to compare the complexities of the ToA EU law defence with the relative simplicity of the CGT equivalent.[69] It is suggested that the whole vast apparatus of s.742A should be replaced by a simple provision:

> This section shall not apply in relation to ...
> (ca) income arising from economically significant activities carried on by the person abroad wholly or mainly outside the UK.

There may be a good reason why this cannot be done: but I cannot see what it could be.

69 See 53.18 (Economically significant activities).

CHAPTER TWENTY NINE

TRANSFER OF ASSETS ABROAD: TRANSFERORS

29.1 Section 720 charge on transferor

This chapter considers the IT charge on transferors who have an interest in offshore entities, or receive capital payments from them. There are strictly two charges: s.720 and s.727 ITA, but s.720 is by far the most important.

Section 720 ITA imposes the charge to tax:

> (1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are UK resident by means of relevant transfers.
> (2) Income tax is charged on income treated as arising to such an individual under section 721 (individuals with power to enjoy income as a result of relevant transactions).
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year.

In this book:

"The s.720 charge" is the charge under this section. The ToA draft guidance calls this "the income charge".

"s.720 income" is income which is treated as arising to the individual under s.721. (It might be called "s.721 income" but the charge is under s.720.)

29.1.1 *Cross references*

The following points are considered elsewhere:

27.10 (Sections 624 and 720: comparison)

46.6 (Rates of tax on transferor within s.720 ITA)

29.2 Who is liable?

Section 720(5) ITA provides:

> The person liable for any tax charged under this section is the individual to whom the income is treated as arising.

ITA EN provides:

> 2141. Subsection (5) provides that the individual to whom income is treated as arising is the person liable. This person is defined in section 721.

So we turn to s.721 ITA but we find a referential definition:

> (1) Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A to C are met.

The charge is imposed on "such an individual as is mentioned in s.720(1)". There are different views possible of how much of s.720(1) is incorporated by the requirement that the individual to be taxed must be "such an individual as is mentioned in s.720(1)". The wise words of Garner are worth quoting here:

> *Such* is a deictic (pointing) term that must refer to a clear antecedent.[1]

The failure to observe this point – obvious though it may seem – has given rise to a good deal of case law. The intention of the ITA rewrite was to preserve the case law and, so far as the law was unclear, to preserve the ambiguities. (It is because the rewrite had such limited objectives that it achieved relatively little.)

ITA EN provides:

> 2144. Sections 739(2) and (3) of ICTA indicate the person liable by using the expression "such an individual" – but do not make it clear how much of section 739(1) is implied by that expression. [Sections 721] and 728 ITA, which are based on section 739(2) and (3) ICTA, reproduce

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1 Garner's *Dictionary of Legal Usage* (3rd ed., 2011), entry under "Such". Pinter exploits the ambiguity in *No Man's Land* (2001):

> "... there are some people who appear to be strong, whose idea of what strength consists of is persuasive, but who inhabit the idea and not the fact. What they possess is not strength but expertise. They have nurtured and maintain what is in fact a calculated posture. Half the time it works. It takes a man of intelligence and perception to stick a needle through that posture and discern the essential flabbiness of the stance. I am *such a man*."

> the expression "such an individual", which has been the subject of case law: see, in particular, *Vestey v IRC* 54 TC 503.

What, then, are the requirements to be "such an individual" as is mentioned in s.720(1)? There are two:

(1) The individual must be resident in the UK; that seems clear.
(2) The individual must be "the transferor"; that was decided in *Vestey*.

29.3 Who is the transferor?

The next question is to identify the transferor (if there is one). Clearly, anyone who actually makes a transfer is a transferor, but the expression is a little wider than that.

29.3.1 *Transfer made by individuals jointly*

If A and B together own an asset, as tenants in common or as joint tenants, and together transfer their interest to a person abroad, each is transferor of their share. RI 201 states:

> Where the same assets are transferred by several individuals, the Revenue's practice is to assess the transferors in proportion to their share of the assets transferred. Thus, where, for example, shares of a UK company are held by three shareholders in the proportion 40%, 40% and 20% and there is [s.720 ITA] liability in respect of the income of an overseas person to which the shares are transferred, the liability is assessed on each of the three shareholders in proportion to their respective holdings.

That seems obvious. It is somewhat theoretical as it would be usual for shares to be held outright rather than jointly, ie (on the figures of the example) one would expect shareholder A and B to hold 40 shares each, and shareholder C to hold 20 shares, rather than A, B and C to be registered as joint holders of 100 shares held by them beneficially in the proportions 40/40/20.

29.3.2 *Transfer procured by individual*

In *Congreve v IRC* the Court of Appeal said in an obiter comment:

> But even if we were prepared to accede to the argument that the preamble [now s.720(1) ITA] connoted activity by the individual concerned, we think this condition would be fulfilled if the execution of the transfer were procured by the individual concerned, even though it

> was not actually executed by him or his agent.[2]

In *Vestey v IRC*, the question of who is a transferor did not arise, because the taxpayers (beneficiaries of a discretionary trust) were clearly not transferors. The House of Lords discussed the question in passing, and the answer was expressed in a variety of different ways. Lord Wilberforce said s.720 applies:

> only where the person sought to be charged
> [1] made [the transfer]
> [2] or, may be, was associated with, the transfer.[3]

The context clearly shows that the meaning at [2] is that Lord Wilberforce was floating a possible view that a person could be charged if they were associated with the transferor, but did not commit himself to that view: "may be" means "possibly".[4]

Lord Wilberforce was not saying:

(1) that there *would* be a s.720 charge if the taxpayer was associated with the transfer. He expressed a doubt on the point.
(2) that there would be a s.720 charge if the taxpayer may be associated (= was possibly associated) with the transfer.

HMRC sometimes like to read the passage in sense (1) or even in sense (2) but that cannot be correct.

The doubts intended to be raised by Lord Wilberforce were resolved in *IRC v Pratt* which decided that an individual who did not make the transfer may be within s.720 if and only if they "procured" the transfer.[5] The term used in *Pratt* is "quasi transferor" but I suggest it is better to use the term "transferor" and to define that term to mean anyone to whom s.720 applies, that is, both those who make a transfer and those who procure it.

The classic example of procuring a transfer is if T owns all the shares in a company and uses power of control to procure the company to make a transfer to a person abroad.

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2 30 TC 163 at p.197.

3 54 TC 503 at p.587A. Lord Salmon agreed. Lord Keith said he agreed with Lord Wilberforce but in his speech he actually put the matter differently.

4 The STC and All ER versions of the report change this (slightly literary) use of the words "may be" into the more usual form "maybe".

5 57 TC 1 at p.51 B –D and p.55 E–F.

> Something of the sort might even be possible in the case of quasi transferors, where two or three of them own the company which makes the transfer, but where it is not possible to do just that, s [720] does not bite at all. ... Where an identifiable portion of the asset transferred can be attributed to a particular transferor then, of course – at any rate in any normal case – that part actually transferred will produce a similar part of the income, and in no case is there any difficulty in applying the section, since one will apply it separately to each of the individual transfers, or each identifiable portion.[6]

This is tentatively expressed, and might perhaps be challenged.

The position would in any event be different if shareholders had different classes of shares with different interests. In that case it may not be possible to separate out their interests in which case the shareholders would not be transferors.

In *Pratt,* a company sold land to an offshore company.[7] That was clearly a transfer. The taxpayers alleged to be transferors were (i) were three directors out of eight; and (ii) held 30% of the company. They had influence but no control at board (director) level or shareholder (general meeting) level. They could not "procure" the transfer of assets made by the company, and so they were not "quasi transferors" in relation to that transfer. So they were not transferors.

The ToA draft guidance provides:

> **INTM600800 Multiple Income charges - Multiple Transferors**
> Where there is a choice of persons who may be taken into account in charging the income then the income is apportioned on a "just and reasonable" basis as referred to in section 743 (2) 2007.
> This has not always been the case. In *CIR v Pratt* (1982) 57 TC 1 the Respondents (in 1964) owned 29% of a company's shares between them. There were 15 other shareholders and 5 other directors. An

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6 *IRC v Pratt* 57 TC 1 at p.50.

7 The sale was at market value but the offshore company resold at a substantial profit after planning permission was granted. So one can see why the Revenue wanted to assess. The sale was before the introduction of the transactions in land rules (in 1969) so the (somewhat far-fetched) application of the ToA rules was perhaps the only option.
The time taken in the appeal is remarkable: assessments from 1965/6 were finally determined by the High Court in 1982.

avoidance scheme was set up which included a number of offshore companies and two offshore trusts, one of which was a family discretionary trust. The Respondents each received loans of £2,000 which were assessed to tax under what was then section 412 ITA 1952 (now section 720 ITA 2007). Walton J dismissed the Revenue's appeal on the basis that it was not possible to do otherwise in this case as there was a plurality of transferors whose respective interests could not be separated out.

He accepted that the House of Lords decision in the case of *Vestey* (1979) 3 WLR 915 did not preclude a person, who was not the transferor, from being liable under section 412 ITA 1952 (now section 720 ITA 2007) if he "procured" the transfer. He also accepted that there could be multiple quasi-transferors, but only to the extent that an identifiable portion of the asset transferred could be attributed to a particular transferor. In the absence of such identifiable portions section 412 ITA 1952 did not provide the means to arrive at an apportionment, or the authority to tax it, and in the absence of any legal basis for such action the section could not apply.

Section 45 Finance Act 1981 was enacted to provide for the apportionment of income.

HMRC's practice (RI 201) where the same assets are transferred by several individuals is to assess the transferors in proportion to their share of the assets transferred. For example, where the shares of a UK company are held by three individuals in the proportions of 40%, 40% and 20% and there is a liability under section 720 ITA 207 in respect of the income of an overseas person to which the shares are transferred, the liability is assessed on each of the three individuals in proportion to their respective holdings.

An officer of Revenue and Customs must be satisfied that the apportionment of income to be taken into account between individuals is on a "just and reasonable" basis (section 743(2) ITA 2007). Of course, taxpayers have the usual rights of appeal against decisions on this point, which are the jurisdiction of the Tax Tribunal (section 751 ITA 2007).

But it is doubtful whether the new legislation reversed the decision in *Pratt* as it did not affect the question of who is the transferor.

Suppose the facts of *Pratt* HMRC had assessed all the shareholders and directors on the grounds that between them they controlled the company and as a matter of fact did procure the transfer. But even if they were (together) transferors, it would be impossible to apportion the income of the person abroad between them; in the words of the judge, “a mind-

boggling exercise of the first water".[8]

In *Carvill v IRC*, T transferred a majority shareholding to a person abroad, and the minority shareholders transferred their shares. HMRC argued (implausibly) that T was the "transferor" of the minority shareholding. But this was (rightly) rejected:

> For an individual to be the transferor in relation to a transfer by another individual would be a considerable extension of this principle. However, there might be cases where, as a matter of fact, one individual's influence over another was so strong that he was the transferor of the other's share but this would clearly be an exceptional case. ...
>
> 72. [Counsel] contends that the taxpayer was the transferor of the old minority shares. In order to find that this was an exceptional case where the taxpayer did in effect force his will on the other shareholders so as to become the transferor of their shares, one would need strong evidence that this was so. Of course, the taxpayer as majority shareholder and one of the founders of a company bearing his name was in a position of some influence. However, the influence did not go as far as telling other shareholders what to do with their shares. Here the decision by the old minority to transfer their shares was one which they came to after discussion, having started with different points of view as to the merits of the transfer. There is no evidence that the taxpayer leaned on any of them heavily, for example, by threatening to sack them if they did not. ... Accordingly, there is no evidence that the taxpayer did anything in relation to the old minority shares which would make him the transferor of them, and I find that he was not the transferor of the old minority shares.[9]

What about a gratuitous transfer from A to B and from B to the person abroad? The question whether A has procured B's transfer does not arise, for A is a transferor by virtue of the transfer to B. The true question for A is whether B's transfer is an associated operation in relation to A's transfer.[10]

Contrast the position where:

(1) T transfers assets to A, in consideration for which A transfers assets to a person abroad.

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8 *IRC v Pratt* 57 TC at p.52.

9 *Carvill v IRC* 75 TC 477, Special Commissioners decision at [71]-[72].

10 See 28.11.1 (Transfer from A to B followed by transfer from B to person abroad).

(2) T transfers assets to a company, in consideration for which the company issues shares to a person abroad.
(3) T (an employee entitled to a bonus) waives the right to the bonus, in consideration for which the employer transfers assets to a pension scheme abroad.

In the first two cases, T is not just a quasi-transferor, T is an *actual* transferor for T has made a transfer of assets. In the third case, T has procured the transfer so is within the scope of s.720.

The ToA draft guidance provides:

> **INTM600820 Transferors: The transfer**
> ... This section considers the link between relevant transfers and the individual who is potentially avoiding liability to income tax by means of relevant transfers. It is the individual who is avoiding liability to income tax who is potentially liable for any tax charged under the income charge and to whom the income is treated as arising. However, there is nothing directly within the income charge provisions to say that individual must also be the person who has undertaken the transactions that have resulted in income becoming payable to a person abroad.
> Notwithstanding this, the general approach is that an income charge will only apply where the individual who is subject to the charge is also the person who has made, or is associated with, the transfer of assets. Where a person other than the individual who made the transfer is treated as having income arising to them then it is the benefits charge that may be in point (see INTM601400 onwards). This link between the transfer and the individual who is potentially subject to tax under the income charge effectively comes from the interpretation placed upon the income charge by the courts.
> The leading case in this respect is *Vestey v CIR* (54 TC 503), in which Lord Wilberforce says (pages 583 and 584):
>
> > 'There are undoubtedly two possible interpretations of (what became section 739 ICTA), particularly having regard to the preamble. The first is to regard it has having a limited effect; to be directed against persons who transfer assets abroad; who by means of such transfers avoid tax, and who yet manage when resident in the United Kingdom to obtain or to be in a position to obtain benefits from those assets. For myself I regard this as being the natural meaning of the section…..The second is to give the whole section an extended meaning, so as to embrace all persons, born or unborn, who in any way may benefit from assets transferred abroad by others…This I regard as a possible but less natural meaning of the section.'

He later added (page 587) that 'the section (what became section 739) (should be) interpreted as applying only where the person sought to be charged made, or may be, was associated with, the transfer.'

In most cases determining whether the individual has made a transfer of assets will be relatively straightforward, but what is meant by 'or may be associated with' the transfer? This is likely to depend on the facts and circumstances of the matter. For example, an individual may wholly own and direct a company. If the company makes a relevant transfer which results in the shareholder having power to enjoy the income of a person abroad, even though the individual has not made the transfer, HMRC would take the view that he, maybe, was associated with it by virtue of his position. The individual can therefore be regarded as having made the transfer such that the connection is made and the income charge applies. Equally if an individual in someway 'procured' a transfer to be made HMRC may regard the relevant connection as made. In the case of *Congreve v CIR* (30 TC 163 at page 197) Cohen LJ observes:

> 'But even if we were prepared to accede to the argument that the preamble connoted activity by the person concerned, we think this condition would be fulfilled if the execution of the transfer were procured by the individual concerned, even though it was not actually executed by him or his agent.'

In this context 'procured' is considered to include 'organised, engineered or brought about' as indicated by the views of Lord Wilberforce in the *Vestey* case at page 583 where he speaks of the individual as having 'organised or engineered transfers' and in the same case at page 602, Lord Keith speaks of transfers 'organised or brought about ' by the individual.

Factors which may need to be considered in determining whether the individual is or may be associated with a transfer of assets or has procured a transfer of assets include:-

- whether the individual had any bargaining power with the person who actually makes the transfer;
- whether there was a contractual connection between the individual and the actual person making the transfer; and
- whether the individual had any proprietary interest, actual or potential, in the assets transferred.

This list is not intended to be exhaustive and it will be relevant to consider all of the facts and circumstances of the matter if there is doubt about whether there is an appropriate connection for an income charge to be applied.

If more than one individual appears to have effected, procured or is, may

be, associated with a transfer of assets, then see INTM600800.
If after consideration of the facts doubt remains about whether the appropriate connection exists such that an income charge applies the views of Trusts & Estates Technical, Bootle should be sought before any charge to tax is raised.

29.3.3 *Can trustees and fiduciaries be transferors?*

A trustees may make a transfer of assets (eg transferring trust property to a foreign company). There are two independent reasons why s.720 does not apply:

(1) A trustee is not an individual so not within the ToA rules.
(2) A trustee is not a transferor as a transferor must be the person beneficially entitled to the assets transferred:

> I think that for the purposes of s [720], it must be the beneficial transfer - the transfer of the beneficial interest - which is in question, and not the bare transfer of the legal title. A trustee, for example, who was directed by his beneficiaries to effect a transfer would not, even if he knew full well what was on foot, become himself liable to fall foul of the section merely on that account.[11]

A person exercising fiduciary powers is not a transferor, eg a person with power of appointing new trustees does not become a transferor if they exercise the power by appointing foreign trustees, because the power is fiduciary.

What if A (perhaps a principal beneficiary but not the settlor) encourages trustees to make a transfer? It is considered that A (not being in control of the trust) cannot be said to procure the transfer made by the trustees.

So the concept of "procuring" a transfer in practice applies to individuals controlling companies which make a transfer; other cases, if theoretically possible, will be rare. An individual who is not a transferor (such as the successful appellants in *Pratt*) might instead fall within s.731 if they receive benefits.

29.3.4 *HMRC practice*

RI 201 provides:

> [1] Section [720 and 727 ITA] can potentially apply not only to an individual who transfers assets but to someone who is "associated

11 *IRC v Pratt* 57 TC 1 at p.49.

with" a transaction (according to the decision of the Courts in *Vestey v IRC*).

[2] The Revenue regard this as including anyone who procured the transfer of assets.

There is not much to say in favour of proposition [1]. It can hardly be said to be "according to the decision of the Courts in *Vestey v IRC*" as it relies on one of the views expressed in *Vestey*[12] where it was qualified by the word "maybe". In fact, if "associated" here has its normal, rather wide sense, point [1] is clearly wrong in the light of *Pratt* and *Carvill*. It is considered that a person is a transferor only if they have made or procured the transfer, and being associated with a transfer (without procuring it) does not make a person a transferor. In a loose sense of "associated" point [1] cannot possibly be correct, for many individuals may be "associated" with a transfer who cannot possibly all be transferors.

It appears that HMRC would now agree, for HMRC Brief 18/11 provides:

> 5.1.1 ... For the income charge provisions [s.720] to apply the individual on whom the charge arises must be the person who transfers the assets or procures the transfer.

In practice HMRC have not generally taken ToA points when UK companies make transfers abroad, even if there is a 100% shareholder who could be regarded as procuring the transfer. There is no significant reference to the ToA provisions in *Bramwell on Corporation Tax* and none in the Company Taxation Manual. If the UK company has a sufficient interest in the non-resident company, the CFC legislation is designed to address the avoidance possibilities. It is not the case that the ToA rules could not apply; just in practice no-one takes any notice of them.[13] But if a UK company makes a transfer to an entirely separate entity, the CFC rules will not apply, and HMRC may fall back on ToA. An example where HMRC say they might raise the point relates to employee benefit trusts. HMRC Brief 18/11 provides:

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12 The comment of Lord Wilberforce is set out at 29.3.2 (Transfer procured by individual).

13 It is noteworthy that the CFC legislation followed shortly after *Pratt*. Though s.725 ITA (reduction in amount charged when CFC involved) acknowledges possible overlap between the CFC rules and s.720. The ToA draft guidance discusses these rules: INTM600720.

5.1.1 ... [1] If the offshore Employee Benefit Trust is a normal commercial arrangement by a company to reward its employees,

[a] the transferor is the employer company;

[b] and in such circumstances the income charge [s.720] is unlikely to be applicable as the transferor and beneficiaries are different people.

[2] However, it may be that the employee has transferred a right to receive a bonus into the offshore Employee Benefit Trust and is therefore the transferor. If this is the case the ToA legislation may apply and the employee will be liable to tax on any income arising in the trust.

[3] If the employer company is controlled by its shareholder/directors and the offshore Employee Benefit Trust was formed solely for their benefit, the director/shareholders may have procured the transfer into the offshore Employee Benefit Trust and could be considered transferors for the purposes of the income charge. Whether or not the ToA income charge is then applied will depend on the facts of each case.

There is a good deal of confusion here:

[1] [a] The fact that the trust is a normal commercial arrangement should be a reason for allowing the motive defence, but does not affect the identity of the transferor. It appears that HMRC are not interested in applying s.720 to "normal commercial arrangements" so they do not care who is the transferor (even in the case of non-resident EBTs).

[b] It is correct that the s.720 charge is unlikely to be applicable. The reason is not exactly that "the transferor and beneficiaries are different people" but that the transferor is a company (not within s.720) and the beneficiaries are non-transferors. Probably that is what the author meant to say.

[2] This is approximately correct; though s.624 may also be in point, and the individual's liability is not on "any income arising in the trust" but income arising from the transferred asset.

[3] This is correct as far as it goes but it is rightly tentative ("may have procured...") and does not explain very much.

The ToA draft guidance returns to this theme:

INTM600580 - The income charge: The transfer

... However, the general approach is that an income charge will only apply where the individual who is subject to the charge is also the person who has made or is associated with the transfer of assets. It is the benefits charge that is more likely to apply where the person who is

treated as having income arising to them is not the person who has made the transfer of assets (INTM601400). This link between transfer and the individual who is potentially subject to tax under the income charge effectively comes from the interpretation placed upon the income charge by the Courts.

The leading case in this respect is *Vestey v CIR* (54 TC 503), in which Lord Wilberforce says (pages 583 and 584):

> 'There are undoubtedly two possible interpretations of (what became section 739 ICTA), particularly having regard to the preamble. The first is to regard it has having a limited effect; to be directed against persons who transfer assets abroad; who by means of such transfers avoid tax, and who yet manage when resident in the United Kingdom to obtain or to be in a position to obtain benefits from those assets. For myself I regard this as being the natural meaning of the section…..The second is to give the whole section an extended meaning, so as to embrace all persons, born or unborn, who in any way may benefit from assets transferred abroad by others…This I regard as a possible but less natural meaning of the section.'

He later added (page 587) that 'the section (what became section 739) (should be) interpreted as applying only where the person sought to be charged made, or may be, was associated with, the transfer.'

In most cases determining whether the individual has made a transfer of assets will be relatively straightforward, but what is meant by 'or may be, was associated with' the transfer? This is likely to depend on the facts and circumstances of the matter. For example, an individual may wholly own and direct a company. If the company makes a relevant transfer which results in the individual who owns the company having power to enjoy the income of a person abroad, even though the individual has not made the transfer, by virtue of his position HMRC would take the view that he, may be, was associated with it and thus that the individual can be regarded as having made the transfer such that the connection is made and the income charge applies. Equally if an individual in someway 'procured' a transfer to be made HMRC may regard the relevant connection as made. In the case of *Congreve v CIR* (30 TC 163 at page 197) Cohen LJ observes:

> 'But even if we were prepared to accede to the argument that the preamble connoted activity by the person concerned, we think this condition would be fulfilled if the execution of the transfer were procured by the individual concerned, even though it was not actually executed by him or his agent.'

In this context 'procured' is considered to include 'organised, engineered or brought about' as indicated by the views of Lord Wilberforce in the *Vestey* case at page 583 where he speaks of the individual as having 'organised or engineered transfers' and in the same case at page 602, Lord Keith speaks of transfers 'organised or brought about 'by the individual.

Features which may need to be considered in determining whether the individual is, may be, associated with a transfer of assets or has procured a transfer of assets are factors such as:-

- whether the individual had any bargaining power with the person who actually makes the transfer;
- whether there was a contractual connection between the individual and the actual person making the transfer; and
- whether the individual had any proprietary interest, actual or potential, in the assets transferred.

This list is not intended to be exhaustive and it will be relevant to consider all of the facts and circumstances of the matter if there is doubt about whether there is an appropriate connection for an income charge to be made.

29.4 Must the transferor avoid or intend to avoid IT?

29.4.1 *The statutory provisions*

Section 720 ITA provides:

(1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are UK resident by means of relevant transfers.

(2) Income tax is charged on income treated as arising to *such an individual* under section 721. ...

The Special Commissioners say:

185. It is clear that the meaning of the phrase "such an individual" must be found in the preamble [now s.720(1)] and that it is not confined to an individual "ordinarily resident in the UK". Once you go beyond that restricted meaning in order to ascertain what individuals are comprised in the phrase "such an individual" it seems to us difficult to find any logical stopping place short of importing the whole of [s.720(1)].

186. In our view it therefore follows that "such an individual" is an individual ordinarily resident in the UK who, *by means of a transfer* of assets in consequence of which income becomes payable to a non-resident, *avoids liability to income tax apart from the operation of*

> *these provisions*.[14]

This is, with respect, clearly right. The question which arises is whether a person who "by means of transfers of assets avoids liability to income tax" means:

(1) a person who in fact avoids income tax (in the absence of the ToA provisions); or
(2) a person who in fact avoids and intends to avoid IT; or
(3) a person who intends to avoid IT (whether or not they in fact do so).

I am inclined to think that solution (1) is the most natural reading, as the word "avoids" suggests avoidance in fact. However the words "by means of" might be thought of as involving some element of intention, so there is also much to be said for solution (2), ie s.720 only applies to a person who in fact avoids and intends to avoid income tax, (though this does overlap with the motive defence).

In *Vestey*, Lord Keith said the section only applied to an individual:

> who has *sought* to avoid liability to income tax by means of such transfers of assets as are mentioned in [s.720(1)].[15]

Lord Dilhorne said the section applied to an individual:

> who has *sought* to avoid income tax[16]

though in the same paragraph he also approved the Court of Appeal's comment in *Congreve* (which one might have thought a somewhat different approach).

Likewise Lord Edmund-Davis:

> individuals whose *purpose* is the avoidance of liability to tax ...[17]

29.4.2 *Position before 1996*

In order to understand the present law, it is necessary first to consider the position before the law was changed in 1996. Case law and statutory reform have complicated what ought to be a simple question with a simple answer.

The starting point is the decision of the House of Lords in *McGuckian v*

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14 *IRC v Botnar* 72 TC 205.
15 p.602G.
16 p.591E.
17 p.601B.

IRC.[18] This was (in short) a case where a transaction was made which was intended to avoid income tax but did not actually do so (because another anti-avoidance provision was overlooked).[19] The Revenue raised an assessment under s.720. The taxpayer argued that s.720 did not apply since income tax was not actually avoided. The argument failed. Lord Steyn said:

> I would reject the argument that it is a condition precedent to [s.720] applying that there must be proof of an actual avoidance of tax liability. Such a construction treats [s.720] as a power of last resort and it substantially emasculates the effectiveness of the power under [s.720]. Nothing in the language or purpose of [s.720] compels such a construction. Properly construed the opening words of [s.720] merely provide that *there must be an intention to avoid liability for tax*. The sensible construction is that [s.720] can be applied even if there are other provisions which could be invoked to prevent the avoidance of tax. That the revenue authorities should have overlapping taxation powers is an unremarkable consequence. And such a construction cannot cause any unfairness to the taxpayer since he cannot be taxed twice in respect of the same income.[20]

Lord Browne-Wilkinson said:

> [Counsel for the taxpayer] submitted that since the dividend would in any event have been taxable under s 470, [s.720] does not apply. He based this submission on the words in [s.720(1)],
>
> > "For the purpose of preventing the avoiding by individuals ordinarily resident in the UK of liability to income tax …".

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18 69 TC 1.

19 The actual facts were not so simple. An interest in possession trust owned a company, and a dividend would have been taxable income of the life tenant. Instead the trustees sold the right to the dividend for a lump sum. This sum was trust capital as a matter of trust law (though it was regarded as income for tax purposes under the *Ramsay* principle). This sale was intended to avoid income tax on the dividend.
It was assumed that the transaction did not actually avoid IT, since the sale of a dividend was caught by anti avoidance provisions (s.730 ICTA 1988) now repealed. Is this right? One might have argued that income tax *was* in fact avoided since even though it was assessable under s.730, no assessment was actually made, but the Revenue did not argue that point. The taxpayer was however assessed under (what is now) s.720 ITA rather than s.730. The simple answer to this should have been to raise the assessment under s.730, as the Court of Appeal decided, but HL did not pursue that approach.

20 69 TC 1 at p.82E.

> He submitted that [s.720] does not apply unless tax has *in fact* been avoided. In my judgment, there is no warrant for this submission. ... the words of subs (1) make it clear that the actual avoidance of tax is not a precondition to the application of the section. The income is deemed to be the income of the UK resident
>
> > "whether it would or would not have been chargeable to income tax apart from the provisions of this section".
>
> It is therefore clear [!] that [s.720] can still apply even though the effect of the transfer of assets abroad would not have been successful in avoiding UK income tax.[21]

It is an understatement to say that the reasoning is not compelling,[22] but the decision is still binding. The position before 1996 was settled. The majority of the House of Lords[23] decided that it was not a requirement of s.720 that income tax had to be avoided, though there did have to be an *intention* to avoid income tax.[24]

Thus the law until 1996 was that:

(1) section 720 only applied to a person who intended to avoid income tax; but

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21 69 TC 1 at p.76.

22 The reason given by Lord Steyn is not compelling since s.720 is not a "power". The reason given by Lord Browne-Wilkinson is not compelling, since the words he cites (which became s.721(5)(a) ITA, repealed 2013 and replaced by s.721(3C)) are needed for where a transfer reduces the rate of income tax (without avoiding it completely). It is significant that neither judge cites the reason given by the other. Unfortunately, it was impossible to have any sympathy with the taxpayer or his advisors, whose actions ("disingenuous in the extreme") were held to be the reason why no assessment was made under the correct section in the first place and whose appeal had "no ethical merit". One suspects that this was a case where the decision was made first and the reasons were found later. The issue was first raised in the House of Lords (it is not mentioned in the lower judgments) and so the Lords did not have the benefit of the consideration of the lower courts on the issue.

23 Lord Lloyd agreed with the other judgments; the other two judges did not consider the point.

24 This area was considered in a thorough Special Commissioners decision just before *McGuckian*: *Botnar v IRC* [1998] STC 38 at pp.63–67. Here the *Revenue* submitted (and the SCs accepted) that s.720 only applies if there is avoidance of IT *in fact.* See para 180. But this has now been overtaken by *McGuckian*. The Special Commissioners also inclined to the view that s.720 only applied if the transferor intended to avoid Income Tax. Had *McGuckian* been decided first, they would no doubt have cited and followed the comment of Lord Steyn set out above. But this has now been overtaken by the statutory reform.

(2) actual avoidance of income tax was not necessary.

29.4.3 *Position from 1996*

Section 721(5) ITA provides:

> It does not matter for the purposes of this section ...
> (c) whether the avoiding of liability to income tax is a purpose for which the transfer is effected.

This applies to income arising on or after 26 November 1996 regardless of the date of the transfer. This does not affect the operation of the motive defence but it reverses point (1): s.720 applies even it there is no purpose of avoiding income tax.

The provision does not expressly deal with point (2) - actual avoidance. It is suggested that the consequence of this amendment is that the question of whether there must *in fact* be an avoidance of income tax needs to be revisited. For Parliament retained the statutory words set out in 29.4.1 (The statutory provisions) which refer to avoiding income tax. The words should be taken to mean something. If they no longer refer (as Lord Steyn thought they did) to the intention to avoid income tax, they should be taken to require that income tax is *in fact* avoided.[25] Thus it is tentatively suggested that the effect of s.721(5) is to reverse the decision of *McGuckian* on this issue.

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25 This is consistent with the view that HMRC take of s.752(1) ITA (transactions in land) which provides: "This Chapter has effect for the purpose of preventing the avoidance of income tax by persons concerned with land or the development of land." BIM provides:

60315. Conditions: Avoidance

Section 776 ICTA 1988 is anti-avoidance legislation (Section 776(1) ICTA 1988). The test for avoidance is an objective one, i.e. has tax been avoided, and not a subjective one relating to the intentions of the participants.

The avoidance need not, therefore, be deliberate, it can be accidental or unwitting ...

60320. Conditions: Avoidance: Straightforward transactions of purchase and sale

Section 776 ICTA 1988 cannot be used to catch straightforward transactions of purchase and sale of land that do not amount to a trade, or adventure in the nature of trade. ...

Section 776 ICTA 1988 is not applicable because the necessary avoidance of tax is not present.

The position for income arising from 1996 is therefore that:

(1) an intention to avoid income tax is not a requirement for s.720 to apply.

(2) income tax must in fact be avoided for the section to apply.

This raises the question of what amounts to the avoidance of income tax in fact. If the taxpayer avoids an assessment (especially by dubious means) then it is suggested that income tax is avoided. Thus the assessment in *McGuckian* would still be upheld under s.720, though for slightly different reasons.

29.4.4 *The HMRC view*

The ToA draft guidance provides:

> **INTM600700 General conditions Legislative purpose**
> ...So, whilst it is clear that the preamble sets the purpose of the legislation; as Lord Browne-Wilkinson says in the *McGuckian* case (69 TC 1 at page 76), "…the words quoted (section 739(1) ICTA) refer not to the intention of the transferor of the assets … but to the intention of Parliament in enacting the section" and in the same case Lord Clyde (at page 85) affirms that, "The opening few lines of that section set out the purpose to be served by the enactment. That purpose is the prevention of avoidance by individuals ordinarily resident in the United Kingdom of liability to income tax by means of certain kinds of transaction"; because of the links to the income charges it does much more, forming an integral part in construing the section as Lord-Browne Wilkinson goes on to say, "That Parliamentary intention is certainly relevant in construing the section".
> However these provisions are not only aimed at transactions whose purpose is avoiding income tax. The first bullet of INTM600620 makes clear that it does not matter whether the avoiding liability to income tax is a purpose for which the transfer is effected. Clarification to this effect was first inserted into the legislation in Finance Act 1997 and applying irrespective of when the transfer or associated operations took place but only in relation to income arising on or after 26 November 1996.
> The Budget Press Release in relation to the amendment introduced in Finance Act 1997 records:
>
> > "The existing provisions which prevent individuals ordinarily resident in the United Kingdom avoiding income tax by the transfer of assets abroad will be amended to clarify their application and ensure that they work effectively. The changes will confirm

long-standing practice in this area.
The amendments will ensure that, for income arising on or after today, the legislation applies where a purpose of the transfer is to avoid any form of direct taxation.
The new measure will have the effect of removing any possible implication in the legislation that the provisions only apply if:
the avoiding of income tax is the purpose, or one of the purposes, for which the transfer is effected."

The provision appears to reflect exactly the sentiments of Lord Clyde in McGuckian expressed in his judgement in June 1997 where he says, continuing on from the quotation above, "It is not required that the transaction should be carried out with that purpose".

Further affirmation of the nature of these introductory words can be gleaned from the speech of Lord Steyn in the McGuckian case, at page 82 where he comments, "I would reject the argument that it is a condition precedent to [what became section 739 ICTA] applying that there must be proof of actual avoidance of tax liability. Such a construction treats [section 739 ICTA] as a power of last resort and it substantially emasculates the effectiveness of the power under [section 739 ICTA]. Nothing in the language or purpose of [section 739 ICTA] compels such a construction. Properly construed the opening words of [the section] merely provide that there must be an intention to avoid liability for tax. The sensible construction is that [section 739 ICTA] can be applied even if there are other provisions which could be invoked to prevent the avoidance of tax. That the revenue authorities should have overlapping taxation powers is an unremarkable consequence. And such a construction cannot cause any unfairness to the taxpayer since he cannot be taxed twice in respect of the same income."

These words should not however be taken to suggest that the income charge provisions apply to any and every transaction that may be a relevant transfer. The provisions remain for preventing the avoiding of liability to income tax. And thus at the heart of the jigsaw puzzle remains the need to identify that there is or would be avoidance of UK income tax before the provisions can be applied.

...

INTM600760 - The income charge Such an individual

The person who is liable for any tax charged under the income charge is the individual to whom the income is treated as arising (INTM600620 bullet 3). That individual is described as 'such an individual'. This is not just any individual but specifically the individual described in the preamble (INTM600700).

The importance of the phrase 'such an individual', which also appeared in the earlier legislation, is evidenced by the consideration that the courts have given to it over the years. For example Lord Nolan records in the case of *Willoughby v CIR* (70 TC at page 114), "The crucial words, as it seems to me, are those in subsection (1) which state that the section is to 'have effect for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfer of assets', coupled with the identification, in subsection (2), of "such an individual" as the subject of liability. What can the words "such an individual" refer to save for an individual of the kind described in subsection (1), that is an individual ordinarily resident in the United Kingdom seeking to avoid liability by means of transfers of assets?"

In context, Lord Nolan was considering here the issue of ordinary residence, see INTM600780, but what is clear is the special significance of the phrase and the fact that it encompasses far more than just any individual. As the Special Commissioner observes in *CIR v Botnar* (72 TC at page 239) "it therefore follows that "such an individual" is an individual ordinarily resident in the United Kingdom who, by means of a transfer of assets in consequence of which income becomes payable to a non-resident, avoids liability to income tax apart from the operation of these provisions"

Whilst it may therefore be the case that there is no 'condition precedent' that there must be actual avoidance of tax liability for an income charge to arise to such an individual, it must be the case that an outcome of the transactions is that, absent the income charge, a liability to income tax would be avoided. And that the individual who is the subject of charge is the one who would, without the income charge, have avoided income tax as a result of relevant transactions. Where, therefore, there is no avoiding of liability to income tax, or otherwise the relevant conditions are not met, there can be no application of the income charge, there being no 'such an individual' as is chargeable by the provisions

A very simple example may illustrate the situation.

Example

Two UK resident individuals each plan to invest in an offshore bank deposit account. The first individual invests directly in the account and receives interest which is part of his income and on which he pays tax through his self assessment. Even though on the face of it there is a relevant transfer he is not 'such an individual' as the income charge applies to as there is no avoiding of a liability to income tax. The transfer of assets provisions therefore do not apply.

By contrast the second individual sets up an offshore entity in a territory

where it will not be charged to tax on its income. This entity places the money on deposit and receives the income. The income that arises to the entity cannot be charged directly on the individual. In this context the individual is 'such an individual' as would avoid liability to income tax apart from the operation of these provisions. Therefore, the transfer of assets income charge applies to prevent the avoiding of liability to income tax if all other conditions are also met.

29.5 Section 721 Condition A (power to enjoy)

Section 721(1) ITA provides:

> Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A to C are met.

I refer below to **"s.721 conditions A to C**".

Section 721(2) sets out condition A:

> Condition A is that the individual has power in the tax year to enjoy income of a person abroad as a result of—
>
> (a) a relevant transfer,
>
> (b) one or more associated operations, or
>
> (c) a relevant transfer and one or more associated operations.

Once one has identified the transferor one asks whether they have "power to enjoy" income of the person abroad.

If the transferor has power to enjoy during part of the tax year, condition A is satisfied for the whole of the tax year.[26] This is an accidental change from the pre-ITA position.

Statutory tax indemnities do not confer power to enjoy, see 30.4.10 (Reimbursement of tax under statutory indemnity).

On a transfer from a UK domiciled person to their foreign domiciled spouse, see 73.12 (Income tax planning for mixed marriage).

29.6 "Power to enjoy"

Section 722 ITA provides:

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26 The usual case will be if the settlor has power to enjoy and is then excluded and so ceases to have power to enjoy; but it could also happen that the settlor acquires power to enjoy during the tax year.

Contrast 27.3.6 (Settlement ceasing to be settlor-interested); 50.4 (Settlor-interested condition).

> (1) For the purposes of section 721, an individual is treated as having power to enjoy income of a person abroad if any of the enjoyment conditions are met.
> (2) In subsection (1) "the enjoyment conditions" means conditions A to E as specified in section 723.

I adopt the statutory terminology and refer to "**enjoyment conditions A to E**".

Section 722(1) states that an individual is *treated* as having power to enjoy if any of the enjoyment conditions is satisfied. It is considered that this is a comprehensive definition of "power to enjoy" but it is impossible to think of any power to enjoy (in the general sense) which does not also fall within one of the enjoyment conditions, so the point is academic.

"Power to enjoy" is elaborately defined and has given rise to a large case law. But in practice there is not often an issue here. In outline, the transferor has "power to enjoy" if they may possibly enjoy any of the income of the person abroad. A transferor has no power to enjoy if they (and their spouses) are excluded from benefit and have no power of control. A widow or widower of the transferor may be included as a beneficiary.

The test is slightly wider than that of a "settlor-interested" trust for the purposes of s.624 ITTOIA[27] though for most practical purposes they are the same. It is hard to see the reason for the distinction, but that is the patchwork nature of income tax.

The enjoyment conditions frequently use the word "benefit". For the meaning of "benefit" in the context of s.731 and s.87 see 30.4 (Benefit). Most of that discussion is relevant here, but there is one difference. In those sections one had to ascertain the value of the benefit. In the case of power to enjoy, all that matters is that there is a benefit, regardless of its value: the value of the benefit does not usually matter.

29.6.1 *Substance*

Section 722(3) ITA provides:

> In determining whether an individual has power to enjoy income for the purposes of section 721, regard must be had to the substantial result and effect of all the relevant transactions.

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27 See 27.3 (Meaning(s) of "settlor-interested").

Section 722(4) provides:

> In making that determination all benefits which may at any time accrue to the individual as a result of the transfer and any associated operations must be taken into account, irrespective of—
>
> (a) the nature or form of the benefits, or
>
> (b) whether the individual has legal or equitable rights in respect of the benefits.

I cannot think of any case where s.722(3) has made or could make any difference, though it has occasionally been referred to. Section 722(4)(a) is likewise otiose. The drafter is only stressing (which need hardly be stressed) that the provisions should not be narrowly construed. In *Vestey* the House of Lords say:

> the direction that regard shall be had "to the substantial result and effect of the transfer and any associated operations" does not in my view authorise any laxity in construing any of the documents by which the transfer or the associated operations are effected. The Court must first determine the meaning and effect of the documents before this provision is applied and it must then consider whether their effect, though in form not beneficial to the settlor, is so in substance. The contrast is between substance and form, so if it can be shown in the present case that the effect of the transfer and the associated operations is to vest a benefit in (for example) a company over which the settlor has complete control, the Court may then say that, though in form the company benefits, in substance the company and the settlor are one and the settlor therefore benefits. But the Court cannot take this last step unless it is shown that the settlor has himself the legal control and no reliance must be placed on his influence over others who are not in law bound to follow his directions.[28]

The example is not a case where s.722(3) is in point, as a benefit to the company held by the beneficiary would constitute power to enjoy under usual principles. An unsympathetic commentator would say that the drafter is simply striving for effect, or expressing exasperation.

Could s.722(4)(b) ever make any difference? An example is a Cayman Island exempted trust, under which it is said that a beneficiary has no

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28 *Vestey v IRC* 31 TC 1 at p.89.

rights,[29] or perhaps a Cayman Island STAR trust.[30]

29.6.2 *Time of enjoyment*

Section 721(4) ITA provides:

> For the purposes of subsection (2), it does not matter whether the income of the person abroad may be enjoyed immediately or only later.

29.6.3 *Enjoyment condition A: Income dealt with to benefit T*

Section 723(1) provides:

> Condition A is that the income is in fact so dealt with by any person as to be calculated at some time to enure for the benefit of the individual, whether in the form of income or not.

"Calculated..."

The nuance of this un-lawyer-like expression was discussed by the Special Commissioners in *Botnar v IRC*:

> 222. [Enjoyment condition A] is concerned with how particular income is dealt with when it arises. [Counsel for the taxpayer] however conceded that this is not confined to its immediate handling on receipt or even to what happens in the year of assessment, if for example it is received late in the year, but that we should look at how it is dealt with within a reasonable time of receipt. ...
> 224. It seems to us that, when the word "calculated" is considered in the context that it refers to income which is "in fact so dealt with", the meaning "likely" is to be preferred to "thought out" in the sense of "intended"; however we are not sure that either "likely" or "intended" gives exactly the same flavour as "calculated". "Calculated" here combines an element of objectivity with an element of forethought.
> 225. It may not however make much difference because if any income was intended to enure for the benefit of [the transferor] it is obviously more probable that it was likely to so enure and that it would be seen

29 See s.83 [Cayman] Trusts Law (2009 Revision); exempted trusts were introduced in the [Cayman] Trust Law 1967 specifically in the hope of avoiding the ToA rules which then applied if the transferor had "rights". The UK responded with the 1969 reforms removing the reference to "rights".

30 It has been argued that a beneficiary of a foundation has no rights, but a sceptical Court refused to accept that; see 84.8.3 (Foreign law views on Foundations).

objectively as likely to so enure.[31]

The ToA draft guidance provides:

> **INTM600880 power to enjoy - condition A**
> ... The meaning of the word 'calculated' in this test was considered briefly by Mr Justice Walton in *Vestey v CIR* (54 TC 503 at page 555) where he observes "that it was submitted to me that "calculated" … meant "likely". This is, of course, one of its possible meanings, although a glance at the Shorter Oxford English Dictionary makes it quite clear that this is not a precise translation of the word "calculated". On the other hand, its primary meaning is "reckoned, estimated, or thought out", and I would think that this is the meaning which is intended here." Walton J went on to say that he thought a stricter interpretation than "likely" is called for. And that is the approach which HMRC have continued to follow in relation to this test.

"...to enure for the benefit"

The ToA draft guidance provides:

> **INTM600880 power to enjoy - condition A**
> ... The benefit may be present or future. It may be in the form of income or not, and may include a payment of any kind (prior to April 2007 the transfer of assets legislation Chapter included a meaning of 'benefit' for the purposes of the Chapter saying - "benefit" includes a payment of any kind). Therefore provided some benefit enures to the individual it need not be a money payment at all. In this context 'enure' means to take, or have effect or serve to the use, benefit, or advantage of a person.
> Some examples taken from Case Law illustrate this point.
> In *Latilla v CIR* (25 TC 116), a non-UK company paid over income to the individual by repaying debentures held by her. Such a capital payment, if it results from dealing with the income of the person abroad, may come within this test. A capital payment may also trigger the income charge - receipt of/entitlement to capital sums further dealt with at (INTM600990).
> In *Lord Chetwode v CIR* (51 TC 647) the whole share capital of a Bahamas company was held by the Bahamas trustee of a settlement for the benefit of Lord Chetwode and his family. Lord Chetwode had a life interest in the trust fund and had very wide powers, including power to

31 72 TC 205. The wording is also discussed *obiter* in *Vestey v IRC* 54 TC 503 at P.555G.

> remove or appoint trustees, and to re-vest in himself the title to the trust fund. The House of Lords said in their Judgement that, in view of the terms of the settlement, in addition to power to enjoy under other conditions, the income of the underlying company was so dealt with as to be calculated to enure for Lord Chetwode's benefit, and thus he had power to enjoy under this condition.

29.6.4 *Enjoyment condition B: Income increases value of T's asset*

Section 723(2) ITA provides:

> Condition B is that the receipt or accrual[32] of the income operates to increase the value to the individual—
>
> (a) of any assets the individual holds, or
>
> (b) of any assets held for the individual's benefit.

First one must identify an asset held by T or for T's benefit. Having identified the asset, one asks whether the receipt of the income increases the value of that asset.

The concept of "assets held by T" is straightforward but what about assets held "for T's benefit"? In *Howard de Walden v IRC* 25 TC 121 a promissory note held by trustees on trust for T for life was considered to be held for T's benefit. One could reach the same result by a different route since T's life interest in the note was itself an "asset" held by T. If the asset is held on a discretionary trust under which T is merely a beneficiary, it is probably not held "for T's benefit". What if the asset is held on interest in possession trusts for T subject to an overriding power of appointment?

The second requirement is that the receipt of the income must increase the value of the asset. This was also considered in *Howard de Walden v IRC*. Here T transferred assets to offshore companies and held (1) a life interest in promissory notes issued by the companies and (2) the benefit of debt due from the companies (T had lent money to the companies).[33] The Court of Appeal held:

> The receipt of the income by each company operates to increase the

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32 The words "or accrual" appeal to be otiose, but it does not matter.

33 In some but not all cases T also held a few shares in the companies. The Court of Appeal did not rely on this because if it had held that T was caught only by virtue of these shares, T would not have been assessable on the income of all the companies.

value of the notes and of the deposit debt...[34]

However it is a question of fact in each case. The question is whether there was a risk of default which is reduced by the receipt of further income. If a debt is sufficiently covered by existing assets of a company, the receipt of further income by the company does not increase the value of the debt and enjoyment condition B is not satisfied. It will not usually matter, as s.727 is likely to apply in cases of this kind.[35]

The ToA draft guidance provides:

> **INTM600900 power to enjoy - condition B**
> ... This heading covers, for example, situations where:-
> a. the individual holds shares in a foreign company, and the accrued income or profits of the company increase the value of its shares;
> b. the individual receives debentures in exchange for transferred assets (see *Howard de Walden v CIR* 25 TC 121);
> c. the consideration for the transferred assets is left as a debt owing to the individual by the company (see *Ramsden v CIR* 37 TC 627).
>
> In these examples the receipt of income by the foreign company increases the value of the shares, debenture or debt, so income need not be remitted, nor even accumulated, for the benefit of the individual. If in fact the income is received by, or accrues due to, the person abroad, and operates to increase the value of any assets held by or for the benefit of the individual, then the test may be considered met for the purpose of applying the income charge.
>
> In the *Howard de Walden* (25 TC 121) case mentioned above, assets had been transferred by a series of transactions to companies resident abroad, and in exchange the individual had effectively received a series of promissory notes. The Court of Appeal held that the income of the non-resident companies increased the value of the promissory notes by increasing the general assets of the companies issuing them and therefore that the test was met for the purpose of the income charge.
>
> In the *Ramsden* case (37 TC 619) an individual transferred assets to a foreign company and left the cost of the assets credited to his account. Although it was held that the income charge - receipt of/entitlement to capital sums did not apply as the unpaid purchase money was not a loan nevertheless the power to enjoy condition was met under this heading and so an income charge arose. The individual's right to recover his debt was an asset held by him, and the value of that right was increased by

34 25 TC 121 at p.133. *Brackett v Chater* 60 TC 134 & 639 is another example.

35 See 29.11 (Transferor receives capital sum).

anything tending to increase the value of the company's assets (that is by the company's receipt of income). Under this heading therefore the individual would have "power to enjoy" income of the company while the debt remained unpaid.
In the *Lord Chetwode* case (51 TC 647) a trust for the benefit of *Lord Chetwode* held shares in a non-UK resident company which received dividends. The House of Lords found that in the circumstances of that case the receipt of dividends by the underlying company operated to increase the value to Lord Chetwode of the assets held by the trustees for his benefit, and he therefore had power to enjoy within this heading as well as within other heads of the test.

29.6.5 *Enjoyment condition C: Individual receives benefit*

Section 723 ITA provides:

(3) Condition C is that the individual receives or is entitled to receive at any time any benefit provided or to be provided out of the income or related money.
(4) In subsection (3) "related money" means money which is or will be available for the purpose of providing the benefit as a result of the effect or successive effects—
(a) on the income, and
(b) on any assets which directly or indirectly represent the income,
of the associated operations referred to in section 721(2).

For completeness, this question also arose in *Howard de Walden*. The Court of Appeal said:

> ... the payments made and to be made in respect of the notes and deposits are "benefits" within the meaning of (c) since "benefit" as defined ... includes a payment of any kind.

There are two issues here. First, is the payment of a debt to T (or payment of the promissory note) a "benefit" in the general sense? The Court of Appeal rightly thought it was not, since they relied on the former definition clause.[36] Secondly, did the former statutory definition of benefit extend the meaning of benefit to include a payment that is not a benefit in the normal sense? The Court of Appeal held that it did. However, the ITA does not contain the definition of benefit on which the court relied, so this argument no longer arises. However the repayment of an interest-

36 For the meaning of "benefit" see 30.4 (Benefit).

free loan is in principle a benefit.[37]

See 29.10.3 (Amount of charge when enjoyment condition C applies).

The ToA draft guidance provides:

> **INTM600920 power to enjoy - condition C**
> ...This test is designed to cover, for example, the individual who holds redeemable debentures; or who is entitled to other capital payments, where these are satisfied out of income or out of assets representing income; and also cases where a chain of companies is involved or a shareholder is entitled to receive dividends.
> In one example the Special Commissioners took the view that a capital sum payable to an individual by annual instalments in consideration for the transfer of assets to a foreign company met this condition and gave a power to enjoy income, as the test was not confined to payments which left the company as income. The test includes a sum received as capital as well as any income received. In such a case the income charge - receipt of/entitlement to capital sums provision may also apply.
> Another example is the case of *Earl Beatty's Executors v CIR* (23 TC 574). Assets were transferred by a series of transactions to a non-resident company in consideration for the issue of debentures repayable in successive years without interest. It was argued that, since these debentures were to be repayable only to the extent of the value of the assets transferred to the company, the individual was getting back nothing but his capital; that is he was receiving no benefit from the income derived from the assets transferred. It was held that since the debentures were charged on both the income and capital of the issuing company, the individual must be deemed to be entitled to a benefit provided out of income within the meaning of this condition. This decision was approved in *Howard de Walden v CIR* (25 TC 121). In that case the individual had a life interest in certain promissory notes issued by a non-resident company, and also had an interest in certain sums of cash on deposit with the company and repayable on demand. It was held that the payments made, and to be made, in respect of the notes and deposits were benefits provided out of the income of the company, the whole of which income could be traced to the assets originally transferred.
> And a final example of where this condition applies is that of an individual who is a shareholder of a non-UK resident company. In *Lee v CIR* 24 TC 207, the individual, as a result of a transfer of assets, held shares in a non-resident company which because of the rights attached

37 See 27.3.3 (Beneficial loan or guarantee).

to them entitled him to receive a dividend out of the income of the company. This was held to be a benefit provided, or to be provided, out of the income of company within this condition. Similarly in the Lord Chetwode case (51 TC 647) the House of Lords found that the terms of the deed of settlement entitled Lord Chetwode to receive a benefit out of the income received by the underlying company, and thus he had power to enjoy within this condition as well as within other heads of the power to enjoy provisions.

In some circumstances where power to enjoy is satisfied because of the receipt of a benefit the extent of the income charge may be affected by the amount or value of that benefit. More details on this are at INTM600980.

29.6.6 *Enjoyment condition D: Possibility of benefit*

Section 723(5) ITA provides:

> Condition D is that the individual may become entitled to the beneficial enjoyment of the income if one or more powers are exercised or successively exercised.
>
> (6) For the purposes of subsection (5) it does not matter—
>
> (a) who may exercise the powers, or
>
> (b) whether they are exercisable with or without the consent of another person.

This would apply to a discretionary trust where T was a beneficiary (or could be added to the class of beneficiaries).

"Income" here includes any asset representing the income, even if that asset does not constitute the actual income (in the strict sense) of the person abroad. In *Vestey v IRC*:

(1) The individual could receive accumulated trust income. Walton J held that the individual had no power to enjoy the trust income within enjoyment condition D because what the individual could receive was trust capital and so no longer "income".[38]

(2) The trust held a company. Walton J held that the individual had no power to enjoy the company's income within enjoyment condition D because what they could receive was dividends from the company and that was not the same as the income of the company.[39]

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38 *Vestey v IRC* 54 TC 503 at p.555.

39 *Vestey v IRC* 54 TC 503 at pp.562-3.

This is bizarre and in the House of Lords Viscount Dilhorne rejected it.[40] It is considered that Dilhorne's reasoning is to be preferred.

The ToA draft guidance provides:

> **INTM600940 power to enjoy - condition D**
> ...Perhaps the most common example of where this test may apply is to the income of a company underlying a settlement whose shares are acquired by the settlement trustees. The individual who made the settlement remains a beneficiary and as such has power to enjoy the income of such a company by becoming entitled to its beneficial enjoyment through the successive exercise of powers, for example, the declaration of a dividend by the company of which the trustees are shareholders, followed by an exercise of discretion as to the application of the dividend, by the trustees.
> This power to enjoy and with it the income charge can apply notwithstanding that income arising to the trustees of a settlement may be caught under the settlements provisions (Chapter 5, Part 5 ITTOIA 2005) and deemed to be that of the settlor. See INTM602360 where more than one set of charging provisions may appear to apply in relation to the same income.
> In another example (*CIR v Botnar* (72 TC 205)) the individual's counsel argued that even if the individual did become entitled to the beneficial enjoyment of income which could be traced to the companies underlying the settlement involved it had not been the income of those companies when it was beneficially enjoyed. The HMRC argument, which was accepted by the Court of Appeal, was that the income which the individual beneficially enjoyed had simply to have been the income of the companies at some earlier stage. It was not necessary that it still possessed the characteristics of being income of the underlying companies when it was beneficially enjoyed. What this condition is concerned with is the beneficial enjoyment in the future of what in the past was the income of the companies.

29.6.7 *Enjoyment condition E: Control*

Section 723(7) ITA provides:

> Condition E is that the individual is able in any manner to control directly or indirectly the application of the income.

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40 p.595. Strictly, Dilhorne only rejected point (1). He did not address point (2). But the reason is the same in both cases so it logically follows he rejected Walton's view on both points. No other judge considered this aspect.

A power to appoint the capital or income of a fund among a defined class (not including the appointor) does not satisfy enjoyment condition E, even if the power is not a fiduciary power.[41]

"Control" means non-fiduciary control and so does not include the powers of control of a trustee or a protector with fiduciary powers. It also does not include the power to appoint new trustees:

> The question is whether he was able to control the application of the income, and to answer that question affirmatively it must in my judgment be possible to say at least that he was in a position to ensure that the trustees would act in accordance with his wishes without themselves giving any independent consideration and accordingly to act in disregard of their fiduciary duty.[42]

This is discussed by the Special Commissioners in *Botnar v IRC*:

> 260. It seems to us that due importance must be given to the words "able… to control" in [enjoyment condition E] bearing in mind the words "in any manner whatsoever, and whether directly or indirectly"...
> 261. In our judgment the ability to control must go beyond an assumption that those controlling the companies will comply with the transferor's wishes and the fact that they do comply is immaterial. We accept the question posed by [Counsel], viz whether [the transferor] was in a position to ensure that the companies would act in accordance with his wishes.

The Special Commissioners then applied this statement of principle to the facts of the particular case:

> 262. There was in fact no material before us to indicate that [the transferor] could have done anything if Dr. Lenz had declined to do what he wanted. The position might have been different if Dr. Lenz was for example an employee who might have been dismissed in the event of failing to cooperate. There was however no evidence to suggest this. We are satisfied that the directors of the companies would have carried out his instructions. We have no doubt that [the transferor] was justified in assuming that Dr. Lenz would do what he wanted. However we do not consider that the mere fact that Dr. Lenz was in the saddle of the settlement meant that [the transferor] was able to ensure that the income

41 *IRC v Schroder* 57 TC 94 at p.116.

42 *IRC v Schroder* 57 TC 94 at p.125, followed in the non-tax case *R v Radio Authority ex p. Guardian Media Group* [1995] 1 WLR 334 at p.345.

> would be applied for his benefit. On the authority of *Schroder* even decisive influence is not enough.
> 263. We readily accept [Counsel's] submission that [the transferor] wished to ensure that the shares would remain in friendly hands. In a sense it could be said that he did in fact control the settlement and the Companies because in fact Dr. Lenz did comply with his wishes: there was no evidence of any action by Dr. Lenz which was contrary to [the transferor]'s wishes. That is not however the same as [the transferor] having the ability, even indirectly, to ensure that the income would be applied in accordance with his wishes.[43]

This is sensible, because a transferor will know whether they have power of control in this sense; whereas if the section were read more loosely, then power of control would come and go from time to time.

Lee v IRC 24 TC 207 offers an example: condition E is satisfied if the transferor holds management shares conferring votes (and so power to appoint and dismiss directors) even if the shares confer no right to dividends or capital. At first sight it may seem illogical that a power to appoint or remove directors should constitute a power to enjoy, when power to appoint or remove trustees does not. Directors and trustees are both fiduciaries. *IRC v Schroder* explains the difference:

> Mr. Lee had power to appoint and remove directors. That power was not a fiduciary power. He could have appointed himself. ... directors do not owe any fiduciary duty to the shareholders. They are trustees of their powers for the company. Mr. Lee was for all practical purposes the company. ... Thus Mr. Lee was in practice securely in the saddle.[44]

In such a case, enjoyment condition B is also satisfied, as company income would tend to increase the value of the voting shares (voting shares do have some value). In practice it is difficult to think of a case where enjoyment condition E is satisfied and none of the other enjoyment conditions would be satisfied. Possibly, condition E had more role to play before 1969, when (what is now) s.720 only applied when the individual had *rights* which conferred power to enjoy; and being an object of a discretionary trust was not enough as the discretionary beneficiary had no rights within the meaning of that section.

The ToA draft guidance provides:

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43 72 TC 205 (Special Commissioners) at p.250.

44 *IRC v Schroder* 57 TC 94 at p.123.

INTM600960 power to enjoy - condition E

...This test covers, amongst other things, the situation where the individual has a controlling interest in a foreign company, either by controlling the voting rights or other rights under company's Articles of Association.

An example of indirect control is found in the case of *Lee v CIR* (24 TC 207). In that case an individual transferred shares to a Canadian company in exchange for the issue to him of shares in the company. The individual was not a director but under the company's bye-laws he had power to elect and remove its directors, and his consent was necessary for any amendment to the bye-laws and for the allotment and transfer of shares. It was decided that the individual had power to control the application of the income of the Canadian company within the meaning of this test because of his power to appoint or remove the company's' directors (who in turn were able to control the company's income).The fact that control was indirect was immaterial.

In *Lord Chetwode v CIR* (51 TC 647) the House of Lords found that, because Lord Chetwode retained extensive powers over the assets of a foreign settlement in which he had a life interest, he had power to enjoy within this condition because he could control the application of the income of the foreign underlying company whose shares were held by the trustees.

It may sometimes be thought that an individual who has transferred assets to a non-UK settlement for example, or who is associated with such a transfer, continues to have power to enjoy the income of the structure by virtue of this condition because of powers expressed in the settlement deed, with or without associated arrangements, such as, for example, a 'letter of wishes' or being a 'protector' in relation to the settlement.

However the Special Commissioners decided in the case of *CIR v Schroder* (57 TC 94) that on the particular facts in that case the test was not met. They found that 'Mr Schroder was able to appoint trustees who…could be expected to deal with the trust income in accordance with his wishes: but he could not compel them to do so and there is no suggestion that any of them would have acted in breach of their fiduciary duties under the settlements.' In dismissing HMRC's appeal against the Commissioners' decision The High Court appears in effect to have distinguished a position of influence from a position of control. Vinelott J said (page 125):

'But the question in the instant case is not whether the settlor was likely to be able to influence or even to exercise a decisive influence over the

> exercise by the trustees of their fiduciary powers. The question is whether he was able to control the application of the income, and to answer that question affirmatively it must in my judgement be possible to say at least that he was in a position to ensure that the trustees would act in accordance with his wishes without themselves giving any independent consideration and accordingly to act in disregard of their fiduciary duty.'
> As Mr Schroder was within the category of persons defined as excluded from benefit under the settlements, so there was no possibility of establishing a power to enjoy by any of the other tests in the particular circumstances of the case.

IRC v Schroder raised a further question on the scope of enjoyment condition E which remains open:

> [Counsel for the taxpayer] submitted that ... para (e) was not intended to apply unless the taxpayer is able to secure that income is applied in a way which produces at least an indirect benefit or in the words of Lord Morton in the first *Vestey* case that his control over the application of income is a power which he is entitled to use to serve his own ends ...

The judge found the Revenue's response "less than compelling" but did not decide the issue:

> ... the question whether para (e) applies to a case where a settlor has a power to direct the application of income for the benefit of others and to the exclusion of any benefit direct or indirect to himself does not arise for decision, and I express no concluded opinion upon it.[45]

The ToA draft guidance shows that HMRC continue to take that point:

> **INTM600960 power to enjoy - condition E**
> ... The test does not however require that the individual is able to derive personal benefit from the power of control. If in fact therefore a settlor of a settlement, for example, does continue to have power to direct the application of income for the benefit of others, even though he himself may be specifically excluded from benefit, this power to enjoy condition may well be met.

The fact that this point remains undecided only goes to show the very limited importance of enjoyment condition E. The ToA draft guidance concludes with the same point:

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45 *IRC v Schroder* 57 TC 94 at p.125-126.

> In most cases it is unlikely that satisfaction of the power to enjoy test will rest on the basis of this condition alone.

29.6.8 *Minority shareholding in offshore company*

If T holds a majority shareholding in an offshore company, T has power to enjoy all the income of the company since enjoyment condition E is satisfied. The same applies if T and T's spouse together have a majority shareholding. What is the position if T has a minority shareholding, say, 10% of the ordinary shares? At first sight one might think that T has power to enjoy all the income of the company, since the income of the company increases the value of T's minority shareholding. But it is suggested that T has only power to enjoy one tenth of the company's income. This was assumed in *Bambridge v IRC*.[46]

29.7 Power to enjoy: Causation condition

It is not sufficient that the transferor has power to enjoy the income of the person abroad. A causation condition must also be satisfied. Section 721(2) ITA provides:

> Condition A is that the individual has power in the tax year to enjoy income of a person abroad *as a result of*—
>
> (a) a relevant transfer,
> (b) one or more associated operations, or
> (c) a relevant transfer and one or more associated operations.

Suppose:

(1) In 1970 A transfers an asset to a non-resident company wholly owned by B, who is not UK resident ("A's transfer").
(2) in 2010 B transfers the company to an offshore trust under which A may benefit ("B's transfer").

A has made a relevant transfer. However, before 2010, A is not within s.720 since A does not have "power to enjoy" the income of the company.

From 2010 onwards, A does have "power to enjoy". A does not have that power as a result of A's transfer alone. However, B's transfer appears at first sight to be an associated operation in relation to A's transfer.[47] It seems at first sight that s.721 condition A is satisfied and A is taxable

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46 36 TC 313. See Boyd, "Requiem for a Man of Straw" [1980] BTR 442 at p.457.
47 See 28.9 (Associated operation: definition).

under s.720 on the income of B's trust! This clearly cannot be right, but why not? This raises questions similar to those discussed in para 28.11.1 (Transfer from A to B followed by transfer from B to person abroad). Before the ITA, the legislation dealt with this by applying a more limited causation test. If B's transfer was an independent act, it "broke the chain of causation" and A's transfer was not the real or effective or operative cause.

From 2007/08, the foundation of that argument has been knocked away. But the courts will have to fill in the hole with a gloss, or the legislation simply does not work. It is suggested that B's transfer is not an associated operation, so A is not within s.720 if there is a "clean break" between A's transfer and B's transfer (the same test as applies elsewhere).

Suppose:

(1) In year 1, T transferred assets to an offshore company ("the original transfer of assets").

(2) In year 2, T lent money to the company interest-free (" the loan").

Suppose in year 1 T has no interest in the shares of the company and so has no power to enjoy its income and is outside s.720.

In year 2, T probably does have power to enjoy the income of the company by virtue of the interest-free loan.[48] However T is not taxed on the income arising from the original transfer of assets in year 1, since that power to enjoy does not arise *as a result* of the transfer or any associated operation. The loan is not an associated operation.[49]

However, T is in principle subject to tax under s.720 on the income arising to the offshore company as a result of the loan in year 2 (if there is any) as the loan is itself a transfer of assets.[50]

On the same facts, if income is used to repay the loan, then enjoyment condition A is satisfied. (So is enjoyment condition C, but that does not matter.)

29.8 Income chargeable: Section 721 Condition B

Section 721(3) ITA provides:

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48 Inter alia, enjoyment condition D is satisfied as income may be used to repay the loan, and (depending on the facts) enjoyment condition B may also be satisfied.

49 See 28.9.2 ("Effected in relation to" the assets transferred).

50 This point did not arise on the facts of *Fynn* as the loan was used to repay a debt, so no income arose to the offshore company as a result of the loan.

> Condition B is that the income of the person abroad would be chargeable to income tax if it were the individual's and received by the individual in the UK.

I cannot think of income which would not be chargeable if received by a UK resident individual in the UK. Perhaps the rule had some historical purpose when enacted in 1936 which has since been lost; but that is speculation.[51]

In practice condition B will always be satisfied. So it does not matter that s.727 has no equivalent condition.

29.9 Section 721 Condition C: Transferor UK resident

Section 721(3A) ITA provides:

> Condition C is that the individual is UK resident for the tax year.

29.9.1 *Transferor not resident when income arises*

Section 720 does not apply to income which arises in a year when the transferor is not resident in the UK.

A non-resident individual is subject to tax at their personal rates on their UK rental income. That individual can transfer UK land to an offshore company in order to avoid higher rate income tax.[52] (It is not usually necessary for a non-resident individual to transfer other assets to a company in order to avoid higher rate tax as income of a non-resident from most other sources is not subject to tax at the higher rates.)[53]

If the individual later becomes UK resident they do not retrospectively become liable under s.720 for income accruing while non-resident. This is consistent with the usual IT position.[54]

Formerly the ToA rules only applied to a person who was *ordinarily* UK resident. The abolition of ordinary residence in 2013 led to a significant extension of the rules. Until 2015/16, there is a transitional relief for transferors not ordinarily UK resident as at 5 April 2013: see 4.30

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51 One possible case (prior to the abolition of ordinary residence in 2013) was a transferor who was ordinarily resident but not resident. If that were possible (which was doubtful) the individual could have benefited from condition B as (being non-resident) they would not have been chargeable on foreign income.

52 Of course, CGT, VAT, IHT and SDLT all need consideration.

53 See 42.1 (Non-residents income tax relief: Introduction).

54 See 10.20 (RFI/gains arising when non-resident, remitted when resident).

(Ordinary residence).

29.9.2 *Transferor not resident when transfer made*

The intention of those responsible for the legislation was that s.720 should only apply if the transferor was (ordinarily) resident in the UK at the time of the transfer.[55] After some vacillation, this was upheld in *IRC v Willoughby*.[56] But that is only of historical interest, as the position now is governed by s.721(5) ITA:

> It does not matter for the purposes of this section ...
> (b) whether the individual is UK resident for the tax year in which the relevant transfer is made (if different from the tax year mentioned in subsection (1))...

Thus non-residence at the time of the transfer is not a defence: s.720 may apply to any person after they become resident, regardless of residence at the time of the transfer. This applies to income arising from 1996 regardless of the date of the transfer.[57]

29.9.3 *Split year*

There is no express split year rule, so the default rule applies: s.720 income is taxable even if it arises during the overseas part of a split year of the transferor.[58] There is no good reason for that. Section 720 income ought to be taxed in the same way as ordinary foreign income.

29.10 Amount of s.720 charge

29.10.1 *Power to enjoy part of income of person abroad*

Section 720 ITA provides:

> (2) Income tax is charged on income treated as arising to such an individual under section 721 (individuals with power to enjoy income as a result of relevant transactions)...
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year.

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55 "There has to be a transfer of assets abroad by an individual resident in this country." (W.S. Morrison, then Financial Secretary) 313 HL Official Reports 5th series col 685, cited *IRC v Willoughby* 70 TC 57 at p.113.

56 70 TC 57 reversing *Herdman v IRC* 45 TC 394.

57 Also see 30.10.1 (Transferor not resident when transfer made; pre-1996 income).

58 See 7.1 (Default rule: individual regarded as resident throughout tax year).

Section 721(3B) ITA provides:

> (3B) The amount of the income treated as arising under subsection (1) is equal to the amount of the income of the person abroad (subject to sections 724[59] and 725).

Prior to 2013, s.720 did not tell us *what* is the amount of income treated as arising. Construction and common sense had to fill the gap.[60] Now we have s.721(3B) but it does not clearly address the problems which arise.

A person may have "power to enjoy" (as defined) over all the income of an offshore person even though their power to enjoy (in the natural sense of that expression) is limited to an unidentifiable part[61] or even none[62] of the income. In such a case T is taxed on all the income. The s.720 income is not limited to the income that T is actually entitled or able to receive. Section 721(3B) ITA confirms the pre-2013 law.[63]

However, if T has power to enjoy (as defined) over only part of the income, T is only taxed on the income which T has power to enjoy:

> The only question is: What income of the non-resident does the resident individual have power to enjoy by reason of the transfer either alone or in conjunction with associated operations? It is that income which is deemed to be income of that individual for all purposes of the Income Tax Acts.[64]

It is suggested that s.721(3B) has not altered this.

29.10.2 *Person abroad with independent source of income*

Suppose:

(1) T transfers assets to an offshore company.

(2) The offshore company has two sources of income:

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59 A narrow exception: see 29.10.3 (Amount of charge when enjoyment condition C applies).

60 See R.S. Boyd "Requiem for a Man of Straw" [1980] BTR 442. See also 28.13 (Capital receipts deemed to be income) and 28.14 (The amount of income of person abroad).

61 eg if T transfers assets to a company in which T holds debentures. If all the income of the company increases the value of the debentures just a little, T has "power to enjoy" all the income within enjoyment condition B.

62 eg if T has control within enjoyment condition E.

63 *Howard de Walden v IRC* 25 TC 121.

64 *Congreve v IRC* 30 TC 163 at p.199.

(a) income from the assets transferred by T;
(b) income from other sources which have nothing to do with T.

(3) T has power to enjoy all the income of the offshore company.

What income is treated as arising to the individual. Is it any income of the person abroad? Or is it only the income which arises as a result of the transfer of assets or associated operations?

The relevant provisions are in s.721:

> (1) Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A to C are met.
> (2) Condition A is that the individual has power in the tax year to enjoy income of a person abroad as a result of—
> (a) a relevant transfer,
> (b) one or more associated operations, or
> (c) a relevant transfer and one or more associated operations...
> (3B) The amount of the income treated as arising under subsection (1) is equal to the amount of the income of the person abroad (subject to sections 724 and 725).

RI 201 states:

> It has not been determined by the Courts whether all the income of the overseas person should be assessed, or only the income of that person to the extent that it arose by virtue or in consequence of the relevant transfer of assets and any associated operation(s). It has been the Revenue's practice (since the decision in *Vestey v IRC* 54 TC 503) to assess on the second of these two possible bases.

The Revenue practice is correct, though in fact the issue has been determined by the Courts: the view that all the income of the person abroad is taxed was dismissed as "quite ridiculous".[65]

This view is supported by s.714(2) ITA which provides:

> The charges apply only if a relevant transfer occurs, and they operate by reference to income of a person abroad that is connected with the transfer or another relevant transaction.

This clearly rejects the view that all income of the person abroad is caught.

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65 Walton J in vehement form in *Vestey v IRC* 54 TC 503 at p.562, followed in *Carvill v IRC* [2000] STC (SCD) 143 at [97] - [98]. The point had been left open in *Howard de Walden v IRC* 25 TC 119.

It suggests however that the measure of income caught is not that which arises as a *result* of the relevant transfer or associated operation, it is income which arises that is *connected* with the transfer or associated operation. "Connected" is not defined. However, while the wording was perhaps designed to give HMRC scope to take one step back from the position stated in RI 201, I cannot think of a case where it would arise in practice.

It is suggested that s.721(3B) has not altered this. The reference to "the income of the person abroad" must be taken as a reference to the income within s.721(2).

29.10.3 *Amount of charge when enjoyment condition C applies*

A special rule applies for a transfer who has power to enjoy under enjoyment condition C.[66] Section 724 ITA provides:

> (1) This section applies if an individual has power to enjoy income of a person abroad for the purposes of section 721 because of receiving any such benefit as is referred to in section 723(3) (benefit provided out of income of person abroad).
> (2) Despite anything in section 720, the individual is liable to income tax under that section for the tax year in which the benefit is received on an amount equal to the whole of the amount or value of that benefit.
> (3) But subsection (2) does not apply so far as it is shown that the benefit derives directly or indirectly from income by reference to which the individual has already been charged to income tax for that tax year or a previous tax year under this Chapter.

This was introduced in 1969 and upsets the reasoning of *de Walden* where repayment of a loan was held to fall within enjoyment condition C. Since the charge is now on the value of the benefit, and the value of a payment for full consideration (such as the repayment of a loan) is nil, there would be no charge under s.720 by reference to enjoyment condition C.

In *Botnar* the Special Commissioners said:

> 245. ... Where the power to enjoy arises the tax is charged not on the income which the taxpayer has power to enjoy but on the value of the benefit. This may bear no relationship whatsoever to the income of the non-resident as long as it originated from it even indirectly. We do not accept that [s.724 ITA] only operates where the benefit received in a

66 See 29.6.5 (Enjoyment Condition C: individual receives benefit).

year exceeds the relevant income.

It is considered that the charge is on the lower of the value of the benefit and the amount of income of the person abroad. The value of a benefit in excess of the income does not come into charge, and if the transferor has power to enjoy the income apart from enjoyment condition C, then this provision does not apply.[67]

The ToA draft guidance provides:

> **INTM600980 Special rule where benefit provided out of income of person abroad**
> This provision [Section 724 ITA] was considered in the case of *CIR v Botnar* (72 TC 205). Although it did not affect the outcome in that case, there is some helpful comment on it. The views expressed there appear to confirm that in the case of actual receipt of a benefit (as opposed to mere entitlement to receive) the provision is determinative of the charge to tax which could produce a radically different result than what might otherwise be the charge under the income charge. Further that where the power to enjoy arises on this basis the tax is charged not on the income which the individual has power to enjoy but on the value of the benefit. This may bear no relationship whatsoever to the income of the person abroad as long as it originated from it even indirectly. The Commissioner rejected the view that the provision only operates where the benefit received in a year exceeds the income of the person abroad. From this it seems clear that where the conditions are met the provision could have the effect of either extending the amount of charge for the tax year beyond the actual income of the person abroad of that year or of limiting the amount of the charge to the amount or value of the benefit where that is less than the income of the person abroad of the tax year.

29.10.4 *Transferor's deductions and reliefs*

Section 746 ITA provides:

> (1) This section applies for the purpose of calculating the liability to income tax of an individual charged under section 720 or 727.
> (2) For the purpose of determining the deductions and reliefs allowed to the individual, the individual is to be treated as if the individual had actually received the amount by reference to which the income treated

67 See Venables, "Section 739 and benefits in kind", OTPR Vol 11 Issue 3 p.1, accessible *http://www.khpplc.co.uk/reviews*

as arising to the individual under section 721 or 728 is determined.

This is needed (at least from 2013/14) to confer tax credits on the transferor, where the income of the person abroad is dividend income.

29.11 Transferor receives capital sum

Sections 727 and 728 ITA must be read together:

> **727 Charge to tax on income treated as arising under section 728**
> (1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are UK resident by means of relevant transfers.
> (2) Income tax is charged on income treated as arising to such an individual under section 728 (individuals receiving capital sums as a result of relevant transactions).
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year. ...
> (4) The person liable for any tax charged under this section is the individual to whom the income is treated as arising. ...
> **728 Individuals receiving capital sums as a result of relevant transactions**
> (1) Income is treated as arising to such an individual as is referred to in section 727(1) in a tax year for income tax purposes if—
> (a) income has become the income of a person abroad as a result of—
> (i) a relevant transfer,
> (ii) one or more associated operations, or
> (iii) a relevant transfer and one or more associated operations, and
> (b) the capital receipt conditions are met in respect of the individual in the tax year (see section 729) , and
> (c) the individual is UK resident for the tax year.
> (1A) The amount of the income treated as arising under subsection (1) is equal to the amount of the income of the person abroad (subject to subsection (2))...
> (2A) Subsection (1) does not apply if—
> (a) the individual is liable for income tax charged on the income of the person abroad by virtue of a charge not contained in this Chapter, and
> (b) all that income tax has been paid...

Section 727 ITA is an independent charging section. Lord Greene explains its purpose in *Howard de Walden v IRC* 25 TC at p.135:

> The provision was made ... to meet devices by which a transferor took care to give himself no "power to enjoy" any income of a non-resident transferee company within the meaning of [s.723 ITA], but obtained the money he required, for example, by borrowing from the company, all the shares being vested (for example) in his children.

Another example would be a non-resident trust or underlying company making an (arm's length) loan to a transferor who was excluded from benefit.

Many of the rules applying to s.720 also apply to s.727. In ITA they are set out twice, but I do not discuss them again here. In particular, the words "such an individual" in s.727(2) restrict the charge to the transferor (just as s.720).

Where the settlor receives a capital sum, it is also necessary to consider the settlor-interested trust rules: see 27.11 (Settlor receives capital sum).

29.11.1 *Nature of s.727 charge*

ITA EN Change 111 provides:

> Section 739(3) ICTA [now s.727] does not deem the capital sum to be income; instead, it takes income which has become payable to persons abroad as a result of the transfer and deems that income to be the transferor's.

In *Vestey v IRC* 54 TC 503, Lord Wilberforce said:

> It is "any income" of the foreign transferees which is deemed to be the income of the recipient of a capital sum, [*indeed of each and every recipient of any capital sum*,][68] small or large, whenever received. From these words there is no escape.

29.11.2 *Relationship of s.720 and s.727*

The ToA draft guidance provides:

> **INTM600680 General conditions Which charge applies?**
> It is possible that for the same tax year an individual could meet the conditions to be potentially chargeable under either of the income charge provisions. The 'no duplication of charge' provisions described at INTM602360 ensure that the same income cannot be taken into account more than once for the purpose of an income charge. The result

68 The words in italics are wrong since s.727 is limited to the transferor.

> would be that if the conditions for both charges were in fact met, only one charge would be made.

This was the case even before the double counting rule was enacted in 1981:

> [Sections 720 and 727 ITA] are ... concurrent and not cumulative. A person cannot be taxed in any one year on the same sum under both [s.720 and also s.727]. Like Warren Hastings, the Crown, in making this concession, doubtless stood amazed at its own moderation ... but make it it did.[69]

In practice it is rare for s.727 to apply in a case where s.720 does not, that is, the transferor receives a capital sum without having power to enjoy. So it is rare to have to look at s.727.

29.12 The capital receipt conditions

Section 729(1) ITA provides:

> For the purposes of section 728(1), the capital receipt conditions are met in respect of the individual in a tax year ("the relevant year") if—
>
> (a) either—
>
> (i) in the relevant year the individual receives or is entitled to receive any capital sum, whether before or after the relevant transfer, or
>
> (ii) in any earlier tax year the individual has received any capital sum, whether before or after the relevant transfer, and
>
> (b) the payment of that sum is (or, in the case of an entitlement, would be) in any way connected with any relevant transaction.

29.12.1 *"Receives or is entitled to receive"*

"Receives or is entitled to receive" is given an artificial meaning in s.729(4) ITA:

> For the purposes of subsection (1), a sum is treated as a capital sum which the individual ("A") receives or is entitled to receive if another person receives or is entitled to receive it—
>
> (a) at A's direction, or
>
> (b) as a result of the assignment by A of A's right to receive it.

---

69 *Vestey v IRC* 54 TC 503 at p.556.

It is considered that a person is not "entitled to receive" a sum until it is due; so if a transferor lends on terms that the loan is repayable on a fixed date, the capital receipt condition is not met before that date.[70] But if the debt is repayable on demand, the transferor is entitled to receive it even if they have not formally demanded it: the notice of demand is a merely administrative matter.

The ToA draft guidance provides:

> **INTM601040 Meaning of 'capital sum'**
> ... This might include, for example, a situation whereby an individual is able to direct an overseas person to make a payment to one of his creditors; or, is able to direct that a loan be made to a third party. The payments being 'capital' in nature may amount to a capital sum for the purpose of this test.

29.12.2 *"Capital sum"*

"Capital sum" is artificially defined. Section 729(3) ITA provides:

> In subsection (1) "capital sum" means—
> (a) any sum paid or payable by way of loan or repayment of a loan, and
> (b) any other sum paid or payable—
> (i) otherwise than as income, and
> (ii) not for full consideration in money or money's worth.

If T lends, repayment of the loan to T is a capital sum. If T sells an asset at market value, payment of the purchase price to T is not a capital sum. The distinction between a loan and a sale is therefore important. "Loan" is a fairly narrow term and does not include the right to an unpaid purchase price even if the purchase price is left outstanding: *Ramsden v IRC* 37 TC 619.

In *Botnar v IRC* 72 TC 205 at p.266 the Special Commissioners say:

> In our judgment the entitlement to use the flat is not a capital sum within the definition in [s.729(3)]; in particular we hold that the entitlement to use was not a "sum" within any normal use of English.

---

70 So in the definition of control, express provision is needed to deal with this; see 85.3.9 ("Entitled to acquire"). But enjoyment condition B also needs consideration in these cases: See 29.6.4 (Enjoyment condition B: income increases value of T's asset).

The ToA draft guidance provides:

> **INTM601060 examples of capital sum**
> ...Other examples might include:-
> e. The situation where an asset is transferred to a person abroad at an inflated price. Where an individual transfers an asset and receives full consideration in money or money's worth even though by general nature that consideration may be a 'capital' receipt it would not be a 'capital sum' for the purpose of these provisions because of the specific wording in the legislation defining the meaning of the term for this purpose. Hence it is only where an inflated price is received that there could be a capital sum for this purpose.
> f. A capital distribution from a foreign company. A foreign company may, under the law of the jurisdiction in which it is established, be able to make a so-called 'capital distribution'. Where such a distribution received by the individual is found in fact not to be an income receipt, and so satisfies the condition to be any other sum payable otherwise than as income, it can be a capital sum for this purpose. In considering whether any such payment or entitlement from a 'foreign possession' (the share holding that results in the payment) is a capital sum due regard must be had to United Kingdom tax law dealing with 'income' from foreign possessions.
> The following are examples of situations where there may not be a capital sum for the purpose of this charge.
> g. If an individual transfers assets to a person abroad for full consideration and leaves the cost of the assets credited to his account with that person, the unpaid purchase money will not normally be regarded as a loan following the decision in *Ramsden v CIR* (37 TC 619).
>
> However although the capital sum test may not be met for the purpose of this income charge, the presence of an account with a person abroad to which sums are credited may be indicative of that individual having the power to enjoy income for example (as in the Ramsden case) through [enjoyment] Condition B.
> h. Where promissory notes or debentures payable on demand are issued to the individual as part of the consideration for the transfer of assets the amount payable under the notes, not being payable by way of loan, and being payable for full consideration is unlikely to be a capital sum for this purpose, as was found in the case of *Lee v CIR* (24 TC 207).
>
> However as discussed at INTM600900 such an issue of promissory notes may give rise to a power to enjoy the income of the person abroad and bring the individual within that income charge.

29.12.3 *"Connected with any relevant transaction"*

In *Fynn v IRC* 37 TC 629:

(1) In 1948, T transferred assets ("the original assets") to an Irish company ("the original transfer").
(2) The company charged the assets for a debt ("the charge").
(3) In Jan 1952, T lent the company £12,000 ("T's loan").

The Revenue assessed T on the income accruing to the company in 1951/2 and 1952/3 under (what is now) s.727.[71]

During those years T was entitled to receive a capital sum (repayment of T's loan). However, the (hypothetical) payment of that sum would not be "in any way connected" with the original transfer or the charge (an operation associated with the original transfer). So the condition in s.729(1)(b) was not satisfied, ie, the capital receipt conditions were not satisfied.

Suppose the same facts but the loan were repaid out of the original assets. In that case T actually receives a capital sum, and the actual receipt is connected with the original transfer; so it is considered that the capital receipt condition would satisfied. (This did not happen in *Fynn*: T wisely released the loan, two years after it was made.)

This is the only use of the expression "connected with" in the ToA provisions (though the definition of associated operations uses the comparable expression "in relation to" and it is suggested that the meaning is the same). "Connected with" is of course an expression used in other anti-avoidance provisions[72] but it is such a vague and context-sensitive expression that no useful guidance can be expected from cases on other provisions.

29.12.4 *Relief where transferor repays loan*

Section 729(2) ITA provides relief where the capital sum takes the form of a loan to the transferor which is repaid:

> But subsection (1)(a)(ii) does not apply merely because of the receipt of a sum by way of loan if the loan is wholly repaid before the relevant year begins.

---

71 These facts raise interesting s.720 issues, which were not discussed in the case; see 29.7 (Power to enjoy: causation condition).

72 For instance, the transactions in securities provisions.

29.13 Time extent of s.727 charge

29.13.1 *Historic income*

It can happen that at one time the capital receipt conditions are not satisfied, and later they become satisfied. The common example would be if the person abroad makes a loan to the transferor who is otherwise excluded from benefit: until the loan is made the transferor may not have received (or been entitled to receive) a capital sum); but on making the loan, the transferor does receive a capital sum so the capital receipt conditions become satisfied at that time.

A transferor who receives a capital sum in this way is not taxed on income arising to the person abroad in a year before the year that the capital receipt conditions are satisfied ("historic income"). Section 727 is not in that sense retrospective:

> While the income of the non-resident trustees would be deemed to be the income of [the taxpayer] on her receipt of the £100,000 [capital sum] on 2 May 1966, *in that and subsequent financial years*, I see nothing in [s.727] which gives it retrospective effect. It does not provide that the income of the non-resident in any year before the person receives or is entitled to receive is to be deemed to be that person's income.[73]

HMRC agree. The ToA draft guidance provides:

> **INTM600660 receipt of/entitlement to capital sum**
> ... It should be noted that no liability can arise under this charge for a tax year before receipt or entitlement to a capital sum. But where there is such a receipt or entitlement liability continues for any subsequent year for which there is income (there need be no further receipt of a capital sum). If, however, entitlement to a capital sum completely ends, and there are no other grounds for an income charge, liability under this charge will not normally be extended beyond the tax year in which that entitlement ceases.
> Where this charge applies for the first time it is the whole of any income of the tax year that is potentially chargeable not merely income arising from the date of receipt or entitlement to the capital sum. This is also the case for any tax year where the entitlement to the capital sum ends; the whole of any income of the tax year is potentially chargeable.

---

73 *Vestey v IRC* 54 TC 503 at p.594.

An alternative view is that s.727 could apply so that the historic income should retrospectively be deemed to be income of the transferor in the year that the income actually arose. That seems unworkable: it would require an unlimited number of past years to be reopened.

Another possible view that s.727 could apply so that the historic income should be deemed to be the income of the transferor in the year of the receipt of the capital sum. That would still require all the past years of the person abroad to be reviewed. There is also the conundrum of how to treat income arising to the person abroad if the transferor was not UK resident during some of those years.

This explains why the capital receipt conditions are satisfied if a transferor is entitled to receive a capital sum, even though they have not actually received it. The application of s.727 makes sense here because on the subsequent receipt of the capital sum the historic income would not otherwise be caught.

29.13.2 *Present and future income*

The s.727 charge applies to income arising in the year in which the capital receipt condition is met. However once that condition is met in one year, it is generally met in all future years, so s.727 in principle applies to the income of the person abroad in the year that the capital receipt condition is first met and all future years.

There are two narrow exceptions to this rule. The first relates to loans to the transferor which the transferor has repaid.[74] The second is this: The capital receipt condition in s.729(1) (so far as relevant) requires that:

> either—
>
> (i) in the relevant year the individual receives or is entitled to receive any capital sum, whether before or after the relevant transfer, or
>
> (ii) in any earlier tax year the individual has received any capital sum, whether before or after the relevant transfer

The condition in (a) is satisfied in a year if the individual receives *or is entitled to receive* a capital sum in that year. The condition is satisfied in a year if the individual received a capital sum in an earlier year.

The condition is not satisfied if:

---

74 See 29.12.4 (Relief where transferor repays loan).

(1) the individual was entitled to receive a capital sum in an earlier year but
(2) the entitlement has ceased[75] and the individual did not actually receive anything.

This was deliberate. ITA EN Change 111 provides:

> But the wording of section 739(3) of ICTA [now s.727] leaves the timing of the charge rather unclear. It reads:
>
> > Where, whether before or after any such transfer, such an individual receives or is entitled to receive any capital sum …
>
> Section 739(6) ICTA [now s.729(2) ITA] provides that income is not deemed to be the individual's under section [727] for any tax year "by reason only of his having received a sum by way of loan if that sum has been wholly repaid before the beginning of that year".[76] Therefore income may be deemed to be the individual's in other cases where there has been an actual receipt of a capital sum in a previous tax year. But [the source legislation] makes no provision about whether section [727] imposes a charge if the individual was merely entitled to receive a capital sum in a previous tax year. In practice, where entitlement to a capital sum has ceased HMRC do not pursue further liability under section [727]. Section 729 ITA gives effect to this practice by providing that the individual must either receive or be entitled to receive a capital sum in the tax year or have received a capital sum in an earlier tax year.

However it must be rare that a transferor is entitled to receive a capital sum without ever receiving a capital sum. An example would be if a transferor lent money to the person abroad and later waived the right to repayment.

In general, therefore, the capital receipt conditions are met in a year if the transferor has received a capital sum in an earlier year. This raises the spectre of a transferor being taxed for all time because they have received a small capital sum. Suppose:

(1) A company under which the transferor has power to enjoy, and under which they are taxed under s.720 ITA.
(2) The transferor receives a capital sum. This does not give rise to any (or any additional) charge under s.727 since all the income is taxed as the transferor's anyway.

---

75 An assignment by the transferor does not count: see 29.12.1 ("Receives or is entitled to receive").

76 See 29.12.4 (Relief where transferor repays loan).

(3) The transferor is then excluded from benefit and ceases to have power to enjoy.

It has been suggested in these circumstances that all future income arising in the company will be deemed to be that of the unfortunate transferor. The same point would apply to a non-resident trust if a capital sum was paid to the settlor, even though the settlor was subsequently excluded from benefit and ceased to be liable under the IT settlor-interested trust provisions. That would be absurd. For good measure, the overlap with s.633 ITTOIA would also lead to a double charge. In practice HMRC do not take that point. It is suggested that s.727 does not normally apply in a situation where s.720 applies, so a capital sum received at that time should be disregarded. A court would no doubt look at the matter differently if there were arrangements under which the transferor effectively enjoyed the income of future years.

The same problem arises if:

(1) Trustees hold a company under which the transferor has power to enjoy, and under which they are taxed under s.720 ITA.
(2) The transferor receives a capital sum.
(3) The trustees then sell the company to a third party.

It has been suggested that all future income arising in the company will be deemed to be that of the unfortunate transferor (though they may not have any right to know from the purchaser what that income will be). That would be absurd. In practice HMRC do not take that point. It is suggested that s.727 does not normally apply in this situation. A court would no doubt look at the matter differently if there were arrangements under which the transferor effectively enjoyed the company's future income.

Walton J proposed a sensible solution to this conundrum. He said in *Vestey* that the charge under s.727 was limited to the amount of the capital sum. Unfortunately his view was rejected by two judges in the House of Lords who commented on the point.[77] However it remains arguable, as the comments in *Vestey* were obiter, the approach to statutory construction is now looser, and the problems which arise were not explored. The disproportionate nature of the rules on any other view would constitute a breach of EU law, and an EU compliant construction should be preferred.

The ToA draft guidance provides a straightforward example of a loan from the person abroad to the individual:

---

77 See the comment of Lord Wilberforce set out in 29.11.1 (Nature of s.727 charge).

> **INTM601040 Meaning of 'capital sum'**
> ... Example
> In years 1 to 4 income arises to a person abroad as a result of a relevant transfer by an individual A. The individual does not have any power to enjoy the income or entitlement to a capital sum; but in year 2 receives a loan. In year 3 the loan is repaid in full and there is no ongoing entitlement to further loans or other capital sums.
> In these circumstances there would be an income charge in years 2 and 3. There would also be ongoing charge for year 4 because of the terms of (a)(ii) in INTM601020 but for the proviso above relating to repayment of a loan where that is in effect the only feature that triggers the income charge - receipt of/entitlement to capital sums.

The TOA draft guidance then considers the position of a loan from the individual to the person abroad:

> ... Not only is the receipt of a loan by the individual a capital sum, the making of a loan by the individual to a person abroad can also satisfy this meaning, carrying as it does an entitlement to repayment. That entitlement would be entitlement to a capital sum and thus the condition would be met from the time that the loan is made to the person abroad. Any repayment of such a loan would itself be a capital sum, it is not however itself a loan and thus will not stop the income charge from running under the proviso described in the first paragraph above. In order to stop this income charge from continuing the individual would need to demonstrate that there was no ongoing entitlement of any description to a capital sum.

29.14 Section 720 remittance basis

Section 726 ITA provides a relief which I call "**the s.720 remittance basis**". Section 726(1) provides:

> This section applies in relation to income treated under section 721 as arising to an individual in a tax year ("the deemed income") if section 809B, 809D or 809E (remittance basis) applies to the individual for that year.

In short, the relief applies to remittance basis taxpayers. Section 726(2) ITA defines the term "foreign" deemed income:

> For the purposes of this section the deemed income is "foreign" if (and to the corresponding extent that) the income mentioned in section 721(2) would be relevant foreign income if it were the individual's.

"The income mentioned in s.721(2)" is the income of the person abroad (or that part over which the individual has power of enjoyment). Section 726(3) ITA provides the relief:

> Treat the foreign deemed income as relevant foreign income of the individual.

In the HMRC view s.720 income is fictional income distinct from the actual income of the person abroad. Since fictional income cannot be remitted, the remittance basis would not work. So s.726(4) ITA provides:

> For the purposes of chapter A1 of part 14 (remittance basis), treat so much of the income within section 721(2) as would be relevant foreign income if it were the individual's as deriving from the foreign deemed income.

In short, the remittance basis applies as if the income accruing to the person abroad were the income of the transferor. There is a tax charge if the income of the person abroad is received/brought/used in the UK by the transferor or by a relevant person (in relation to the transferor).

It is desirable for trusts and companies within s.720 to segregate (1) foreign income and (2) capital. They can then remit capital (IT-free) rather than income (chargeable at IT rates). If they fail to do so then the mixed fund rules will apply.

29.14.1 *Remittance during overseas part of split year*

Section 726(5) ITA provides:

> In the application of section 832 of ITTOIA 2005 to the foreign deemed income, subsection (2) of that section has effect with the omission of paragraph (b).

To see the significance of this we need to turn to s.832(2) ITTOIA:

> For any tax year for which the individual is UK resident, income tax is charged on the full amount of so much (if any) of the relevant foreign income as is remitted to the UK—
>
> (a) in that year, or
>
> *(b) in the UK part of that year, if that year is a split year as respects the individual.*

The significance is that (contrary to the usual rule) s.720 income is taxable if it is remitted during the overseas part of a split year. There is no good

reason for that. It is considered that the s.720 and s.731 remittance bases ought to operate in the same way as for ordinary foreign income.

29.14.2 *Payment of s.720 income to transferor while non-resident*

Suppose:

(1) Year 1: Income accrues to a company within s.720. The transferor ("T") receives s.720 income but that income is (un)taxed under the s.720 remittance basis.
(2) Year 2:
    (a) T becomes non-resident.
    (b) The company distributes its income by way of dividend. T receives actual income (a dividend) but because this dividend is received in a non-resident year, it is not taxed either on receipt or when remitted to the UK.
(3) Year 3:
    (a) T becomes UK resident.
    (b) T remits that dividend to the UK.

The question is whether the dividend received in the UK in year 3 constitutes a remittance of the s.720 income of year 1. Is the dividend which the individual received derived from the s.720 income. The answer is that the dividend received is derived from the income of the person abroad, and so is taxable on receipt in the UK in year 3.[78]

The position is no better if T remits the dividend in year 2, as this is in principle caught by the temporary non-residence rules.

In short, one cannot "wash" income taxable on the s.720 remittance basis by a distribution to T in a year of T's temporary non-residence. That view fits the object of s.720 which is to put the transferor in the same position as if they had not made the transfer: see *Chetwode v IRC* 51 TC 647.

29.14.3 *Pre-2008 s.720 income and transitional rules*

In the following discussion I use the term **"pre-2008 s.720 income"** to mean foreign income arising before 6 April 2008, which

(1) fell within s.720 ITA or its predecessor, s.739 ICTA, but
(2) qualified for relief under s.726 (in its 2007/08 form), or its predecessor, s.743(3) ICTA, a kind of remittance basis which in

78 See s.726(4). This seems even clearer if one remembers that distribution relief would be available, had the dividend in fact been taxable; see 31.4 (Distribution relief).

earlier editions of this work I called "the foreign domicile defence." There was no tax charge when the income arose if it was not received in the UK.

Before 2008/09 it is considered that there was no charge under these sections if such income was received outside the UK but later brought to the UK. This was so whether the income was brought to the UK by:

(1) the person abroad who received it; or
(2) the transferor (if they received the income outside the UK from the person abroad).[79]

Para 170 Schedule 7 FA 2008 provides:

> The amendments made by paras 161 to 179 have effect for the tax year 2008-09 and subsequent tax years.

Pre-2008 s.720 income remitted after 2008/09 is not caught by s.726 in its current form, as the condition in s.726(1)(a) is not met.[80] So there is still no charge on the remittance of pre-2008 s.720 income. This is right and fair, since there was no charge on remittance before 2008. However (given the retrospective operation of some other 2008 reforms) this may have been an oversight. A passage in the TAH suggests its author thought that pre-2008 s.720 income is taxable on remittance after 6 April 2008.[81] But it seems to me that this is clearly wrong.

---

79 See *Taxation of Foreign Domiciliaries* 6th edn para 16.14 (s.720 foreign domicile defence). There were good reasons for this: see *Taxation of Foreign Domiciliaries* 6th edn para 14.12 (Critique of s.648 clawback). Needless to say, no reason was given for changing the position.

80 Contrast the usual RFI remittance basis, where para 83 Sch 7 FA 2008 fills that gap: see 10.15.1 (Transitional rules for pre-2008 RFI/gains).

81 TAH para 1224 provides:
"The provisions described in TAH 1223 [including the current s.720 remittance basis] have effect for the tax year 2008-09 and subsequent years. There are no specific transitional arrangements for introduction of the new provisions. As the [s.720] income charge only looks at income arising to the person abroad in the tax year it should not be necessary to have regard to income of earlier years in determining whether there is an amount that is to be regarded as foreign deemed income. However if there is foreign deemed income then in considering any possible charge under Part 8 ITTOIA it will be appropriate to consider all sums remitted to the UK in the tax year even if they arise, for example, from income of periods prior to the introduction of these provisions. Those remittances will fall to be tested against the rules in Chapter A1 Part 14 ITA 2007 as to whether they are taxable remittances."

29.14.4 *s.720 income of years 2005/06 to 2007/08: HMRC view*

In the following discussion I use the term "**2005-2008 s.720 income**" to mean foreign income arising in the years 2005/6 to 2007/8 (inclusive), which fell within (what was then) s.739 ICTA.

TAH para 1222 records the bizarre view that ITTOIA absent-mindedly abolished the foreign domicile defence, formerly in s.743(3) ICTA, so that 2005-2008 s.720 income was always charged on an arising basis:

> Following the tax law rewrite [ITTOIA] new and separate charging provisions were introduced for all types of foreign income replacing the general charge under what was Case IV/V of Schedule D. The new provisions, included in ITTOIA, also provided, on a claim, an alternative basis for calculating certain income categorised as 'relevant foreign income' and the amount on which an individual would be taxed.
>
> From the introduction of ITTOIA non-UK domicile status could impact this relevant foreign income and resulted broadly speaking in the income subject to the claim being taxed only when received in the UK.
>
> Apart from minor adjustments consequential upon the introduction of ITTOIA the transfer of assets provisions giving exclusion from charge for certain income of non-UK domiciled individuals remained largely unchanged. However the exclusion [s.743(3) ICTA] was only for income that would not be chargeable to tax on the basis of domicile status alone. It could be argued that following the new charging provisions brought into effect by ITTOIA, which carried no distinction on the basis of domicile, that from 6 April 2005 there was no such income that fell to be excluded on the basis of domicile under the transfer of assets provisions.

I have not come across any reference to this argument before the publication of the TAH in 2009, nor do HMRC say expressly whether they regard it as correct. I find it hard to imagine that anyone could take the argument seriously. But in practice the point is academic as HMRC will not usually take any notice of it:

> However the introduction of ITTOIA was not intended to change the law under transfer of assets in this way and as a result HMRC continues to operate the income charge provisions in this interim period in the same way that they were operated prior to April 2005, subject to cases where there appears to be manipulation of the interaction of the new provisions. Where you identify a case that appears to involve manipulation refer it to the Transfer of Assets Technical Adviser in CAR (Residency) Offshore Personal Tax Team.

If the argument were actually right, so 2005-2008 s.720 income was by

law taxed on an arising basis, without any foreign domicile defence, then HMRC could not of course assess the income in a subsequent year when it was remitted. They could only assess it in the year that it arose. One could envisage circumstances when taxpayers would want to raise the argument. Similar issues would arise in relation to the s.624 remittance basis. However I doubt if these wider ramifications of the argument will ever need to be considered.

ToA draft guidance provides:

> **INTM602000 Non-UK domiciled individuals: The position between 6 April 2005 and 5 April 2008**
> The approach that will therefore be taken in this period will generally be that described in Examples 1 and 2 at INTM601980

29.15 Interaction with s.624 (and other anti-avoidance provisions?)

Section 721(3C) ITA provides:

> Subsection (1) does not apply if—
> (a) the individual is liable for income tax charged on the income of the person abroad by virtue of a charge not contained in this Chapter, and
> (b) all that income tax has been paid.

Thus s.624 has priority over s.720. That matters as s.624 confers an indemnity, which s.720 does not.

Although the provision refers to any "charge not contained in this Chapter" I cannot think of any case to which it could apply, apart from s.624.

Previously s.720 was simply described as overlapping with other anti-avoidance provisions.[82]

29.16 No indemnity for transferor

The transferor has no express statutory indemnity against the person abroad for tax paid under s.720. It is considered that no indemnity can be implied.

29.17 Tax return: Disclosure of s.720 income

S.720 income is returned in Boxes 10-13 in the Foreign pages (form

82 *McGuckian v IRC* 69 TC 1.

SA106) 2013/14. SA106 Notes 2013/14 provides:

> ***Dividends and all other income received by a person abroad***
> **Boxes 10 to 13**
> If you have transferred, or taken any part in the transfer of assets, as a result of which income has become payable to a person abroad, you may need to complete these boxes. All items chargeable as income under the transfer of assets provisions should be entered in this section only. Helpsheet 262 *Income and benefits from transfers of assets abroad and income from non-resident trusts* has more details on how you complete these boxes.

Helpsheet 262 (Income and benefits from transfers of assets abroad and income from non-resident trusts - 2013/14) provides:

> **How do you report the income?**
> Unless you are completing box 46 on page F 6 of the Foreign pages[83] ... report the amount of income as follows:
> - enter in box 11 on page F 3 of the Foreign pages details of all dividends received on which you are chargeable including any allowable UK or foreign tax credit
> - enter in box 13 on page F 3 of the Foreign pages all other income including any tax paid on that income.
>
> You should enter details of the relevant transactions that have given rise to the income, and the offshore structures involved, in the 'Any other information' box, box 19 on page TR 7 of your tax return.
> You should enter all income that is chargeable to tax under the transfer of assets provisions at boxes 11 and 13 of the Foreign pages not in the corresponding boxes elsewhere in the return for the type of income involved. For example, if interest income arose to a foreign company and that income is treated as yours under the transfer of assets provisions, then you should enter the income at box 13 not in the relevant boxes for interest. If you are non-UK domiciled then you may not have to enter all of the income if some of the income arising to the person abroad is from a source outside the UK and not remitted to the UK. See 'How do you report income or benefits if you are non-UK domiciled?' on page 6.

This reflects the rule that s.720 income is distinct from the income of the person abroad.

I do not see what box 10 is for. Perhaps it is a mistake from amending the 2009/10 version of the form.

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83 See 32.45 (Tax return: disclosure of motive defence claim).

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TAXATION OF NON-RESIDENTS AND FOREIGN DOMICILIARIES 2014-15

VOLUME THREE

by

JAMES KESSLER QC

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CHAPTER THIRTY

TRANSFER OF ASSETS ABROAD: NON-TRANSFERORS

30.1 Non-transferors: Introduction and terminology

This chapter considers the IT charge on non-transferors, ie beneficiaries other than the transferor, who receive benefits from non-resident entities.

Section 731 ITA imposes the charge to tax:

> (1) Income tax is charged on income treated as arising to an individual under section 732 (non-transferors receiving a benefit as a result of relevant transactions).
> (2) Tax is charged under this section on the amount of income treated as arising for the tax year. ...
> (3) The person liable for any tax charged under this section is the individual to whom the income is treated as arising. ...

In this book:

"The s.731 charge" is the charge under this section. The ToA guidance calls this "the benefits charge".

"s.731 income" is the income treated as arising to an individual under s.732. (It might be called "s.732 deemed income" but the charge is under s.731.)

The charge applies if income is treated as arising under s.732, to which we must turn as the second stage of our journey. Section 732(1) ITA sets out five sets of conditions. I refer to them as **"the fundamental s.731 conditions"**. They are as follows:

> *(a) a relevant transfer occurs.*

I refer to this as **"the relevant transfer condition"**.

> *(b) an individual who is UK resident for a tax year receives a benefit in that tax year.*

his contains two aspects, the receipt of a benefit and residence. So far as the residence aspects are concerned, I refer to this as **"the 731 residence condition"**.

> *(c) the benefit is provided out of assets which are available for the purpose as a result of—*
> *(i) the transfer, or*
> *(ii) one or more associated operations.*

I refer to this as **"the benefit causation condition"**.

> *(d) the individual is not liable to income tax under section 720 or 727 by reference to the transfer and would not be so liable if the effect of sections 726 and 730 were ignored.*

I refer to this as **"the transferor's s.731 defence"**.

> *(e) the individual is not liable to income tax on the amount or value of the benefit (apart from section 731).*

I refer to this as **"the s.731 capital condition"**.

Where there is a relevant transfer to a trust or company, and the motive defence and ss.720 and 727 do not apply, I describe this trust or company as being **"within section 731"**.

If all five fundamental conditions are satisfied one moves on to s.732(2) ITA:

> Income is treated as arising to the individual for income tax purposes for any tax year for which section 733 provides that income arises.

The third stage is to compute the amount of income treated as arising: this is dealt with in s.733 ITA (and s.734).

Lastly, there are some defences to the charge: in particular the s.731 remittance basis and the motive defence.

30.2 Relevant transfer condition

The first fundamental s.731 condition is the relevant transfer condition. Section 732(1) ITA provides:

> This section applies if—
> (a) a relevant transfer[1] occurs,

1 See 28.2 ("Relevant transfer").

Despite the present tense ("occurs") this condition is met in a year if a relevant transfer occurred in an earlier year. Grammarians call this "the historic present".

30.3 S.731 residence condition

The second fundamental s.731 condition requires residence. Section 732(1) ITA provides:

> This section applies if ...
>
> (b) an individual who is UK resident for a tax year receives a benefit in that tax year,

If an individual receives a benefit in a year but is not resident for the year there is no charge under s.731 in relation to that benefit in that year.

What if B later becomes UK resident? Suppose:

(1) Year 1: B is not resident in the UK, but receives a benefit.

(3) Year 2: B becomes resident in the UK but receives no benefit in that year.

The fundamental condition in s.732(1)(b) is still not met in year 2: the individual must be resident for the year that they receive a benefit.

Residence at the time that relevant income arises is not in principle necessary. Suppose:

(1) Year 1: B is non resident and relevant income arises.

(2) Year 2: B is UK resident and receives a benefit.

The s.731 residence condition is satisfied so there is in principle a charge under s.731 by reference to the income of year 1.

Formerly the ToA rules only applied to a person who was *ordinarily* UK resident. The abolition of ordinary residence in 2013 lead to a significant extension of the rules. Until 2015/16, there is a transitional relief for non-transferors not ordinarily UK resident at 5 April 2013: see 4.30 (Ordinary residence).

30.3.1 *Split year*

There is no express split year rule, so the default rule applies: s.731 income is taxable even if it arises during the overseas part of a split year of the individual who receives a benefit.[2] There is no good reason for that. Section 731 income ought to be taxed in the same way as ordinary foreign

2 See 7.1 (Default rule: individual regarded as resident throughout tax year).

income.

30.4 Benefit

The second fundamental s.731 condition requires (in short) that the individual receives a benefit. Section 732(1) ITA provides:

> This section applies if ...
>
> (b) an individual who is UK resident for a tax year *receives a benefit* in that tax year.

The word benefit is very common in tax statutes and in other areas of law.[3] So there is plenty of material for discussion, though it is always necessary to consider the word in its context.

In this section I discuss the meaning of "benefit" for the purposes of s.731 and for the purposes of s.87 TCGA as the issues are (more or less) the same.

Similar issues arise in other contexts. It would be impossible to write a full list, but they include:

(1) Cases where there is a tax charge on the value of a benefit:
   (a) s.394 ITEPA (charge on benefit from retirement benefit scheme)
   (b) s.201 ITEPA (employment-related benefits)

(2) Cases where there is a tax charge if there is a possibility of "benefit" in any circumstances (regardless of its amount or value):
   (a) s.624 (settlor-interested trusts)
   (b) s.86 (settlor-interested trusts)
   (c) s.720 (power to enjoy)

There is (sensibly) no statutory definition of benefit for our purposes.[4] It is well established that "benefit" is a word of wide import.

For the benefit of funding a beneficiary's tax appeal, see 32.47 (Appeals).

30.4.1 *Arm's length transaction*

A transaction for which the individual gives full consideration is not a

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3 For discussion of "benefit" in a trust law context see Kessler, *Drafting Trusts and Will Trusts* (12th ed., 2014), para 13.12 (What does a settlor exclusion clause cover?).

4 For completeness: The pre-ITA legislation stated that "benefit" included a payment of any kind: s.742(9)(c) ICTA. This had (more or less) no practical effect, and was sensibly omitted in the ITA rewrite.

benefit.[5] It does not matter if the other party is a connected person (eg a sale to or from a family trust or company).

What if the parties act at arm's length and have no gratuitous intent but owing to some mistake the individual gives less than full consideration? This is not a benefit.[6]

30.4.2 *Receipt or sale of equitable interest*

RI 201 states:

> For the purposes of [s.731 ITA] a benefit is treated as not including
> [1] either the giving[7] of a life interest to a beneficiary or
> [2] the receipt by a beneficiary of the proceeds of selling a life interest.

Point [1] (conferring a life interest) is not a benefit if the interest is revocable (or else the value of the benefit is nil). If the interest is not revocable, then its receipt is in the widest sense a benefit, but for tax purposes it should be regarded as a right to a future benefit, rather than a immediate benefit. To tax a "benefit" of this kind is clearly outside the scheme of the Act. Otherwise there would be a double charge, eg, when trustees appointed assets to a beneficiary contingently on attaining the age of 21 and again when the beneficiary reached 21 and became absolutely entitled.[8]

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5 This is self-evident; but if authority is needed, see *IRC v Lactagol* 35 TC 230 and *Wilson v Clayton* 77 TC 1. For CGT the position is dealt with by statute, but only for the avoidance of doubt: see 51.6.4 (Arm's length transaction).

6 *Wilson v Clayton* 77 TC 1 decided that this is the case in the context of employment-related benefits. Note the reference to arm's length transactions in the passage from *Cooper* cited at 30.4.8 (Benefit to which a beneficiary becomes entitled under terms of trust); the same should apply for s.731.

7 "Giving" a life interest is informal, lay language. The term must refer to the conferring of a life interest by exercise of a power of appointment. Presumably it also includes the conferring of a life interest by exercise of a power of advancement or re-settlement.

8 The Special Commissioners reached this conclusion in the context of employment-related benefits: *Dextra Accessories v Macdonald* 77 TC 146 at [9]-[12]. The point was (rightly) not appealed. In the context of s.731, one could also reach the same conclusion by saying that the "benefit" (if there was one) was not "provided out" of trust assets. In the context of s.87 TCGA, one could reach the same conclusion by saying that the "benefit" (if there was on) is not "from the trustees". But the better analysis is simply that there is no "benefit" within the meaning of the charging provision.

Point [2] (receipt of proceeds of sale of a life interest) is outside the scope of s.731 because a sale at market value is not a "benefit" to the vendor, or because the value of the "benefit" (if there was one) is zero.[9] If the sale was for more than market value there is a benefit but the benefit is not provided out of trust assets so it is not within s.731.[10]

Although RI 201 refers to a life interest, the same reasoning must apply to the conferring of any type of interest under the settlement.

30.4.3 *Sale of company within s.731*

The same reasoning applies on the sale of shares or securities in a company within s.731. This leads to an interesting anomaly:

(1) B holds shares in a company which has accumulated relevant income within s.731. B sells the shares. No charge arises under s.731 as B does not receive a benefit (even when B spends the proceeds of sale).

(2) Trustees hold shares in a company which has accumulated relevant income. They sell the company. The sale proceeds represent the relevant income[11] and so if the trustees appoint the proceeds to B, B receives a benefit taxable under s.731.

30.4.4 *Interest-free loan and enjoyment of asset in kind*

RI 201 continues:

> But it ["benefit"] is otherwise treated as including all benefits taken into account in determining whether an individual has power to enjoy income for the purposes of [s.720 ITA]. It therefore includes for example receipt of a loan at less than a commercial rate of interest, and the use of trust property at less than an open market rental.

Interest-free loans and use of property at less than full rent are benefits: *Cooper v Billingham* 74 TC 139. On valuation of that benefit, see 30.7 (Valuation of benefits).

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9 The drafter of FA 1984 Sch 14 para 5(4) reached the same conclusion for the purpose of (what is now) s.87 TCGA.

10 On a sale of an equitable interest, watch:
(1) CGT on the disposal of the interest; and
(2) Schedule 4A TCGA.

11 See 30.28 (Relevant income reinvested: tracing).

30.4.5 *Loan (not to life tenant): Interest paid at commercial rate*

A loan on commercial terms is not a benefit. That is clear on first principles, but if authority is needed, see *Vestey v IRC:*

> … a loan may well benefit a person even if it is made at a commercial rate of interest, as it may tide him over a difficult period, but I do not think that if money is so lent it is applied "for the benefit" of the debtor within [the forerunner of s 624].[12]

> I find it impossible to hold that a sum of money lent at a commercial rate of interest is "payable to or applicable for the benefit of" the borrower in the sense of this Section.[13]

A relatively simple way of avoiding a benefit (and hence avoiding s.731 and s.87) is:

(1) a trust makes a loan at a market rate of interest;
(2) if appropriate, provide the beneficiary with funds to pay the interest; and
(3) the beneficiary pays the interest.

Take care that the interest does not have a UK source.[14] The same may be done for the use of property in kind provided the property is not in the UK.

Similarly, repaying a loan is not a benefit.

30.4.6 *Loan (not to life tenant): Interest rolled up*

What if interest at a commercial rate is rolled up unpaid? There is no income tax charge on unpaid interest.[15] In principle there is still no benefit. However, if the intention is that the interest will never be paid, the provision for payment of interest is a sham and ineffective for tax purposes. There are many trust law issues: do the trustees have power to make the loan? Unwinding the arrangement after the death of the beneficiary needs careful thought.

30.4.7 *Interest-bearing loan to life tenant*

It is in general not possible to have an interest-bearing loan to a life tenant,

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12 *Vestey's Executors v IRC* 31 TC 1 at p.114.

13 31 TC 1 at p.121.

14 See 18.5 (Interest: location of source).

15 *Girvan v Orange Personal Communications Services* 70 TC 602.

under a transparent *Baker*-type[16] trust, because a person cannot pay interest to himself. Accordingly one cannot avoid a charge on a benefit in kind by purporting to charge interest, whether the "interest" is purportedly paid[17] or purportedly rolled up.[18] It would be different if:

(1) interest was payable after the death of the life tenant;
(2) the loan was issued at a discount instead of at interest;
(3) the trustees had expenses which were met by the interest (so the interest was not paid to the life tenants).

There is a school of thought that maintains (to my mind over-optimistically) that interest-bearing loans to life tenants offer a solution to the problem of extracting trust funds free from s.731 and s.87. HMRC do not take that view.

30.4.8 *Benefit to which a beneficiary becomes entitled under terms of trust*

Suppose:

(1) A beneficiary is entitled to trust property absolutely subject to satisfying some contingency (eg attaining the age of 25).
(2) The contingency is satisfied (the beneficiary reaches 25 and becomes entitled to the trust property).

There is a "capital payment" for the purposes of s.87 TCGA: see s.97(2) TCGA.[19] There is no equivalent provision in the transfer of asset rules. However, it is considered that the beneficiary does receive a "benefit" and the value of the "benefit" is equal to the value of the trust property. The concepts of "value" and "benefit" can (just) be stretched to support this conclusion[20] and any other view would be inconsistent with the scheme of

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16 It would be different if the trust was a non-transparent *Garland*-type trust. See 26.3 (Taxation of life tenant).

17 Even if the parties go through a ceremony under which:
(1) the life tenant pays "interest" to the trustees; and
(2) the trustees return it to the life tenant.
Even if the parties do this there is no IT charge on the "interest": *Styles v New York Assurance* 2 TC 460. This point was overlooked in *Rogge v HMRC* [2012] UKFTT 49 (TC) (where the taxpayer was not represented by counsel).

18 However, if interest accrues unpaid and the life tenant dies, the position alters and outstanding interest becomes payable to the trust (unless Apportionment Act 1870 principles apply, which will be rare).

19 See 51.6.3 (Termination of settlement).

20 Contrast *R v Allen* [2000] 2 All ER 142 [2000] 1 Cr App R(s) 497 accessible *http://www.kessler.co.uk/tfd-archive*, where the Court of Appeal stretched the word in a comparable way in order to uphold a confiscation order.

the provisions. This view is supported by *Cooper v Billingham* 74 TC 139 CA at [39]:

> The whole scheme of the legislation requires the Court to see what benefit a beneficiary actually receives, in cash or in kind, otherwise than as income or under an arm's-length transaction. Any pre-existing beneficial interest belonging to the beneficiary is irrelevant. The Judge dealt with this point shortly[21] but there was no need for him to say more.

Likewise, if L is entitled to a life interest, and a trust asset is transferred to L, the value of the benefit received is the value of the asset, not the value of the reversionary interest in the asset.[22]

30.4.9 *Benefit on liquidation or redemption of shares or securities*

A similar point arises where:

(1) A shareholder holds shares in a company within s.731.
(2) The shareholder receives assets of the company on the liquidation of the company or on the redemption of its shares.

It is arguable that the shareholder does not receive a "benefit" since they merely receive the property to which they are entitled in the liquidation or redemption; or (which comes to the same thing) that the value of the "benefit" is nil. After all, a sale of the shares would not be a benefit, and is commercially similar. And no-one would say that there is a benefit for the purposes of employment income benefit in kind rules. On the other hand, the liquidation is analogous to becoming entitled under a trust. The better view, consistent with the scheme of the Act, is that the receipt of funds from the company is a "benefit" for the purposes of s.731. Similar points apply on the redemption of debt securities.

30.4.10 *Reimbursement of tax under statutory indemnity*

SP 5/92 provides:

> 8 The settlor's right, under Para 6 Sch 5 TCGA, to reimbursement (or any payment in reimbursement) of tax paid under that Schedule is not regarded as creating an interest in a trust for the settlor under the provisions of [Chapter 5 part 5 ITTOIA] where the settlor, the settlor's

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21 The judge said: "... The recipient's existing interest under the trust has to be left out of the calculation for the purpose of valuing the benefit ...", 74 TC 139 at p.155.

22 This was stated (*obiter*) by the judge in *Cooper v Billingham* 74 TC 139 at p.155. It is the converse of the rule that the receipt of a life interest is not a benefit: see 30.4.2 (Receipt or sale of equitable interest).

> spouse, and any companies in which they are participators cannot otherwise benefit from the trust, eg where the only beneficiaries are the settlor's children. Similarly, this statutory right to, or payment in, reimbursement is not regarded as bringing the settlor within the provisions of [s.633 ITTOIA, and the ToA provisions], nor as a capital payment for the purposes of s.97 TCGA.
>
> 9 Further, this statutory right is not regarded as a reservation of benefit for inheritance tax purposes; nor is a provision in the trust deed either requiring the trustees to recognise the settlor's right to reimbursement under Para 6 Sch 5 TCGA or to reimburse the settlor. But where a settlor does not pursue the statutory right to reimbursement, the failure to exercise this right may give rise to an inheritance tax claim under s.3(3) IHTA, in which case the usual rules for lifetime transfers would apply.
>
> 10 A provision written into a settlement deed requiring the trustees to recognise the settlor's right to reimbursement under Para 6 Sch 5 TCGA, or to reimburse the settlor, is not, of itself, regarded as giving the settlor an interest in the settlement for the purposes of Sch 5, nor as bringing into play the provisions of [s.624 ITTOIA, and the ToA Provisions].

HMRC have suggested that this does not apply if reimbursement is made before the settlor has paid the tax for which they need reimbursement. But it is submitted that there is never a benefit (or the value of the benefit is nil) when trustees pay a sum to a settlor in a *bona fide* settlement of a claim or prospective claim for reimbursement.[23]

30.4.11 *Payment of IHT*

No individual receives a benefit when trustees pay IHT charges on the trust. This is the case for the IHT 10-year charges and the IHT charges on the death of a life tenant with an estate, but it is necessary to consider them separately:

(1) The IHT 10-year charges are payable by the trustees of the settlement concerned: s.201(1)(a)IHTA.

Beneficiaries[24] who receive capital payments are also liable for the

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23 In practice this is an issue for s.87 but not for s.731 (because the settlor will be the transferor and qualify for the transferor's s.731 defence in any event). For other issues relating to reimbursement, see 30.22 (Relevant income used to pay expenses); 80.24 (Failure to exercise right of reimbursement).

24 For non resident trusts, settlors are also liable.

IHT, but:

(a) They have a right to recover from the trust fund: s.212 IHTA.

(b) Also they are only liable if the tax remains unpaid after it ought to have been paid: s.204(5) IHTA.

Accordingly the payment of IHT 10-year charges by the trustees (or by anyone else) is not a benefit to any individual beneficiary.

This is so even if that beneficiary was (secondarily) liable for the tax under s.201(1).

(2) The IHT charge on the termination of an estate (during the life of the life tenant or on the death of a life tenant) is likewise payable by the trustees of the settlement concerned: s.201(1)(a) IHTA.[25] But the same points apply:

(a) The life tenant has a right to recover from the trust fund: s.212 IHTA.

(b) The life tenant is only liable if the tax remains unpaid after it ought to have been paid: s.204(5) IHTA.

Accordingly the payment of IHT by the trustees (or by anyone else) is not a benefit to the life tenant. It cannot be a benefit to be relieved of a secondary liability of this kind, where one has an effective right of indemnity. Further, in the case of a wide common form trust, even if the class of beneficiaries as a whole may be said to receive a benefit, no individual receives a quantifiable benefit.

30.4.12 *Moral, sentimental and other benefits difficult to quantify*

The word "benefit" is used with two distinct meanings, a strict or narrow meaning, and a wide meaning:

(1) *Financial advantage only* In the narrow sense, "benefit" means a benefit which can be valued, that is, it can quantified in financial terms. The usual case will be the provision to a person of an asset, or services, where the benefit to the person is quantifiable as the value of the asset, or the value of the services.

(2) *Non-financial benefit also* In the wide sense, "benefit" includes not only financial advantage, but also non-financial advantages, ie something which confers some mental satisfaction, which meets a moral obligation, or which may be described as indirect or intangible.

An example is a contribution of (say) £5,000 to charity. The charity

25 In this case the life tenant is also liable for the IHT, under s.201(1)(b) IHTA.

receives a financial advantage of £5k, a straightforward benefit in the narrow sense. Someone who wishes to support the charity, or feels a moral obligation to do so, may receive a benefit in the wider sense. The payment may satisfy their wish or moral obligation; but one cannot value their benefit as £5k. It is a non-financial benefit.

A similar example is the provision of a fund for the benefit of a person's children.

Another example is the payment of (say) £5,000 school fees. The child receives a service (education). This is a straightforward benefit in the narrow sense; it can be valued at £5k.[26] The parent (assuming the parent wants the children to be privately educated) receives a benefit in the wider sense. They have a wish or moral obligation satisfied; but one cannot value their benefit as worth £5k. It is a non-financial benefit.

The context must decide which meaning of "benefit" is applicable.

In the *trust* law context of common form powers of advancement or appointment, such as a power to apply for the advancement or "benefit" of a beneficiary, the word "benefit" has the wider meaning. Thus a power to apply funds for the benefit of a beneficiary can in principle be exercised by making a payment to a charity which the beneficiary wishes to support.[27]

In a *tax* law context, the narrow meaning is normal and the wide meaning is exceptional. For instance, the word "benefit" in the context of s.624 ITTOIA or s.86 TCGA (settlor-interested trusts), or the IHT gift with reservation provision, refers to financial benefits only. No-one has ever suggested that a payment for a person's minor children could be a "benefit" to the parent, so as to bring those sections into application, though it normally would be a benefit in the wider (non-financial) sense: one would normally expect the parent to be gratified by the payment.[28] (It may alternatively be said that if the parent receives a benefit, its value is nil. I would prefer the view that a "benefit" of nil value should not be called a "benefit" at all. But the end result would be the same, at least in

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26 It is considered that the basis of valuation of a benefit should be the cost to the provider. But the detail of the basis of valuation of the benefit does not alter the point being made here that the benefit is one of a financial nature, which can be valued.

27 The leading case is *Re Clore* [1966] 1 WLR 955; see Kessler, *Drafting Trusts & Will Trusts* (11th ed., 2012), para 11.11 (Power of advancement used to create new trusts).

28 If it were a benefit to one parent, it would similarly be a benefit to the other parent, and indeed grandparents godparents and family friends; that can hardly be right.

a s.731 or s.87 context, where the charge is on the value of the benefit.)

If a power to apply funds for the benefit of a beneficiary is exercised by making a payment to a charity which the beneficiary wishes to support, the payment is a benefit (in the narrow sense) to the charity[29] so s.87 gains may accrue to the charity (though the charity would normally qualify for CGT charity relief).

All this is clear on principle, and does not need authority, but for completeness, the Tribunal took this view in *Burton v HMRC*:

> [60] 'Benefit' in s 97(5)(b) [TCGA] must be construed in the context of these taxing provisions rather than for the purpose of deciding the validity of an advancement or appointment under powers contained in a settlement. The legislation forms a detailed self-contained code to impose a tax charge on capital payments received by a beneficiary. This requires the benefit received or treated as received to be identifiable and quantifiable if there is to be sufficient certainty to impose a tax charge for any particular year of assessment....
>
> [62] The wider concept of benefit is difficult to apply in the context of s 87 in a way that the concept of a benefit which is identifiable and quantifiable is not. For example, a gift to charity by the trustees of a settlement may not give rise to a charge to tax on the trustees so as to create trust gains, but has been held to be for the benefit of a beneficiary as regards validity as it discharges a moral obligation (*Re Clore* ... [1966] 1 WLR 955). The beneficiary is surely not chargeable in those circumstances under s 87... What has been received or treated as received in those circumstances by the beneficiary for tax purposes notwithstanding its validity as being for the benefit of the beneficiary? Nothing in the sense of a capital payment received other than possibly a moral satisfaction has materially benefited the beneficiary such that a tax charge can be imposed in respect of it.... [30]

Burton concerned a s.86 flip-flop scheme.[31] HMRC argued that the beneficiary received a benefit in a year ("year 1") of a very subtle nature:

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29 This view is supported by a comment in *Fuller v Evans* [2000] 1 All ER 636, [2000] WTLR 5, accessible *http://www.kessler.co.uk/tfd-archive* that a common form settlor exclusion clause prohibits trustees from applying property for the benefit of beneficiaries by conferring a financial benefit on the settlor (eg in a situation where parents were in need of assistance and children-beneficiaries recognise a moral obligation to help them).

30 *Burton v HMRC* [2009] SFTD 682; Judge Wallace took a similar view at [44].

31 See 52.2 (Outline of flip-flop schemes).

the avoidance of a CGT liability under s.86 on a disposal anticipated in the following tax year ("year 2"). So this was not a case of mental satisfaction benefit, though it was a case of a benefit whose value was difficult or impossible to quantify. The two-judge Tribunal disagreed on whether that was a "benefit" at all, but both judges agreed that if it were, the value of the benefit *in year 1* (the year assessed) was nil, so there was no s.87 charge.[32] But these facts are not likely to recur; so it is not necessary to consider this aspect further.

30.4.13 *Payment of school/university fees*

Suppose trustees pay school fees for a child in circumstances where the parents have no obligation to pay the fees. The child receives a benefit from the trust. The parents merely receive an intangible, non-financial advantage (if they regard the education with approval). We have already noted that this is not a "benefit" to the parents for tax purposes.

Suppose trustees pay school fees in circumstances where a parent has a family law obligation to meet the fees (such as may arise on a divorce or in other family law proceedings). It might be said that the parent receives a benefit (being relieved of legal obligation). However it is considered that the benefit to the parent is outside the scope of s.731 because it is merely incidental.[33]

Suppose trustees pay school fees in circumstances where a parent (or both parents) are under a contractual obligation to pay the school fees (ie the parent has entered into the contract with the school). The position here depends on the facts:

(1) It may be that the parent is entitled to reimbursement from the trustees (eg if the parent entered into the contract at the request of the trustees and on terms that the trustees will meet the fees, or as agent for the trustees). In that case the trustees provide the benefit to the children and the parent does not receive a benefit from the reimbursement.[34] It does not matter that the school are not party to the arrangement (eg the parent may be acting as agent for an undisclosed principal).

(2) It may be that the trustees are voluntarily meeting a liability of the parent; in that case, the parent is providing the benefit to the child, and the trustees are providing a benefit to the parent.

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32 HMRC's argument that the benefit was an outright payment was rightly rejected.

33 See 30.6.2 (Trust makes payment to meet divorce order: H not a beneficiary).

34 Contrast 30.4.10 (Reimbursement of tax under statutory indemnity).

In practice (assuming it is desired to arrange that the benefit is received by the child, not the parent) it is recommended that the contract should be between the trustees and the school, or (if that is not desired) there should be an agency agreement between the trustees and the parent,
Then the position should be clear.

If a parent is the settlor, s.629 ITTOIA needs consideration.

See too App 6.1 (Students).

30.4.14 *Use of house or chattels*

Suppose a house (or chattels) is provided to a life tenant who then allows their spouse (or partner or children) to live there (and to enjoy the chattels). The same analysis applies. The indirect benefit which the spouse (or partner or children) receive is not a "benefit" for tax purposes, or, alternatively, the benefit is disregarded as merely incidental.

30.4.15 *"Benefit" provided in breach of trust*

Suppose trustees transfer an asset to a person in breach of trust. In principle the recipient holds the asset on constructive trust for the trustees, so the transfer is not a benefit, or (even if it were a benefit) the value of the benefit is nil.

While the context may show that the word benefit is (mis)used to include a transfer of an asset which the transferee is required to return to the transferor,[35] that is not the case here.

It is possible for an act which is a breach of trust to confer a benefit on the recipient, eg if trustees allow their claim against the recipient to become statute barred.

Trustees may confer a benefit in breach of trust (without transferring an asset) eg allowing an individual who is not a beneficiary to occupy trust property. Whether that confers a benefit on the individual depends on whether the trustees have a claim against the individual to recover the value of the benefit.

Thus whether an act in breach of trust constitutes a benefit requires an examination of the rights of the parties; it cannot be answered yes or no as a general proposition.

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35 An example is *Venables v Hornby* 75 TC 553 CA at [26]. The point was not considered on appeal.

30.5 Who is the recipient of a benefit?

It is important to identify the recipient of a benefit because the individual who receives the benefit is the one who is taxable. It is especially important where some beneficiaries are and others are not UK resident, or remittance basis taxpayers, because the identity of the recipient may affect not only who pays the tax but whether any tax is payable at all.

There may be scope for tax saving by arranging that the benefit is received by the beneficiary who is a remittance basis taxpayer.

There are many possible permutations of circumstances and the documentation is very important.

30.5.1 *Who receives benefit of occupation of property?*

Suppose trust property is held by a common form discretionary trust:

(1) The property is occupied by H and W (who are living together).
   (a) If the trustees grant a H licence to occupy, W occupying jointly, but as licencee of H, then the benefit from the trust is received by H.
   (b) If the trustees grant a licence to H and W, each receives the benefit of joint occupation. How does one value that? In normal cases, the value of each benefit is half the value of sole occupation.

(2) The property is occupied by H (or H and W) together with C (a child of H). If the trustees grant a H licence to occupy, the benefit is enjoyed by H alone, not by C.

(3) The property is occupied by C (an adult) alone. If the trustees grant a licence to H, who permits C to occupy, the correct analysis should be that C has received the benefit indirectly (for s.87 purposes) or as a result of an associated operation (for s.731 purposes).

The same applies if the property is held by a company held by the discretionary trust (except the licence would be granted by the company at the direction of the trustees).

Suppose property is held on trusts under which H has an interest in possession. If H occupies, he receives the benefit. If H and W occupy, H alone receives the benefit. What if H choses not to occupy? In such a case H may not be entitled to occupy in which case there will be no benefit. If H permits C to occupy alone, C has received the benefit indirectly.

Suppose property is held on trusts under which H and W have joint interests in possession. If they both occupy they receive the joint benefit

equally. Suppose H and W have interests in possession in unequal shares. It is suggested that they receive the benefit of occupation equally, notwithstanding the inequality in their interests in possession.

In all these cases the position is of course different if the person in occupation is required to pay some form of compensation to the trustees or to the life tenant or joint life tenant.

30.5.2 *Who receives benefit of payment of money?*

Likewise with money. If the trustees pay a capital sum to H, and H uses it for family expenditure, the benefit is received by H; but if paid by H under an arrangement whereby it is transferred on to W, or to a child, the benefit may be received indirectly by the child. See 30.8 (Benefit causation condition).

For the purposes of s.87 TCGA charge, the concept of "receipt" is explained by s.97(5) TCGA.[36] There is no statutory equivalent for s.731 but it is suggested that the same rules apply: s.97(5) merely states the natural meaning of "receipt".

As the discussion of school fees above illustrates, the question of who receives a benefit may overlap with the question of whether there is a benefit at all.

30.6 Benefit conferred in context of divorce

30.6.1 *Trust makes payment to meet divorce order: H a beneficiary*

Suppose a trust where H is a beneficiary and W is not.

(1) A court orders H to make a payment to W.

(2) A trust makes a payment to H to allow him to meet the obligation.[37]

That is a straightforward benefit to H. W does not receive a benefit; she gives full consideration.[38]

Suppose a slightly different step (2): The trust makes the payment to H directly in satisfaction of W's obligation. The result is the same.

Suppose a slightly different step (1): the court order requires that H shall *pay or cause to be paid* to W a specified sum. That is a standard form of order. But the result is the same.

The same applies if H and W are both beneficiaries.

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36 See 51.7 (Receipt from the trustees).

37 As a matter of trust law, this is permitted even though H is not a beneficiary.

38 It is important to understand the family law background, as to which see 11.35.1 (Is a transfer on divorce made for "consideration"?).

30.6.2 *Trust makes payment to meet divorce order: H not a beneficiary*

Suppose:
(1) W is a beneficiary of the trust and H is not.
(2) A court orders H to make a payment to W.
(3) The trust makes the payment to W.

I find it difficult to see how this problem could arise. The trustees could make a payment to W but not in satisfaction of the court order, as H cannot *cause* the payment to be made.[39] There is also a benefit to H, which would be a breach of trust.

The trust law case of *Fuller v Evans* seems at first sight to contradict this analysis.[40] In this case the Court ordered:

> [H] do pay or cause to be paid to [W] … periodical payments
> (a) for [the children's] general maintenance £9,000 per annum
> (b) such amount as is sufficient to defray their school fees...

There was a common form accumulation and maintenance trust for the children. H was the settlor, and so excluded. The judge said:

> 4. The issue before me is whether the trustees may in their discretion exercise their power to provide moneys out of the trust to pay for the children's maintenance and education, though the effect of such payment may be in whole or in part to relieve the settlor from the burden of his obligations under the consent order to pay for his children's maintenance and education.

The judge concluded:

> 9 [The settlor exclusion clause under which H was excluded from benefit] does not preclude the trustees from exercising the power conferred upon them by reason of any incidental (and unintended) conferment of relief on the settlor. This conclusion of course does no more than leave it open to the trustees to exercise a discretionary power to make provision for the education and maintenance of the two children out of the settlement funds. The trustees can only exercise that power if they consider that to do so is in the best interests of the beneficiaries despite the existence of the consent order and the obligations of the settlor thereunder. The trustees must have regard to the obligation of the

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39 If H is a trustee it may be said that he causes the payment to be made, but the conflict of interest would make the payment void.

40 [2000] 1 All ER 636.

> settlor to provide for the beneficiaries' maintenance and education when undertaking the decision-making process but the existence of that obligation is no more than a consideration to which due weight must be given .... If the trustees reach the conclusion that it is in the best interests of the beneficiaries to make such provision out of trust funds, they are free to do so.

No doubt trust income so applied would in principle[41] be the income of the children. This decision gives a sensible result. It would be surprising if the effect of the common form court order was to sterilise trust funds which prior to the divorce had been intended for the maintenance and education of the children. Moreover if the trust bore the cost then H had to be discharged from the court order: the children did not need two sets of school fees. But that case represents a high water mark: payments from H to W are different from payments for the maintenance of children. If the trust makes the payment to W, it is considered that H would not be discharged. If H were discharged, the benefit to H from the trust if it makes a payment to W is not "incidental".

30.6.3 *Court order against company*

The 2012/13 edition of this work considered the position where a court orders a company within s.731 to transfer property to the spouse of the shareholder. But it seems that the Court does not have jurisdiction to make an order of that kind, except in the case where the company is a nominee,[42] so this issue should not arise.

30.7 Valuation of benefits

The amount of s.731 income depends on the "amount or value" of the benefit.[43] "Amount" refers to cash benefits (outright payments of money) and "value" refers to non-cash benefits.

The amount of s.87 gains depends on the amount of the capital payment and s.97(4) TCGA provides:

> For the purposes of sections 86A to 96 and Schedule 4C the amount of
> [a] a capital payment made by way of loan, and
> [b] of any other capital payment which is not an outright payment

41 In practice s.629 ITTOIA would need consideration.

42 *Prest v Petrodel Resources* [2013] 2 AC 415.

43 See step 1 of s.733 discussed 30.13.2 (Step 1: Total Benefits).

of money,

shall be taken to be equal to the value of the benefit conferred by it.

In this section I discuss the valuation of benefits for the purposes of s.731 and for the purposes of s.87 TCGA as the issues are (more or less) the same.

Arguments that the value of the benefit is nil tend to overlap with arguments that there is no benefit at all.

There are no statutory valuation rules for s.731 or for s.87.[44] Lord Reid rightly says:

> "Value" is an elusive word: it may mean market value, it may mean value in money to the owner, or it may have other meanings like the value of the work necessary to produce it, or even sentimental value.[45]

The ToA draft guidance provides:

> **INTM601600 examples of the amount or value of a benefit**
> ...a. Receipt of a monetary payment: where the benefit received is money, generally speaking the amount or value of the benefit is likely to be the amount received. As INTM601560 explains where the payment is received in foreign currency the amount or value will generally be determined by applying the appropriate sterling exchange rate at the date of receipt.

30.7.1 *Value of living accommodation*

In *IRC v Botnar* the Special Commissioners discuss the valuation of living accommodation for the purposes of what is now s.724(2) ITA (enjoyment condition C) but the same applies for the purposes of s.731 and s.87. They say:

> 28. It seems to us that the whole of the value of a non-convertible benefit should, in the absence of any other objective means of valuation, be measured by reference to what it would have cost the individual receiving it. ... When measuring what benefit an individual receives it is not in our view relevant to ask whether he would have purchased the benefit himself. If that were the test a penurious individual receiving a non-money benefit under [enjoyment condition C, where the charge is on the value of the benefit] would escape tax however substantial the benefit

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44 Contrast the elaborate valuation rules for employment-related benefits; such is the patchwork nature of UK taxation.

45 *Heaton v Bell* 46 TC 211 at p.246.

since he could not have paid for it.
29. The measurement of the benefit by reference to what it would have cost the individual will take account of the terms on which it was provided. In this case although nothing was recording in writing, there is a clear inference that the use of the property was provided on the footing that Mr and Mrs Botnar bore the recurrent outgoings.
30. It may be that it will not be easy for a valuer to assess what the cost of a benefit such as this would have been since it is wholly hypothetical there being no market for such benefits. However, it seems to us that one approach may be to take the open market rental and to adjust this by reference to the lack of security of tenure, non-assignability and outgoings born by Mr and Mrs Botnar and any other special factors.[46]

The ToA draft guidance provides:

INTM601600 examples of the amount or value of a benefit
b. Rent free accommodation: where the benefit received is the provision of accommodation without charge to the individual the amount or value of the benefit is likely to be determined from a consideration of the market rental that the property may have fetched at the time the benefit is received.
However, it must be kept in mind that the language of the provision is of an individual who 'receives' a benefit. Therefore where, as in the case of rent free accommodation, the individual goes on receiving the benefit by continuous occupation of the property there is in effect an ongoing and continuous benefit. As taxation of a benefits charge is for a tax year it will generally be appropriate to consider the amount or value of the benefit for that entire period where there is a continuous provision of a benefit for the whole or part of that period. It will therefore be appropriate in such instances to consider the 'annual value', or appropriate proportion thereof, of the benefit received not merely any value at the point of first receipt. Thus in the case of rent free accommodation it will not only be appropriate to consider the amount or value of the benefit during the particular tax year, but if that benefit continues to be provided to consider its value for each subsequent period during which there is continuing provision and to have regard to any changes that may occur in the value of the benefit (for example because of changes in market place for rental values). These principles of continuous provision are likely to apply to most situations where an asset is made available for use over a period of time (see (c) below).

46 Supplementary Special Commissioners Decision at p.262.

c. Asset made available for use: the principles to be applied where an asset is made available for use by an individual are likely to be similar to those described above for rent free accommodation. Where the benefit provided is on an ongoing and continuous basis it will generally be appropriate to look at the tax year as a whole and consider the 'annual value' of the use of the asset in relation to that tax year (or part thereof) together with any ongoing costs to the person providing the benefit of its provision for use by the individual. Subject to obtaining any necessary professional valuation advice, as a rule of thumb it might be appropriate to adopt methodology for the benefits charge in this area similar to that which may apply in the employment related benefits field where an asset is made available for use (see for example section 205 ITEPA 2003).

30.7.2 *Value of other assets*

The ToA draft guidance provides:

INTM601600 examples of the amount or value of a benefit

...

d. Asset passed to the individual: where the benefit received is in the form of an asset, other than cash, and the ownership of that asset actually passes to the individual, as opposed to an asset being made available for use which remains in the ownership of the provider, the amount or value of the benefit is likely to be determined by reference to the value of the asset at the point in time when it is received by the individual. In most cases this is likely to be similar to the approach that may be adopted for capital gains purposes where it may be appropriate to determine the open market acquisition value of the asset to the individual.

e. Satisfying a debt: where the benefit received takes the form of a personal debt or liability of the individual being settled on the individual's behalf, the amount or value of the benefit is likely to be determined as if the individual had received an equivalent amount of money. There are a variety of circumstances that may come under this heading from the provision of credit or debit cards, making direct payments to a third party service provider (such as for children's school fees), or the settling of an outstanding personal liability (such as a utility bill, or personal tax liability for example).

30.7.3 *Interest-free loans*

Cooper v Billingham raises the question of the valuation of interest-free loans:

[Counsel for the taxpayer] argued that the value of the benefit conferred

> as required for the purposes of s.97(4) [TCGA] would vary according to the circumstances of the borrower, for example how creditworthy he might be and therefore his ability to borrow at better or worse rates on the market, and that those circumstances might differ from time to time. That may be true and could in theory cause difficulties of qualification in a particular case.[47]

The status of the borrower as life tenant is disregarded in determining the existence or valuation of the benefit. This is not stated expressly but follows from the scheme of the Act.[48] There is not much point in having a charge on benefits if interest-free loans are untaxed.

ToA draft guidance raises the question, but the author had no idea what the answer may be:

> **INTM601620 Examples of the amount or value of a loan**
> One of the most common examples of a benefit involves loans of one form or another. These loans can take the following forms:
> - interest free loans
> - loans made charging interest at a rate below commercial rates
> - loans made charging interest at a commercial rate
> - loans made charging interest which remains unpaid
> - back to back arrangements.
>
> Interest free loans are considered to be within the provisions, the charge being calculated by reference to the amount of interest forgone by the lender. This position was challenged in the courts where it was argued that in effect where a loan was payable on demand there was no benefit. The judges disagreed with this and said that the focus needed to be not on the making of the loan but on the Trustees successive acts in not calling the loan in. (Cooper v Billingham and Fisher v Edwards 54 TC 139) Similarly where there are loans at interest rates lower than those that would be charged by banks or other commercial lenders a benefit may arise.
>
> In the case of an interest free loan made to the individual, the amount of the benefit would normally be considered to be equivalent to the interest payable at a commercial rate on a similar loan from an unconnected third party. For this purpose we treat the 'official rate' of interest as being the appropriate rate to use. Where interest is paid but at less than commercial rates, the amount of the benefit will be that interest payable at a commercial rate less the interest paid.

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47 74 TC at p.155.

48 74 TC at p.154F. The reasoning was upheld by the Court of Appeal.

A loan made to an individual for full commercial consideration, is a 'benefit' but such a loan would in practice normally be regarded as a nil benefit, and therefore have no taxable value. If the interest payable on the loan is not paid, consideration should be given as to whether the 'unpaid' interest in each year should be the amount of benefit in each year. Regard should be had to the circumstances under which the interest is unpaid. For example, has the payment of interest been waived? If repayment of interest (or capital) is waived then this will be regarded as a benefit received by the individual for the year in which waiver takes place.

There may be instances of so called 'back to back' arrangements which should be carefully considered. For example, an individual who is a beneficiary of a trust may borrow money from a bank at commercial rates of interest. The trustees may deposit substantial funds with the bank (lender) as collateral for the loan. The arrangements may mean that repayments of capital and interest on the bank loan are rolled up and on maturity the loans are either renegotiated or replaced by larger loans from other banks. The end result is that the individual, although legally responsible for the repayments of capital and interest payments, has had, perhaps for many years, the benefit of substantial loans without a cost. In such circumstances, the value of the benefit may be considered on the basis that the loans were interest free and the benefit arrived at as referred to above.

The above assumes that monies made available to the individual were in fact by way of loan and, in appropriate cases, evidence of a loan having been made, should be obtained. If, on enquiry, it transpires that the payment was not a loan, or if a loan there is little likelihood of a demand for repayment (Williams v CIR 54 TC 257), then the payment should be treated as a cash payment, as referred to earlier.

30.7.4 *Payment for benefit*

The ToA draft guidance provides:

INTM601600 examples of the amount or value of a benefit

...If the individual receiving a benefit makes any contribution towards that benefit the contribution will normally be taken into account in determining the amount or value of the benefit. For example, an individual is provided with accommodation that is a benefit for the purpose of the benefits charge. It is agreed that the value of the use of the accommodation based on rental is £10,000 for the tax year. In that year the individual pays a rental of £5,000. It will normally be

appropriate to take account of the contribution such that the amount or value of the benefit is regarded as £5,000.

30.8 Benefit causation condition

The third fundamental s.731 condition is the benefit causation condition. Section 732(1) ITA provides:

> This section applies if ...
>
> (c) the benefit is provided out of assets which are available for the purpose as a result of—
>
> (i) the transfer, or
>
> (ii) one or more associated operations ...

There are two alternative conditions here:

(i) the benefit is provided out of assets which are available for the purpose as a result of the transfer; or

(ii) benefit is provided out of assets which are available for the purpose as a result of associated operations.

I refer to these as benefit causation conditions (i) and (ii). They are comparable to the relevant transfer causation conditions.

Thus, not every benefit that an individual receives falls within s.731: there must be a nexus between the benefit and the transfer.

Contrast the s.87 charge which applies where a beneficiary receives a benefit directly or indirectly from the trustees. The wording is different but the concept is similar.[49]

30.8.1 *Benefit to B1, used by B1 to benefit B2*

Suppose:

(1) A discretionary trust within s.731 has accumulated relevant income.

(2) In 1970, a beneficiary ("B1") receives a trust asset ("B1's asset"). Although B1 receives a benefit assume B1 does not pay tax under s.731 because he is non-resident, or qualifies for the s.731 remittance basis.[50] This seems on a simple reading to be an associated operation (in relation to the transfer of assets to the trust).

(3) In 2000 B1 (independently and not as part of a prior arrangement)

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49 See 51.7.1 (Indirect receipt from trustees).

50 Although strictly the position of B2 is the same even if B1 *is* taxed on B1's benefit, whether as a capital benefit under s.731 or as an income benefit under ITTOIA.

gives the asset to another beneficiary[51] ("B2") who is UK resident. B2 has received a benefit. Benefit causation condition (i) is not satisfied. However, it seems at first sight that benefit causation condition (ii) is satisfied, so B2 is at first sight subject to tax under s.731. This clearly cannot be right; but why not? It is necessarily part of the scheme of s.731 that when one beneficiary ("B1") receives a benefit, and uses the benefit to benefit another ("B2") only the first benefit counts. Otherwise what should be regarded in economic reality as a single benefit may give rise to a series of tax charges as it passes from one beneficiary to another and to another.[52] But why is this the case? The best answer is that the operations are not associated. Mere historic association is not enough. These must be something more.[53] It is suggested that the principles to apply are those of a "clean break" test.[54]

Consider a trust where the settlor ("S") is a beneficiary and the settlor wishes to make a payment to another beneficiary ("B"). A direct payment from the trustees to B may be within the scope of s.731. In that case the solution may be to make regular payments to S who may subsequently make a gift to B, but this can only succeed if the gift by S is genuinely independent, which may be impossible to arrange.

In *Denny v HMRC*:

(1) S (son of the taxpayer T) created a trust in the 1990's.
(2) The trust property was appointed to S (then non-resident); the date of this is not recorded.
(3) In 2000 S used the funds to lend £0.5m to his father, T. T repaid over the following year.

The Tribunal dealt with the s.731 issue in a single sentence:

> We find that section [731] does not have effect because even if the loan to [T] could be considered a "benefit" within [s.732] it was not provided out of "assets which were available for the purpose", but rather from

---

51 If B1 transfers the asset to a person ("C") who is not a beneficiary of the trust (in the sense that trust income cannot be used to benefit C) then C cannot be subject to tax under s.731 as there is no relevant income in relation to C. But in a standard form discretionary trust there is a wide power to add beneficiaries; so trust income is relevant income in relation to every person in the world (whether or not they are specifically identified as "Beneficiaries" in the trust deed).

52 Assume there is sufficient relevant income.

53 The argument would be the same as in 28.11 (Person abroad receives income as indirect consequence of transfer).

54 See 80.4 (Gift from A to B followed by gift to trust by B).

funds owned by Mr Lyster Denny available for his own purposes. No charge arises under its provisions.[55]

30.8.2 *Transfer between trusts*

Suppose:

(1) A trust ("trust 1") within s.731 has accumulated relevant income.
(2) Trust 1 transfers funds ("the transferred funds") to a new UK trust on similar terms ("trust 2").
(3) A beneficiary ("B") receives a benefit from trust 2 out of the transferred funds.

The transfer from trust 1 to trust 2 is an operation associated with the earlier transfer to trust A.[56] B has received a benefit and the benefit is provided out of assets which are available as a result of the transfer and the associated operation. So B is taxed under s.731. The benefit causation condition is satisfied.

Suppose trust 2 was an established trust with a trust fund ("fund 2"). If B receives a benefit from fund 2 B is not taxable under s.731 because that fund is not available as a result of the transfer of assets to trust 1.

It follows that a transfer between settlements will not in principle avoid s.731 charge. There is no reason why it should (except a misconceived analogy with the s.87 statutory rules which have no equivalent in the ToA code.

30.9 Benefit causation condition: Two transfers of assets

(1) A settlor by a single disposition transfers assets to a trust within s.731.
(2) Part of the trust fund is invested in assets which yield relevant income.
(3) Another part of the trust fund consists of a house occupied rent-free by B.

B pays tax on the benefit by reference to the relevant income.

By contrast, suppose:

(1) A settlor by *two* separate transfers creates *two* trusts within s.731:
    (a) a trust which holds income-producing assets and accumulates relevant income; and

---

55 [2013] UKFTT 309 (TC) at [96]. There is no analysis, but this was a case where the taxpayer appeared in person, and HMRC did not instruct counsel.

56 A transfer between trusts is not a "clean break". After all, trustees are expected to pay close attention to the wishes of the settlor, and in doing so they are merely filling in the blanks left by the settlor: see *Muir v Muir* [1943] AC 468.

(b) a trust which holds the family home.

(2) B enjoys the benefit of free occupation in the home.

B is not subject to tax under s.731 as there is no relevant income in relation to this benefit. Thus the use of two trusts may avoid a tax charge under s.731 which would have arisen if there were one.

Indeed, it is not necessary to use two trusts. The same applies if there are two separate transfers of assets to one trust.

30.10 Transferor's s.731 defence

The fourth fundamental s.731 condition is the transferor's s.731 defence. Section 732(1) ITA provides:

> This section applies if—...
>
> (d) [i] the individual is not liable to income tax under section 720 or 727 by reference to the transfer
>
> [ii] and would not be so liable if the effect of sections 726 and 730 were ignored ...

This is sensible. There is no need to apply s.731 to a transferor to whom s.720 applies. The application of s.720 gives HMRC all they should need.

Section 732(1)(d)[ii] makes clear that this defence applies to a transferor who is a remittance basis taxpayer even though the s.720 income is (un)taxed under the s.720 remittance basis.[57] Section 732(1)(d)[ii] is only for avoidance of doubt, and the position would be the same if those words were omitted.

30.10.1 *Transferor not resident when transfer made; pre-1996 income*

It has never been a requirement of s.731 that the transferor was (ordinarily) resident, at the time of the transfer, but this was a requirement of s.720 until 1996.[58]

RI 201 provides:

> Similarly, a transferor of assets who is outside the charge to tax under Section 739 ICTA [now s.720 ITA] in respect of income arising before 26 November 1996 through being not ordinarily resident in the UK at the time of the transfer, is not assessed under [what is now s.731 ITA].

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57 See 29.14 (Section 720 remittance basis).

58 See 29.9.2 (Transferor not resident when transfer made).

This is looking at a transferor "T" (wherever domiciled) who:
(1) makes a transfer of assets before 26 November 1996;
(2) is not UK (ordinarily) resident when T made the transfer;
(3) later becomes UK (ordinarily) resident.
T was not taxable under s.720 until 26 November 1996. I refer to income arising before that date as "pre-1996 income". If T receives a benefit after 26 November 1996[59] T is not taxable under s.731. This is right because the transferor's s.731 defence does not apply to *income* liable to tax under s.720. It applies to an *individual* liable to tax under s.720. In the example, T (once resident and after 26 November 1996) becomes an individual who is "liable to tax under s.720". This is something of a windfall for T, but of course non-transferors may be taxed as the pre-1996 income is relevant income.

30.10.2 *Transferor not resident at other times*

RI 201 does not address the situation where T is outside the scope of s.720 only because T is not resident for a period. Suppose:
(1) T is resident when T makes the transfer;
(2) T is non-resident for a period ("the non-resident period");
(3) T returns to the UK.
The reasoning above shows that on these facts T is also outside s.731; T qualifies for the transferor's s.731 defence in relation to income of the non-resident period as well as the income arising while resident.

30.10.3 *Spouse of transferor*

Section 714(4) ITA provides:

> In this Chapter references to individuals include their spouses or civil partners.

Accordingly the spouse/civil partner of the transferor also qualifies for the transferor's s.731 defence. This only applies during the life of the transferor as a former spouse/civil partner is not a "spouse" or a "civil partner".[60]

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59 I need not now consider the position if the benefit was received before 26 November 1996 but the result was probably the same.

60 See App 1.3 (Meaning of "spouse") and App 1.4 (Meaning of "civil partner").

30.11 S.731 capital condition

The fifth fundamental s.731 condition is (in my terminology) the s.731 capital condition. Section 732(1) ITA provides:

> This section applies if ...
>
> (e) the individual is not liable[61] to income tax on the amount or value of the benefit (apart from section 731).

This is sensible. There is no need to apply s.731 to a benefit liable to IT. The IT liability is all that HMRC should need.

30.11.1 *Benefit (un)taxed under remittance basis*

For this purpose a remittance basis taxpayer is "liable" to income tax on unremitted foreign income.[62] In particular, an income receipt from a trust is taxed (if at all) under general principles[63] and not under s.731.

This question arises because the s.731 remittance basis is more limited than the ordinary ITA remittance basis. For instance, suppose:

(1) A discretionary trust within s.731 receives UK source income (or both UK and foreign source income).

(2) A remittance basis taxpayer ("B") receives income ("unremitted foreign trust income") from the trust.

B is taxable on the unremitted foreign trust income on the ITA remittance basis but assume the income is not remitted, so no tax is due. Can HMRC argue that B is subject to tax on the unremitted foreign trust income under s.731?[64] The answer is, no, because B is "liable" to IT on the benefit. By

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61 The word in the pre-ITA legislation was "chargeable" not "liable" but the change has not altered (and has perhaps clarified) the position.

62 This might not seem to accord with the natural meaning of "liable"; but it is consistent with the well established rule that pension schemes and charities are "liable" to tax for the purposes of DTAs even though they qualify for pension scheme or charity exemptions; see Kessler & Marre, *Taxation of Charities and Non-Profit Organisations*, (9th ed., 2013), para 14.2.2 (Liable to tax) (online version *http://www.taxationofcharities.co.uk*). *Stonor v IRC* [2001] STC (SCD) 199 might be cited against this view but a Special Commissioners decision on other provisions, arguably obiter, and not fully argued, does not count for much. This view is also consistent with the rule that unremitted foreign income is "chargeable" to IT; see 51.6.1 (Definition of capital payment).

63 See 25.3 (Tier 3: Discretionary income payment: charge on beneficiary).

64 The s.731 remittance basis is not in point if the benefit relates to UK source relevant income: see 30.35 (Section 731 remittance basis).

contrast, if B had received capital instead of income from the same trust, B would have been subject to tax on the benefit under s.731!

Of course, the word "liable" (like all words) takes its meaning from the context. So perhaps here HMRC may argue that unremitted foreign income is not "liable" to income tax, for the purposes of the s.731 capital condition? There is no good reason to construe the word in that wider way. This result is consistent with the rule that the transferor's s.731 defence applies even to income (un)taxed on the remittance basis.[65] Anti-avoidance provisions, like hypotheses, should not be multiplied unnecessarily.

30.12 Is a benefit within s.731 a capital payment?

The definition of "capital payment" for s.87 purposes is discussed in 51.6 (Capital payment). For present purposes the relevant part of the definition is that a capital payment is any payment "which is not chargeable to income tax on the recipient".

In the following discussion "**a non-capital payment**" is a payment which is not a capital payment.

30.12.1 *Benefit giving rise to s.731 charge in year of receipt*

The pre-ITA position was straightforward. Section 740 ICTA was, I think, tax on the benefit.[66] If a person received a benefit which was subject to tax in the year of receipt, under s.740 (ie assume there was relevant income) then the benefit was a non-capital payment for CGT purposes.

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65 See 30.10 (Transferor's s.731 defence). A further objection to this HMRC argument is that there may be a double charge to tax:

(1) Tax under s.731 on receipt of the unremitted foreign trust income.

(2) Tax under general principles when the foreign trust income is later remitted to the UK.

Arguably, double counting relief applies: see 31.6 (Double-counting relief). But there is no provision allowing tax paid under s.731 to be reclaimed.

66 Section 740(2) ICTA provided:

"(2) ... the amount or value of any such benefit as is mentioned in subsection (1) above, if not otherwise chargeable to income tax in the hands of the recipient, shall -

(a) to the extent to which it falls within the amount of relevant income of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year... "

It is not immediately obvious that the position is the same from 2007/08. For s.731 is not expressed as a charge on the benefit. It appears at first sight to be a charge on fictional, deemed income: the amount or value of the benefit is merely an element in the computation of the amount of the s.731 income. However it cannot be the case that the same benefit gives rise to CGT on the benefit and deemed income on an amount equal to the benefit. A strained construction is needed to avoid absurdity. There are two possible solutions:

(1) Either (contrary to first appearances) s.731 is in fact a charge on benefits; or
(2) The reference (in the definition of capital payment) to a payment which is "chargeable to IT" should be read as including a benefit giving rise to deemed income.

Section 97(3) TCGA (see below) adopts the first view and so does s.734(1)(c) ITA.[67] Ultimately it makes no difference for present purposes which solution one adopts, but the better view is that s.731 is a tax on the benefit.

30.12.2 *Benefit matched to relevant income after year of receipt*

The pre-ITA position was straightforward. In the absence of express provision, a benefit which is not taxable under s.740 ICTA only for lack of relevant income might arguably have been a non-capital payment. But this argument was ruled out by s.97(3) TCGA. I set out the text of s.97(3) indicating the ITA amendments in track-change format:

> The fact that the whole or part of a benefit is by virtue of ~~section 740(2)(b) of the Taxes Act~~ section 733 of ITA 2007 treated as the recipient's income for a year of assessment after that in which it is received—
>
> (a) shall not prevent the benefit or that part of it being treated for the purposes of sections 86A to 96 and Schedule 4C as a capital payment in relation to any year of assessment earlier than that in which it is treated as his income; but
> (b) shall preclude its being treated for those purposes as a capital payment in relation to that or any later year of assessment.

Post ITA this wording is not apt because under s.731 (on a first reading) a benefit is not "treated as the recipient's income". Section 731 is a charge

67 See 30.14 (Section 733 computation when benefit subject to CGT).

on deemed income. But a strained construction is required to give effect to the obvious intention, that a benefit outside s.731 (for lack of relevant income) is a capital payment for CGT and it is considered that s.731 should be regarded as a tax on the benefit.

Thus if:

(1) a benefit is conferred,

(2) the benefit is not subject to s.731 in year of receipt for lack of relevant income the benefit can be taxed as a capital payment in year of receipt. If:

(3) the benefit is not subject to s.87 in year of receipt (for lack of s.2(2) gains) the s.731 charge in the following year has priority over the s.87 charge in that year; and so on.

30.12.3 *Benefit where s.731 remittance basis applies*

A benefit which falls within s.731 but qualifies for the s.731 remittance basis is taxed on the remittance basis, but is nevertheless "chargeable" to tax, so it is a non-capital payment. HMRC agree. Residence and Domicile: FAQ provides:

> **Interrelation between s727 or s731 ITA and s87**
> **Q** Could it be clarified that where a payment has been made - such as one under s731 which has attracted relevant income but has been protected from tax by non remittance - such a payment will not be regarded as a capital payment for s87 purposes?
> **A** Where a payment (benefit) results in an amount becoming taxable by virtue of s731 ITA 2007, but the charge is deferred by a remittance basis claim because no relevant amount has at that time been remitted to the UK, the benefit will not also be taken into account for the purpose of s87 TCGA. Where the 'capital receipt' condition is met for the purpose of a charge under s727 ITA, even though the charge may be deferred by a remittance basis claim, nothing in that section alters the nature of any payment that triggered the charge.[68]

By contrast, s.731 does not apply to a benefit which does not meet any of the five fundamental s.731 conditions (for instance a benefit to a transferor) and such a benefit is a capital payment.

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68 *http://www.hmrc.gov.uk/cnr/res-dom-faqs.htm* The rubric to the FAQ explains: "Most of the FAQs have now been incorporated into the new guidance. Those that have not are reproduced below."

30.12.4 *Benefit where motive defence applies*

The pre-2006 wording was that "Sections 739 and 740 *shall not apply*" where the motive defence applied, so it was clear that a benefit where the motive defence applied could be a capital payment.

Under the current legislation, where the motive defence applies, the individual who receives a benefit "is not *liable to income tax*" under the ToA provisions. It might be argued that the benefit is chargeable (even if the individual is not liable) but is considered that a benefit where the motive defence applies is a capital payment: it is not chargeable to IT within the meaning of the capital payment definition.

30.12.5 *Interaction with IHT exit charge income exemption*

Section 65(5) IHTA provides an exemption from the exit charge otherwise payable under s.65:

> (5) Tax shall not be charged under this section in respect of—
> (b) a payment[69] which
> [i] is (or will be) income of any person for any of the purposes of income tax or
> [ii] would for any of those purposes be income of a person not resident in the UK if he were so resident ...

I refer to this as **"the exit charge income exemption"**.

If a UK resident beneficiary receives a benefit which is taxable in the year of receipt under s.731, it is considered that this exemption applies. The benefit is income of the recipient.

Suppose:

(1) at the time the benefit is received there is no relevant income; but
(2) the person abroad receives relevant income later in the tax year.

It is considered that the exemption still applies: the benefit is still taxable. This explains why s.65(5) refers to a payment which is *or will be* income.

Similarly, if a UK resident beneficiary receives a capital payment which is subject to income tax under OIG s.87, the capital payment is subject to income tax and the exit charge income exemption applies.

This is consistent with the object of the relief, which is to prevent a double charge to IT and IHT.

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69 Section 63 IHTA provides:
"In this Chapter, unless the context otherwise requires ... "payment" includes a transfer of assets other than money".

What if the beneficiary is non-resident? The relief applies because the payment "would for IT purposes be income of a person not resident in the UK if he were so resident."

30.13 Computation of charge

30.13.1 *Introduction*

In outline, where an individual receives a benefit, s.731 imposes a charge on the lesser of:
(1) the value of the benefit; and
(2) the amount of relevant income in relation to that individual.[70]
However, the details are more complicated than this outline suggests.

The computation is governed by s.733 ITA. This is only a computation provision. It does not apply unless the five fundamental conditions of s.732 are met. I refer to the computation made under s.733 as "**the s.733 computation**". There are six steps in the computation.

The rewrite legislation is defectively drafted (it reproduces defects from the source legislation and adds some new ones). It could serve as a case study as to how much obscurity can be found in step-based drafting, an innovation of the tax law rewrite in their search for clarity.[71] The task here is to find a construction which (if loose) will yield a workable scheme of taxation.

30.13.2 *Step 1: Total benefits*

In order to follow Step 1, we need to read it in the context of s.732 and the opening words of s.733

> **732(1)** This section applies if—
> (a) a relevant transfer occurs,
> (b) an individual who is UK resident for a tax year receives a *benefit* in that tax year.
> (c) the *benefit* is provided out of assets which are available for the purpose as a result of—
> (i) the transfer, or
> (ii) one or more associated operations,
> (d) [in short - the individual is not the transferor]

70 Contrast s.720, which in general imposes a charge on the whole of the income accruing to the person abroad.

71 See 51.10.7 (Commentary: step-based drafting).

(e) the individual is not liable to income tax on the amount or value of the *benefit* (apart from section 731).

...

733(1) To find the amount (if any) of the income treated as arising under section 732(2) for any tax year in respect of *benefits provided as mentioned in section 732(1)(c)* take the following steps.

Step 1

Identify the amount or value of *such benefits* received by the individual

[1] in the tax year and

[2] in any earlier tax years *in which section 732 has applied*.

The sum of those amounts and values is "the total benefits".

I (slightly reluctantly) adopt the statutory terminology and refer to benefits within step 1 as "**Total Benefits"**. I refer to benefits within Step 1[1] as **"present year Total Benefits"** and benefits within [2] as **"earlier year Total Benefits"**.

There are two obscure references in Step 1:

(1) Which benefits are counted as Total Benefits? One does not identify *all* benefits received by the individual, but only "such benefits". The drafter has overlooked the basic rule that "such" ought only to be used when it refers to a clear antecedent.

(a) On one view, "such benefits" refers back to the words in the first sentence of s.733(1): "benefits provided as mentioned in s.732(1)(c)". So "such benefits" refers to all benefits which meet the benefit causation condition.

(b) On another view,"such benefits" refers back to s.732(1) which uses the word benefit three times. "Such benefits" means benefits in respect of which all five fundamental s.731 conditions are satisfied (not just the benefit causation condition).

The difference between the two views is, for instance, that on the first view an income-taxable benefit can count as "such benefits" and on the second view an income-taxable benefit does not count (because of the s.731 capital condition). Likewise, on the first view a benefit received by a non-resident can count as "such benefits" but on the second view it cannot (because of the s.731 residence condition).

The second view is to be preferred as it yields more sensible results.[72]

(2) Which benefits from earlier years are Total Benefits? One does not

72 If one adopted the first view one could avoid the problems which arise by a generous application of s.743 ITA (no duplication of charges) but it is better to avoid that solution since the relief depends on HMRC discretion.

count *all such benefits* received by the individual, but only such benefits in tax years "in which s.732 has applied". It is not of course enough that *section 732 applies,* for the section no doubt applies every year to some taxpayer or other. Section 732 must apply having regard to the circumstances of the transfer or the individual in the earlier year.

If this is right, the definition of "Total Benefits" can be expanded to mean the following:

[1] *Present year total benefits* must meet the following conditions (in order to be "such benefits"):

(a) a relevant transfer has occurred
(b) an individual who is UK resident for the present tax year ("B") receives a benefit in that tax year
(c) the benefit is provided out of assets which are available for the purpose as a result of—
  (i) the transfer, or
  (ii) one or more associated operations,
(d) B is not the transferor; and
(e) B is not liable to income tax on the benefit (apart from section 731).

[2] *earlier year benefits* must meet the following conditions (in order to be "such benefits" and to meet the requirement that s.732 applies in the year):

(a) The relevant transfer has occurred
(b) B was UK resident for the earlier year and received a benefit in the earlier year ("the earlier year benefit").
(c) the earlier year benefit is provided out of assets which are available for the purpose as a result of -
  (i) the same transfer as [1] (a) above, or
  (ii) the same associated operations as [1] (c) above
(d) B is not the transferor, and
(e) B is not liable to income tax on the earlier year benefit (apart from section 731).

30.13.3 *Step 2: Total untaxed benefits*

"Total Untaxed Benefits" has a relatively commonsense definition. Step 2 provides:

> Deduct from the total benefits the total amount of income treated as arising to the individual under section 732(2) for earlier tax years as a result of the relevant transfer or associated operations.
> The result is "the total untaxed benefits".

We need a label to describe the deduction, as it is impossible to follow a discussion which refers more than once to "the total amount of income treated as arising to the individual under section 732(2) for earlier tax years as a result of the relevant transfer or associated operations". I refer to the deduction as "**prior year s.731 income**".

A straightforward example is if:

(1) Year 1: B receives benefit £100.

(2) Year 2: B receives benefit £100.

The Totals Benefit is £100 + £100 = £200. But assuming in year 1 B was treated as receiving £100 s.731 income, then the prior year s.731 income is deducted, so Total Untaxed Benefits are computed thus:

Total Benefits	£200
Prior year s.731 income	-£100
Total Untaxed Benefits	**£100**

Section 734 ITA provides for another deduction from Total Untaxed Benefit: since this only arises infrequently I deal with it separately below; see 30.14 (Section 733 computation when benefit subject to CGT).

30.13.4 *Steps 3 and 4: Relevant income and total relevant income*

Steps 3 and 4 concern relevant income and total relevant income, and are discussed as a separate topic below.

30.13.5 *Step 5: Available relevant income*

Step 5 provides:

> Deduct from total relevant income—
>
> (a) the amount deducted at Step 2 [ie prior year s.731 income], and
>
> (b) any other amount which may not be taken into account because of section 743(1) and (2) (no duplication of charges).
>
> The result is "the available relevant income".

The deduction in Step 5(b) is discussed in 31.6 (Double-counting relief).

What is the reason for the deduction in Step 5(a)? ITA EN explains a double taxation problem in the pre-ITA law:

> Section 740 of ICTA [now s.731 ITA] leaves several questions unanswered.
>
> It provides that
>
> [a] if the relevant income exceeds the benefit, the amount or value of the benefit is chargeable to income tax in the individual's

hands,

[b] but does not make provision about the treatment of the excess of the relevant income over that amount.

[c] Taken literally and in isolation, section 740(2)(a) suggests that whenever a benefit is received the amount or value of the benefit must be compared with *all* the relevant income that has arisen on or after 10 March 1981, regardless of whether the receipt of previous benefits has involved charges by reference to that income before.[73]

For instance, if the relevant income is only £100, and T receives benefits of £100 annually, T would appear to be taxed each year on £100, so the relevant income in effect comes into charge again and again. I refer to this as **"the RI multiple counting problem"**. I confess I had not noticed the problem, but point [c] seems correct if one takes the words "literally and in isolation" (which is of course never the right approach to a statute).

The EN then give two independent reasons why no problem arose, that is, it identifies two pre-ITA solutions to the RI multiple counting problem:

> But
>
> [1] relevant income is defined as income that can directly or indirectly be used to provide a benefit in the tax year [ie in the year that the tax charge arises], and
>
> [2] section 744(1) and (2)(c)[74] of ICTA [now s.743 ITA] prevent the same relevant income being taken into account more than once.
>
> It is therefore considered that the *surplus* relevant income *(if it continues to be available)* has not been taken into account and so must be carried forward year by year until extinguished by a benefit or benefits. Section 733 of this Act gives effect to this view by providing [only] for *surplus* relevant income to be carried forward.[75]

Note that it is assumed in solution [1] that in order to identify the amount of relevant income, one asks whether income can be used to provide a

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73 Section 740(2) ICTA provided so far as relevant:
" ... the amount or value of any such benefit as is mentioned in subsection (1) above, ... shall— (a) to the extent to which it falls within the amount of relevant income of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year".

74 The original erroneously reads: (2)(b).

75 Change 1113, p.472; emphasis added.

benefit at the time the tax charge arises, ("if it continues to be available") not at the time that the relevant income accrues.

Example 1: one beneficiary

Suppose a trust with Total Relevant Income of £200 and:
(1) Year 1: B receives a benefit (£100) and £100 s.731 income. Assume the benefit is not paid out of relevant income.
(2) Year 2: B receives another benefit (£200).
The computation in year 2 goes as follows:
Step 1: The Total Benefits of B are £300.
Step 2: The Total Untaxed Benefits of B are computed thus:

Total Benefits	£300
Prior year s.731 income	- £100
Total Untaxed Benefits:	**£200**

Steps 3 and 4: The Total Relevant Income is £200.
Step 5: The Available Relevant Income is computed thus:

Total Relevant Income	£200
prior year s.731 income	- £100
Available Relevant Income:	**£100**

Step 6: the amount of s.731 income in year 2 is the lower of Total Untaxed Benefits and Available Relevant Income = £100.

That is fair and reasonable and tax law rewrite's solution to the RI multiple counting problem has worked.

Example 2: two beneficiaries

Now suppose a trust with Total Relevant Income of £200 and:
(1) Year 1: B receives a benefit (£100) and £100 deemed income under s.731.
(2) Year 2: C (not B) receives a benefit (£200).
The computation for C in year 2 goes as follows:
Step 1: The Total Benefits of C are £200.
Step 2: The Total Untaxed Benefits of C are £200 (nothing is deducted).
Step 5: Total Available Income = £200: There is no deduction from the Total Relevant Income under Step 5(a) because nothing is deducted at Step 2.
Here the Step 5(a) deduction does not prevent double taxation. The tax law rewrite team have only partly solved the RI multiple counting problem which (on a literal reading and taken in isolation) they identified. They have solved the problem where the *same* beneficiary receives benefits in

different years. They have not solved it where *different* beneficiaries receive benefits in different years. Why is C not taxed on £200?

C must fall back on one of the two pre-ITA solutions identified by the tax law rewrite team:

(1) that distributed income ceases be relevant income (because it ceases to be available); so the amount of relevant income is only £100 (assuming B's benefit is a distribution of relevant income); or (if relevant income is not distributed):
(2) Step 5(b): double counting relief.

Solution (2) applies if the distribution to B did not consist of relevant income. It depends on HMRC discretion, but that was the position before the ITA rewrite, so nothing has changed.

Example 3: one beneficiary receives a distribution of relevant income

The second difficulty is that the rewrite team solution – a deduction for prior year s.731 income – does not link in with the first of the pre-ITA solutions to the RI multiple counting problem. Suppose a slight variant to example 1: a trust with Total Relevant Income of £200 and:

(1) Year 1: B receives a benefit (£100) and £100 s.731 income. Assume the benefit *is* paid out of relevant income.[76]
(2) Year 2: B receives another benefit (£200).

The computation in year 2 goes as follows:

Step 1: The Total Benefits of B are £300.

Step 2: The Total Untaxed Benefits of B is computed thus:

Total Benefits	£300
Prior year s.731 income	- £100
Total Untaxed Benefits:	**£200**

Steps 3 and 4: The Total Relevant Income is £100 (because £100 has already been distributed and is not available to provide a benefit.)

Step 5: The Available Relevant Income appears to be:

Total Relevant Income	£100
prior year s.731 income	- £100
Available Relevant Income:	**£0??**

B should have £100 s.731 income in year 2, not £0! I think that the best solution is to say that where relevant income is distributed, no further deduction is allowed at Step 5, so there is no double deduction. Though

76 For instance, trust income is accumulated and then paid to the beneficiary as capital.

this is reading a good deal into the provision.

30.13.6 *Section 733 computation where s.731 remittance basis applies*

Where the s.731 remittance basis[77] applies, s.731 income is still treated as accruing to the foreign domiciled individual under s.731, even though not remitted. So the s.731 remittance basis does not prevent a deduction under Step 2 (and Step 5(a)) if applicable.

Suppose the facts of example 1 or 3 above, but the benefit which B received in year 1 was an unremitted foreign benefit which qualified for the s.731 remittance basis. The computations are exactly the same. Thus benefits to B within the s.731 remittance basis reduce available relevant income in relation to B (whether or not made out of relevant income) just as where the arising basis applies.

Suppose the facts are as in example 2 above, but the benefit which B received in year 1 was a foreign benefit which qualified for the s.731 remittance basis. There is as before no deduction under Step 2 or Step 5, but C must fall back on the two pre-ITA solutions to the RI multiple counting problem:

(1) that distributed income ceases be relevant income (because it ceases to be available); or (if relevant income is not distributed):
(2) Step 5(b): double counting relief.

Solution (2) depends on HMRC discretion, but it is considered that the relief ought to apply to relieve C. Of course, B may not agree. Suppose a variant of example 2:

Example 4: two beneficiaries (one taxed on remittance basis)

Suppose a trust with Total Relevant Income of £200 and:

(1) Year 1: B receives a benefit (£100) and £100 deemed income under s.731. B is a remittance basis taxpayer and does not remit the benefit so no tax is due.
(2) Year 2: C receives a benefit (£200).
(3) Year 3: B receives the benefit in the UK.

The computation for C in year 2 is the same as example 2:
Step 1: The Total Benefits of C are £200.
Step 2: The Total Untaxed Benefits of C are £200 (nothing is deducted).
Step 5: Total Available Income = £200: There is no deduction from the

77 See 30.35 (Section 731 remittance basis).

Total Relevant Income under Step 5(a) because nothing is deducted at Step 2.

Is C taxed on £200? C must fall back on one of the two pre-ITA solutions identified by the tax law rewrite team:

(1) that distributed income ceases be relevant income (because it ceases to be available); so the amount of relevant income is only £100 (assuming B's benefit is a distribution of relevant income); or (if relevant income is not distributed):

(2) Step 5(b): double counting relief.

If the distribution to B did not consist of relevant income solution (2) is the only one available. It depends on HMRC discretion but it is considered that it ought to be allowed. It follows that C will be taxed in year 3. C may argue that B ought to be taxed and B's may be subject to tax remittance should be tax free, but that seems less "just and reasonable". That is consistent with the s.87 rules where a s.2(2) amount (trust gain) may be matched to a capital payment to a remittance basis taxpayer.

30.13.7 *Step 6: Computation of charge*

We have at last reached the final step of the s.733 computation. Step 6 is as follows:

> Compare the total untaxed benefits and the available relevant income.
> The amount of the income treated as arising under section 732(2) for any tax year is the total untaxed benefits unless the available relevant income is lower.
> If the available relevant income is lower, it is the amount of income treated as so arising.

That is, the s.731 income is the lesser of:

(1) Total Untaxed Benefits; and

(2) Available Relevant Income.

30.13.8 *Section 733 computation: Commentary*

The reader who has laboriously followed the text to this point will agree that s.733 needs to be rethought and rewritten.

30.14 Section 733 computation when benefit subject to CGT

Section 734 ITA provides:

> **Reduction in amount charged: previous capital gains tax charge**
> (1) This section applies if—

(a) benefits provided as mentioned in section 732(1)(c) are received in a tax year,

That is, the benefit is in principle taxable under s.731.

(b) for that tax year the whole or part of any benefits so provided is a capital payment to which section 87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 applies (chargeable gains: gains attributed to beneficiaries),

That is, the benefit is in principle taxable under s.87.

(c) it is such a payment because the total untaxed benefits[78] exceed the available relevant income (see Step 6 in section 733(1)) and so it is not treated as income arising to the individual under section 732(2), and

That is, the benefit was not subject to income tax for lack of relevant income.

(d) because of that capital payment chargeable gains are treated as accruing to the individual in that or a subsequent tax year under any of the provisions referred to in para (b).

The CGT charge applies under the rules set out in 30.12 (Is a benefit within s.731 a capital payment?).

(2) For any tax year after one in which such chargeable gains are so treated, the amount of income treated as arising to the individual under section 732(2) in respect of benefits provided as mentioned in section 732(1)(c) as a result of the transfer or operations in question is calculated as follows.
(3) The amount is calculated under section 733(1) as if the total untaxed benefits were reduced by the amount of those gains.

This ensures that a benefit charged under s.87 is not later also charged to IT.

30.15 "Relevant income": Definition

"Relevant income" is a central but perplexing concept. The absence of litigation on the subject is because HMRC have in practice generally

78 Section 734(4) provides:
"In this section 'the total untaxed benefits' and 'the available relevant income' have the same meaning as in section 733(1) (see Steps 2 and 5)."

applied the legislation in a way which leads to a sensible result.

Section 733(1) Step 3 provides the definition:

> *Step 3*
> Identify the amount of any income which—
> (a) arises in the tax year to a person abroad, and
> (b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual.
> That amount is "the relevant income of the tax year" in relation to the individual and the tax year.

The condition in Step 3(a), income arising to a person abroad, is the same as in the transfer of asset conditions.[79]

Strictly one should not use the term "relevant income" in the abstract. Relevant income can exist only *in relation to an individual*. There may be relevant income in relation to A which is not relevant income in relation to B (eg income of a discretionary trust under which A can benefit and B cannot). There may be relevant income in relation to anyone in the world (eg income of a discretionary trust with a power to benefit anyone in the world). But where the context is clear, one may refer to "relevant income" in isolation (leaving the words "in relation to the individual" and the identity of that individual to be inferred from the context).

The s.731 concept "relevant income" must not be confused with "relevant foreign income."

30.16 Deemed income of person abroad

30.16.1 *Capital deemed to be income*

Although the statute refers to "income", capital receipts of the person abroad are sometimes treated for tax purposes as income of the person abroad, and such receipts can therefore be relevant income.[80]

30.16.2 *Stock dividends and accrued income profits*

Suppose non-resident trustees receive a stock dividend from a UK

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79 See 28.5 (Income "becomes payable" to person abroad).

80 See:
(1) 28.13 (Capital receipts deemed to be income).
(2) 33.7.2 (Non-resident company or institution).
(3) 35.10 (OIG arising to non-resident trust).

company. In that case "income is *treated* as arising to the trustees": see s.410(3) ITTOIA. The amount is deemed "income" for ToA purposes, but it is considered that it is not relevant income. The amount is fictional so one cannot say that it "can" be used for the benefit of any beneficiaries. The shares issued in the stock dividend can be used for that purpose, but they are not the same income.[81] The distinction between a gain and an amount equal to the gain is one on which HMRC insist in a DTA context;[82] here the distinction between the actual stock dividend and the fictional income is similar but clearer.

The same point arises if a person abroad is treated as receiving AIP income. The amount is treated as income becoming payable to the person abroad for ToA purposes[83] but it is considered that it is not relevant income. The amount is fictional so one cannot say that it "can" be used for the benefit of any beneficiaries. The proceeds of the AIP securities can be used for that purpose, but that is not the same income.

HMRC may argue that one should carry through the deeming:[84] if the person abroad is treated as receiving income, the (deemed) income must be treated as if it can be used to benefit beneficiaries (even though it does not exist). If that were right, however, two difficulties would arise:

(1) How would the rule that distributed income is not relevant income[85] operate in this context? In order to distribute the AIP income would it be necessary to distribute the entire proceeds of the transfer (sale) of the security? Perhaps the matter would be analogous to the DDS scheme.[86] Then the only way to avoid relevant income by distribution would be to distribute the entire proceeds of the securities. Perhaps a division would be possible as it is under the mixed fund rules.[87]

(2) How does one deal with AIP loss relief? This tends to support the view that AIP income is not relevant income.

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81 See to 28.13 (Capital receipts deemed to be income).

82 See 59.2 (Characterisation).

83 See 37.14 (Transfer of assets abroad).

84 For the general approach to deeming provisions, see App 2.1 (Construction of deeming provisions).

85 See 30.23 (Relevant income of trust distributed as income in year it arises) to 30.27 (Distributed income: HMRC view).

86 See 38.12.1 (Section 731 ITA).

87 See 37.9.2 (Mixed funds and separating income/capital: sale with accrued interest).

30.17 Is income of life tenant relevant income?

Consider an interest in possession trust: one where the trust income is payable to a beneficiary ("L").

If L is UK domiciled and resident, the trust income is not relevant income because it does not meet the condition in Step 3(a). It does not arise to a person abroad.

If L is not UK domiciled then the condition in Step 3(a) is satisfied. Nevertheless, the trust income is not relevant income because it is distributed.[88]

There is nothing surprising in this conclusion: there is no need for s.731 in these circumstances, and one would not expect it to apply. If it did apply there could be double taxation – L being taxed on the income L receives, and on other benefits (if L receives any) to the value of the relevant income.

30.18 Is trust income within s.624 relevant income?

One must consider UK resident and domiciled settlors separately from those who are non-resident or domiciled.

30.18.1 *UK resident and domiciled settlor*

Suppose:

(1) a non-resident discretionary trust within s.731;

(2) a UK resident and domiciled settlor ("S") has an interest in the trust.

All the trust income is within the scope of s.624 ITTOIA. Section 624 ITTOIA provides in such a case:

> Income which arises under a settlement is treated for income tax purposes as the income of the settlor *and of the settlor alone* ...
> (Emphasis added)

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88 See 30.23 (Relevant income of trust distributed as income in year it arises). Even if that were wrong:

(1) The trust income is not relevant income in relation to L. One would not say in ordinary language that the trust income *can* be used for providing a benefit for L. The income *is* the property of L.

(2) The trust income is not relevant income in relation to any other person. Since the income belongs to L, one cannot say that the income "can" be used to benefit anyone else. See 30.20 (Income which "can" be used to benefit another person).

The trust income is not relevant income as it does not meet the condition in Step 3(a): the income is treated by s.624 as accruing to S, so it cannot be regarded as arising to a person abroad. This is so even if S (wrongly) fails to pay the tax due on the income.

30.18.2 *UK resident foreign domiciled settlor*

Now suppose:

(1) a non-resident discretionary trust within s.731;
(2) a UK resident but not UK domiciled settlor ("S") has an interest in the trust; and
(3) the trust income is actually subject to tax under s.624 ITTOIA (the s.624 remittance basis does not apply).[89]

In this case the condition in Step 3(a) is satisfied since even applying s.624 the income is treated as accruing to S. However, it is considered that the condition in Step 3(b) is not satisfied: if the income is treated as that of S, and of no other person, it is not income which "can be used for providing a benefit" for anybody else. So the income is not relevant income.

The position is different if and to the extent that the income is within the s.624 remittance basis. Section 624 does not apply to income which qualifies for the s.624 remittance basis.[90] Accordingly the trust income can, in principle, be relevant income for s.731. What happens then if the income is later remitted, so it becomes taxable on S under s.624? It is tentatively suggested that the income retrospectively ceases to be relevant income, so that tax paid under s.731 can be recovered by a beneficiary. In practice this could arise only in fairly unusual circumstances, eg where:

(1) Year 1
    (a) a beneficiary ("B") receives a benefit;
    (b) foreign source income arises on which the settlor ("S") is not subject to tax as the s.624 remittance basis applies. This is relevant income in relation to B, so B pays tax under s.731.
(2) Year 2: that income is remitted to the UK, so S pays tax under s.624.

Where s.720 applies (as well as s.624) see 30.19 (Is income within s.720 relevant income?).

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89 This may be because there is UK source income, or foreign income is received in the UK, or S does not claim the remittance basis. See 27.4 (Section 624 remittance basis).

90 See 27.4 (Section 624 remittance basis).

30.18.3 *Non-resident settlor*

Suppose now:
(1) a non-resident discretionary trust within s.731; and
(2) a non-resident settlor ("S") has an interest in the trust.
Section 624 does not apply to foreign source trust income.[91] Accordingly foreign source income may in principle be relevant income.

Section 624 does apply to UK source income. Here too it is submitted that the condition in Step 3(b) is not satisfied: if the income is treated as that of S, and of no other person, it is not income which "can be used for providing a benefit" for anybody else. So UK source income is not relevant income.

30.19 Is income within s.720 relevant income?

The analysis is different if income falls within s.720 and not s.624 because the wording of the provision is different.

The application of s.720 does not prevent income from being relevant income, as the s.720 income is different income from the income of the person abroad,; see 59.5 (DT reliefs: s.720 ITA). Double-counting relief prevents a double charge.[92] This is surprising, because it is not clear who qualifies for the relief: the transferor or a beneficiary who receives a benefit. But it is difficult to construe the legislation any other way.

30.20 Income which "can" be used to benefit another person

An essential feature of the definition of relevant income in relation to an individual is the condition in Step 3(b) that the income "can be used for providing a benefit" for the individual.

"Can", like most common words, has a variety of meanings, but the meaning here must be:

> Expressing a possible contingency; = May possibly.[93]

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91 See 27.6 (Non-resident settlor).

92 See ? (Section 720 and s.731 overlap).

93 *Oxford English Dictionary* (2nd ed., 1989). Another meaning of "can" is "to be able; to have the power, ability or capacity". This meaning applies where one says that a *person* "can" do something. This meaning is not applicable here where the subject of "can" is the income. *Income* does not have any power, ability or capacity: only a *person* does. There is a fine discussion of *can* in Williams, *Tradition & Change in Legal English* (2005), at 2.8.

30.20.1 *Income of individual*

Of course, any income "can" be used for the benefit of any individual in the world if it is received by a beneficial owner who so directs. That contingency must plainly be ignored or the definition does not work.[94]

30.20.2 *Income received by company owned by individual*

Suppose an individual, T, transfers assets to a non-resident company all the shares of which T owns absolutely. Assume the transfer does not qualify for the motive defence. So long as T remains owner of the company, the income of the company is not relevant income in relation to any person (other than T[95]).

For the position if T later gives the company to a trust, see 30.31 (Is income of company held by a trust relevant income?).

30.20.3 *Income of trust only payable to B on remote contingency*

Now consider this type of trust,[96] divided into two sub-funds:

(1) A's sub-fund: income to be applied for the benefit of A or accumulated; capital to be paid to A at the age of 25; if A dies under

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94 The issue is not so much the meaning of the word "can": if income is paid to A it is obvious that it "can" (in the sense of "may possibly") be paid to B if A so directs. The better way to put the issue is: which hypothetical contingencies should be taken into account in order to ask the question whether or not income "can" be used for providing a benefit?

The question is similar to the issue which arises for the purposes of the settlement provisions, whether income "may" be used to benefit the settlor "in any circumstances whatsoever". These words do not include the possible circumstance that there may be "a mere voluntary application of income by a beneficiary to the settlor": see *Glyn v IRC* 30 TC 321 at 329. A similar question arose in reverse in *Inglewood v IRC* [1983] STC 133. The question was whether one could say that a beneficiary "will" become entitled to an interest in possession: held that one should ignore the contingency that the beneficiary may not become entitled by virtue of the beneficiary voluntarily assigning the interest to another person.

Another way to reach this conclusion is to say that the income "can" be used to benefit the individual, but not "as a result of the relevant transfer or associated operations" (the application of the income by the beneficial owner not counting as an associated operation).

95 Strictly the income of the company may be relevant income in relation to T, but T is not concerned with s.731 as T will qualify for the transferor's s.731 defence.

96 This was quite a common form before the abolition of relief for Accumulation and Maintenance trusts in 2006.

25, the share accrues to B's share.

(2) B's sub-fund is held on similar terms: income to be applied for the benefit of B or accumulated; capital to B at 25 with accrual to A if B dies under 25.

Suppose income is accumulated on A's sub-fund. It is relevant income in relation to A. Is it relevant income in relation to B? It is payable to B only on the contingency that A dies under 25. It is suggested that this income is not relevant income in relation to B. One would not, in normal language, say that the income "can" be used to benefit B just because A may die under 25. The contingency is too remote.

If A dies under 25:

(1) income of A's sub-fund arising after the death of A is (of course) relevant income in relation to B;

(2) income of A's sub-fund arising before the death of A subsequently becomes relevant income in relation to B if the "timing" issue discussed below is correctly answered.

If this is correct, the concept here is not the same as in s.624 ITTOIA, where the issue is whether income "may become payable" to the settlor *in any circumstances whatsoever*.[97] Applying (as one should) a purposive approach, this is the fair and just result and consistent with the general scheme of s.731. A settlor or transferor has the opportunity to exclude themselves completely in a straightforward manner, and is taxed if they fail to do so. A beneficiary (not the settlor/transferor) does not have the same opportunity. To tax B on income of A's fund (on the facts of the above example) would not be just or fair.[98]

30.20.4 *Income of discretionary trust*

Conversely, consider a common form discretionary trust. In principle, all trust income "can" (in the sense of "may possibly") be used to benefit any beneficiary, if the trustees exercise their discretion, and that is a

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97 See Williams, *op. cit.* p.139; *may* (compared with *can*) "tends to convey a more hypothetical degree of possibility". It is reasonable to assume that the drafter of the transfer of assets provisions did not copy the language of the settlement provisions because a different result was intended.

98 Some support can be found in the discussion of "can" (albeit in a different context) in *Mandla v Dowell Lee* [1983] 2 AC 548 at p.565. A similar unfairness does arise for CGT under s.87 TCGA. However, it is possible to avoid that by transfers to another settlement.

contingency which naturally should be taken into account. Trust income is relevant income in relation to all beneficiaries.

Suppose, however, the trustees (perhaps guided by a letter of wishes) regard the fund as divided into (say) two shares for separate families. If there is no practical possibility that more than one half of the income will be used for one particular beneficiary, there is a reasonable argument that only one half of the income is relevant income in relation to that beneficiary.

Trustees of a common form discretionary trust have power to benefit anyone in the world. However, in practice the trustees will wish to identify a more limited class, and it is arguable that trust income is not relevant income in relation to other (theoretically) potential beneficiaries.

30.21 When does one ask?: The timing issue

One must ask whether income "can" be applied for the benefit of an individual. *At what moment in time does one ask this question?*

(1) It often happens that, at the moment it arises, income can be used to provide a benefit for a person, B, but at a later point in time it cannot be so used; for instance if income of a discretionary trust is:
   (a) distributed to another individual (not B);
   (b) transferred to another trust (under which B cannot benefit); or
   (c) retained by the trustees, but on terms under which B cannot benefit; or
   (d) used to pay trust expenses.

(2) The converse also sometimes happens: at the moment it arises income cannot be used to provide a benefit for B, but at a later time it can be so used; for instance:
   (a) if B is born after the income arises;
   (b) if one share of a trust fund later accrues to another share (eg on the death of a beneficiary);[99] or
   (c) (arguably) where a company within s.731, wholly owned by A, which has accumulated income during A's ownership, is later given to B or to a trust under which B can benefit.[100]

So it is often important to ask at what moment in time one puts the question. I refer to this as **"the timing issue"**. There are in principle

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99 See 30.20.3 (Income of trust only payable to B on remote contingency).

100 See 30.31 (Is income of company held by a trust relevant income?).

several possible answers:
(1) the moment that the income arises;
(2) the moment that the benefit is provided, if later than (1);
(3) after a "reasonable" period (whatever that might be);
(4) the end of the tax year in which either (1) or (2) or (3) occurs;
(5) the earlier or later of some combination of the above.
An important consequence of all solutions except (1) is that trustees of a discretionary trust or company within s.731 would usually have some period of time after income has accrued, during which they may:
(1) distribute income; or
(2) apply the income in the payment of expenses.
Then the income will not be relevant income in relation to the beneficiaries because *at the moment when one asks the question* it is no longer income which "can" be applied for the benefit of the beneficiaries.

To answer the timing question we must return to the legislation. Section 733 ITA Steps (3) and (4) provide:

> *Step 3*
> Identify the amount of any income which—
> (a) arises in the tax year to a person abroad, and
> (b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual.
> That amount is "the relevant income of the tax year" in relation to the individual and the tax year.
> *Step 4*
> Add together the relevant income of the tax year and the relevant income of earlier tax years in relation to the individual (identified as mentioned in Step 3).
> The sum of those amounts is "total relevant income".

Steps 3 (taken with step 4) can be read in various ways:

> *Step 4*
> Add together
> [1] the relevant income of the tax year *being the amount of any income which—*
> *(a) arises in the tax year to a person abroad, and*
> *(b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual.*

and
[2] the relevant income of earlier tax years in relation to the individual *being the amount of any income which—*
(a) arises in the [earlier] tax year to a person abroad, and
(b) as a result of the relevant transfer or associated operations can
[i] [at any time in that earlier year] **or**
[ii] [at the end of the earlier year] **or**
[iii] [at the time that the benefit is conferred, or the time that the income arises if later]
be used directly or indirectly for providing a benefit for the individual.

(In this quote the words in normal font are the words of Step 4; the words in italics are the words of Step 3; the words underlined are added; note that some words must be added in any event.)

In clause [2][b] readings [i] [ii] [iii] are alternatives.

It is considered that one looks to the position at the later of:
(1) the end of the tax year in which the relevant income has accrued, or
(2) the end of the tax year in which the benefit accrues.
One asks whether *at that time* the income:

> can ... be used for providing a benefit for the individual.

Another way to put it is that one asks the question with the benefit of hindsight, taking into account facts known at the time that the question matters.

The main reason for this view is that it is more sensible to ask the question at the time it matters.

The moment the income arises is not a suitable moment to ask the question. In some cases it is impossible to ascertain the moment at which income arises and all that the tax system attempts is to attribute income to an accounting period or year of assessment.[101] In other cases it is only possible to ascertain a moment at which income arises by rules of a somewhat arbitrary kind.[102] Similarly, the moment that the benefit arises is not a suitable moment. Some benefits (such as interest-free loans) also arise over a period. Moreover it is not practical to have to compute relevant income on every separate occasion that a benefit is provided during the year.

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101 eg trading or property income.
102 eg the rules in ss.18–19 ITEPA (When general earnings are received).

The legislation does not provide an express answer, but it does offer at least a hint in support of this view. Step 3 does not refer to "relevant income" in isolation. It refers to relevant income *of the tax year in relation to ... the tax year*. It is obviously necessary to attribute relevant income to a tax year, eg to deal with the situation where:

(1) an individual receives a benefit in year 1;
(2) the benefit is not taxed because there is no relevant income in year 1;
(3) relevant income arises in year 2.

There is only relevant income *of year 2* and so the s.731 charge arises in year 2 and not in year 1. However, the reference in Step 3 is to income of the tax year *in relation to the tax year*. These extra words suggest that the relevant income of tax year 2 in tax year 2 may be different from the relevant income of tax year 2 in tax year 3. In year 3 one must ask again what is the relevant income of year 2.[103]

The Tax Law Rewrite agree. ITA EN provides:

> It is therefore considered that surplus relevant income (*if it continues to be available*) has not been taken into account and so must be carried forward year by year until extinguished by a benefit or benefits.[104]

30.22 Relevant income used to pay expenses

HMRC practice is that income used to pay trust or company administration expenses will reduce relevant income.

ToA draft guidance provides:

> **INTM601680 relevant income**
> *Example 1*
> A foreign company with investment business has interest income of £100,000 for a tax year. It pays costs for management of the company of £25,000 out of its income. Assuming all other conditions for a benefits charge are met, the relevant income of this company for that purpose would be considered to be £75,000, the amount that can be used for providing a benefit.
> It is worth noting that if the income of this company fell to be taken into account for the purpose of the income charge [s.720] the amount of the income for that purpose would be considered to be £100,000.

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103 I have considered whether any guidance is to be found in the principle that income tax is an annual tax. However, that does not shed much light on the problem.

104 The EN passage is discussed in 30.13.5 (Step 5: Available Relevant Income).

This applies even to income used for capital (rather than income) expenditure. Income used to meet a statutory indemnity ceases to be relevant income (even a CGT indemnity, ie a capital liability):

> **CIOT Letter (extract)**
> It would also be helpful if the Revenue could confirm that if the trustees do in fact make a payment to the settlor in response to a request for reimbursement, either under [s.646 ITTOIA] or under para 6 of Schedule 5 to TCGA, such a payment would not be regarded as: ...
> (b) Taken into account for [s.731 ITA] purposes...
> **The Revenue reply** ...
> (b) *it will reduce the relevant income if paid out of income* but will not be a payment [ie not a benefit.][105]

Income used to pay a sum in lieu of interest ceased to be relevant income (even though the payment is of a capital nature). Tax Bulletin 8 provides:

> ESC D41 allowed, inter alia, demand loans made to offshore trustees on better than commercial terms before 19 March 1991 to be put on commercial terms after that date. This enabled a trust to remain outside the condition in para 9(3), Schedule 5, TCGA 1992. In order to meet the terms of this concession, it may have been necessary to pay a sum in lieu of interest in respect of periods ended 5 April 1992. Where this was the case, such a payment would ... qualify as a deduction ... *for the purposes of [s.731 ITA] provided it was paid out of trust income*.
> Where the amount in lieu of interest was paid to a person who is not a beneficiary under the terms of the trust, it would nevertheless be treated as a capital payment to that individual under TCGA 1992, Section 97. If the amount in lieu of interest was paid by a company underlying the trust, that payment would not qualify for a deduction from the profits of that company [because it is capital and not income].

Thus income used to pay interest ceases to be relevant income. Income used to repay borrowed capital also ceases to be relevant income; though if this principle was pushed to extremes in a tax avoidance scheme, the sum borrowed might be regarded as representing the relevant income: see 30.28 (Relevant income reinvested: tracing).

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105 *Taxation Practitioner*, April 1996 p.25 accessible *http://www.kessler.co.uk/tfd-archive* emphasis added. For other issues relating to reimbursement see 80.24 (Failure to exercise right of reimbursement). See too 30.4.10 (Reimbursement of tax under statutory indemnity).

30.23 Relevant income of trust distributed as income in year it arises

Suppose income ("the trust income") accrues to trustees of a discretionary trust within s.731, and is distributed (as income) to a beneficiary, "B1", in the same tax year.

30.23.1 *Position of other beneficiaries*

The trust income is not relevant income in relation to any other beneficiary, since the income was distributed to B1. One cannot say that the income "can" be applied for the benefit of anyone else – if my answer to the timing issue is correct. This is significant for the other beneficiaries who receive a benefit within s.731 (whether before or after the year in which the income arises and is distributed). They will not pay tax on the benefit by reference to the distributed income, because it is not relevant income. (They may pay tax on the benefit by reference to other relevant income if there is any.)

That must be correct, because otherwise there could be double taxation (B1 taxed on trust income and another beneficiary taxed under s.731).[106]

30.23.2 *Position of recipient beneficiary*

It is suggested that the income is not relevant income in relation to B1: it is not income which *can* be used for B1's benefit; it is income which *is* used for B1's benefit.[107] This is significant for B1 if:

(1) B1 is a remittance basis taxpayer, and
(2) B1 received a benefit in the UK, and
(3) the trust income is paid to B1 and not remitted to the UK.

B1 is taxed on the RFI remittance basis on the income B1 receives from the trust. B1 is not taxed on the benefit by reference to the distributed income, because it is not relevant income. (B1 may pay tax on the benefit by reference to other relevant income if there is any.)

30.24 Relevant income of trust distributed as income after year it arises

Suppose income accrues to trustees of a discretionary trust, within s.731, and is retained (without being accumulated) in that tax year, but is

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106 Arguably s.743 ITA would provide relief: see 31.6 (Double-counting relief). But this is not a satisfactorily solution as it is not clear who pays the tax.

107 The same argument as 30.17 (Is income of life tenant relevant income?) but not so strong.

distributed (as income) to beneficiary B1 in a subsequent year. If:

(1) a UK resident beneficiary ("B2") had received benefits in a past year, and

(2) had not paid tax under s.731 in the past year, for lack of relevant income,

B2 will pay tax under s.731 in the year in which the income arises.

Suppose, however, that there have been no earlier benefits so this is not in point. The position is then the same as in the above paragraph, if my answer to the timing issue is correct:

(1) The income is not relevant income of B1.

(2) The income is not relevant income of any other beneficiary.

It seems that this is the generally held view. STEP say:

> In our experience, most advisers take the view that, where actual income
> [1] has been segregated[108] and
> [2] in a future year is used to pay a disbursement or to make an income distribution to an individual,
> it will cease to be relevant income in relation to other individuals because it is no longer available to provide a benefit to them. HMRC have been known to accept this view.
> In practice, trustees often do not pay all relevant disbursements or make decisions regarding the use of income during the tax year in which the income arises, preferring to wait until the trusts accounts have been finalised. This may not be until some time after the tax year end and it seems inequitable to treat beneficiaries differently on the basis that the trustees have taken this view.[109]

In the ToA draft guidance, HMRC expresses a different view:

> **INTM601680 relevant income**
> *Example 1*
> A foreign company with investment business has interest income of £100,000 for a tax year. It pays costs for management of the company of £25,000 out of its income. Assuming all other conditions for a benefits charge are met, the relevant income of this company for that purpose would be considered to be £75,000, the amount that can be used for

108 Author's note: it is doubtful whether segregation of income is necessary.

109 Response to HMRC Consultation "Reform of an anti-avoidance provision: Transfer of Assets Abroad" (October 2013) *http://www.step.org/sites/default/files/response_letterhead_TransferOfAssetsAbroad.pdf*

providing a benefit...

Example 2

The same company decides at the end of the tax year to add its 'net profit' of £75,000 to its reserves. Two years later it makes a payment of £50,000 and contends this reduces relevant income. As relevant income has to be considered on a tax year by tax year basis HMRC would take the view that relevant income of the tax year remained £75,000 as in Example 1 above.

30.25 Relevant income of trust accumulated

30.25.1 *Income accumulated and retained on wide discretionary trusts*

If trustees of a common form discretionary trust accumulate income, it remains relevant income in relation to all beneficiaries as long as it is retained by the trustees, because the trust capital (which represents the accumulated income) can be used to benefit any beneficiaries.

30.25.2 *Income accumulated and retained on narrower trusts*

The position would be different if under the terms of the trust:

(1) B was in the class of beneficiaries to whom income could be paid; but
(2) B could not benefit in any way from income after it had been accumulated.

Accumulated income would cease to be relevant income in relation to B. This may happen automatically under the terms of the trust; for instance, a formerly common form of accumulation and maintenance trust provided:

(1) Income as it arises may be used for the benefit of any beneficiary under 25 ("B12", "B2" or "B3").
(2) If not so used, it is accumulated and added to the share of one particular beneficiary (B1) and can only be used for the benefit of B1 (not B2 or B3).

On receipt the income is relevant income in relation to B1, B2 and B3. After accumulation it is relevant income only in relation to B1.

A similar point arises in relation to a common form discretionary trust. Accumulated income is relevant income in relation to all the beneficiaries. Suppose the trustees exercise their overriding power to exclude B from the accumulated income, not from other trust capital. The income ceases to be relevant income in relation to B. It makes no difference whether this is done in the year of receipt or later.

Similar points arise if the income is transferred to a new trust, or if the income of a company within s.731 is capitalised by the issue of bonus

shares.

30.25.3 *Income accumulated but later distributed as income*

It has been suggested that once income is accumulated, it is forever relevant income in relation to all the beneficiaries to whom it could have been paid. Subsequent distribution is irrelevant (unless it gives rise to a s.731 charge). This view gives rise to anomalies:

(1) Some receipts which are capital for trust law purposes are treated as income for s.731,[110] and these cannot be "accumulated" in the normal trust sense. It would be odd if they were treated differently from ordinary income for s.731 purposes.

(2) Income of a company within s.731 cannot be "accumulated" in the trust sense. It would be odd if companies were treated differently from trusts.

It is considered that the process of accumulation does not by itself make any difference to the s.731 position. If income of a common form discretionary trust is accumulated, and later distributed as income to B1, it ceases to be relevant income in relation to other beneficiaries. This only applies if the sum distributed is (or represents) the accumulated relevant income. This raises tracing issues discussed below.

30.25.4 *Income accumulated and distributed as capital*

Suppose income of a common form discretionary trust is accumulated and distributed as capital to a beneficiary, B. It is considered that the income ceases to be relevant income in relation to any beneficiary except B. (It is relevant income in relation to B so that B is in principle subject to tax under s.731 if B is resident in the UK. Any other conclusion would be absurd.)

A capital distribution out of accumulated relevant income to a UK resident individual is taxable under s.731. It is not a capital payment and so does not reduce s.2(2) amounts. However the same payment to a charity or a non-resident individual will reduce s.2(2) amounts and relevant income.

30.26 Corporate income distributed to trust

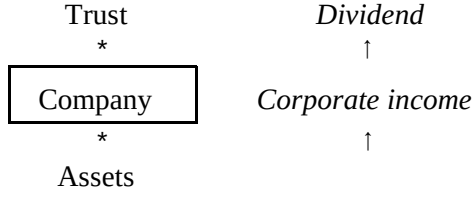
Suppose a company within s.731 is held by a common form discretionary

110 See 28.13 (Capital receipts deemed to be income).

trust within s.731:

(1) the company receives income ("**corporate income**");
(2) the corporate income is distributed by way of dividend and retained by the trustees.

Thus:



The corporate income ceases to be relevant income so it is not counted twice. One cannot say that the corporate income and the dividend income are *both* available to provide a benefit.[111]

Suppose:

(1) a company within s.731 is held by a common form discretionary trust;
(2) the company's income is distributed by way of liquidation and retained by the trustees.

Double counting relief does not apply. It is suggested that the trustees receipt represents the relevant income, so the liquidation does not affect the s.731 position. (Any other view would allow tax avoidance and not be attractive to a court.)

30.27 Distributed income: HMRC view

RI 201 states:

> For the purposes of Section 740(3) ICTA [now s.733 ITA] the measure of "relevant income" is treated as not including such part of the income as has already been genuinely paid away to a beneficiary or to a bona fide charity.
>
> Once relevant income has arisen *and continues to be available to provide a benefit*, it must in the Revenue's view be carried forward year by year until extinguished by such a benefit, even if it is capitalised in the accounts of the overseas person.
>
> (Emphasis added)

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111 Even if that were wrong, it is suggested that double counting relief prevents the corporate income and the dividend income from counting as relevant income; see 31.10 (Section 731 trust/company structure).

This does not address all the permutations discussed above, but it seems to be generally consistent with the above.

ToA draft guidance provides:

> **INTM601680 relevant income**
>
> Only income arising on or after 10 March 1981 can be taken into account as relevant income as the benefits charge only applied from that date (INTM601440).
>
> The different language of the benefits charge highlights the fact that what is taken into account as relevant income for the benefits charge may be somewhat different to the measure of income that may fall to be taken into account for the income charge. As it is only income that can be used which is taken into account it will be appropriate to look in most cases at any factors that may prevent income being so used. For example, any part of the income that has been genuinely paid away may not be capable of being termed as income that can be used for providing a benefit.
>
> It should however be kept in mind that relevant income has to be considered on a tax year by tax year basis so that once an amount has been determined as being relevant income of a tax year it will fall to be taken into account as relevant income in any subsequent years benefits charge calculation. It cannot be amended by, for example, a subsequent disbursement, neither will it cease to be relevant income if, for example, it ceases to be regarded as income within the structure perhaps because it has been capitalised.
>
> In considering whether any part of the income has been genuinely paid away in a manner such as it could not be regarded as income that can be used for providing a benefit, there are three broad categories of disbursements that will generally be taken into account:-
>
> - income genuinely paid away in meeting legitimate expenses;
> - income distributions paid out of income;
> - taxes paid by the person abroad out of income.
>
> It is likely to be largely a question of fact whether income can be used for providing a benefit, and regard should be had, where necessary, to relevant constituting documentation of the person abroad as well as any applicable foreign law that may have a bearing on the way the person abroad acts and operates.
>
> The following examples may help to illustrate how relevant income will generally be determined...
>
> *Example 3*
>
> A foreign trust has no income of its own, but owns a foreign company which has rental income of £100,000. The trustees make a payment out of trust capital to a beneficiary of £30,000. In considering what is

relevant income for the purposes of the benefits charge the income of both the company and the trustees is taken into account. The relevant income will thus be £100,000 as it is income that can indirectly be used for providing a benefit. The payment out of the trust does not impact that.

30.28 Relevant income reinvested: Tracing

The requirement is that "income" can be used to provide a benefit. "Income" here includes any asset representing income, even if that asset does not constitute "income" (in any sense) of the person abroad.[112] Thus it makes no difference if the relevant income is invested in another asset.

Suppose:

(1) A non-resident company held by a trust has received relevant income ("**the corporate relevant income**").

(2) The trustees sell the company to a purchaser.

It has been suggested that the corporate relevant income ceases to be relevant income in relation to the beneficiaries, because (after the sale) that income can no longer be used to benefit them. That would be absurd, but there is no difficulty in construing the legislation to avoid that absurdity. The proceeds of sale represent the corporate income, so the sale has not affected the relevant income position at all: as long as those proceeds can still be used for the benefit of the beneficiaries there is still relevant income in relation to the beneficiaries.

30.29 Tracing: distributions from mixed funds including relevant income

The principle that distributed income ceases to be relevant income applies only if the asset distributed constitutes or includes the relevant income. Whether or not this is the case raises questions of tracing.

The ideal approach is for a trust or company within s.731 to keep relevant income in a separate account. Then funds distributed from that account must be identified as the relevant income.

This section considers what happens if relevant income is mixed with other funds, and there is a distribution from the mixed fund. This is unchartered territory, but it is suggested that the law should follow the case

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112 Similar principles apply for the RFI remittance basis; see 10.3.6 (Income/capital terminology in remittance basis context) example 4. A similar principle applies in ascertaining what is income for the definition of power to enjoy; see 29.6.6 (Enjoyment Condition D: possibility of benefit).

law and practice on pre-2008 remittance basis mixed fund rules.

30.29.1 *Distribution from trust within s.731*

Suppose:

(1) Trustees of a discretionary trust within s.731 receive relevant income and pay it to a mixed fund (ie holding income and trust capital together).
(2) They pay a sum out of that fund in exercise of a power over trust income.

It is considered that the sum distributed would be (or represent) the relevant income. Income comes out first.

Suppose:

(1) The trustees receive relevant income, accumulate it and pay it into a mixed fund (ie holding accumulated income and trust capital together).
(2) They pay a sum out of that fund in exercise of a power to apply accumulated income as income.

It is suggested that the sum distributed would be (or represent) the relevant income.

Suppose:

(1) The trustees receive relevant income, accumulate it and pay it into a mixed fund (ie holding accumulated income and trust capital together).
(2) They pay a sum out of that fund in exercise of a power to distribute capital.

It is suggested that the trustees could by appropriate documentation identify the sum distributed as the relevant income.[113] Otherwise there must be an apportionment.

30.29.2 *Distribution from company within s.731*

Suppose:

(1) A company within s.731 receives relevant income and pays it to a mixed fund (ie holding relevant income and other company funds together).
(2) The company declares a dividend.

In the absence of documentation, it is suggested, on analogy with a trust, that income comes first out of the mixed fund. If the company has only

113 See 13.12.1 (Remittance from mixture of taxed and untaxed income).

received income (ie has not realised capital gains), the dividend clearly represents the relevant income rather than share capital.

Suppose:

(1) A company within s.731 receives relevant income and pays it to a mixed fund (ie holding relevant income and other company funds together).

(2) The company repays a loan or buys in redeemable shares out of that fund.

In principle the repayment of a loan or a share buy back comes out of capital. It is tentatively suggested that the company could by appropriate documentation earmark the sum repaid as the relevant income. In that case relevant income could be distributed by repayment of a loan and so cease to be relevant income.

30.29.3 *Distribution of company shares*

Suppose a non-resident company held by a trust has received relevant income ("**the corporate income**"). If the trust transfers the company to an individual, the corporate income ceases to be relevant to beneficiaries (except the individual). If the trust transfers the company to a new trust, the corporate income is relevant income in relation to the beneficiaries of the new trust but not in relation to beneficiaries of the old trust who cannot benefit under the new trust. This is a sensible rule as it allows different branches of a family to separate their interests fairly.

30.30 Avoiding relevant income: Tax planning

One possible approach is:

(1) distribute all income (from a discretionary trust or underlying company within s.731) to a foreign domiciled settlor immediately it arises;

(2) the settlor may re-settle the income on the same trusts.

This avoids relevant income in the trust or company.[114] It would be better to have an interest in possession trust so income at the trust level will be distributed automatically. Watch the GAAR: it is best to avoid provocative circularity.

A variant of this idea is to distribute income to a beneficiary who is not the settlor/transferor, but who is non-resident (or domiciled) and so outside s.731. Watch the GAAR here.

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114 Also this ensures that the settlor receives the benefit of distribution relief (if applicable); see 31.4 (Distribution relief).

30.31 Is income of company held by a trust relevant income?

30.31.1 *Income accruing while company held by trust*

Suppose a trust with a common form power of appointment holds an underlying company to which s.731 applies.[115] Income of the company is in principle relevant income in relation to all beneficiaries. It remains so as long as the company retains the income.

30.31.2 *Income accruing before company is acquired by trust*

Suppose:

(1) An individual ("T") owns all the shares of a company within s.731.
(2) T gives the shares to a trust with a common form power of appointment.

Income of the company arising after the gift of T is in principle relevant income in relation to the beneficiaries of the trust.

What is the status of income arising before the gift ("old income")? HMRC say that old income is also relevant income in relation to all the beneficiaries. HMRC's argument is simple: at the relevant time (when benefits are received) the old income "can" be used for the benefit of beneficiaries. The tax consequences of this are so severe that one feels it cannot be right, but what is the flaw in the argument?

At the time when the old income accrued to the company, that income "can" only be used to benefit T, the sole shareholder, so it is not relevant income in relation to anyone else. After the company has been given to the trust the same income "can" be used to benefit others. That is sufficient to meet the "can" condition, if my answer on the timing issue is correct.

However, it is not enough that income "can" be used to benefit a person. The definition of "relevant income" requires that the income can be used to benefit an individual:

> as a result of
> (i) the relevant transfer or
> (ii) associated operations.[116]

I refer to this as "**relevant income causation conditions (i) and (ii)**".

---

115 In practice the motive defence may apply to the transfer to the company; see 32.31 (Transfer from non-resident trust to underlying company).

116 The reference here is to the reference to associated operations in s.732(1)(c).

Now, in this case there are two transfers:

(1) The transfer of assets to the company ("transfer 1").

(2) The transfer of the shares in the company to the trust (an associated operation) ("transfer 2").

It is suggested that where the two transfers are not part of a single arrangement, but entirely independent, transfer 2 is not an associated operation in relation to transfer 1. So relevant income causation condition (ii) is not satisfied. Relevant income causation condition (i) is not satisfied since transfer 1 is not the cause of the fact that the income can be used to benefit the beneficiaries. The reasoning is the same as 28.11.1 (Transfer from A to B followed by transfer from B to person abroad).

30.32 Individual not a beneficiary when income arises

30.32.1 *Beneficiary unborn when income arises*

Suppose:

(1) In Year 1 a discretionary trust within s.731 receives and accumulates relevant income.

(2) In Year 2 a beneficiary is born.

Is the income accumulated in year 1 before the birth relevant income in relation to that beneficiary? The answer depends on the timing issue. If my view is right, undistributed income accumulated before birth can be relevant income in relation to the newborn beneficiary, and that view does make more sense, having regard to the general scheme of the legislation.

30.32.2 *Individual in existence but not a beneficiary when income arises*

Suppose:

(1) In Year 1 a discretionary trust within s.731 receives and accumulates relevant income. The class of beneficiaries consists of the issue of the settlor and their spouses.

(2) In Year 2 an individual ("W") marries a beneficiary and so joins the class of beneficiaries.[117]

Is the income accumulated in year 1 before the marriage relevant income in relation to W? The answer depends again on the timing issue. If my view is right, undistributed income accumulated before the marriage can be relevant income in relation to W. Those who take the view that pre-

117 It is assumed there is no power to add beneficiaries so the income could not be applied for the benefit of the individual before the marriage.

birth income is not relevant income might consistently take the view that this pre-marriage income is not relevant income. This is not quite a *reductio ad absurdum*, but it is surely a bold view. If necessary, a court would hold that W "can" benefit in year 1 because of the possibility that W may marry a beneficiary in year 2. See *IRC v Tennant* 24 TC 215. But this contingency may be very remote, so my preferred analysis is less artificial.

30.32.3 *Beneficiary dead when income arises*

Now suppose the opposite situation:

(1) Year 1: a beneficiary receives a benefit from a trust (which is not taxable for lack of relevant income).
(2) Year 2: the beneficiary dies.
(3) Year 3: relevant income accrues.

Here it is plain that there is no tax charge on the beneficiary. Income cannot be deemed to have accrued to them once they are dead.

The same applies in relation to income which accrues in the tax year of death, but after the death. One cannot say that income accruing after the death of a person "can" be applied for their benefit.

30.32.4 *Individual excluded from benefit*

Income arising after a former beneficiary is excluded from benefit cannot (on any view) be relevant income in relation to that beneficiary. It is not necessary that the beneficiary should be excluded from benefit altogether: just that they are excluded from benefit from the income.

30.33 Transfer between trusts

Section 90 TCGA provides a code dealing with transfers between settlements for the purposes of s.87 TCGA.[118] This is needed because a s.2(2) amount is computed in relation to settlements. Each settlement has a s.2(2) amount attributed to it.

Section 731 by contrast has no such need. Relevant income is *not* computed in relation to settlements. It is computed in relation to individuals. Thus a transfer of relevant income from trust 1 to trust 2 does not reduce the relevant income if the beneficiaries of trust 1 and trust 2 are the same.

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118 See 51.32 (Rebasing: transfers between trusts).

30.34 Tax and tax credits of person abroad

This topic is not difficult to understand – at least it does not seem difficult once one has understood it. But it is impossible to summarise briefly. In order to understand the law one must carefully distinguish three concepts:

(1) The actual income of the person abroad.
(2) Relevant income for s.731.
(3) The income which is deemed under s.731 to accrue to the UK resident individual who receives a benefit ("s.731 income").

These must not be confused!

The *actual income* of the person abroad is taxed (if at all) under general principles.

Relevant income is not taxed as such: it is merely something computed as a part of the process of ascertaining the amount of s.731 income.

Section 731 deemed income is taxed at the beneficiaries marginal rate.

This section considers the complications which arise if the actual income of the person abroad is subject to UK tax or foreign tax. How does this affect the s.731 income? What (if anything) is there to prevent double taxation: (1) tax on the person abroad and (2) tax on the beneficiary.

It is necessary to consider separately the position where the person abroad is:

(1) A discretionary trust.
(2) Any trust, on the purchase of own shares.
(3) A company owned by an individual.
(4) A company owned by a non-resident trust.

30.34.1 *Tax and tax credits of non-resident discretionary trust within s.731*

A non-resident discretionary trust will normally pay tax on its actual UK source income at the rate applicable to trusts. The amount of tax paid reduces the relevant income so that if the gross income is £100 and tax is 45%, the relevant income is reduced to £45. However, s.731 makes no further allowance for a beneficiary. So if a beneficiary receives a benefit of £55, taxable under s.731, they pay tax at their marginal rate on the £55. The effective rate of tax on the actual income of the person abroad can therefore reach 69.75%. Section 743 ITA probably does not help. It would be much better if the beneficiary received an income receipt from the

trust.[119] Then s.731 would not apply[120] and instead the beneficiary will effectively obtain some credit for the UK tax paid by the offshore trust under the regime of Chapter 7 Part 9 ITA.[121]

The same point applies where the income accruing to the offshore trustees is subject to foreign tax which can qualify for double taxation relief in the UK under ESC B18. It is best to arrange that the income is received by a UK resident beneficiary in the form of income, avoiding s.731 income where the possibility of any double taxation relief is lost.

An IIP trust is better still for dividend income.

30.34.2 *Purchase of own shares*

The receipt on a purchase of own shares by a UK company is income.

Any trust, discretionary or IIP, is subject to additional rate tax on a purchase of own shares. This raises the same tax problems as income of a discretionary trust under ss.481, 482 ITA. One solution is to alter the terms of the trust before the purchase, so the proceeds of sale belong to the life tenant. Another solution may be to make the trust UK resident for income tax purposes.

30.34.3 *Tax and tax credits of non-resident company within s.731*

A non-resident company will normally pay tax on its actual UK source income at the basic rate. The amount of tax paid reduces the relevant income so that if the gross UK source income is £100 and tax is 20%, the relevant income is reduced to £80. Once again, s.731 makes no further allowance. So if an individual receives a benefit of £80, on which they are taxed under s.731, they pay tax at the appropriate rate on the £80. The effective rate of tax on the actual income of the person abroad is therefore nearly 52% for a higher rate taxpayer and 60% for an additional rate taxpayer.

A similar point arises in relation to dividend income, which is not taxable in the hands of the company.

It would be slightly more efficient if the beneficiary received a dividend from the company. Then s.731 would not apply. The individual may still

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119 As to how to achieve this, see 25.8 (Payment from discretionary trust: income or capital receipt?).

120 See 30.11 (S.731 capital condition).

121 Unfortunately the credit is less than full credit in the case of dividend income. The regime is too complex to set out here.

not receive any credit for the tax paid by the offshore company but their dividend income would at least be taxed at the slightly lower dividend rates.

30.34.4 *Tax planning by means of UK resident company*

Further tax planning is to make the company UK resident (or to acquire a UK resident company). Then the actual income of the company is paid out by way of dividend (assuming this is possible as a matter of company law) and taxed at the dividend upper rate with the benefit of the UK tax credit. Watch s.1071 CTA 2010. The benefit of this kind of planning varies with the applicable rates of tax which depend on the circumstances of the beneficiaries and whether it is s.731 or s.87 which would apply on a capital payment.

30.34.5 *Section 731 credit for tax of person abroad: Commentary*

In the 6th edition of this book I said:

> These are harsh rules, but the unfairness of s.731 is generally avoidable in practice and any other rule would certainly be extremely complicated to draft and to administer.

The complexity arises in matching s.731 income with the taxable income of the person abroad. But now the FA 2008 has introduced matching rules. (Complexity was not a serious concern to the architects of the 2008 reforms.) What is sauce for the goose is sauce for the gander. If the matching rules must be retained, fairness requires that there should also be a system of credit for tax on the relevant income.

The better solution would be the rough and ready but simpler rules which took effect from 1981 to 2008, but at present we have the worst of both worlds: complexity and unfairness.

30.35 Section 731 remittance basis

Section 735 ITA[122] provides a relief which I call "**the s.731 remittance basis**". Section 735(1) provides:

> This section applies in relation to income treated under section 732 as

122 Flagged (somewhat unnecessarily) by s.731(2A) ITA:
"(2A) But see section 735 (non-UK domiciled individuals to whom remittance basis applies)."

> arising to an individual in a tax year ("the deemed income") if section 809B, 809D or 809E (remittance basis) applies to the individual for that year.

In short, the relief applies to remittance basis taxpayers.

30.35.1 *"Foreign" income*

In order to understand the law one must carefully distinguish:
(1) relevant income (in short, income arising to the person abroad); and
(2) income treated under section 732 as arising to an individual. Statute calls this "the deemed income" but I use the term "**s.731 income**" to distinguish it from the myriad types of deemed income in the taxes acts.

Further, the legislation distinguishes between two types of relevant income and two types of s.731 income.
(1) Relevant income may be:
  (a) foreign relevant income or
  (b) not foreign (which one might call UK relevant income).
(2) S.731 income may similarly be:
  (a) foreign: the statutory term is "foreign deemed income" but I will use the term "**foreign s.731 income**".
  (b) not foreign.

The crucial term is "foreign s.731 income". Section 735(2) ITA provides:

> For the purposes of this section the deemed income is "foreign" if (and to the extent that) the relevant income to which it relates would be relevant foreign income if it were the individual's.

I deal with the concept of "relates" in the next section.

30.35.2 *Operation of the s.731 remittance basis*

Assuming we have identified foreign s.731 income, we can turn to s.735(3) ITA which provides the relief:

> Treat the foreign deemed income as relevant foreign income of the individual.

This incorporates the RFI remittance basis. It would not work by itself as the s.731 income (being fictional) does not exist and cannot be remitted. So s.735(4) ITA provides:

> For the purposes of chapter A1 of Part 14 (remittance basis) treat relevant income, or a benefit, that relates to any part of the foreign deemed income as deriving from that part of the foreign deemed income.

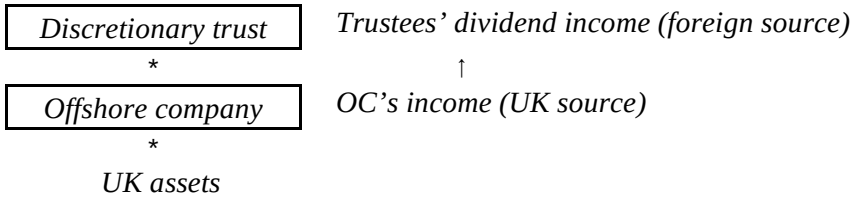
This means:

> For the purposes of the remittance basis provisions treat *both*
> [a] relevant income *that relates to any part of the foreign deemed income*[123] *and*
> [b] a benefit that relates to any part of the foreign deemed income as deriving from that part of the foreign deemed income.[124]

Thus we have three fictions. First we pretend that the individual receives s.731 income. Secondly, we pretend that that s.731 income is RFI. Thirdly, we pretend that certain relevant income *and* certain benefits derive from that RFI.[125] The third fiction feeds into remittance condition B. If anything derived from that benefit (or from that relevant income) is received in the UK by the individual or by a relevant person (in relation to the individual), there is a taxable remittance.

30.35.3 *Distribution of UK source income*

Suppose an offshore company ("OC") within s.731 is owned by a trust within s.731:



If OC receives and retains UK source income, that is not foreign relevant

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123 If relevant income relates to s.731 income then the s.731 income relates to the relevant income: that is, "relates" is a transitive concept and if A relates to B then B relates to A.

124 That is, the phrase "that relates to any part of the foreign deemed income" qualifies "relevant income" as well as "benefit".

125 Contrast the solution adopted for the s.87 remittance basis, where the capital payment (corresponding to the remittable benefit) is deemed to derive from the s.87 gains, but the s.2(2) amount (corresponding to remittable relevant income) is not. So there is no charge on the remittance of the trust's gain, only on remittance of the capital payment.

income. However, if OC distributes the income to the trust, OC's income ceases to be relevant income. Instead the income of the trust is relevant income (unless distributed), but this income is foreign source income and so in principle excluded relevant income. So where UK source income is received by an underlying company, the s.731 remittance basis can be made available by distribution of that income from the company. This seems anomalous. However, s.731 provides a rough justice in other areas where that favours HMRC, so it is not altogether surprising if on this occasion an anomaly may favour the taxpayer.

30.35.4 *Remittance during overseas part of split year*

Section 735(5) ITA provides:

> In the application of section 832 of ITTOIA 2005 to the foreign deemed income, subsection (2) of that section has effect with the omission of paragraph (b).

The significance is that (contrary to the usual rule) foreign s.731 income is taxable if it is remitted during the overseas part of a split year; see 29.14.1 (Remittance during overseas part of split year).

30.35.5 *2008 transitional rules*

Para 170 Sch 7 FA 2008 provides:

> The amendments made by paras 161 to 169 have effect for the tax year 2008-09 and subsequent tax years.

Section 735 does not apply to benefits accruing to a person abroad before 2008/09 because the condition in s.735(1)(b) is not met.

30.36 Section 731 matching rules

In order to decide whether the remittance basis applies, we need to identify the foreign s.731 income, so we need to identify the relevant income to which the s.731 income "relates", to see if it is foreign relevant income.

In order to operate the remittance basis if it applies, we need to identify the benefits that relate to s.731 income in order to see if it has been remitted.

Although statute uses the word "relate" the rules are better described as matching rules.

These rules are set out in s.735A ITA. This works in four stages.

30.36.1 *Place benefits in date order*

Section 735A(1) ITA provides:

> For the purposes of section 735—
>
> (a) place the benefits mentioned in Step 1 [benefits within s.731][126] in the order in which they were received by the individual (starting with the earliest benefit received)

Some benefits are not received at any particular moment in time, eg the benefit of rent-free accommodation, and it is not possible to place them in the order in which they are received. Perhaps there should be a time apportionment.

One then makes certain deductions from the benefits:

> (b) deduct from those benefits so much of any benefit within section 734(1)(b) as gives rise as mentioned in section 734(1)(d) to chargeable gains or offshore income gains.

See 30.14 (Section 733 computation when benefit subject to CGT).

30.36.2 *Place UK/foreign relevant income in due order*

Section 735A(1) ITA continues:

> (c) place the income mentioned in Step 3 for the tax years mentioned in Step 4 ("the relevant income") in the order determined under subsection (3)

Note that Steps 3 and 4 here refer to the steps in s.733; confusingly the reference is not to the steps in s.735A(3) which immediately follow.

This takes us to s.735A(3) ITA:

> The order referred to in subsection (1)(c) is arrived at by taking the following steps.
>
> *Step 1*
>
> Find the relevant income for the earliest tax year (of the tax years referred to in subsection (1)(c)) [ie the tax years where s.731 applies]
>
> *Step 2*

126 Section 735A(2) ITA provides:

> "In subsection (1) references to a step are to a step in section 733(1)."

> Place so much of that income [relevant income] as is not foreign[127] in the order in which it arose (starting with the earliest income to arise).
> *Step 3*
> After that, place so much of that income as is foreign in the order in which it arose (starting with the earliest income to arise).

In order to carry out Steps 2 and 3 it is necessary to distinguish between:
(1) foreign relevant income; and
(2) other relevant income ("**UK relevant income**").
It is then necessary to ascertain the date that the relevant income arises. Some income is not received at any particular moment in time, eg trading and property income, where the income is computed as a net figure after allowing deductions. Section 735A(5) ITA deals with this:

> For those purposes [for purpose of putting relevant income into date order] treat income for a period as arising immediately before the end of the period.

TAH para 1234 provides:

> ... For example, business profits accrue over an accounting period to say 31 December so for the purpose of this provision the income would be treated as arising on 31 December. Therefore if in a tax year there was say interest income arising on 30 September and business profits accruing over an accounting period to 31 December, for the purpose of this provision they would be placed in the order interest first and profits second.

The author probably assumed that interest is not "income for a period" and so the interest is not affected by s.735A(5). In fact, interest is income for a period to which it relates, even though it is only charged when it arises. But normally interest is paid in arrears, ie interest arising on (say) 30 September is for a period ending 30 September, so the end result is the same.

Then one carries out Steps 1–3 for subsequent years, year by year:

> *Step 4*
> Repeat Steps 1 to 3.
> For this purpose, read references to the relevant income for the earliest

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127 Section 735A(4) ITA gives a commonsense definition to "foreign" relevant income: "For the purposes of subsection (3) relevant income is 'foreign' where it would be relevant foreign income if it were the individual's."

tax year as references to the relevant income for the first tax year after the last tax year in relation to which those Steps have been undertaken.

Amended as step 4 requires, steps 1-3 provide:

Step 1
Find ~~the relevant income for the earliest tax year~~ *the relevant income for the first tax year after the last tax year in relation to which those Steps [Steps 1-3] have been undertaken* (of the tax years referred to in subsection (1)(c)) [ie the tax years where s.731 applies]
Step 2
Place so much of that income [relevant income] as is not foreign in the order in which it arose (starting with the earliest income to arise).
Step 3
After that, place so much of that income as is foreign in the order in which it arose (starting with the earliest income to arise).

30.36.3 *Deduction from relevant income*

Section 735A(1)(d) ITA provides:

(d) deduct from that income any income that may not be taken into account because of section 743(1) or (2) (no duplication of charges),

Section 735A(6) ITA provides:

Subsection (1)(d) does not apply if the income may not be taken into account because the individual has been charged to income tax under section 731 by reason of the income.

30.36.4 *Place s.731 income in date order*

Section 735A(1)(e) provides:

place the income treated under section 732(2) as arising to the individual in respect of the benefits in the order in which it is treated as arising (starting with the earliest income treated as having arisen),

30.36.5 *The matching rule*

Having identified all these matters, and placed them in date order, we can at last turn to the matching rule itself. Section 735A(1)(f) ITA provides:

treat the income mentioned in para (e) [s.731 income] as related to—
(i) the benefits, and
(ii) the relevant income,

by matching that income with the benefits and the relevant income (in the orders mentioned in paras (a), (c) and (e)).

30.36.6 *Summary*

In short, the matching rules are:

(1) Match to relevant income of earlier years before later years.

(2) Within the years, match to UK relevant income before foreign relevant income.

Why does the legislation not simply say that? For a discussion of the drafting issues see 51.10.7 (Commentary: step-based drafting).

The rule is arbitrary (but any matching rule is arbitrary).

30.36.7 *HMRC examples*

ToA guidance provides:

INTM601760 The benefits charge: Example

This example assumes all years are after April 2007 but before April 2013 and that all of the conditions necessary for a benefits charge to apply are met.

A transfer of assets is made in Year 1 as a result of which income arises to a person abroad. An individual who is resident in the United Kingdom and who did not make the transfer receives cash benefits, as set out below, out of assets which are available for the purpose as a result of the transfer and associated operations. The benefits are not otherwise liable to income tax and the individual is not liable to an income charge [the s.720 charge].

Year	Relevant income	Benefits received
1	£10,000	£5,000
2	£20,000	£10,000
3	£10,000	£10,000
4	£10,000	£5,000
5	£50,000	£100,000

To determine whether there is income treated as arising to the individual in Year 5 and if so what amount apply the Steps formula. Assume for this that the formula was also applied in Years 1 – 4 and resulted in income being treated as arising of £5,000 Year 1, £10,000 Year 2, £10,000 Year 3, and £5,000 Year 4.

Step 1 – 'the total benefits'

Add together the benefits received in the tax year (Year 5) and in any earlier year in which benefits charge could or has applied. The earlier years to take into account are Years 1 – 4.

Year 5	Benefit	£100,000
Years 1 – 4	Benefits	£30,000
The total benefits		£130,000

Step 2 – 'the total untaxed benefits'

Deduct from the total benefits, the amount of income treated as arising to the individual in any earlier tax years:

The total benefits		£130,000
Income for benefits charge	Years 1 - 4	- £30,000
The total untaxed benefits		£100,000

Step 3 – 'the relevant income of the tax year'

The income of year 5 which can be used for providing a benefit for the individual is £50,000, which is 'the relevant income of the tax year'.

Step 4 –'total relevant income'

Add together the relevant income of year 5 and the relevant income of years 1-4.

Relevant income of year 5	£50,000
Relevant income of yr 1-4	£50,000
Total relevant income	£100,000

Step 5 – 'the available relevant income'

Deduct from the total relevant income, the amount deducted at Step 2. In this example there are no other deductions to be taken into account.

Total relevant income	£100,000
Deducted at Step 2	- £30,000
The available relevant income	£70,000

Step 6 – the amount of income treated as arising for the tax year

Compare the result of Step 2 with the result of Step 5:

Total untaxed benefits	£100,000
Available relevant income	£70,000
The lower of the two is	£70,000

The amount treated as income arising to the individual in year 5 is therefore £70,000. This is neither the relevant income of that year nor the benefits received in that year.

It may be noted that there are still £30,000 of benefits unmatched in this example therefore if for example there was further relevant income in a subsequent year a further Steps calculation would be made for that year.

INTM601780Example - where modifications apply

The income and benefits set out in the table below result from a transfer of assets in 2000-01. It is agreed that an exemption applies to the transfer such that there is no income or benefits charge. Following the death of the transferor a transaction is undertaken in 2007-08 in relation to the assets of the fund, designed for the purpose of tax avoidance. It is agreed no exemption applies to prevent a potential benefits charge for 2007-08. What is the benefits charge for that year?

Year	Relevant income	Benefits received
2000-01	£50,000	£10,000
2001-02	£50,000	£10,000
2002-03	£50,000	£10,000
2003-04	£50,000	£10,000
2004-05	£50,000	£10,000
2005-06	£50,000	£10,000
2006-07	£50,000	£10,000
2007-08	£5,000	£10,000

First there is no charge under either the income or benefits charge for 2000-01 to 2006-07 as an exemption applies in relation to the original transfer

For 2007-08 there would be no benefits charge if an exemption applies.

As there are both pre-5 December 2005 and post-4 December 2005 transactions, the relevant exemption is in section 740 ITA 2007. (see INTM602840).

As the transaction after 4 December 2005 does not meet the conditions for exemption section 740(3) requires the modifications described at INTM601740 to apply for the purpose of the benefits charge.

To determine the amount of income (if any) to be treated as arising to the individual for 2007-08 the Steps approach has to be applied and with the specified modifications (INTM601720).

Step 1 – 'the total benefits'

Add together the benefits received in the tax year (2007-08) and in any earlier year in which benefits charge could or has applied.

In this example there are two possible approaches to 'earlier years'. Either that there are no earlier years to be taken into account under this Step as there was an exemption and thus the provisions did not apply (all earlier years were pre-ITA 2007). Or that the benefits of all earlier years have to be taken into account and that the modifications provided by section 740(6)-(7) ITA 2007 apply to this Step. The modification if applied in this way would seem to require 2000-01 – 2004-5 benefits to be left out and that for 2005-06 to be time apportioned. If applied in this way the benefit received in 2006-07 would also be taken into account so that "the total benefits" would then become £10,000 + £10,000 plus £3,333 (4/12 * £10,000). Such an approach would not seem to be consistent with an exemption applying for 2006-07, as it would in effect bring those benefits back into the calculation in 2007-08 and result in an equivalent amount of income being charged. HMRC take the view that the apportionment required by section 740(7) will only be relevant where there are transactions in 2005-06 post-4 December, with a pre-5 December transaction in that or an earlier year. In this example therefore there are no earlier years to take into account in this Step as there are no earlier years to which a benefits charge applied, or to which a benefits charge would have applied but for an insufficiency of relevant income to match against benefits.

2007-08	Benefit	£10,000
2000-01 to 2006-07	Exemption for all yrs	£0
The total benefits		£10,000

Step 2 – 'the total untaxed benefits'

Deduct from the total benefits, the amount of income treated as arising to the individual in any earlier tax years:

The total benefits		£10,000
Income for benefits charge	2000-01 – 2006-07	£0
The total untaxed benefits		£10,000

Step 3 – 'the relevant income of the tax year'

The income of 2007-08 which can be used for providing a benefit for the individual is £5,000, which is 'the relevant income of the tax year'.

Step 4 –'total relevant income'

Add together the relevant income of 2007-08 and the relevant income of years 2000-01 – 2006-07. The modification provided by section 740(5) requires the earlier years' income be taken into account even though there was an exemption.

Relevant income of 2007-08	£5,000
Relevant income of 2000-1 to 2006-07	£350,000
Total relevant income	£355,000

Step 5 – 'the available relevant income'

Deduct from the total relevant income, the amount deducted at Step 2. In this example there are no other deductions to be taken into account.

Total relevant income	£355,000
Deducted at Step 2	£0
The available relevant income	£355,000

Step 6 – the amount of income treated as arising for the tax year

Compare the result of Step 2 with the result of Step 5:

Total untaxed benefits	£10,000
Available relevant income	£355,000
The lower of the two is	£10,000

The amount treated as income arising to the individual in 2007-08 is therefore £10,000.

If in this example the 'tainting' transaction had taken place after 4 December 2005 and before 5 April 2006, then even though the ITA 2007 Steps approach did not apply for that year (see INTM601800) the effect would have been the same and applying the 'modifications' would have resulted in a comparison of time apportioned benefits of 2005-06 with relevant income of that and all earlier years. If the facts above for 2007-08 had been those of 2005-06 the result would have been a benefits charge of £3,333 for 2005-06 regardless of when after 4 December 2005 (and before 5 April 2006) the tainting transaction took place.

TAH gives a number of examples, most of which are self-evident, but two are worth setting out here. Para 1234 Example 10 involves UK and foreign relevant income (7 items of income altogether) and non-UK benefits (2 benefits altogether):

			Relevant income		**Benefits**
Item	**Date**		*UK*	*Foreign*	**(non-UK)**
1	*Year 1*	30 Sept	500		
2		31 Dec		500	
3	*Year 2*	31 Dec		1,000	750
4	*Year 3*	30 Sept		500	
5		31 Dec	500		
6	*Year 4*	30 Sept		500	
7		31 Dec	500		750 *[or 1,500]*

The HMRC analysis is:

> There are potential transfer of assets benefits charges in Yr 2 of 750 and Yr 4 of 750.

More analytically, the individual receives s.731 income of £750 in years

2 and 4.

> In Yr 2, 250 will be foreign deemed income and ring fenced to be charged under Part 8 ITTOIA as and when there is an amount remitted to the UK. 500 is charged under transfer of assets.

More analytically, the £750 s.731 income of year 2 is matched as follows:
£500 is matched to income item 1: that £500 is not deemed RFI and so is charged on an arising basis.
£250 is matched to income item 2: that £250 is deemed RFI and taxed on the s.731 remittance basis, ie on a future remittance of the benefit or the foreign relevant income. I would not use the term "ring-fenced" to describe this, but it might serve as a loose metaphor.

> In Yr 4 the whole 750 will be deemed foreign income [*recte* foreign deemed income].

More analytically, the £750 s.731 income of year 4 is matched to the remaining unmatched £250 of item 2 and to the first £500 of item 3. The £750 is deemed RFI and taxed on the s.731 remittance basis.

> If however the benefit in Yr 4 was 1500, then only 1250 would be ring fenced as foreign deemed income and 250 would be charged under transfer of assets.

More analytically, if the benefit in Yr 4 was 1500, the individual receives s.731 income of £1,500 in year 4. That is matched as follows:
£250 is matched to the remaining unmatched part of income item 2.
£1,000 is matched to income item 3.
The total of £1,250 is deemed RFI and taxed on the s.731 remittance basis.
£250 is matched to income item 5 and is taxed on the arising basis.

TAH para 1236 Example 11 is a slightly more complex example with:
(1) UK and foreign relevant income - 12 items altogether.
(2) UK and foreign benefits - 4 benefits altogether.
An individual who is ordinarily resident, but not domiciled, in the UK has received cash benefits from an offshore structure in circumstances where the conditions for the transfer of assets provisions to apply are met. The 'remittance basis' of taxation applies for each year.

			Relevant income		**Benefits**	
Item	**Date**		*UK*	*Foreign*	*UK*	*Foreign*
1	*Year 1*	30 Sept	500			
2		31 Mar		800		1,000

3	*Year 2*	31 Mar	100			1,400
4		31 Mar		1,000		
5	*Year 3*	31 Mar		500		
6		31 Mar	500			
7		31 Mar	500			
8	*Year 4*	30 Sept	200		1,000	
9		31 Mar		500		
10	*Year 5*	30 Sept	500			600
11		30 Sept		100		
12		31 Mar		400		

The HMRC analysis is (to say the least) informal in its use of terminology and it should be recast along the lines of example 10. This is done here by adding only brief comments in italics as the text is long and the reader will have the idea.

Year 1

The potential benefits charge [*s.731 income*] is 1000 (being the lesser of 1300 relevant income and 1000 benefits received).

As all of the conditions for Section 735 to apply are met, consider whether any of the potential charge [*s.731 income*] is foreign deemed income. The principles in Section 735A are used for this purpose.

- First match the 1000 with the UK [*relevant*] income of 500. As this income cannot be relevant foreign income then 500 cannot be foreign deemed income and thus is charged under the transfer of assets benefits charge [*on an arising basis*].
- The remaining benefit [*£500 s.731 relevant income*] is then matched with the foreign [*relevant*] income of 800. This [*relevant*] income would be relevant foreign income if it was the individuals and thus 500 of the deemed amount [*s.731 income*] is foreign deemed income. This is treated as relevant foreign income and becomes potentially chargeable under Part 8 ITTIOA 2005 [*ie is taxed on the s.731 remittance basis*].
- There is a balance of 300 relevant income that remains unmatched.

Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds.

The total taxable amount for the year under transfer of assets benefits charge is therefore 500.

Year 2

The potential benefits charge [*s.731 income*] is 1400 (being the lesser of the total relevant income 2400 and the total benefits 2400 less 1000 already charged).

Calculate how much of the total potential charge [*s.731 income*] can be regarded as foreign deemed income applying Section 735A-

The potential chargeable amount [*s.731 income*] is in effect matched with-

(a) 300 of foreign [*relevant*] income from year 1. This gives foreign deemed income of 300 chargeable [*on the s.731 remittance basis*] under Part 8.
(b) 100 UK income of year 2. As this income cannot be relevant foreign income this amount of 100 remains chargeable [*on an arising basis*] under the transfer of assets benefits charge.
(c) The foreign [*relevant*] income of year 2 of 1000. As this would be relevant foreign income if it were the individual's this amount can [*must*] be regarded as foreign deemed income and so chargeable [*on the s.731 remittance basis*] under Part 8.

The result is that of the potential charge [*s.731 income*] of 1400, 100 is charged under transfer of assets benefits charge [*on the arising basis*] and 1300 is ring fenced and treated as relevant foreign income chargeable [*on the s.731 remittance basis*] under Part 8 ITTOIA.

The total charge under the transfer of assets benefits charge is therefore 100.

Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged [*on the s.731 remittance basis*] under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds.

Year 3

Although there is further relevant income in this year there are no unmatched benefits so there can be no potential charge [*s.731 income*] under transfer of assets benefits charge so a consideration of S735 is not applicable.

Year 4

The potential charge [*s.731 income*] is 1000 (being the lesser of the total relevant income 4100 and the total benefits 3400 less 2400 already charged).

Work out the deemed foreign income [*foreign s.731 income*] applying Section 735A-

The potential chargeable amount [*s.731 income*] is in effect matched with

(a) The UK relevant income 500 from year 3.
(b) The foreign [*relevant*] income of 500 from year 3.

The total amount charged under the transfer of assets benefits charge is therefore 500.

500 is ring fenced as foreign deemed income and treated as relevant foreign income *charged on the s.731 remittance basis*].

Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged [*on the s.731*

remittance basis] under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds.
There is 700 of unmatched relevant income to take forward.

Year 5
The potential charge [*s.731 income*] is 600 (being the lesser of the total relevant income 5100 and the total benefits 4000 less 3400 already charged).
Work out the deemed foreign income [*foreign s.731 income*] applying Section 735A-
The potential chargeable amount [*s.731 income*] is in effect matched with
(a) The UK relevant income 200 from year 4.
(b) 400 of the foreign relevant income from year 4.
The total amount charged under the transfer of assets benefits charge is therefore 200.
400 is ring fenced as foreign deemed income and treated as relevant foreign income.
Where any amount is remitted to the UK during that or any subsequent year which is a remittance for Chapter A1 Part 14 ITA 2007 (the Remittance Basis) then part or all of the ring fenced amount may be charged [*on the s.731 remittance basis*] under Part 8 ITTOIA in the year of remittance, subject as appropriate to the rules on remittances from mixed funds.
As the benefit was received in the UK a minimum of the ring fenced amount of this year will be charged under Part 8 ITTOIA and consideration would need to be given to whether there are further untaxed amounts of ring fenced income that would be charged for this year applying the relevant remittance basis rules.
There is 1100 of unmatched relevant income to take forward.

The ToA draft guidance provides further examples at IHTM602420.

30.36.8 *Planning implications*

Where the s.731 remittance basis applies the best planning by far is to arrange that the person abroad (the foreign trust or company):
(1) does not have any UK source income and
(2) does not remit its foreign income.
Then there is no need to worry about the complex s.735A matching rules.
The relatively simple position is that there is a remittance if the benefit is received in the UK.

This also avoids the double charge to UK tax which arises when benefits are matched to UK source relevant income.

The next best planning is to arrange that:
(1) UK source income arises in years where no s.731 benefit is provided; and

(2) In a year where a s.731 benefit is provided, the person abroad has no UK source relevant income *and* has foreign source relevant income of an amount sufficient to match the value of the benefit (ie the foreign source relevant income will frank the benefit). If the trust property is held through an underlying company, a dividend from the company may conveniently achieve that.

30.36.9 *Section 731 remittance basis: Commentary*

The reader who has followed the text to this point will agree that the s.731 remittance basis is unworkably complicated. The rule should simply be that there is a tax charge if the benefit is remitted, and the matching rules completely abandoned. That would be fairer, consistent with the principle of the remittance basis, consistent with the s.87 remittance basis, and a simplification.

The 2013 ToA consultation raised a proposal to amend the matching rules, but this has been abandoned.[128]

30.37 Where is a benefit received?

The s.731 remittance basis requires one to identify:

(1) where a benefit is received (or at least, whether it is received in the UK); and

(2) where anything derived from that benefit is received.

Identifying a place of receipt of a benefit is comparable to identifying the situs of property or the location of a source of income. There are no satisfactory solutions to these problems which can only be solved by somewhat arbitrary selection of connecting factors. But while situs and source rules are mostly long established and workable rules, the place of receipt of a benefit is a wholly new question on which there is no guidance to be found.

It may be that some benefits are not received in any identifiable place; but just as every asset has a situs (and only one situs),[129] and every source of

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128 HMRC, "Reform of an anti-avoidance provision: Transfer of Assets Abroad Outcome of Consultation (December 2013): "Having carefully considered the views put forward in the consultation and through the working group, the Government has decided not to pursue legislative change to the matching rules at present." *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/267976/Transfer_of_assets_outcome_of_consultation.pdf*

129 See 82.3 (Every asset has one situs).

income has a location (and only one location) for IT purposes,[130] it is considered that every benefit should have one (and only one) place of receipt for s.731 purposes. However to identify that place will sometimes require an arbitrary selection of connecting factors.

The benefit of the transfer of money paid to a beneficiary's bank account is received where the account is kept.

It is suggested that the benefit of the transfer of a debt or shares is received where the debt or shares are situated under private international law principles. As an alternative, it is arguable that the benefit might be received in the jurisdiction whose law governs the transfer of the asset.

30.37.1 *Interest-free (or low-interest) loan*

Where is the benefit of an interest-free (or low-interest) loan received? The most attractive possible solutions are:

(1) where the money lent is received; or

(2) where the debt is situate under private international law principles.[131]

To find the answer one must first identify exactly what is the benefit. The benefit may be said to be:

(a) The money received by the borrower

(b) The contract of loan

(c) The lender's decision to leave the loan outstanding

(d) The interest foregone

Solution (a) is wrong: the benefit is not the money received. The benefit is (in some way) receiving the money on advantageous terms.

Solution (d) is wrong as the interest foregone does not exist, so cannot be a benefit (and it cannot be received anywhere).

It is considered that in the case of a fixed term loan, the benefit is the contract of loan; and in the case of a loan repayable on demand, the benefit is the decision to leave the loan outstanding. In either case, it is suggested that the benefit is received where the debt is situate.[132]

The same solution would apply if the benefit was leaving outstanding a

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130 See 14.3 (Approach to locating a source of income).

131 For these principles, see 82.13 (Simple contract debt); 82.15 (Specialty obligation).

132 Another possible solution is to ask where the situs of the source of the interest would be for IT purposes, if interest were payable on the loan. But this should be rejected since (1) the rules for identifying the source of interest are hopelessly unclear and (2) when interest is not payable this would be a difficult hypothetical question to answer.

debt which was not a debt for money lent, for instance, if the offshore person sold an asset for full value to the individual and left the purchase price outstanding.

It is arguable that the money lent (although not the benefit) is derived from the benefit but even that seems difficult to sustain.[133]

30.37.2 *Rent-free (or low-rent) use of chattel or land*

The position is different if the benefit is rent-free (or low-rent) use of a chattel or land. The chattel or land does not belong to the bailee (unlike money lent under an interest-free loan, which does belong to the borrower). So the benefit is received where the land is situated, or where chattel is for the time being.

30.37.3 *Release of debt*

Suppose:
(1) money is lent to a beneficiary;[134]
(2) the loan is later released (a benefit).
Where is this benefit received? Again the choice is:
(1) where the money lent (or property representing it) was received
(2) where the money lent (or property representing it) is situate from time to time;
(3) where the debt is situate.
The argument is similar to the discussion above on interest-free loans. The better view is that the place of receipt is where the debt is situate. The same applies on the waiver of interest, but there it is even clearer that solution (1) is not correct. The money lent is not, strictly, derived from the benefit.

30.37.4 *Payment of debt*

Suppose:
(1) A beneficiary owes money to a third party.
(2) The debt is paid by the person abroad (a benefit).
where is this benefit received? It is suggested that it is received where the

133 Contrast 11.15.6 (T lends income/gains to R).

134 It makes no difference whether the loan is at a commercial rate (not a benefit), or an interest-free loan (which confers the separate benefit of interest foregone until the date of release).

debt is situate.

30.37.5 *Receipt of benefit outside UK and subsequent remittance*

Suppose:

(1) a UK resident foreign domiciled individual receives a benefit in the form of the transfer of money (or a chattel) outside the UK, and

(2) later remits that money (or chattel) to the UK.

The benefit becomes taxable under the s.731 foreign domicile remittance basis. Before 2008 the contrary was arguable.

For this reason, the tax consequence of a benefit received by one beneficiary may depend on whether *other* beneficiaries have remitted their benefits (and so used up relevant income). One might expect one beneficiary (with access to trust documents) to be able to find out what benefits other beneficiaries have received and where. But a beneficiary is not entitled to find out, and often will be unable to find out, whether benefits received by other beneficiaries have been remitted. The legislation is in many cases unworkable. But in 2008 workability was not regarded as a requirement of anti-avoidance legislation.

If the beneficiary is not resident when they receive the benefit but resident when it is received in the UK, there is no tax charge.

30.38 Section 720 and 731 remittance basis compared

Sections 720 and 731 both offer a form of remittance basis. The s.720 remittance basis is more generous. So a transferor (chargeable under s.720 but not s.731) will often be in a better position than other beneficiaries (chargeable under s.731)! For example:

(1) Suppose T (UK resident, foreign domiciled) creates a trust within s.720. T occupies a property owned by the trust. The trust also receives and accumulates foreign income. There is no tax charge. T is not subject to tax under s.720.

(2) Now suppose T dies and B occupies the same property. B is taxed on the benefit of the rent-free accommodation under s.731. The s.731 remittance basis does not help B because the benefit is received in the UK.

30.39 Summary of responses to s.731

(1) Avoid relevant income by
  (a) distributing income:
    (i) as it arises; or

(ii) in a year before a beneficiary receives a benefit; or

(b) using interest in possession settlements in preference to discretionary; or

(c) not using trusts and companies where inappropriate.

(2) Motive defence.

(3) Remittance basis.

(4) Arrange that foreign domiciled beneficiaries receive benefits of an income nature (outside s.731).

30.40 Tax return: Disclosure of s.731 income

S.731 income is returned in Box 42 in the Foreign pages (form SA106) 2013/14. The note by this box reads:

> If you have received a benefit from a person abroad, enter the value or payment received.

The reference to a benefit is a reference to an income taxable benefit, so if a foreign domiciled individual received a benefit which is not subject to IT (because of the remittance basis or for lack of relevant income) then the figure here should be nil. HMRC agree.

Helpsheet 262 (Income and benefits from transfers of assets abroad and income from non-resident trusts - 2013/14) provides:

> **How do you report benefits?**
> Unless you are completing box 46 of the Foreign pages – see 'How do you qualify for an exemption from charge on income or benefits?' on page 6 – you should enter the amount computed at Step 6, in box 42 on page F 6 of the Foreign pages.
> Please enter in the 'Any other information' box, box 19 on page TR 7 of your tax return:
> - the full name and address of the person abroad receiving the available relevant income
> - the details of the relevant transactions that have given rise to the income
> - how you have calculated the benefits included on the return.
>
> Where the benefit has come from a UK resident trust in the circumstances described in the previous section, also give details of those circumstances including the full name of any other trust involved.

CHAPTER THIRTY ONE

TRANSFER OF ASSETS ABROAD: RELIEF FROM OVERLAPPING CHARGES

31.1 Relief from overlapping ToA charges: Introduction

The transfer of asset rules could often give rise to double UK taxation, and there are four reliefs to prevent this. Statute does not provide names for the reliefs, so I coin the following terminology:

Name of Relief	ITA Section	Outline of Relief
Transferor's credit	745(1)	Credit for tax paid by transferee
Transferee's credit	unclear	Credit for tax paid by transferor
Distribution relief	743(2A)(2B)	Relief on distribution to transferor
Double-counting relief	743(1)	General DT relief

These provisions were rewritten in 2013 as part of the programme to ensure that s.720 income was distinct from the income of the person abroad, in order to override DT relief.[1] As far as concerns the double taxation issues discussed in this chapter, it is considered that the changes have not had any impact.

31.1.1 *Cross references*

This chapter considers rules which prevent double UK taxation; for the separate issues of DTAs and foreign tax credit relief, see:
59.5 (DT reliefs: s.720 ITA)
59.6 (DT reliefs: s.731 ITA).

31.2 Undistributed UK taxable income of offshore company

Suppose an offshore company ("OC") receives and retains UK taxable

1 See 59.5.2 (Person abroad treaty-resident outside UK).

income.[2] If s.720 ITA did not apply, there would be one charge to tax: income tax borne by OC. However, if s.720 applies, it appears at first sight that there are two charges to tax:

(1) OC pays income tax at the basic rate under ordinary principles.

(2) The transferor ("T") pays income tax on the same income under s.720.

What is there to prevent double taxation?

31.2.1 *Transferor's credit*

Section 745(1) ITA provides relief for T:

> Income tax at the basic rate, the starting rate for savings or the dividend ordinary rate is not charged under section 720 or 727 in respect of any income if (and to the corresponding extent that) the income mentioned in section 721(2) or 728(1)(a) [the income of the person abroad] has borne tax[3] at that rate by deduction or otherwise.[4]

I refer to this as "**transferor's credit**".

HMRC Helpsheet 262 (income and benefits from transfers of assets abroad) 2013/2014 provides:

> **What if tax has been paid on the income?**
> If the amounts included in boxes 11 and 13 of the Foreign pages include tax credits or other tax paid on the income of the person abroad, then you may be able to claim a deduction against your liability for that tax. You will only be entitled to relief for the tax paid by the person abroad if it is in effect tax on 'the same' income, and only to the extent that the tax has actually been paid by, and not refunded to, the person abroad. You should include the amount of tax for which you can claim relief in Column C and also include it in box 2 of the Foreign pages. You should

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2 OC's income would be UK taxable if the income has a UK source and so is subject to income tax, eg UK rental income. (Perhaps another possibility may be that OC is carrying on a trade in the UK through a PE, and so is subject to corporation tax; but the better view is that the ToA rules do not apply to income within the charge to CT).

3 The statute assumes that OC would pay income tax. In *R v Dimsey & Allen* 74 TC 263 at [55] Lord Scott suggested (without deciding) that transferor's credit would also apply if the person abroad paid corporation tax on the income and not income tax. But after 2013 that would be rarely if ever arise.

4 This was considered in *R v Dimsey & Allen* 74 TC 263 at [53]:
"This provision would have dealt with the case where the transferee's income included income sourced in the UK and from which tax had already been deducted at source. But the words 'or otherwise' show that the provision would have covered also any case in which the transferee had paid tax on its income."

> note Column E of your claim. In addition, you should send a schedule with the Foreign pages, showing the amount of each item of income, and tax credit/tax paid on that income, which has been included in boxes 11 and/or 13, and Column C.
> ... If you do not yet know the final amount of tax paid by the person abroad, you should estimate the amount of credit available and amend your tax return when the final details are known. You must draw attention to the estimate and explain the circumstances in the 'Any other information' box, box 19, of your tax return. If any additional tax becomes payable as a result of using an estimate the usual provisions for charging interest on tax paid late will apply.
> If the income on which you are liable to tax under these provisions is a 'foreign dividend', then you may be entitled to a non-payable UK tax credit (see page FN 7 of the Foreign notes).

31.2.2 *Transferee's credit*

The limitation of the transferor's credit was explained in *R v Dimsey & Allen* 74 TC 263 at [56]:

> Section [745(1)] ... is looking at the double taxation problem from the point of view of the transferor on whom the liability to pay tax on deemed income is being imposed. There is no comparable provision protecting the transferee in a case where, under s [720], the transferor has paid tax on his deemed income.

In the course of argument in *R v Dimsey & Allen*, HMRC announced a practice to solve this problem:

> **The Inland Revenue's Practice on section [720]**
> [1] If in any case tax is paid by the transferee, the Inland Revenue will give credit for that tax against any charge to tax on the transferor under section [720 ITA] on the same income;
> [2] and conversely, if in any case tax is paid on any income by the transferor under section [720], the Inland Revenue will not tax the transferee on that income.
> So that in every case, the Treasury received in all the full amount of tax chargeable on the transferor as if he were the only person liable.

Point [1] is the transferor's credit. I refer to point [2] as "**the transferee's credit**". The consequence is that either:

(1) T pays all the tax on the income (and OC pays none); or
(2) (a) OC pays tax (usually basic or dividend ordinary rate); and
    (b) T has the credit for OC's tax (so T usually pays higher/

additional rate tax only).

This statement does not say whether (1) or (2) is to be the case. As far as HMRC are concerned it does not matter because the amount of tax collected will generally be the same. If T is the beneficial owner of OC, it may likewise not make much economic difference to T whether T or OC pay the tax. But T may have "power to enjoy" the income of OC while only having a remote and not particularly valuable interest in it.[5] One can imagine a situation where T and OC each ask HMRC to assess the other! There is no mechanism for tax paid by T to be recovered from OC or vice versa. HMRC have a broad discretion, subject to judicial review if they act unreasonably. How in practice should HMRC collect tax? It is suggested that HMRC's starting point should be that tax is to be borne by OC, where tax is reasonably collectible from OC, ie if:

(1) the income is dividend income with a tax credit (in this case, of course, no one has any choice about the matter);
(2) tax is collectible under the non-resident landlord regulations, ie if OC complies with those regulations; or
(3) OC is prepared to complete UK tax returns and pay the tax on its income.

It is fair that OC, which receives the income, should pay the tax on it. Then only higher/additional rate tax is normally collected from T. Only in cases where OC refuses to pay should all the tax be collected from T. This seems consistent with the extract from "Notes on Foreign" cited above.

It is arguable that double-counting relief[6] is the statutory basis for the transferee's credit. If that is correct, the transferee's credit is law and not a concession.

31.2.3 *Taxpayer confidentiality*

The use of transferor's credit and transferee's credit require that transferor or the person abroad knows details of tax paid by the other person. Section 18 Commissioners for Revenue and Customs Act 2005 authorises HMRC to disclose this information:

> (1) Revenue and Customs officials may not disclose information which is held by the Revenue and Customs in connection with a function of the

5 For instance, if OC owes T a small debt.

6 See 31.6 (Double-counting relief).

Revenue and Customs.

(2) But subsection (1) does not apply to a disclosure—

(a) which—

(i) is made for the purposes of a function of the Revenue and Customs, and

(ii) does not contravene any restriction imposed by the Commissioners...

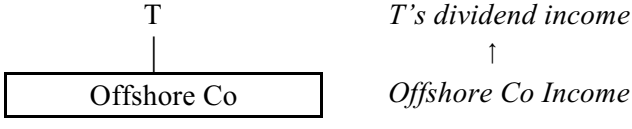
31.3 Distribution to T of income of company within s.720

So far we have been considering undistributed income of OC. I now turn to consider the position where the income is distributed to T by way of dividend. Suppose:

(1) An offshore company ("OC") within s.720 receives income ("OC's income").

(2) T owns all the shares in OC.[7]

(3) The income of OC is distributed by way of dividend to T ("T's dividend income"):



Possible charges to tax here are:

(1) IT on OC's income (paid by T) under s.720.[8]

(2) IT on the dividend (paid by T) on normal principles.

Is there any relief from economic double taxation?

31.4 Distribution relief

Section 743 ITA provides:

(2A) Subsection (2B) applies if—

(a) in the case of an individual, an amount of income is taken into account in charging income tax under section 720 or 727, and

(b) the individual subsequently receives that income.

(2B) The income received is treated as not being the individual's

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7 The position is not materially different if the shares in OC are held in a trust under which T has an interest in possession.

8 Or IT on OC's income paid by OC and T, but with credit to avoid double taxation: see above. That makes no difference for the purpose of this example. It is assumed here that T is not a remittance basis taxpayer.

income for income tax purposes.[9]

I refer to this as "**distribution relief**". There are three conditions for this relief to apply:

(1) Income treated as arising to the individual is taken into account in charging income tax under s.720.
(2) The individual receives the income.
(3) The dividend income which the individual receives is "that income", ie the same as the income taken into account in charging IT, ie the same as the income of the person abroad..

Condition (1) would normally be satisfied.[10] Condition (2) is *ex hypothesi* satisfied.

31.4.1 *When is income "the same" for purposes of distribution relief?*

At first sight condition (3) is more doubtful. The income which the individual actually receives is the dividend income. The income which is taken into account in charging IT under s.720 is the income of the person abroad. The two are not the same. But if that is correct, then distribution relief can never apply at all, which cannot be correct.

OC's income and the dividend income are in substance or economic reality the same income. It is true that they are usually regarded for tax as separate sources of income, not the same income. "The income of the company and the income derived from the company by the shareholders are two quite different incomes."[11] However for this purpose one looks to the substance and does not apply a formalistic view. This would be reasonably clear even in the absence of authority, because (on the

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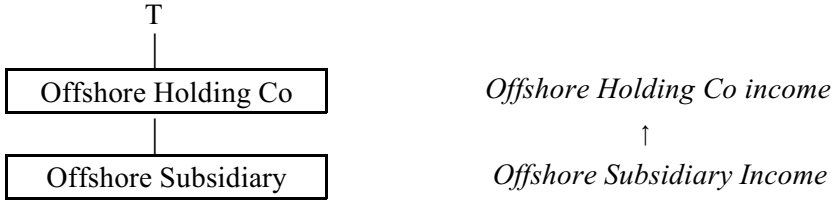
9 A historical note. FA 2013 rewrote distribution relief, which was formerly in s.743(4) ITA, which provided: "If income treated as arising to an individual is *charged to income tax* under section 720 or 727 and the individual subsequently receives that income, it is treated as not being the individual's income again for income tax purposes."
For the reasons for the change, see 31.1 (Relief from overlapping ToA charges – Introduction).

10 See 31.2 (Undistributed UK taxable income of offshore company); 31.7.1 (When is income taken into account in charging IT under s.720?).

11 *Vestey v IRC* 54 TC 503 at p.562. This is obvious but if further authority is needed, see *Canadian Eagle Oil v The King* 27 TC 205 at p.257: "for the purposes of Income Tax, the income of a foreign company and the income received from it in dividends by its British shareholders are not to any extent or effect one and the same income, but are two distinct incomes".

formalistic view of income identity) it is impossible for T to receive the "same" income as OC. The source must change when T receives it.

This is confirmed by *Aykroyd v IRC*.[12] The facts were relatively simple. T (UK domiciled) held an offshore holding company (within s.720) which held an offshore subsidiary (within s.720):[13]



(1) In 1936/7 the offshore subsidiary received income within s.720 ("the offshore subsidiary income").
(2) In 1937/8 the offshore subsidiary paid that income by way of dividend to the offshore holding company ("the offshore holding co income"). This income was also within s.720.
(3) The transferor ("T") was assessed on the offshore holding co income in 1937/8. T was not assessed on the offshore subsidiary income in 1936/7.

This was not an individual/company structure but a company/subsidiary structure, but in the context of distribution relief the issue is the same.

T argued that T could be assessed at stage (1) and so could not be assessed at stage (2). T relied on distribution relief. Macnaghten J accepted (rightly) that the relief could apply to the sequence of two dividends:

> If the Appellant had in fact been charged in the year 1936–37, he could not have been charged again in the year 1937–38.

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12 24 TC 515. The substance (as opposed to a formalistic) view of income identity is also applied in other contexts in the transfer of assets code. In *Vestey v IRC* Walton J held that a shareholder had no "power to enjoy" the income of the company in which he held shares because (applying the formalistic view of income identity) the shareholders had power to enjoy *different* income! However, this view was rejected in the House of Lords. See 29.6.6 (Enjoyment condition D: possibility of benefit). Similarly the court looked at the economic substance in order to determine whether two assets were "the same" (for the purposes of stamp duty subsale relief) see *Fitch Lovell v IRC* [1962] 1 WLR 1325.

13 More accurately, there were several holding and subsidiary companies, but nothing turns on that.

That is, the offshore holding co income was (for the purposes of distribution relief) the same income as the offshore subsidiary income.

The ToA draft guidance provides:

> **INTM602380 Income to be taken into account once**
> ... Income that arises to a person abroad may be distributed to another person who is also a person abroad – for example a group company may make a distribution to its parent company. HMRC generally accept that in such situations the legislation should not be construed so as to effectively duplicate the amount of income that may be taken into account for the transfer of assets provisions. In such situations it will be appropriate to consider to what extent the distribution and the underlying income from which is paid are the same income.
> Specific cases of difficulty concerning the amount of income to be taken into account should be referred to SPT Trusts and Estates Technical in accordance with the instructions at INTM [ ] to [ ].
> **INTM602440 Subsequent receipt of income**
> ... Issues can arise when an individual who has been taxed under section 720 or section 727 ITA 2007 in relation to the income of a non-resident trust or company and the entity concerned makes a subsequent distribution of income to the individual. HMRC accept that generally the reference to income in section 740 (4) and sections 743 (2A) and (2B) can be construed to cover such situations. ...
> **INTM602520 Deductions and reliefs**
> ... Where the income of a foreign company has been subject to the income charge and subsequent dividend left out of account, it may be that the dividend is charged to tax by a UK paying agent such as a bank before being paid to the individual concerned. If this is the case relief should be given for that tax or repayment made, whichever is appropriate.

31.4.2 *Distribution relief: Conclusion*

Thus, even though OC's income is distributed to T:

(1) there is only one charge to income tax, the charge under s.720;

(2) T has the benefit of tax credits or DT Relief relating to OC's income.

At first sight this seems anomalous. If s.720 did not apply (eg because the individual owning OC was not the transferor or because the motive defence applied) then the position is quite different:

(1) there will be two charges to tax if OC's income is UK source:

(a) income tax on OC's income paid by OC under ordinary

principles; and

(b) income tax on the dividend paid to T.

(2) T does not have the benefit of tax credits or DT Relief relating to OC's income.

On reflection, this is not an anomaly. The object of s.720 is to put the transferor in the same position as if they had not made the transfer: see *Chetwode v IRC* 51 TC 647. This view is rightly accepted by HMRC (despite the irritation of the judge in *Anson v HMRC* but the issue may not have been fully explained to him).[14]

31.4.3 *Identifying income qualifying for distribution relief*

It may happen that the income of OC for company law purposes is greater than the income of OC for tax purposes (eg because of capital allowances). Distribution relief applies only so far as the income of the company has been taken into account in charging income tax under s.720. For example, OC may have taxable income of 10, but accounting profits of 100. If OC declares a dividend of 100, then the charges to tax are:

(1) IT on OC's income of 10 on T under s.720.

(2) IT on the dividend on the amount of 90 (ie 100–10).

In these circumstances, the use of an offshore company does give rise to tax on the distribution which would not have arisen if there were no company.

Suppose OC receives £100 and spends £20 on expenses, but, the company having spare assets available for distribution, £100 is nevertheless distributed. It is suggested that the dividend of £100 should be identified with OC's income of £100 and so qualifies for distribution relief in its entirety. The £20 spent on expenses is attributed to other assets, even though as a matter of tracing it was paid for out of the s.720 income. The position is analogous to the *Duke of Roxburghe* case.[15]

31.4.4 *Planning: Distribution and re-settlement*

Where distribution relief applies it is generally worthwhile distributing income to T; T may re-settle the income if desired. If this is not done during T's life, the benefit of the relief is lost, as distribution relief will not

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14 [2012] UKUT 59 (TCC). For the motive defence aspects of this case, see 32.48 (Can an individual disclaim the motive defence?).

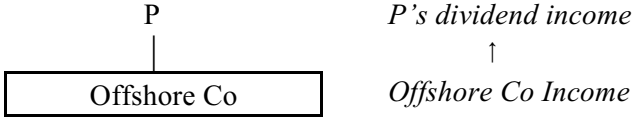
15 20 TC 711. See 13.12.1 (Remittance from mixture of taxed and untaxed income).

apply later.[16]

31.5 Distribution (*not* to T) of income of company within section 720

Suppose:

(1) An offshore company ("OC") within s.720 receives income ("OC's income").
(2) The transferor ("T") is not a shareholder in OC but has "power to enjoy" the income.[17]
(3) P (a UK resident third party) owns all the shares;[18]
(4) The income of OC is distributed by way of dividend to P.



In these circumstances it appears that there is economic double taxation:

(1) OC's income is subject to tax in the hands of T (or T and OC) under s.720.
(2) P is subject to tax on the dividend.

Distribution relief does not apply because that relief only applies where OC's income is subsequently received by the transferor, T. The transferor credit and the transferee credit do not cover this situation. However, double-counting relief applies.

31.6 Double-counting relief

Section 743 ITA provides:

> (1) No amount of income may be taken into account more than once in charging income tax under this Chapter.
> (2) If there is a choice about the persons in relation to whom any amount of income may be taken into account in charging income tax[19] under this

16 This may also be done to avoid relevant income accumulating in a company held by a trust; see 30.31 (Is income of company held by a trust relevant income?).

17 T may have power to enjoy by holding a debenture or through being a beneficiary of the trust which holds OC. Similar points arise if T receives a capital sum.

18 The position is not materially different if the shares in OC are held in a trust under which P is life tenant, and to which s.624 ITTOIA does not apply.

19 Section 744 ITA provides:

"**744 Meaning of taking income into account in charging income tax for s.743**
(1) References in section 743 (no duplication of charges) to an amount of income

Chapter, it is to be taken into account—

(a) in relation to such one or more of them as appears to an officer of Revenue and Customs to be just and reasonable, and

(b) if more than one, in such respective proportions as appears to the officer to be just and reasonable.

I refer to this as "**double-counting relief**". This provision is vaguely worded, but I suggest it prevents double taxation:

(1) Where T1 is charged under s.720 and T2 is charged under s.720; ie there were two transferors (but *Vestey* decided that there can only be one transferor).

(2) Where T1 is charged under s.731 and T2 is charged under s.731; eg where two different individuals receive benefits, the s.733 computation often prevents a double charge (but not always).[20]

(3) Where T1 is charged under s.720 and T2 is charged under s.731.[21]

(4) Where T1 is charged under general principles and T2 is charged under s.720 or s.731.

This therefore applies in the circumstances of the example of 31.5

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taken into account in charging income tax are to be read as follows.

(2) In the case of tax charged on income under section 720 (charge where income enjoyed as a result of relevant transactions)—

(a) if section 724(1) (benefit provided out of income of person abroad) applies, they are references to an amount of the income out of which the benefit is provided equal to the amount charged, and

(b) otherwise they are references to the amount of the income mentioned in section 721(2).

(3) In the case of tax charged on income under section 727 (charge where capital sums received as a result of relevant transactions), they are references to the amount of the income mentioned in section 728(1)(a).

(4) In the case of tax charged under section 731 (charge to tax on income treated as arising to non-transferors where benefit received as a result of relevant transfers), they are references to the amount of relevant income taken into account under section 733 (income charged under section 731) in calculating the amount to be charged in respect of the benefit for the tax year in question."

20 See 30.13.5 (Step 5: Available Relevant income).

21 Although the words in s.743(1) could be construed to apply to situation (3) only, that would be absurd. Indeed, it is unusual that income could be taxed under s.720 and s.731. An example might be if income accrues which is not within s.720 because it is not remitted to the UK, then there is a charge under s.731, and then there is a remittance. Another example might possibly be if s.720 does not apply (because the transferor has no "power to enjoy") but subsequently there is a capital payment within s.727. Another possible case is in 30.19 (Is income within s.720 relevant income?).

(Distribution (*not* to T) of income of company within s.720). Before the enactment of double-counting relief in 1981, there was economic double taxation in these circumstances. Lord Greene did not regard this as double taxation. In an obiter comment in *Howard de Walden v IRC* 25 TC at 131, decided in 1940, he said:

> [Counsel] pointed out that in so far as the right to enjoy income of the four companies is vested in the Appellant's son, who holds the majority of the shares, income received by the son will be taxed in his hands in the ordinary way and at the same time the Appellant will be liable to tax on the whole income of the companies which is deemed to be his. This, said [Counsel], involves double taxation since no relief is afforded by [distribution relief, now s.743(2B) ITA]. There is a short answer to this argument. There is no double taxation since the subject-matter of tax is different, the income of the son being one thing and the income of the companies being another.

Several passages of *Howard de Walden* exhibit an anti-taxpayer ethos which may be attributable to the war-time background; "as we are at war", as Darling J said in another context, "the ordinary mode of construing legislation has been suspended".[22]

Formalistically Lord Greene is right, the situation is one of economic rather than juristic double taxation. However, since the purpose of distribution relief is to avoid economic double taxation, both fairness and the scheme of the Act suggest that double-counting relief should do the same work in this context. It is considered that Lord Greene's comment does not support the contrary view.

In practice this situation is rare as T either has no "power to enjoy" and so is outside s.720, or else T is life tenant/shareholder and receives the dividends personally and distribution relief applies.

31.7 Section 720 trust/company and company/subsidiary structure

So far we have been considering the (relatively) simple situation of an offshore company (OC) held by an individual (or an IIP trust). We now turn to consider the position where OC is held by a non-resident settlor-interested discretionary trust. That is, trustees of a discretionary trust within s.720 ITA and s.624 ITTOIA hold a non-resident company within s.720:

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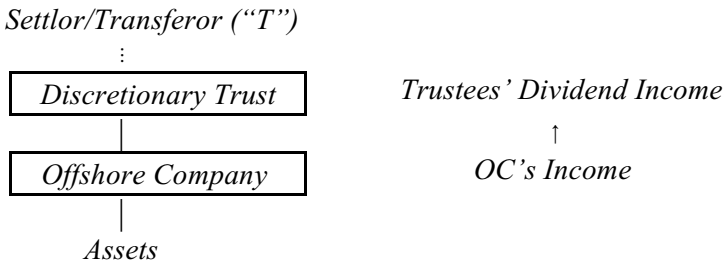
22 Cited in Foxton, "*R v Halliday* in Retrospect" [2003] LQR 455.



Suppose:

(1) Income is received by the OC ("OC's income" at "stage 1").
(2) OC's income is paid to the trustees as dividend income ("the trustees' dividend income" at "stage 2").

In principle this might give rise to two tax charges on T:

(1) OC's income charged under s.720 at stage 1;
(2) The trustees' dividend income charged under s.720 or s.624, stage 2.

Distribution relief should prevent double taxation? It will be recalled that distribution relief applies if:[23]

(1) OC's income is within s.720;
(2) the trustees' dividend income is received by T;
(3) the trustees' dividend income is "that income" (ie the same income as OC's income);
(4) OC's income is taken into account in charging income tax on the individual under s.720.

Condition (1) is satisfied. Condition (2) is satisfied because income is treated as received by T. Condition (3) is also satisfied: see 31.4.1 (When is income "the same" for purposes of distribution relief?).

31.7.1 *When is income taken into account in charging IT under s.720?*

The next requirement of distribution relief is that the income must be taken into account in charging IT under section 720. In *Aykroyd*[24] T failed because T had not been "charged":

> It was suggested that, if the [offshore subsidiary's income] were liable to assessment for the year 1936–37, that provision [s.743(2B)] prevented them being chargeable in the following year. But that argument depended on the substitution of the word "chargeable" for the word "charged". There is no ground that I can see for making any such substitution. ... as he had not been charged in the previous year,

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23 See 31.4 (Distribution relief).

24 See 31.4.1 (When is income "the same" for purposes of distribution relief?).

> there was nothing to prevent him being charged in the year in question.

This is not obiter, but it is at first sight surprising and it certainly does not appear from the Judge's terse comment that the Court had the benefit of a full argument on the point. Perhaps the position is clearer after the 2013 reforms, though I do not think anyone had much doubt even before.

This does not mean that HMRC have an unfettered discretion:

(1) to assess T on the subsidiary company's income; or
(2) to assess T on the holding company's income.

Under self-assessment, T will normally self-assess T's income and should in principle return the income of the offshore subsidiary as T's income and distribution relief applies. However, where T does not pay tax due on the offshore subsidiary's income HMRC can collect tax on the offshore holding company's income and distribution relief does not apply.

Often it may not matter whether tax is charged on the offshore subsidiary's income or the offshore holding company's income. However, it may matter:

(1) For identifying the source of the income to which s.720 applies. Is the transferor taxed under s.720 in respect of the subsidiary's income or the holding company's income? This may affect:
    (a) rates of tax, eg if the underlying company receives interest or rental income it may makes a difference of 7.5% (the difference between the higher or additional rates and the dividend upper or dividend additional rates).
    (b) availability of transferor's credit for UK tax paid by the company and double tax relief.
    (c) source of income.
(2) It may also affect the year in which the income is subject to tax.

31.7.2 *Double-counting relief*

This provision is discussed in 31.6 (Double-counting relief). It will apply in a s.720 trust/company or company/subsidiary structure but where distribution relief covers the same ground it should not be needed.

31.7.3 *Trust/company structure: HMRC practice*

RI 201 provides:

> where income arises in an offshore company underlying a settlement and the income is not paid up immediately to that settlement the provisions of section [720 ITA] will be invoked where necessary to

assess the income of the underlying company.

The position therefore depends on whether income is paid up "immediately".

(1) *If the income is not paid up immediately*. The provisions of s.720 will be invoked. This is straightforward. RI 201 does not address the question (discussed above) of relief for a subsequent dividend by the underlying company.

(2) *If the income is paid up immediately*. RI 201 implies that:
   (a) s.720 will not be applied so the settlor/transferor will not be taxed on OC's income; and
   (b) the settlor will be taxed on the trust income (as life tenant or under s.624) in the normal way.

An important question is exactly the moment when one moves from (1) to (2). What is the meaning of "immediately"? Does it mean within a day? Or a week? Or at any time within the same tax year? Or at any time before the relevant returns are due or submitted? Do HMRC have a discretion? Does the answer depend on the type of income? One must bear in mind that some forms of income cannot be quantified until the end of an accounting period (eg trading and rental income).

If income is distributed immediately, RI 201 does not expressly address the question whether the settlor is taxed on OC's income or on the dividend. It makes a difference because OC's income may have a tax credit and the rates of tax may be different. But by implication if s.720 is not "invoked" then the tax must be charged on the dividend.

This is a sorry muddle. In practice, the author suspects that HMRC apply the "immediately" concept with latitude and are not concerned as long as they can see that income comes into tax in one year or another, in one form or another.

31.7.4 *Trust/company structure: Further example*

Suppose in the trust/company structure illustrated at 31.7 (Section 720 trust/company and company/subsidiary structure) the company:

(1) receives £100 income;
(2) spends £20 of the £100 it received on expenses (not deductible for the purposes of s.720); and
(3) distributes £80.

It is suggested that £100 is taxable at stage (1) and the £80 is tax free at stages (2) and (3). Close examination of RI 201 (see above) suggests HMRC might assess £20 at stage (1) and £80 at stage (2). It is doubtful

whether the statement is meant to bear close examination, but it makes little difference in practice.

31.8 Life policies

In *IRC v Willoughby* 70 TC 57 Professor Willoughby ("T") transferred assets to a non-resident life insurance company as a premium for a life policy. T was not taxed on the income accruing to the insurance company as the motive defence applied. Had the defence failed, there would in principle have been double taxation:

(1) T would pay income tax on income arising to the life insurance company (to the extent that it arose as a result of T's premium); and
(2) T would pay income tax on the gain arising from the policy under the chargeable event provisions.

HMRC argued that relief was available under two provisions, s.547(2) ICTA and distribution relief.

The Special Commissioner rightly rejected the argument that distribution relief applied:

> ... s.743(2B) only relieves from tax income which is subsequently received by an individual whose income it has been deemed to be in earlier years under s.739(2).

The s.720 income is not the same as the chargeable event income.

Section 547(2) ICTA then provided:

> Nothing in subsection (1) above [deeming chargeable event gains to be taxable income] shall apply to any amount which is chargeable to tax apart from that subsection.

The Commissioner rightly dismissed the argument that this conferred relief:

> So far as double taxation is concerned, in my view s.547(2) [ICTA] and s.743(4) [ICTA] do not provide relief. The former gives relief if the amount of the gain arising in connection with a policy on the happening of a chargeable event, which is deemed to form part of the individual's total income for the year in which the event happens, is chargeable to tax apart from subs (1) of s 547. This does not provide relief for the taxation of income under s.739 [ICTA] in the years before the chargeable event occurs.

That is not the end of the story, as the tax law rewrite have expanded the scope of the relief. Section 527 ITTOIA provides:

(1) This section applies if the whole or part of any receipt or other credit item is taken into account in calculating both—
  (a) the amount of a gain treated as arising under this Chapter, and
  (b) an amount on which income tax is charged otherwise than under this Chapter or on which corporation tax is charged.
(2) The amount of the gain on which tax is charged under this Chapter is reduced by so much of the amount of that receipt or other credit item as is taken into account in both those calculations.

It appears from EN ITTOIA change 95 that this change was intended to benefit traders in policies[25] but it could arguably apply here. There is also a hint in *Willoughby* at p.84 that relief may be available by concession, but that would obviously not bind HMRC. In practice, fortunately, it will be rare for the ToA rules apply to income arising as a result of policy premiums or other payments to life companies.[26]

31.9 Section 731 charge followed by income distribution

I now turn to consider double taxation issues relating to s.731. The transferor's credit, the transferee's credit and distribution relief only apply to s.720, so they have no relevance here.

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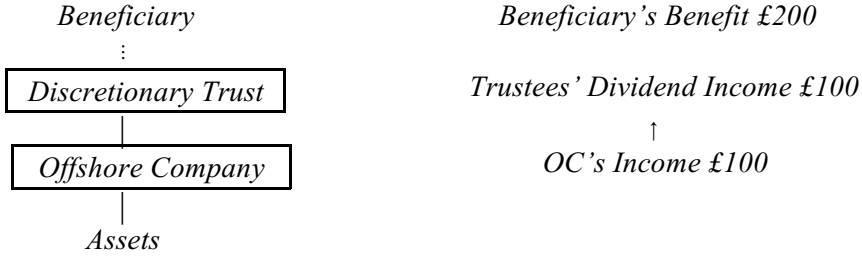
25 "**Change 95: Gains from contracts for life insurance etc: reductions for sums chargeable to tax apart from section 547(1) of ICTA: section 527**
This clarifies the meaning of the exception from the charge to tax under section 547(1) of ICTA given by section 547(2) of ICTA for any amount chargeable to tax apart from section 547(1) of ICTA.
Section 547 of ICTA deals with the method of charging chargeable event gains to tax. This differs according to the person who is interested in the policy. For example, under section 547(1) of ICTA where the rights in a policy or contract are held by an individual as beneficial owner the gain forms part of the individual's total income. However, section 547(2) of ICTA states "Nothing in subsection (1) shall apply to any amount which is chargeable to tax apart from that subsection.".
In practice, the words "amount which is chargeable to tax" in section 547(2) of ICTA are taken to mean the amount of the receipts and credits taken into account for the purposes of ascertaining the overall taxable profit under another provision, rather than the actual amount that is charged to tax under another provision, which in the case of a trader, for instance, will be the net profits of the trade.
Section 527 which rewrites section 547(2) of ICTA makes it clear that the amount chargeable to tax under Chapter 9 of Part 4 of this Act is reduced by the amount of the receipt or other credit item that is taken into account in calculating the amount on which income tax is charged otherwise than under Chapter 9 of Part 4 or the amount on which corporation tax is charged."

26 See 33.7.5 (Income accruing to life company).

Suppose:
(1) trustees of a trust receive income and do not distribute it;
(2) a beneficiary receives a benefit taxable under s.731;
(3) the income is later distributed to the beneficiary as income.
It is understood that the distributed income is not taxed. This might be regarded as informal concession but the better view is that double-counting relief applies here.

31.10 Section 731 trust/company structure[27]

The problem is best illustrated by example:



Trustees of a discretionary trust within s.731 hold a non-resident company within s.731.
(1) £100 income is received by the company ("the company's income" at "stage (1)").
(2) The £100 is paid to the trustees as dividend income ("the trustees' dividend income" at "stage (2)").
(3) A beneficiary ("B") receives a benefit of £200.
Is the relevant income £100 or £200? That is, does the interposition of the company double the relevant income? If so, then the s.731 charge on B is in principle on £200.

It is suggested that double-counting relief applies; see 31.6 (Double-counting relief).[28]

---

27 Contrast 31.7 (Section 720 trust/company and company/subsidiary structure).

28 If that is wrong, then a second argument is that after the company's income is distributed it ceases to be relevant income. See 30.26 (Corporate income distributed to trust). This argument will not avail if the facts are a variant of the above example:
(1) £100 income is received by the company;
(2) a beneficiary receives a benefit of £200;
(3) the £100 is subsequently paid to the trustees as dividend income.
For then even if the company's income ceases to be relevant income after being distributed, it does so too late.

31.11 Section 720 and s.731 overlap

Suppose:
(1) A transferor ("T") is taxed on income of a person abroad under s.720
(2) A beneficiary ("B") within s.731 receives a benefit.

The starting point is that the income of the person abroad (although within s.720) is also relevant income;[29] but double-counting relief applies; see 31.6 (Double-counting relief).

There are four permutations:
(1) T and B are both arising basis taxpayers
(2) T is a remittance basis taxpayer and B is an arising basis taxpayer
(3) T is an arising basis taxpayer and B is a remittance basis taxpayer
(4) T and B are both remittance basis taxpayers

31.11.1 *T and B both arising basis taxpayers*

ITA EN provides:

> Where a non-UK domiciled individual transfers assets but is not chargeable to tax under section 739 ICTA [now s.720 ITA] owing to section 743(3) ICTA [the s.720 remittance basis, now replaced by the somewhat different s.735 ITA], there is no bar in HMRC's view on the application of section 740 ICTA [now s.731] to others who did not themselves make the transfer but were beneficiaries of it. HMRC interpret section 732 ITA in the same way.[30]

It appears from this that where the s.720 remittance basis does not apply (so the transferor is taxed under s.720 on an arising basis) there is a bar on taxing the beneficiaries under s.731. The reason is not given, but could have been:
(1) The income was not relevant income; (but this was doubtful and is not the case from 2013).
(2) Double-counting relief.

Now HMRC practice has changed, and the rule to charge the transferor in priority to the beneficiary is said to be a normal rule but not an absolute one. The ToA draft guidance provides:

> **INTM602480 Just and reasonable basis**
> Where there is a choice of individuals in relation to whom any amount of income

29 See 30.19 (Is income within s.720 relevant income?).

30 See Change 105 in ITA EN Vol III, annex 1. The same point was made in RI 201.

> of a person abroad may be taken into account in arriving at the amount of an income charge or benefits charge, it can sometimes be difficult to determine the amount of income taxable on each individual. To alleviate such difficulties, the legislation provides for the income to be apportioned on a 'just and reasonable' basis
>
> How this is done will depend on the circumstances. For example, individual A may be chargeable on the whole of the income of an overseas company under the income charge. Individual B may receive a benefit from the same company that falls to be charged under the benefits charge. In this situation the income of the company should only be taken into account once (INTM602380) and it will normally be just and reasonable to include the whole of the income arising as an income charge, as the individual who has sought to avoid tax in setting up the structure in the first place will be charged to income tax and will therefore suffer no inequity in bearing the full brunt of the legislation. In this example, individual B may not have a benefit charge for the particular tax year, although the benefit may be subject to a charge in a subsequent year (INTM601700).
>
> However, there may be exceptional circumstances where the benefit charge is seen as being just and reasonable, for example where the income charge arises due to an individual receiving a loan from the person abroad which is repaid after a very short period so that there is no continuing liability on that individual.
>
> ... Each case must be dealt with on its merits and the 'just and reasonable' basis is that which appears to be so to an officer of Revenue and Customs. Appeals against such decisions are the jurisdiction of the Tribunal (previously the Special Commissioners.) (INTM603560)

In practice there will be few if any cases where the beneficiary is taxed instead of the transferor.

The same will apply if T is a remittance basis taxpayer and B is an arising basis taxpayer.

31.11.2 *T is a remittance basis taxpayer and B is an arising basis taxpayer*

The ITA EN passage cited above shows that HMRC have historically regarded B as taxable. Before the 2008 reforms T was wholly exempt on income not received in the UK, so that was sensible and probably correct. Since 2008 the position has changed, as T is now taxable on the income on a remittance basis. It is not probably just and reasonable to tax B on an arising basis, in accordance with standard practice.

31.11.3 *T and B are both remittance basis taxpayers*

There is no guidance on the position where T is taxed on the s.720 remittance basis and B is taxed on the s.731 remittance basis. It is suggested that it is just and reasonable to tax whoever is first taxable, ie to tax T if the income is remitted but to tax B if the benefit is remitted without a remittance of the income. The contrary is arguable.

31.12 Overlapping s.731 charges: Benefits exceed relevant income

The ToA draft guidance provides:

> **INTM602480 Transfer of assets: General provisions: Just and reasonable basis**
>
> ...
>
> Where more than one individual is subject to the benefits charge in respect of benefits which they receive in the same year, it will be necessary to apportion the relevant income (INTM601680) among the individuals. Only by considering the facts of the particular case will it be possible to decide fairly the amount of income to be treated as arising to each individual and subject to the benefits charge. In cases where the total benefits are fully covered by the relevant income, each individual will be potentially subject to charge on the amount or value of the benefits received. Where the relevant income is less than the total amount or value of the benefits, the most appropriate apportionment of the relevant income is by reference to the ratio of the benefits received by each individual in the year to the total of the benefits provided in the year.
>
> However, in a case where it was clearly intended that A's benefit be provided out of the relevant income of the year, and B's benefit out of that of a subsequent year (if, for example, A's benefit was paid three quarters through the year and represented the whole income of the year, while B's benefit was paid nearly at the end of the year to deal with some unexpected contingency) then A might justifiably be taxed on the whole of the benefit in the year of receipt, and B taxed in subsequent year.

31.13 Overlapping s.720 charges

The ToA draft guidance provides:

> **INTM602480 Transfer of assets: General provisions: Just and reasonable basis**
>
> ...
>
> When looking at the just and reasonable basis for apportionment, where there is more than one individual with power to enjoy the income of the person abroad, account should be taken as to who actually made, procured or was associated with the transfer as these parameters may affect the quantum and the nature of the charge. In addition, it is necessary to have regard to the intended outcome of the arrangements which have resulted in income becoming payable to a person abroad. For example, if individual X subscribes for shares in a Jersey company

> for £1000 and individual Y enters into a service agreement with that company, then each individual may be subject to the income charge. However, it may well be that the asset of real value is the service agreement and that should be reflected in any apportionment of the income between the individuals.
>
> Where the same assets are transferred by several individuals the transferors would normally be assessed in proportion to their share of the assets transferred. For example, where shares of a UK company are held by three individuals in the proportions 40%, 40% and 20% and there is liability under Section 720 ITA 2007 in respect of the income of an overseas person to which the shares are transferred, the liability is assessed on each of the three shareholders in proportion to their respective holdings. This example demonstrates both the requirement to avoid duplication of charge (INTM602380) and the 'just and reasonable' basis.

It is considered that double-counting relief is not applicable as there no overlap here, the transferors are only charged on income from their own transfer.

CHAPTER THIRTY TWO

TRANSFER OF ASSETS ABROAD: MOTIVE DEFENCE

32.1 Motive defence: Introduction

Sections 736 to 742 ITA provide a defence to the ToA provisions which I call "**the motive defence**" (or where comparing it to other purpose tests, "the ToA motive defence").[1] The ToA draft guidance calls it "the avoidance purpose exemption".

The ToA motive defence is one of a large number[2] of unallowable purpose tests in UK tax legislation. Although there is a wide variation in matters of detail, they share a common framework, and cases on these other provisions can shed light on the ToA motive defence. The most litigated is the purpose test for the transactions in securities rules.

32.1.1 *Terminology*

Section 736(3) ITA provides two self-explanatory terms:

> In this section and sections 737 to 742—
> "**post-4 December 2005 transaction**" means a relevant transaction effected on or after 5 December 2005, and
> "**pre-5 December 2005 transaction**" means a relevant transaction effected before 5 December 2005.

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1 A note on terminology. The word "motive" is not used in the legislation, and is perhaps not ideal because a distinction is sometimes drawn between purpose and motive. However the label is convenient, reasonably accurate, and sufficiently well established that it is not worth looking for any alternative. It originates from the Inland Revenue's Notes on clause 18 Finance Bill 1936, accessible *http://www.kessler.co.uk/tfd-archive*.

2 HMRC Discussion Document "Simplifying Unallowable Purpose Tests" (2009) p.7 gave the number as "over 200" but many have been added since then, and no-one could compile a full list.

In this chapter:

(1) "**Old Conditions A and B**" are conditions A and B in s.739 ITA (applying to pre-5 December 2005 transactions).

(2) "**New Conditions A and B**" are conditions A and B in s.737 ITA (applying to post-4 December 2005 transactions).

References to Condition A or B (without more) means either the old or the new version of the Conditions.

There have been two explanations of the 2006 clauses: Explanatory Notes on the Draft Clauses, published 5 December 2005, and Explanatory Notes on the Finance Bill 2006. I refer to these as "**EN Draft Clauses (2005)**" and "**EN FB 2006**".

I distinguish between:

(1) An "**innocent**" transaction, one which satisfies Condition A or B (in short, no tax avoidance purpose); and

(2) a "**tainted**" transaction, one which does not satisfy Condition A or B.

For the definition of "**relevant transactions**" see 28.10 (Significance of associated operations).

32.2 Motive defence condition A

Section 737 ITA sets out New Condition A:

> (1) This section applies if all the relevant transactions are post-4 December 2005 transactions.
>
> (2) An individual is not liable to income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs—
>
> (a) that Condition A is met, or
>
> (b) in a case where Condition A is not met, that Condition B is met.
>
> (3) Condition A is that it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

Section 739 ITA sets out Old Condition A:

> (1) This section applies if all the relevant transactions are pre-5 December 2005 transactions.
>
> (2) An individual is not liable for income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs that condition A or B is met.

(3) Condition A is that the purpose of avoiding liability to taxation was not the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

32.3 Motive defence condition B

Section 737(4) ITA sets out New Condition B:

> Condition B is that—
> (a) all the relevant transactions were genuine commercial transactions (see section 738), and
> (b) it would not be reasonable to draw the conclusion, from all the circumstances of the case, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.

Section 739(4) ITA sets out Old Condition B:

> Condition B is that the transfer and any associated operations—
> (a) were genuine commercial transactions, and
> (b) were not designed for the purpose of avoiding liability to taxation.

32.4 Enactment history

The original wording was much simpler. It provided exemption if:

> the transfer and any associated operations were effected mainly for some purpose other than the purpose of avoiding liability to taxation.[3]

The Solicitor-General explained why the text was changed to (what is now) Old Conditions A & B:

> A taxpayer[4] transferred a large amount – he was not one of the small people for whom my hon. and learned Friend was pleading – of foreign securities to a trust company abroad on certain trusts under which the income was to be accumulated until the death of the taxpayer. There was a discretion to the trustees to pay certain portions of the income to

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3 Section 18 FA 1936. Section 28 FA 1938 substituted the text which is now Old Conditions A and B.

4 Presumably a UK resident and domiciled transferor. (HMRC did not contend at that time that (what is now) s.720 applied to a transferor unless UK resident at the time of the transfer, and a foreign domiciled transferor would have qualified for the remittance basis.) So one can see why HMRC found the case troubling.

> the taxpayer or to his son. The deed gives to the taxpayer and his son power, with the consent of the trustees, to revoke the trust, or, alternatively, they can withdraw all or any part of the trust property for their own benefit. The trust income has been accumulated, and none of it has been distributed. The vigilant Revenue authorities pursued this taxpayer, and he contended, successfully, as it transpired, on appeal, that the foreign trust was born because of his fears as to the financial position of this country and the dangers of the situation on the Continent ... in 1936. He stated that he wanted to find a stable country where he could make safe provision for his family. The Special Commissioners decided that the main purpose of the transaction was occasioned by A's pessimistic view of the European situation at the time; that, arising out of that, his main intention was to make provision for his family in a safer country; and that, if there was any intention of avoidance of taxation, it was incidental to the main purpose. They therefore decided that there was no liability under Section 18 FA 1936. That instance has only to be cited to the Committee for the Committee to realise that on this particular matter the hon. Member for Chesterfield (Mr. Benson) was a true prophet in 1936, when he said that the word "mainly" would be too wide.[5]

A case on similar facts might still succeed today, but the test is stiffer. The taxpayer would need (in short) to show that tax avoidance was not even one of the purposes of the transfer.

32.5 "Commercial" in Old Condition B

Commercial is a requirement for Condition B but not Condition A.

In Old Condition B the term is not defined. "Commercial" is an imprecise word.[6] The epithet "genuine" does not add anything.[7] In New Condition B there is a complex definition which is considered in the next section.

It is considered that there is no single factor which determines what is "commercial" but a number of factors may indicate one way or the other.

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5 Hansard 27 June 1938, col 1610. It is impressive that an income tax dispute relating to 1936/7 was resolved by a Special Commissioners' decision early in 1938.

6 *IRC v Plummer* 54 TC 1 at p.48: "What exactly is comprehended in the phrase ... 'a bona fide commercial transaction', I do not know" (Viscount Dilhorne). Cf *IRC v Goodwin* 50 TC 583 at p.598.

7 See 32.17.3 ("Genuine").

32.5.1 *Transfer with element of bounty*

A transaction made with bounty (gratuitous intent) is not commercial.[8] By contrast, a transfer intended to make money is commercial.[9]

For instance, a gift to a trust for the benefit of the settlor's family is not commercial. The same applies even if the class of beneficiaries includes the settlor and the trust is revocable. By contrast, a transfer of assets to a company wholly owned by oneself may be a "commercial transaction" even if the transfer is for less than full (or nil) consideration, and a transfer to an employee trust may be commercial.[10]

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8 *Bulmer v IRC* [1967] Ch 145, citing *IRC v Goodwin* 50 TC 583 at p.607. HMRC adopt this approach in Venture Capital Schemes Manual:
11040. EIS: income tax relief: the investor: no tax avoidance [December 2012]
ITA07/S165
An investor in a company is not eligible for relief unless the subscription is made for genuine commercial reasons and not as part of a scheme or arrangement the main purpose or one of the main purposes of which is the avoidance of tax.
Commerciality
This requirement rules out any subscription which is motivated by considerations of benevolence. This could be the case if, for example, the company were the proprietor of an unsuccessful professional football club and a supporter of the club paid a large premium for shares in the company; that may well [interestingly, the text formerly said *would clearly*] not be a commercial subscription. Similarly, if the company is owned by a person whom the investor wishes to benefit, and the investor pays a large premium for the shares with the object of increasing the value of the other person's shares, that too would not be a commercial subscription. Deathbed investments are unlikely to be made for genuine commercial reasons."

9 Ambrose Bierce makes the same point in The Devil's Dictionary (1911) defining "Merchant": "A commercial pursuit is one in which the thing pursued is the dollar." Likewise *C&E Commrs v Morrison's Academy* [1978] STC 1: "I am not at all quite clear what is meant by a 'commercial element' if it is something different from the pursuit of profit...".
For an interesting empirical study of how the word commercial is understood, see Creative Commons, *Defining "Noncommercial"A Study of How the Online Population Understands "Noncommercial Use"*(2009) accessible *http://mirrors.creativecommons.org/defining-noncommercial/Defining_Noncommercial_fullreport.pdf*

10 This is supported by *Wannell v Rothwell* 68 TC 719 at p.733B, a case on loss relief which uses the word "commercial". See too *IRC v Levy* 56 TC 68 at p.87. The issue arose in a case on the meaning of settlement-arrangement. The definition of settlement-arrangement does not include the word "commercial" but the case law "bounty" requirement overlaps with the concept of "commercial".

32.5.2 *Non-business transaction*

In *Carvill v IRC* the Special Commissioner ventured this explanation:

> There was not much difference between the parties about what constituted a bona fide commercial transaction. [Counsel for the taxpayer] contended that this was any genuine transaction which implements or facilitates a business end; [Counsel for HMRC] contended that the transaction must be in furtherance of commerce, ie a trade or business. I shall follow these two meanings.[11]

This seems a fair paraphrase though one should always beware of a paraphrase. At first sight it does not seem to take us very far because the word "business" is notoriously wide and slippery. Nevertheless, one can suggest examples of transactions which should not be classified as commercial because they are not in furtherance of a business. One is the transfer to a trust to avoid the hazards of war, discussed in 32.4 (Enactment history). Another example is a transfer to avoid claims by non-business creditors, eg a claim on divorce or forced heirship. These transfers involve an element of bounty (and may be classified as non-commercial for that reason) but in any event they should be classified as non-commercial transactions because they are not in furtherance of a business purpose.

The HMRC draft guidance for unallowable purpose tests correctly states at para 10110:

> Often, a business will take the view that tax is a commercial cost and minimising it is a commercial aim. ... However, in deciding whether a "purpose test" is triggered, minimising tax is not regarded as a business or commercial purpose.[12]

32.5.3 *Making or managing investments*

RI 201 provides:

> The expression "bona fide commercial" in [Old Condition B] is taken to apply [1] only to the furtherance of trade or business, and [2] not to

11 [2000] STC (SCD) 143 at p.166.

12 HMRC Discussion Document "Simplifying Unallowable Purpose Tests" (2009) *http://www.hmrc.gov.uk/ria/unallowable-purpose-tests.pdf*.

the making or managing of investments.[13]

The TOA draft guidance provides:

> **INTM603020 Commercial transactions**
> ... In this context, HMRC have treated 'commercial' as applying only to the furtherance of trade or business, and not to the passive holding of investments (RI 201 refers).

Proposition [2] (that "commercial" does *not* apply to making or managing investments) is untenable:

(1) The statement does not say what the position is if the making or management of investments constitutes a business. A transfer may be both in the furtherance of a business *and* in the course of making or managing investments.[14] The intended meaning seems to be that investment transactions in the course of a business are commercial, but investment transactions which are not in the course of a business are not commercial. The (elusive) concept of business is distinct from the concept of what is commercial.

(2) More fundamentally, making or managing investments *is* generally regarded as "commercial" even if it does not constitute a business. What can be more "commercial" than the management to maximise investment return? This point is recognised in *Lewis v IRC*:

> It is trite law that in exercising their duties trustees must use as much diligence as a prudent man of business ... Faced with the self-investment problem their duty was to act in a business-like manner: this they did. Put another way, they acted commercially as was their duty. In our view it would be construing the statute too narrowly to hold that they did not carry out the transactions for bona fide commercial reasons, unless an investment decision cannot be for

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13 RI 201. This was perhaps the view of the drafter of s.724 CTA 2010 which refers to transactions:

"(a) for genuine commercial reasons *or* (b) in the ordinary course of making or managing investments."

But para (b) might have been added for the avoidance of doubt, or for some exceptional case, and it is not clear that the drafter really thought that making or managing investments would not usually be commercial.

14 The proposition that making or managing investments may constitute a business is self-evident; but if authority is needed, see s.105(3) IHTA which refers to the business of making or holding investments; and s.1218 CTA 2009 which refers to "a company whose business consists wholly or partly of making investments".

commercial reasons.[15]

(3) Section 738(4) ITA assumes that making/managing investments may be "commercial" (in the ordinary sense of the word).[16]

Proposition [1] (that the expression "commercial" applies *only* to the furtherance of trade or business) was put to the Commissioners in *Carvill*, where it obtained some support, see above. Nevertheless, it is too narrow. In practice, commercial transactions will normally further trades or businesses so the issue will not often arise. But there are counter examples, as discussed above: making or managing investments is in principle a commercial transaction even if it is not in the course of a business.

The most that can be said is that a transaction which is not in furtherance of a trade/business is less likely to be commercial than one which is in furtherance of a trade/business, but this factor is not decisive.

32.5.4 *Commercial from whose viewpoint?*

From whose viewpoint does one assess commerciality? The answer is that it should be looked at from the viewpoint of the transferor, but it would be a rare arrangement under which one party is and another party is not acting commercially. In *IRC v Willoughby* HMRC accepted that bonds were commercial transactions for Royal Life who issued them but argued that they were not for Professor Willoughby who acquired them. The Special Commissioner did not agree:

> If a contract is entered into by two people and it is a bona fide commercial transaction for one of them, it cannot be not a bona fide commercial transaction for the other party to the contract in the absence of any reason for impeaching the latter's good faith.[17]

The point was not discussed on appeal.

32.6 "Commercial" in New Condition B

Section 738 ITA contains a definition of "commercial" for the purposes of New Condition B. The definition is artificial in that it excludes some transactions that are "commercial" in the normal sense of the word. New Condition B is therefore rather narrower than Old Condition B.

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15 [1999] STC (SCD) 349 at p.362.

16 See 32.6.3 (Investments restriction).

17 70 TC at p.86H.

Section 738(1) ITA provides:

> For the purposes of section 737, a relevant transaction is a commercial transaction only if it meets the conditions in subsections (2) and (3).

Is s.738 an *exhaustive* definition of "commercial" or is it merely a partial, exclusory definition? That is, if a transaction meets the requirements set out in the section, is it necessarily "commercial" or must the transaction also be "commercial" in the ordinary sense of the word? The wording in s.738(1) ("a ... transaction is a commercial transaction only if ...") could be read as an exhaustive or a partial exclusory definition. It is suggested that s.738 is an exhaustive definition. The legislation is intended to make the law clearer, and a partial definition does not do that. In practice it is difficult to think of a transaction which meets the definition which is not commercial in the ordinary sense of the word, so the issue may not arise.

32.6.1 *Course of business*

Section 738(2) ITA sets out the first requirement of "commercial":

> It [the relevant transaction] must be effected—
> (a) in the course of a trade or business and for its purposes, or
> (b) with a view to setting up and commencing a trade or business and for its purposes.

In the following discussion I use the word "business" to mean "trade or business".[18]

At first sight this more or less encapsulates the natural meaning of "commercial". But in fact it is restrictive. An individual may make an investment which is not in the course of a business, eg a purchase of a company. This is commercial in the general sense of the word, but it is not "commercial" within the new definition. Section 738(2) thus gives effect to HMRC's proposition [1] of the meaning of "commercial" in Old Condition B.[19]

If a transaction is made between X and Y, it may be in the course of a business of X but not in the course of a business of Y. For example, if Y (an individual) subscribes for shares in X Ltd, an investment company, the issue of shares may be in the course of the business of X Ltd. That is

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18 For HMRC views on what constitutes a business, see CG Manual para 65715 [April 2011] and Shares and Assets Valuation Manual para 111110 [July 2013].

19 See 32.5.3 (Making or managing investments).

sufficient to meet the requirement of s.738(2).

32.6.2 *Arm's length requirement*

Section 738(3) ITA sets out the second requirement of "commercial":

> It [the relevant transaction] must not—
> (a) be on terms other than those that would have been made between persons not connected with each other dealing at arm's length, or
> (b) be a transaction that would not have been entered into between such persons so dealing.

Taken literally, this would exclude an interest free loan to a wholly owned company (even if it is a trading company). Such loans are commercial in the normal sense of the word. One wonders whether that was foreseen by the drafter. EN Draft Clauses (2005) claims that the change merely "clarifies and confirms" the correct interpretation of the existing statute. It is suggested that the provisions should be construed purposively, so that an interest free loan to a wholly owned company *is* a commercial transaction.

A dividend is a commercial transaction, as such transactions are often entered into between companies and minority shareholders (who are in principle not connected to the company).

The ToA draft guidance provides:

> **INTM603020 Commercial transactions**
> ... The above provisions [s.738(2)(3)] ensure that transactions taking place other than at arm's length will not satisfy the terms of Condition B. This will prevent individuals claiming exemption on contrived grounds of 'commerciality'.
> [1] An example of this might be where an offshore company is established as a conduit or 'money box' for personal fee income.

The metaphors of conduit and moneybox are imprecise, but I take this example as a reference to the facts of *Brackett v Chater*,[20] where the transfer of assets was that T entered into a service contract, at an undervalue, with a non-resident company which was held by a settlor-interested discretionary trust made by T. This is an example of a transfer which fails the commerciality test of s.738(3)(a). On the other hand, that

20 60 TC 134 & 639.

contract was not a commercial transaction in the ordinary sense, and the commissioners rejected the taxpayer's argument that the motive defence applied, so this is not a case where the new definition was needed, or would have made any difference.

> [2] It will also prevent claims that the establishment of a non-resident family trust was for 'commercial' reasons.

The statutory definition is not needed here: no-one suggests that the establishment of a family trust is "commercial" in the normal sense.[21]

> [3] HMRC accept that the creation of some trusts will satisfy the 'commerciality' tests, for example an employee benefit trust established for the benefit of a group of employees and funded on arm's length terms.

32.6.3 *Investments restriction*

Section 738(4) ITA restricts the definition of commercial by providing an artificial definition of "trade or business":

> For the purposes of subsection (2), making investments, managing them or making and managing them is a trade or business only so far as—
>
> (a) the person by whom it is done, and
>
> (b) the person for whom it is done,
>
> are persons not connected with each other and are dealing at arm's length.

First one must identify: (a) "the person *by* whom it is done". "It" must refer to the making or managing of investments. Thus we must identify the person carrying on the business.

Next one must identify: (b) "the person *for* whom it (the business) is done". This is gibberish. A business is not in normal English "done for" anyone. Presumably the reference is to the customers of the business. For example, if the business is a property business perhaps it is done for the tenants? Is the business of buying and selling shares done for counterparty vendors and purchasers?

If one can identify a person within (b), the making/managing of investments is only business "so far as" it is done for unconnected persons. Normally an activity is or is not a business: it cannot be a business to a limited extent? If it is, what follows: what if most but not all

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21 See 32.5.1 (Transfer with element of bounty).

of the customers are unconnected?

While one might, charitably, rewrite the subsection so that it meant that the business must be substantially carried on between unconnected persons, the proper course would be for a court to dismiss it as meaningless.

The subsection does not apply to a company *trading* in financial assets since these are not "investments".[22]

Suppose T subscribes for shares or debentures in (or makes a loan to) an investment company. The transaction satisfies s.738(2) since the company is carrying on a trade or business. The transaction satisfies s.738(3) if it is on arm's length terms. The business satisfies s.738(4) provided the company's business is conducted with third parties: it does not matter that T and the company are connected.

The ToA draft guidance provides:

> **INTM603020 Commercial transactions**
> ...The aim of this is to distinguish between asset management activity (which is a business chargeable for reward) and merely holding assets for possible increase in value.

If that is the aim, s.738(4) ITA does not seem aptly worded to achieve it.

32.6.4 *"Commercial": Commentary*

When one contemplates the difficulties raised by the statutory definition, one appreciates the wisdom of the 1938 drafter in leaving "commercial" undefined. The word "commercial" is often used motive defence tests[23] and nowhere else is it defined. It is suggested that the statutory definition of commercial in s.738 ITA serves no useful purpose, and unless some such purpose can be identified, it should be repealed.

32.7 "Avoidance", "mitigation", "tax reduction", "evasion": Introduction

I turn to discuss the complicated, emotionally charged, and in practice constantly abused term "tax avoidance." It is helpful to begin with a fourfold categorisation:

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22 See 44.11.1 ("Investment": Terminology).

23 There are too many to give a full list but among the most important are s.138 TCGA; s.734 CTA 2010.

(1) *Tax evasion*: Conduct which constitutes a criminal offence (fraud on HMRC or similar offences). This normally involves dishonest submission of an incorrect tax return. Dishonesty is essential to the offence.
(2) *Honest misdeclaration*: The submission of an incorrect tax return without dishonesty. Those involved may be culpable (guilty of neglect or wilful default) but not dishonest.
(3) *Tax avoidance*: Arrangements that reduce tax liability in a manner contrary to the intention of Parliament (I come later to consider this concept in more detail).
(4) *Tax mitigation*: Conduct which reduces tax liabilities without "tax avoidance" (not contrary to the intention of Parliament).

The distinctions between these concepts (especially avoidance/evasion and avoidance/mitigation distinctions) are now commonplace. They may appear obvious. They are taught to every student. No policy debate would be possible without them. However, these concepts and their associated terminology have only emerged after a gradual process of development and even now the terminology is not always adopted. It is essential to bear this in mind on reading sources on this subject.[24]

32.7.1 *Avoidance/evasion distinction*

An avoidance/evasion distinction very similar to the present was recognised very early (and was surely self-evident at any time) but at first there was no terminology to express it. In 1860 Turner LJ suggested evasion/contravention (where evasion stood for the lawful side of the divide).[25] In 1900 the distinction was noted as two meanings of the word

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24 eg the 1920 Royal Commission on the Income Tax Cmd. 615 discussed evasion, honest mis-declaration and avoidance in one chapter headed "The Prevention of Evasion". In this discussion the words "avoidance" and "evasion" were used quite indiscriminately, see para 625. It is an interesting question whether the absence of terminology hampered discussion of the issues or whether the lack of discussion or interest led to the absence of suitable terminology. I suggest the latter: in the 1920s, criminal prosecution for tax evasion was rare, and only in blatant cases. Thus the avoidance/evasion distinction was not relevant. Likewise, tax avoidance (in the modern sense) was then still in its infancy so the avoidance/mitigation distinction also had little relevance.

25 *Fisher v Brierly* (1860) 1 de G F&J 643 at p.663. It is a pity this terminology did not catch on because it is more transparent than avoidance/evasion.

"evade".[26] The technical use of the words avoidance/evasion in the modern sense originated in the USA where it was well established by the 1920s.[27] It was slow to be accepted in the UK. By the 1950s, knowledgeable and careful writers in the UK had come to distinguish the term "tax evasion" from "avoidance/mitigation".[28] The distinction is now accepted internationally:

> 72. The terms "tax evasion" and "tax avoidance" have not always been

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26 *Bullivant v AG* [1901] AC 196 at p. 207:

> "The word 'evade' is ambiguous. ... there are two ways of construing the word 'evade': one is, that a person may go to a solicitor and ask him how to keep out of an Act of Parliament – how to do something which does not bring him within the scope of it. That is evading in one sense, but there is nothing illegal in it. The other is, when he goes to his solicitor and says, 'Tell me how to escape from the consequences of the Act of Parliament, although I am brought within it'. That is an act of quite a different character."

27 It is found in the scholarly Sears, *Minimising Taxes*, 1922, Vernon Law Book Co and can be traced to Oliver Wendell Holmes in *Bullen v Wisconsin* (1916) 240 US 625 at p.630. It is regarded as basic in Dennis Hartman, *Tax Avoidance*, Legal Publishing Soc, Washington (1930) which cites two textbook definitions in similar terms. The practice of tax avoidance was more advanced in the USA; the first published work on the subject in England was Moore, *The Saving of Income Tax Surtax and Death Duties*, (1935) (the publication of which lead to the enactment of the ToA provisions).

28 The 1955 Royal Commission Cmd. 9474 para 1016:

> "It is usual to draw a distinction between tax avoidance and tax evasion. The latter denotes all those activities which are responsible for a person not paying the tax that the existing law charges upon his income. *Ex hypothesi* he is in the wrong, though his wrongdoing may range from the making of a deliberately fraudulent return to a mere failure to make his return or to pay his tax at the proper time. By tax avoidance, on the other hand, is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right, except so far as some special rule may be introduced that puts him in the wrong."

Note that "evasion" is used here (unlike present usage) to describe dishonest criminal evasion and honest mis-declaration. Lord Templeman used this (by then old-fashioned) terminology in *IRC v Challenge Corporation* [1986] STC 548: "Tax evasion occurs when the commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a re-assessment. Fraudulent evasion may lead to a criminal prosecution as well as re-assessment." It does aid clarity if the term "evasion" is restricted to what Lord Templeman terms "fraudulent evasion".

used precisely or with a uniform meaning.[29] Strictly speaking, tax evasion is considered to consist of wilful and conscious non-compliance with the laws of a taxing jurisdiction. Tax evasion is an action by which a taxpayer tries to escape legal obligations by fraudulent or other illegal means. The illegal conduct might involve simply failing to report income or fabricating deductions, or it may involve highly sophisticated tax planning that is premised on false or intentionally deceptive representations to the tax authorities. Tax evasion may arise as a result of a failure to properly report income that is legally earned. It may also result from the evasion of tax on income that arises from illegal activities, such as smuggling, drug trafficking, and money-laundering. In a broader sense, tax evasion may encompass a reckless or negligent failure to pay taxes legally due, even if there is no deliberate concealment of income or relevant information.

73. Tax avoidance, in contrast, involves the attempt to reduce the amount of taxes otherwise owed by employing legal means.[30] However, the borderline between evasion and avoidance in specific cases may be difficult to define. For one thing, the criminal laws of countries differ, so that behaviour that is criminal under the laws of one country may not be criminal under the laws of another.[31] In addition, the definitions of civil and criminal tax fraud may overlap, so that it is within administrative discretion whether or not to pursue a criminal fraud case in a specific instance. In reality, there is a continuum of behaviour, ranging from criminal fraud on one extreme, to civil fraud, to tax avoidance that is not fraudulent but which runs afoul of judicial or statutory anti-avoidance rules and therefore does not succeed in minimizing tax according to law, and finally to tax-planning behaviour which is successful in legal tax reduction. ...[32]

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29 [Footnote original] Part of the problem is a linguistic one. In English, "tax evasion" is synonymous with tax fraud, and means criminal activity. In French, "evasion" means avoidance. Tax evasion should therefore be translated into French as "fraude fiscal". ...

30 [Footnote original] Black's Law Dictionary (Fifth Edition) has defined "tax avoidance" as: "The minimization of one's tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with tax evasion, which entails the reduction of tax liability by using illegal means".

31 [Footnote original] While most countries define criminal tax fraud fairly broadly, there are some exceptions. For example, Switzerland has a narrow concept of "tax fraud", which is an offence subject to imprisonment, defining it as the use of "forged, falsified or substantially incorrect documents". See Direct Federal Tax Law, art. 186.

32 United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries) 2003.

A discussion of evasion in the criminal sense is outside the scope of this book. It is important for our purposes to note that the term "evasion" was regularly used (by modern standards, misused) in the sense of avoidance, in law reports and elsewhere, at least up to the 1970s.[33] Now that the terminology has received official approval in the UK[34] this usage can be condemned as erroneous; but it still happens, in the language of lawyers[35] as well as in the language of politicians.[36] It is sometimes helpful to use the expressions "legal avoidance"[37] and "illegal evasion", to make the meaning clearer.

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33 Examples include: *Coutts v IRC* [1964] 1 AC 1393 at p.1420; *Jamieson v IRC* (1963) 41 TC 43 at p.70; *Cory v IRC* [1965] AC 1088 at p.1107; *Greenberg v IRC* (1971) 47 TC 240 at p.271: "Parliament attempted to prevent this and other methods of tax evasion by provisions in the Finance Act 1960". This usage seems to have stopped in the 1970s; at this time UK economists were giving increasing attention to the subject of tax avoidance and evasion (*Tax Avoision*, p.1, IEA 1979) and perhaps their work had an effect on legal usage. Note that this is purely a semantic and not a substantive point that is being made here. The old usage certainly does not reflect the view that the evasion/avoidance distinction is unreal or unclear or that one can shade into the other. The legal distinction between the two is tolerably clear since evasion involves dishonesty, a tolerably well defined and understood concept. The term "avoision" used in the IEA publication referred to was coined as a convenient term to mean avoidance/evasion. The book noted the lack of *economic* distinction between the two concepts; the economic similarity was the justification for the new coinage. (The book also noted the blurring of a moral distinction between the two concepts either because avoidance was seen by some as immoral or because evasion was seen by some as not immoral; the book did not suggest a lack of a legal distinction which was unquestioned then and still should be now.)

34 *Craven v White* 62 TC 1 at p.197; OED 2nd edition (1989) entry under "Taxation."

35 For example, see *R v Charlton* [1996] STC 1418 at p.1421.
This is particularly common in EU case law, which regularly uses "evasion" where avoidance is meant; eg *Cadbury Schweppes v IRC* [2006] STC 1908 at [50]; *Thin Cap Claimants v HMRC* [2007] STC 326 at [37] discussed 60.8.4 (Need to prevent tax avoidance)). Either EU translators do not know the UK distinction or they do not know the UK terminology, perhaps being mislead by the French word *evasion* which means (in UK terminology) avoidance.
Similarly, s.482 United States Internal Revenue Code refers to allocation of income that "is necessary to prevent evasion of taxes" but the intended concept is one of avoidance.

36 Eg The Progress Tackle Tax Avoidance Charter: "HMRC HAS GOT TO GET A GRIP … 4. Get tough on tax avoiders by mounting more prosecutions." See *http://www.progressonline.org.uk/campaigns/tackle-tax-avoidance*

37 "Legal avoidance" is a standard term in recent double tax conventions.

32.7.2 *Avoidance/mitigation distinction*

The clear[38] articulation of the *concept* of an avoidance/mitigation distinction goes back only to the 1970s[39] and the concept originated from economists, not lawyers. In 1973 C.T. Sandford wrote:

> A government may have one of three attitudes to a particular 'avoidance' measure – using the wide definition of avoidance.
> It may welcome it; the government may have deliberately offered a tax concession to promote some objective, e.g. tax concessions on mortgage interest ... in order to encourage owner-occupation; or investment and initial allowances to stimulate new investment in development areas.
> Second, without having sought positively to encourage a particular 'avoiding' action the government may find it entirely acceptable as when an income tax payer reduces his tax liability by taking a wife or having children; or when a person on retirement transfers savings from a building society to some other form of investment in order to reclaim income tax.[40]
> Third, the government may deplore certain actions as contrary to its intentions; the action is in accord with the letter of the law but not its spirit. *Only actions in this third category should rank as 'avoidance'*.[41]

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38 One can find some earlier examples: *Mangin v IRC* [1971] AC 739 is a moderately clear example; the concept is embryonically present in *Newton v Commissioner of Taxation of Australia* [1958] AC 450. But these cases do not draw the line as clearly or quite on the same basis as Sandford and modern cases following him.

39 In 1946, Wrottesley J was unaware of it. Discussing the motive defence, he said: "There cannot, I think, be two opinions as to what 'avoiding' means. Where what is to be avoided is a liability, it must mean to evade, or to keep out of the way of, whether it be as in Richard III, 'The censures of the carping world', or anything else unpleasant that might befall a man, such as a tax": *Congreve v IRC* 30 TC 163. This is describing avoidance in the loose or etymological sense (including mitigation).

40 Child allowance was abolished in 1979, and one can now reclaim tax deducted from building society interest; but that does not spoil the validity of the examples.

41 *Hidden Costs of Taxation*, IFS, 1973, p.113 (emphasis added). Sandford proposed a second requirement of "avoidance" which he related to the taxpayer rather than to the legislature:

> "It is reasonable to confine 'avoidance' to action which results in the would-be avoiders substantially achieving the objective to which the tax had become an obstacle. Let us give some examples. If a man ceases to buy cigarettes because of tobacco tax he has not achieved his pre-tax objective, i.e. to smoke. Buying sweets instead of cigarettes therefore, is not avoidance. Again, if a taxpayer decides to use most of his wealth for a consumption spree because estate duty makes it not worth

The use of the *terminology* avoidance/mitigation to express this distinction is an innovation of Lord Templeman in 1986.[42] The expression "tax avoidance" has very often been used in the loose sense, meaning or including mitigation.[43] The reason may be either that the author does not have any avoidance/mitigation distinction in their mind or (if they do) that they are not using the modern terminology to express it. Even now, the term "tax avoidance" is sometimes still used in a loose or etymological sense to include mitigation but nowadays this usage is sometimes jocular, which suggests that the technical meaning is seeping into public consciousness.[44] Likewise "mitigation" was and sometimes still is used in the sense of "avoidance".[45]

In this book I use the words "avoidance" and "mitigation" in the strict sense. It would be convenient to have a neutral term to describe both avoidance and mitigation (what is described above as the loose

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while saving for heirs, he is not 'avoiding' for he has abandoned his objective of passing property to heirs. On the other hand, if he reacts to estate duty by making *inter vivos* gifts (assuming he survives for seven years), this is avoidance; it has achieved, though by a more circuitous route, the objective of passing to heirs an intact property."

This is problematic, because there is no obvious way to identify the "objective to which the tax has become an obstacle", and it has not been adopted into the law.

42 *IRC v Challenge* [1986] STC 548. Lord Templeman was describing a concept relatively new to tax jurisprudence and framing terminology altogether new to describe it. But in accordance with the (according to Austin, "childish") declaratory theory of law, he did not say so.

43 C.T. Sandford:

"Amongst tax practitioners the generally accepted definition of avoidance ... is any legal method by which a person can reduce his tax bill... this definition can cover almost anything... I can legally reduce my income tax bill by buying a more expensive house (on which I get additional mortgage interest relief), getting married, having more children, taking out more insurance or simply stopping work."

(*Hidden Costs of Taxation*, IFS, 1973).

44 The author once saw an advertisement for PEPs: "Be a tax avoider!" (PEPs were a tax free investment now replaced by ISAs.) For another example, see *Board of Inland Revenue v Hoe*, A.P. Herbert's *More Uncommon Law*: "Evidently those who do not smoke or drink are ... avoiding taxation."

45 eg C.T. Sandford wrote in 1973 that tax avoidance (in the strict sense) "is often referred to by expressions such as tax planning or tax mitigation": *Hidden Costs of Taxation*, IFS, 1973, p.104. *Craven v White* 62 TC at p.203 (a requirement of *Furniss v Dawson* is that a transaction "had no other purpose than tax mitigation").

etymological sense of "tax avoidance"). There is no agreed term, but "tax reduction",[46] "tax saving", "tax planning" and "tax advantage" might all be used in this sense. It may be less confusing if less elegant to refer to "avoidance/mitigation" where one wishes to refer to the two.

32.8 Meaning of "avoidance" in motive defence

The House of Lords in *IRC Willoughby* decided that "avoidance" in motive defence meant tax avoidance in the strict sense and not mitigation:

> ... it was essential to understand what was meant by "tax avoidance" for the purposes of s 741 ICTA [now Conditions A and B]. Tax avoidance was to be distinguished from tax mitigation. ... My Lords, I am content for my part to adopt these propositions.[47]

This would have surprised those who framed the legislation in 1936/8; they were unaware of any avoidance/mitigation distinction. But the enormously increased complexity of the tax system since 1936 makes the distinction sensible, perhaps necessary. HMRC accepted that the purchase of an ordinary offshore bond should be taxed under the chargeable event provisions and not under the ToA provisions. One way[48] to reach that result is to give a narrow meaning to tax avoidance and so to widen the motive defence.

32.8.1 *Purpose of tax evasion*

Suppose an individual transfers assets abroad with the dishonest purpose of *evading* UK taxation. Can one apply the avoidance/evasion distinction and say that the individual did not intend to *avoid* taxation, so that – while they may be liable to criminal sanctions – the motive defence applies and

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46 INT Manual provides:

> **208010 Introduction to the motive test** [April 2011]
> ... Despite numerous valiant attempts there has never been a consensus about what is meant by 'tax avoidance' ...
> The [CFC] motive test attempts to solve the first problem by avoiding any mention of the term 'tax avoidance', settling instead for the rather more neutral concept of a 'reduction in tax' ...

47 [1997] STC 995 at p.1003.

48 An alternative, less satisfactory, would be to refuse to recognise the tax purpose of the acquisition, by saying that it is merely incidental, or by applying a *Brebner* or choice principle: see 32.14.1 (A choice principle?). Another solution is to say there is no relevant transfer.

excludes the transfer of assets rules? The answer is plainly no. The argument is anachronistic, since in 1936 and for 40 years afterwards, the word "evasion" was used in English jurisprudence to describe avoidance. More fundamentally, the context shows that the expression "tax avoidance" includes (criminal) tax evasion. This was assumed without argument in *R v Dimsey & Allen* 74 TC 263.

32.9 Meaning of "taxation" in the motive defence

"Taxation" in Old Conditions A and B means any form of UK taxation, and not only income tax: *Sassoon* v *IRC*:

> In my view the nature of the [motive defence], instead of requiring a strict interpretation of the word 'taxation' in favour of the taxpayer, calls for a liberal interpretation in favour of the Crown. The draughtsman no doubt had in mind to cover what he would have called all bona fide transfers, that is to say transfers which would be regarded by the Revenue as not made for any fiscal purpose which they would regard as improper. The word 'taxation' is a short expression of such an idea and I think a happy one. Death duties, National Defence Contribution, perhaps other taxes or duties would all be within the Revenues mind in deliberately choosing the wide word 'taxation', in order to make sure that their concession of transfers for other purposes should not be used to deprive the Revenue of other taxes than income tax or Sur-tax.[49]

The International Manual provides:

> **600040 Transfer of assets abroad** [June 2014]
> **Overview of ITA 2007/S736 - 742 - exemption from liability**
> ..In the context of this test "taxation" includes any UK tax liability, for example, Inheritance Tax, Capital Gains Tax, Corporation Tax as well as Income Tax.

Sassoon, though criticised,[50] is a decision of the Court of Appeal and

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49 25 TC 154 at p.159 cited in ToA draft guidance para INTM603000.

50 For the following reasons:

(1) The rule that an intention to avoid (say) stamp duty should have *income* tax consequences gives rise to obvious anomalies. The usual principle is that each tax must be considered separately. This is the approach usually adopted by anti-avoidance provisions: eg s.682 ITA (transactions in securities), or s.137 TCGA. But see s.75(5)(a) FA 1986 for an exception.

(2) Since *Sassoon* was decided, the word "tax" has been given a limited definition. Section 989 ITA provides:

should be taken to represent the law.

Foreign tax is not "taxation" for this purpose. The House of Lords assumed that this was so without argument in *Herdman v IRC* 45 TC 394. This must be right since (1) it is illogical that the purpose of avoiding foreign taxes should have UK tax consequences and (2) it would be impractical to apply an avoidance/mitigation distinction to foreign taxes (where the distinction would depend on the foreign tax culture and attitudes). the ToA draft guidance provides:

> **INTM603000 Avoidance purpose exemption: Taxation**
> The case [Sassoon] also established the taxation meant UK taxation. If it is intended to avoid foreign tax and only foreign tax is avoided the transfer of assets provisions will not apply.

For the purposes of New Conditions A and B these rules are set out in s. 737(7) ITA:

> In this section—
> "revenue" includes taxes, duties and national insurance contributions,
> "taxation" includes[51] any revenue for whose collection and management the Commissioners for HMRC are responsible.

"'tax', if neither income tax nor corporation tax is specified, means either of those taxes".

There are two reasons why this statutory change does not affect the position:

(a) A definition of *tax* does not in principle determine the meaning of the cognate word *taxation*. (Would a definition of "engine" determine the meaning of the cognate word "engineer"?)

(b) The decision in *Sassoon* was given the implied approval of Parliament in the 1952 consolidation and it is not likely that the 1970 consolidation was intended to alter that.

(3) Section 720(1) ITA refers only to the avoidance of income tax; but see s.721(5)(c) ITA.

(4) Dicta in *Vestey v IRC* 54 TC 503 are said to be inconsistent with *Sassoon*; but this point was not an issue in *Vestey*.

(5) A reversal of *Sassoon* would cut down considerably the multitude of issues that the motive defence currently raises: see 32.21 (Practical examples: introduction).

While of course "context is king", it is clear that the word "taxation" is sometimes used in an IT context to mean any tax; see for instance s.22 F(No 2)A 1931.

51 This is not an exhaustive definition. At present it is difficult to see what other tax may be caught, but this could be relevant if there was a change in the responsibilities of HMRC (eg a new tax was introduced which was managed by a different Government department).

32.10 Identifying and classifying purpose: The old conditions

It is considered that the identification of a tax avoidance purpose requires a two-stage approach: identifying and classifying purpose.

32.10.1 *Identify purpose of transferor: Stage 1*

One must look into the mind of the transferor to ascertain whether their purpose was (to use the neutral term) to reduce tax. If they had no purpose to reduce tax then the motive defence applies.

In *IRC v Pratt* [1982] STC at p 795, Walton J observed:

> It is not 'the transferor's purpose in effecting the transfer' but 'the purpose for which the transfer was effected'.

But surely one cannot say:
(1) "the purpose for which the transfer was effected"
could be different from
(2) "the transferor's purpose in effecting the transfer"?
(1) is equivalent in meaning to (2). A transfer itself cannot have a purpose: only a human being (or at least, a sentient mind) can have a purpose. "Purpose", if it means anything, is an attribute of a mind.[52] If one says that an inanimate but man-made object such as a tool has a purpose, one is only attributing to the tool the purpose in the mind of the maker or user of the tool. I do not think that Walton J's statement (read in context) contradicts this view.

HMRC agree:

> **10200 Whose purpose?**
> A purpose test will define the person whose purpose is being considered. Some purpose tests refer to the purpose of a scheme or transaction: in this case, the purpose of the parties to the transaction needs to be considered.[53]

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52 The issue here overlaps with the objective/subjective issue discussed below.

53 HMRC Discussion Document "Simplifying Unallowable Purpose Tests" (2009). *http://www.hmrc.gov.uk/ria/unallowable-purpose-tests.pdf*
Similarly at p.14: "One particular difficulty with testing the purpose of arrangements rather than the purpose of a person is that arrangements are self-evidently inanimate. Any purpose inherent in such arrangements must usually be derived from the purposes of a person or persons who are party to the arrangements." Similarly the draft guidance for unallowable purpose tests at para 10110.

32.10.2 *How to ascertain the purpose of the transferor?*

The issue is subjective in that it depends on what is in the mind of the transferor.

How does one ascertain the transferor's subjective purpose? All facts which may shed light on their purpose must be taken into account. Exemption is not due solely on the basis of an assertion by individuals that tax avoidance was not their subjective intention, because that (self serving) assertion may not be credible in the light of other relevant facts.

It is highly relevant to consider the objective questions:

(1) whether the transfer did reduce tax significantly; and

(2) whether the tax reduction was foreseeable at the time of the transfer.

If the tax reduction was not foreseeable, it is not likely to have been the purpose to achieve it. Conversely the fact that a tax advantage is objectively foreseeable as a consequence of the transfer may be cogent evidence of subjective purpose. We normally have the purpose of achieving the foreseeable consequences of our acts. However, this is not necessarily so. First the transferor may not have foreseen the advantage even though a "reasonable person" might have done so: no-one at all times acts with the foresight of the "reasonable man".[54] Secondly, the transferor may have been aware of (or even have wanted) the advantage but it may nevertheless not properly be classified as their "purpose".[55]

Before *Willoughby* identifying a purpose of reducing tax was the beginning and end of the matter because an avoidance/mitigation distinction had not been recognised in this context. Now there is a second stage.

32.10.3 *Classifying purpose: Stage 2*

If the transferor did have the purpose of reducing tax, one must (applying *Willoughby*) categorise that purpose as "avoidance" or "mitigation". This is determined objectively (in the sense that the issue is independent of the mind of the transferor).

It would be wrong at stage (2) to ask whether the transferor subjectively thought their purpose was "tax avoidance" (as opposed to mitigation) because avoidance/mitigation is a question of law, a decision for the Court

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54 Contrast s.8 Criminal Justice Act 1967, the principle of which is also part of the common law: *Frankland v The Queen* [1987] AC 576.

55 See 32.13 (Foresight and purpose) and 32.14 (Consequence and purpose).

and not for them. Indeed, it would generally be pointless, since (unless the individual is a tax lawyer) they will not know the correct meaning of the terms.

The motive defence therefore involves a mixture of objective and subjective elements, as often happens.

Stage (1) – the mind of the transferor – is a question of fact, decided by the first-tier tribunal, which conveniently allows the appellate courts to say very little about it:

> The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide on a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence....
> ... the Special Commissioners came to a reasonable conclusion on the evidence before them. They could have reached a contrary conclusion, which would have been equally unassailable, had they taken a different view of the evidence;. ..[56]

Anything said on the subject of tax avoidance in motive defence cases before *Willoughby* needs to be reviewed because it will not have considered stage (2).

32.10.4 *HMRC view(s): Objective purpose*

RI 201 states:

> [1] If a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes
> [2] even if the transferor did not form the subjective intention[57] of avoiding tax.[58]

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56 *IRC v Brebner* 43 TC 705.

57 RI 201 is (I think) using "intention" as a synonym for the statutory word "purpose", but the difficulty of RI 201 becomes more apparent if one disallows that move. It is surely nonsense to say:

> "If a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes even if the transferor did not form the subjective purpose of avoiding tax."

58 This is loosely based on a dictum of Lord Nolan in *IRC v Willoughby* [1997] STC 995 at p.1003:

> "Where the taxpayer's chosen course is seen upon examination to involve tax avoidance (as opposed to tax mitigation), it follows that tax avoidance must be at least one of the taxpayer's purposes in adopting that course, whether or not the taxpayer has formed the subjective motive of avoiding tax."

This is a rejection of the stage (1) test set out above. In the HMRC view a transfer may have been effected for a tax avoidance purpose even though the transferor did not have the subjective purpose of obtaining a tax reduction. That must be wrong for several reasons. First, the natural meaning of "purpose" is to connote a subjective concept. This meaning is supported by high authority.[59] Of course context may show the word is used in an unusual sense, but that is not the case here. Secondly, this is the way that the motive defence has always been applied and understood.[60]

While the HMRC statement clearly rejects a subjective purpose test, it is not clear what test HMRC wish to apply instead. What is meant by a transaction "involving" tax avoidance? Sometimes HMRC have argued that the statute requires one to identify the "objective purpose" of the transfer. The attraction of putting the matter this way is that it is close to the wording of the statute. The difficulty is that the expression "objective purpose" is an oxymoron. If that means anything, it means, I think, the purpose which an ordinary reasonable person would have if they had made the same transfer in the circumstances of the transferor. It is difficult to identify purpose in this way because different people may do the same act with different purposes. And which circumstances are relevant? For instance, take the example of the transferor concerned as to the situation

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59 "I shall begin by considering the word 'purpose', for both sides have relied on this word in different senses. Broadly, the appellants contend that it is to be given a subjective meaning and the Crown an objective one.
I have no doubt that it is subjective. A purpose must exist in the mind. It cannot exist anywhere else."
Chandler v DPP [1964] AC 763 at p.804. *Dicta* apparently to the contrary in *Newton v Commissioner of Taxation* [1958] AC 450 at pp.465–466 are rightly criticised and distinguished in John Avery Jones [1983] BTR 22–24. Twenty years later, Avery Jones had the opportunity to make the same point judicially in *Carvill v IRC* [2000] STC (SCD) 143, 75 TC 477. A subjective test also applies for the escape clause in the transactions in securities rules; see *Addy v IRC* 51 TC 71 at p.81E.

60 The drafter of s.33(3) FA 1944 and s.32(3) FA 1951 plainly agreed. This provided (in short) that where "the main benefit which might have been expected to accrue" from a transaction was tax avoidance, then tax avoidance "was *deemed* to have been the purpose of the transaction". This imposed an objective standard and only makes sense on the assumption that the word "purpose" (in text based on what is now Condition A) was otherwise determined subjectively. The point is made expressly in *Crown Bedding v IRC* 34 TC 107 at p.115.

in Europe in 1936.[61] Their subjective purpose was not tax avoidance. Was their objective purpose tax avoidance? I do not know how to begin to answer the question.

The test that HMRC ultimately wanted to apply is that a transfer has a tax avoidance purpose if it has a tax saving *result*, if its *effect* has been to save tax, or at least if it was reasonably foreseeable that it would do so. This test does make sense (unlike "objective purpose") and it is practical to apply. The difficulty with this test is that it is not consistent with the wording of the statute. Purpose and result/effect are two entirely different concepts, and there is no getting away from that.

The ink had hardly dried on the HMRC statement when the Special Commissioners rejected it: *Beneficiary v IRC*,[62] *Carvill v IRC*.[63] Until 2008 HMRC contended that these cases were wrongly decided. However, HMRC sensibly abandoned that position before the Tribunal in *Burns v HMRC*,[64] where the Commissioner said:

> It seems to me to be settled law that what I must address is "purpose", rather than objectively ascertained effect, or presumed effect.

In practice the "objective purpose" argument is now (I think) resolved. This is confirmed in the HMRC draft guidance for unallowable purpose tests para 10030:

> Thus, where there is a purpose test, the consequences of a transaction will be dependent on the subjective purpose of the taxpayer. It is entirely possible that two taxpayers entering into similar transactions, but with different purposes, will be taxed differently....[65]

The draft guidance cites with approval a comment in a VAT case where a manufacturing company purchased a horse for promotional purposes:

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61 See 32.4 (Enactment history).

62 "We reject counsel's submission that we should look at effect. Purpose is not effect and in our view it is essential to look into the minds of the actors to discover their purpose". But: "The question of whether there was tax avoidance must be looked at objectively". *Beneficiary v IRC* [1999] STC (SCD) 134 at [143].

63 [2000] STC (SCD) 143 at [9]–[13], 75 TC 477 (Special Commissioners). The dictum of Lord Nolan in *IRC v Willoughby* mentioned above which appears to favour an objective approach is, as *Carvill* demonstrates, inconsistent with a long line of authority and has to be ignored (as in *Carvill*) or explained (as in *Beneficiary*).

64 [2009] STC (SCD) 165.

65 HMRC Discussion Document "Simplifying Unallowable Purpose Tests" (2009) *http://www.hmrc.gov.uk/ria/unallowable-purpose-tests.pdf*.

> The Tribunal must not substitute the test of what the average businessman would do for the test of what was in the mind of the witness at the time of the expenditure. Once the Tribunal accepted Mr Flockton's evidence that the company's only purpose in purchasing the racecourse was to further its business, the question whether Mr Flockton and the other directors ought to have believed that the purchase and running of the horse would be for the company's benefit became irrelevant.[66]

Para 10050 of the draft guidance is worth setting out in full:

> **10050 Avoidance - what is purpose?: effects do not determine purpose**
>
> There is a clear difference between the purpose of a transaction and its effects. The effects are the advantages or benefits actually obtained (whether intended or not); these benefits can often be computed mathematically and can usually be measured objectively.
>
> In *IRC v Brebner* 43 TC 705, Lord Clyde states:
>
> > "The material question is not what was the effect of each or all of the inter-related transactions, the question is what was the main object or objects for which any of them was adopted. Section 28(1) of the Finance Act, 1960 [now s.734 CTA 2010], draws a clear distinction between effect and object."
>
> In the Special Commissioners' decision of *Snell v HMRC* [2008 SpC 699], it was observed that the implications of the case were that:
>
> > "That case is also authority for the proposition that there is a clear distinction between the effect and the object of a transaction. I take that to mean that however directly a transaction leads to a tax advantage the question whether that was one of its objects is not answered by that clarity of effect"
>
> In *Mallalieu v Drummond* [1983 BTC 380] (see BIM 37910) Lord Brightman said:
>
> > "The object of the taxpayer in making the expenditure must be distinguished from the effect of the expenditure."
>
> Thus, merely reviewing the effects of a transaction will not usually enable a conclusion to be drawn as to the taxpayer's purpose.

This is subject to one qualification:

> However, in the *Vodafone* case (see BIM 38220) Millett LJ said that:
> "Some consequences are so inevitably and inextricably involved in the payment that unless merely incidental they must be taken to be a purpose

66 *Ian Flockton Developments v C&E Commrs* [1987] STC 394.

> for which the payment was made."[67]
> So, in some circumstances, the "inevitable consequences" of a payment do allow the inference to be drawn that a particular purpose existed, even if that was only an unconscious motive of the taxpayer.

32.11 Identifying and classifying purpose: The New Conditions

Old Conditions A and B refer simply (?) to the purpose for which the transactions were effected or designed. New Condition A is that:

> *it would not be reasonable to draw the conclusion, from all the circumstances of the case*, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

New Condition B is that:

> *it would not be reasonable to draw the conclusion, from all the circumstances of the case*, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.

The new words are italicised. What difference do they make? Perhaps we should look first to see what HMRC said they intended to achieve:

> 59. The new section 741A ICTA [New Conditions A and B] aims to ensure that all relevant factors are taken into account in deciding whether exemption is due. That is the normal way of applying any purpose test, but in relation to section 741 [Old Conditions A and B] the view is sometimes expressed by tax practitioners that the present test should be interpreted more narrowly. They contend that
> [1] it is only necessary to look at the subjective intentions of the individual, and
> [2] that no account need be taken of any other circumstances, even if they included for example the fact that a particular transaction might have been structured in such a way that it directly resulted in a significant tax reduction that was not on the face of it intended by Parliament.

There are two distinct "contentions" here. The first is correct. The second cannot be taken seriously: see 32.10.1 (Identify purpose of transferor: stage 1).

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67 *Vodafone Cellular v Shaw* 69 TC 376

> 60. HMRC has consistently taken the view that such a narrow interpretation of section 741 is not a correct reading of the law. If such an interpretation is accepted, the purpose of the transfer of assets abroad legislation to prevent individuals avoiding income tax in the way defined [*sic*] in sections 739 and 740 could not be properly achieved. The new test makes it the condition for exemption that the individual must broadly show that it would not be reasonable to conclude from all the circumstances of the case that any of the transactions had a tax avoidance purpose. The wording of the test is intended to put it beyond doubt that exemption will not be due solely on the basis of an assertion by individuals that tax avoidance was not their subjective intention. Evidence of individuals' subjective intention will be one factor to take into account. However, all other relevant circumstances of the particular case must also be considered, including the actual objective outcome of the transactions.[68]

These paragraphs are somewhat muddled. I think it is making the point made at 32.10.1 (Identify purpose: stage 1). All relevant circumstances must be taken into account in order to identify an individual's purpose. A particularly significant fact is whether the transaction resulted in a significant tax reduction, that is, the actual objective outcome of the transactions.

I have wondered whether the drafter's aim here is something different: to replace the subjective purpose test (which clearly applies to the Old Conditions) with an objective results test. However this is inconsistent with what the EN actually said. First, the current (subjective) test is not the view "sometimes expressed by tax practitioners": it is the view of the two most distinguished Special Commissioners of the day and firmly grounded in the law. Moreover, if it were the intention to substitute a subjective purpose test with an objective results test, then "evidence of individuals' subjective intention" should cease to be "one factor to take into account". It will be completely irrelevant. However, the one thing that is clear is that the passage is unclear. It is wrong to try to construe a muddled explanatory note in order to understand a statutory provision. We do not wish to move to the position, sometimes said to apply in the USA, that "if the legislative history is unclear, you read the words of the statute".

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68 EN Draft Clauses (2005). The point is made more briefly in EN FB 2006 para 66.

Turning, as we must, to the legislation itself, we find that the test still depends on the purpose of the transactions. It is reasonably clear that:
(1) this means the purpose of those who carried out the transactions, and
(2) purpose means subjective purpose.
What the new legislation stresses (if only for the avoidance of doubt) is that all the circumstances of the case must be taken into account in order to ascertain the subjective purpose.

Had the drafter sought to replace a purpose test with an objective results test, then they would have used quite different wording, and, indeed, a precedent existed in s.33(3) FA 1944 and s.32(3) FA 1951.

This view is confirmed in the HMRC discussion paper "Simplifying Unallowable Purpose Tests" (2009) p.18:

> An alternative test to a "main purpose" test would be to assess whether "it is reasonable to assume that the main, or one of the main purposes is unallowable". In this way, purpose can be assessed objectively and the test can potentially penetrate purported subjective purposes which do not stand up to objective scrutiny. The potential impact of such drafting is currently being examined. In the future, such an approach may be recommended if the outcome of internal consideration and external comment is positive.

The outcome was not positive, and the response document provided:

> There was widespread opposition to any use of a 'reasonable to believe' test in respect of any purpose threshold.
> The proposed framework will therefore recommend that policy owners do not use a 'reasonable to believe' test.[69]

32.12 Transfer made for tax and non-tax purposes

32.12.1 *Condition A*

Condition A depends on whether the purpose of avoiding liability to taxation was the purpose *or one of the purposes* for which the transfer or associated operations were effected.

If one of these purposes is tax avoidance, the transfer fails condition A. It does not matter what the other purposes are.[70]

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69 HMRC Discussion Response Document "Simplifying Unallowable Purpose Tests (2009), p.7.

70 This is plain from the terms of the statute but if authority is needed, see *Philippi v IRC* 47 TC 75 at p.110.

32.12.2 *Old Condition B*

Old Condition B contains two requirements; both must be satisfied. The first is that the transfer and any associated operations were commercial transactions. Secondly that the transfer and associated operations were not designed for the purpose of avoiding liability to taxation.

What happens if a commercial transaction has two or more purposes? HMRC say in RI 201:

> The Revenue's view is that one of the essential conditions of s 741(b) ICTA would not be satisfied where there was a significant element of tax avoidance purpose in the design of the transfer and any associated operations.

This paraphrase is rather[71] too generous to HMRC. The Special Commissioner stated:

> One must ask in para (b) whether the transfer was designed for the purpose of avoiding tax or not. This seems to me to require that the main purpose was not tax avoidance because if one has to categorise a transaction as being either designed for the purpose of tax avoidance or not, when it is clearly accepted that a transaction may be designed for more than one purpose, the only way to categorise the design into one purpose is to look at the main purpose of the design. I think, therefore, that the taxpayer's contention of sole purpose is too loose a test and the Revenue's contention of significant purpose is too stringent a test although it will in practice be difficult to determine the difference between a significant and a main purpose.[72]

The point of Condition B is that (if one passes the "commercial" requirement) the "no tax avoidance" requirement is easier to satisfy. Otherwise there is no reason to have two Conditions.

32.12.3 *New Condition B*

The wording has changed in New Condition B. The test is now whether:

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71 Depending to an extent what nuance one gives to the malleable word "significant".

72 *Carvill v IRC* [2000] STC (SCD) 143 at [89], 75 TC 477. The same Special Commissioner cited and followed this passage in *4Cast v Mitchell* [2005] STC (SCD) 280 at [12].

> any one or more of those transactions was *more than incidentally* designed for the purpose of avoiding liability to taxation.

This brings the law into line with RI 201.[73] At first I thought (like the Special Commissioner) the difference is relatively slight. But (depending what nuance is given to the malleable word "incidentally") the change does make a difference. Since a merely incidental motive is not likely to amount to a "purpose" at all, a claim which fails Condition A will rarely (if ever) qualify under Condition B. For this reason (and because the "commercial" requirement in New Condition B is so narrow) New Condition B is dead letter law.

32.12.4 *Condition B: Commentary*

Why did Parliament not simply repeal Condition B, rather than amend it out of existence in a way which needs pages to analyse and discuss? Perhaps the full extent of what was done was not realised. Perhaps it was, but it was thought that repeal would raise fiercer objections. However that may be, the rational course would either be to repeal Condition B completely and gain the benefit of simplicity or to return to old Condition B, which had a role to play in aiding commercial life and the economy.

32.13 Foresight and purpose

32.13.1 *Terminology*

In ordinary English usage, and in general legal usage, the words "object", "purpose" and "intention" are used synonymously and interchangeably. (The word "motive" often has a slightly different nuance, but there is no need to pursue that here.)

Sometimes an attempt is made to desynonymise the terms, in order to find labels for some distinction. However none of these attempts have found general acceptance. So although distinctions in meaning may be proposed, or agreed, there is no agreed terminology to express them. Nothing has changed since Lord Simon commented in 1975:

> A principal difficulty in this branch of the law is the chaotic terminology, whether in judgments, academic writings or statutes. Will, volition, motive, purpose, object, view, intention, intent, specific intent

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73 I take "more than incidental" in New Condition B to have the same meaning as "significant" in RI 201.

> or intention, wish, desire; necessity, coercion, compulsion, duress – such terms, which do indeed overlap in certain contexts, seem frequently to be used interchangeably, without definition ....[74]

It seems to me that this should not cause too much difficulty - indeed in the absence of substantial law reform we have no choice but to cope with it - provided that one remembers that these terms are occasionally given narrower and more precise meanings, but those meanings should not be regarded as generally applicable.

For instance, clause 14(1) of the draft Offences Against the Person Bill[75] defines intention in a way which illustrates one possible meaning of the word "purpose":

> A person acts *intentionally* with respect to a result if—
> (a) it is his *purpose* to cause it, or
> (b) although it is not his purpose to cause it, he knows that it would occur in the ordinary course of events if he were to succeed in his purpose of causing some other result.

This draws out an important distinction, but it is unfortunate that the terminology used to express is "intention" and "purpose".[76] In this sense, purpose is narrower. If a person has the purpose of causing another result, but knows the tax saving would occur if they succeed in their purpose of causing the other result, they have the *intention* to obtain the tax saving but not the *purpose*.

However the word "purpose" is not usually understood this way:

> The word [purpose] can be used to designate either
> [1] the main object which a man wants or hopes to achieve by the contemplated act, or ...
> [2] those objects which he knows will probably be achieved by the act, whether he wants them or not.
> I am satisfied that in the criminal law ... its ordinary sense is the *latter* one.[77]

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74 *DPP v Lynch* [1975] AC 653 at p.688.

75 A Home Office consultation paper, 1998, never implemented.

76 Bentham's terminology was direct and oblique intention: *The Principles of Morals & Legislation*, Chapter VIII (Of Intentionality). See Kaveny's excellent "Inferring Intention from Foresight" 120 LQR 81 and Bratman, "Intention, Plans & Practical Reason", (1987), Chapter 10 (Intention and expected side effects). See Avery Jones "The mental element in anti-avoidance legislation" [1983] BTR 22.

77 *Chandler v DPP* [1964] AC 763 at p.804, emphasis added.

Here the same distinction is drawn, but the words "purpose" and "object" are used to express it.

Generally, however, "object" and "purpose" are regarded as the same. HMRC rightly say:

> For example, Romer LJ in the *Bentleys Stokes* case[78] uses the words 'object', 'motive' and 'purpose' quite indiscriminately... there is no difference between purpose and object.[79]

The significance of this is that cases on the transactions in securities purpose test can be and often are cited as relevant to the ToA motive defence. The ToA motive defence refers to purpose and the TiS motive defence refers to object, but that makes no difference. A more significant difference is that the TiS motive defence refers to the *main* object; the ToA motive defence refers to purpose and not to the *main* purpose. But although there is perhaps a difference in nuance, I do not think that makes a great deal of difference.[80] In the HMRC view it makes no difference at all:

> Whether a purpose is more than incidental, and if so whether it is a main purpose, will be a question of fact for the Tribunal to decide. In HMRC's view, any purpose which is more than incidental is prima facie a main purpose.[81]

32.13.2 *"Purpose" in the motive defence*

In RI 201 HMRC say:

> "Purpose" is taken to be the end it is sought to achieve by the transaction.[82]

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78 *Bentleys, Stokes and Lowless v Beeson* 33 TC 491.

79 HMRC Discussion Document "Simplifying Unallowable Purpose Tests" (2009) , para 10040 *http://www.hmrc.gov.uk/ria/unallowable-purpose-tests.pdf*.

80 This was presumably the view adopted in *Willoughby* in the Court of Appeal where *Brebner* , a TiS case, was cited in a case on the ToA motive defence Condition.

81 HMRC Discussion Document "Simplifying Unallowable Purpose Tests" (2009) para 10140 *http://www.hmrc.gov.uk/ria/unallowable-purpose-tests.pdf*.

82 This is based on *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] AC 450 at p.465. Note by the way how use of the passive voice ("it is sought to achieve") ducks the issue of whose purpose one is looking for. See George Orwell's essay, "Politics and the English Language" accessible *http://orwell.ru/library/essays/politics/english/e_polit*.

This adopts (I think) the narrower concept of purpose and it is suggested that this is correct. Purpose in the motive defence is what a person wants or hopes to achieve (not merely foresight). In practice, the issue arises in Condition A cases.[83]

the ToA draft guidance provides:

> **INTM602960 Avoidance purpose exemption: Purposes**
> ...Over the years there has been long debate about exactly how a test of purpose should be construed, in particular whether the test is an objective or a subjective one. Purpose is that which an individual is seeking to achieve or the end the individual intends to reach. It must be distinguished from motive which focuses on why an individual does something (see Lord Denning in *Newton v Commissioners of Taxation of the Commonwealth of Australia* [1958] AC 450).
> HMRC take the view that the proper way to apply a purpose test is to consider all of the facts in an objective manner, but that is not the same as saying the test is 'objective'. It is clearly wrong to assert that it is only necessary to look at the purpose individuals ascribe to their actions in deciding whether exemption is due; but it is equally wrong to say that only the outcome is relevant. It is essential to consider both. Thus, purpose or intention is essentially a subjective concept, but in practice the objective facts must be examined to draw an inference: see Pennycuick J in *Lloyd's Bank v Marcan* [1973] 2 All ER 359 at 367-8: The word 'intent' denotes a state of mind. A person's intention is a question of fact. Intent may be proved by direct evidence or may be inferred from surrounding circumstances. Intent may also be imputed on the basis that a person must be presumed to intend the natural consequences of his or her act: see Hatherley LC and Giffard LJ in *Freeman v Pope*.
> This approach is borne out by the construction of the new exemption test, referring as it does to all the circumstances of the case in considering purposes including the intentions and purposes of any person who designs, effects, or provides advice in relation to the relevant transactions or any of them.
> Although the words within the current provisions may be new, 'purposes' is not new. And, as was said when the newly worded purpose

83 The issue should not arise in a Condition B case (commercial transactions). In a situation where one wanted the commercial transaction, and merely had foresight that a tax saving would follow, even if the tax saving was regarded as *a* purpose (as in the wide *Chandler* sense of purpose) it would not be the main (or significant) purpose.

test was introduced, its aim was to 'clarify' the law. In other words the new language aimed to better reflect or make clearer the existing understanding and approach to the test.

32.14 Consequence and purpose

A consequence of a transaction is not necessarily its purpose. This was stated in a "celebrated"[84] passage in *IRC v Brebner*:

> [1] My Lords, I would only conclude my speech by saying, when the question of carrying out a genuine commercial transaction, as this was, is reviewed, the fact that there are two ways of carrying it out - one by paying the maximum amount of tax, the other by paying no, or much less, tax - it would be quite wrong, as a *necessary* consequence, to draw the inference that, in adopting the latter course, one of the main objects is, for the purposes of the section, avoidance of tax.
> [2] No commercial man in his senses is going to carry out a commercial transaction except upon the footing of paying the smallest amount of tax that he can.
> [3] The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners [now the first-tier tribunal] to decide upon a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence.[85]

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84 *IRC v Willoughby* [1995] STC at [167], 74 TC at [89].

85 *IRC v Brebner*; emphasis original but paragraph numbers added. There are minor stylistic differences between the law reports [1967] 2 AC 18 at p.30, and 43 TC 705 at p.718. I here set out the AC version which is more authoritative and more correct (in particular, using the word *speech* rather than *judgment* in the first line).
Another way to read this passage in *Brebner* is to see it as an early recognition of an avoidance/mitigation distinction but that would be anachronistic because the distinction was not then made. It would also be wrong because that distinction is irrelevant in the transactions in securities code. This is stated in *Marwood Homes v IRC* [1999] STC (SCD) 44 at [20]:
"Taking steps to obtain relief under s 242 following payment of a dividend outside a group election is clearly within the spirit of the ACT code in the tax legislation. But the fact that a transaction has been carried out to achieve a benefit conferred by a statutory provision will not of itself exclude the application of s 703 [transactions in securities rules]. This follows from the definition of tax advantage in [what is now s.732 CTA 2010] which covers both everyday tax planning and transactions, such as traditional dividend stripping, which fall more obviously within the mischief that s 703 was introduced to counteract. The only safeguards available to the taxpayer are the clearance procedures and the escape clause. It cannot therefore avail

The point being made here is not (or not just) that mere foresight of a tax advantage does not entail a tax avoidance purpose.[86] Lord Upjohn goes further in point [3]: he states that where there is a "commercial transaction", *a conscious choice* of the tax advantageous course over an alternative does not "necessarily" entail that tax is the main purpose or even one of the purposes of the transaction.

At what point does a conscious choice of a tax advantageous course become a tax avoidance purpose in its own right in addition to the commercial purpose? Lord Upjohn does not give an answer to this: to say at [3] that it is a question of fact for the Commissioners, if true, is not exactly helpful.

It is suggested that a useful approach may be to ask: does the tax advantage form an incidental or subsidiary consequence of achieving the commercial transaction (as opposed to being an end in its own right)? If so, there is no tax avoidance purpose. This is an evaluative test which is perhaps easier to state than to apply, but it may sometimes be helpful. It overlaps with an avoidance/mitigation distinction, since an advantage which is judged to be incidental or ancillary to a commercial or family transaction is less likely to be contrary to the intention of Parliament: it is more likely to constitute mitigation than avoidance.

I suggest the point made in *Brebner* is really this: where one of the reasons for a transaction is a commercial (non-tax) reason, one should be slow to conclude that another purpose is tax avoidance than in the case of a purely tax motivated transaction. This reflects the reasonable assumption that a purely tax motivated transaction is more likely to be contrary to the intention of Parliament and a commercial transaction is less likely to be. I refer to this as the *Brebner* principle.

The *Brebner* principle applies not only to commercial transactions, but also to any transaction carried out for primarily non-tax reasons including "ordinary family dealing", which would include most trust transfers, at

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Marwood to rest its case on the simple proposition that the dividends ... were directly within the spirit of s 242."

This does follow from a natural reading of the definition of "tax advantage" now in s.732 CTA 2010 (the income tax equivalent has changed). This term includes a relief from or repayment of tax, as well as the avoidance or reduction of a charge to tax. The concept thus includes both tax avoidance and mitigation.

86 The point made at 32.13 (Foresight and purpose) and 32.14 (Consequence and purpose).

least those where the settlor is excluded.[87] In practice, this issue arises in motive defence Condition A cases.[88] It is considered that the *Brebner* principle continues to apply to New Conditions A and B. It is true that the terms of New Condition B (that incidental purposes are to be disregarded) suggest that incidental purposes in New Condition A are *not* to be disregarded. But the *Brebner* principle is identifying matters that are not "purposes" at all.

32.14.1 *A choice principle?*

The *Brebner* dictum is sometimes regarded as supporting a "choice principle":

> Choosing between two alternatives – if one is carrying out a commercial or a family or an investment transaction, choosing the most tax-efficient – is not avoidance.[89]

But this formulation goes too far: if a UK settlor creates a trust for their family – a family transaction – they have to choose between UK and foreign trustees; but the choice of foreign trustees by the UK settlor is avoidance.[90]

One can accept a choice principle if it is combined with the concept of the intention of Parliament, ie if the settlor makes choices within the intention of Parliament, there is no tax avoidance; this is equivalent or very similar to the concept of "special tax regime".[91]

In an earlier edition I suggested a distinction between:

(1) a tax saving which arises because the transfer *is made* (ie it would not arise if the transfer had not been made)[92]; and

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87 *Mangin v IRC* [1971] AC 739 at p.751 and p.756, restating the *Brebner* principle in the context of an extremely free reading of a New Zealand provision.

88 Because in a commercial transaction, incidental tax avoidance purposes are in any event disregarded.

89 Baker "Tax avoidance, tax mitigation and tax evasion", accessible *http://www.taxbar.com*.

90 It seems that the choice principle has been abandoned in Australia, as a "false dichotomy": see Myers "Tax avoidance and the High Court since Sir Garfield Barwick" accessible *http://www.law.unimelb.edu.au/files/dmfile/Myers1.pdf*.

91 See 32.16.2 (Special tax regime).

92 Such as the saving of the settlor's own tax liabilities arising from the transfer; see 32.22.1 (No avoidance of settlor's tax liabilities).

(2) a tax saving which arises because the transfer is made *in one particular way* (ie it would not arise if the transfer were made in some other way).[93]

This does not work, because classifying a transfer in category (1) or (2) is an arbitrary or evaluative exercise.

32.15 Purpose: Advisors and agents of transferor

In a case where a transferor is acting by attorney, the purpose of the attorney should, on normal agency principles, be attributed to the transferor.

In the case where:

(1) a company makes a transfer, and

(2) there is no quasi transferor,[94]

usual company law principles must be applied to attribute to the company the purpose of the individuals acting on its behalf.

If a person relies wholly on advisors (eg parents, professionals) and executes documents without more than a vague idea of approving proposals put to them and not properly understood, they have adopted the purpose of their advisors or (which comes to the same thing) the purpose of their advisors is to be attributed to them. In *IRC v Pratt*, a transferor (who had transferred £80k to a Bahamian company) "did not understand the scheme: it was masterminded by his own professional advisors". Nevertheless, "he, *through his advisors*, was fully acquainted with the fact that what was to follow was a tax avoidance scheme, he must fall fairly within the section".[95]

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93 Such as the saving of the beneficiaries' tax liabilities on a transfer to foreign trustees (which would not arise on a transfer to UK trustees).

94 In such a case of course there would be no *individual* "transferor" who is within s.720: see 29.3.2 (Transfer procured by individual). The purpose of the company which makes the transfer is still relevant for the application of the motive defence to s.731 ITA.

95 57 TC 1 at pp.47, 49. The same point is made in *Burns v HMRC* [2009] STC (SCD) 165 at [20] and [39]: "The purpose for which the two girls effected the transactions was simply to do what their parents suggested, and it seems appropriate to me to proceed on the basis that the two girls effectively sought to achieve those purposes that influenced their parents."

The same principle applies for the transactions in securities rules; see *Addy v IRC* 51 TC 71 at p.81g. Likewise for the definition of "settlor": see 80.28 (Purpose of advisors and agents of settlor). In *Federal Commissioner of Taxation v Consolidated Press Holdings* (2001) 207 CLR 235 the High Court of Australia said it was "both

For the purposes of New Conditions A and B, s.737 ITA provides:

> (5) In determining the purposes for which the relevant transactions or any of them were effected, the intentions and purposes of any person within subsection (6) are to be taken into account.
> (6) A person is within this subsection if, whether or not for consideration, the person—
> (a) designs or effects, or
> (b) provides advice in relation to,
> the relevant transactions or any of them.

This only restates the law applicable to the Old Conditions A and B; it makes no difference to the position.

The significance of taking tax advice is discussed in *Ebsworth v HMRC* [2009] UKFTT 199 (TC):

> 13. Much was made, particularly in cross-examination, of certain of the notes made by Mr. Ebsworth's tax advisers. For the reasons discussed below I did not find them particularly illuminating in reaching my decision as they were what one would expect from a tax adviser engaged to advise on tax rather than as a commercial or other adviser. Taking tax advice does not of itself make tax avoidance one of the main objects of the transactions concerned....
> 62. The fact that Mr. Ebsworth sought tax advice (with Mrs. Ebsworth) does not of itself mean that tax avoidance was a main object of the transactions. [The paragraph then cites Lord Upjohn in *Brebner*].

The GAAR guidance makes the same point:

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possible and appropriate to attribute the purpose of a professional advisor to the taxpayer". I stress this because the opposite view was taken in *Philippi v IRC* 47 TC 75 where the Court of Appeal said at p.114:

"Young Mr. Philippi ... said that he never had any idea of tax in his mind when he made that transfer. It was true that it was saving him a great deal in UK tax ... but that had not occurred to him; the only reason why he had made the transfer was because his father and other members of the family had told him that he ought to do so. He appears to have had no idea why they gave him that advice. The Commissioners accepted ... his evidence that what he had done he did on his father's advice."

Assuming that this implausible story is true (though "young Mr Philippi" was aged 23 at the time of the transfer) the Court should have held that he had adopted the (tax avoidance) purpose of his father. The point was not argued and *Philippi* should not be followed on this issue.

> C3.7 It is important to note that the fact that tax advice has been obtained is not, of itself, an indication that the obtaining of a tax advantage is a main benefit[96] of the arrangement. Where large sums are involved many taxpayers will routinely seek professional advice, including tax advice.[97]

The ToA draft guidance provides:

> **INTM602960 Avoidance purpose exemption: Purposes**
> ... If any professional advice obtained in a particular case is treated as a relevant factor and the individual states that they had no intention to avoid tax, it is reasonable to see whether the advice they acted on is consistent with that contention. If the individual proceeds in accordance with advice obtained (or simply instructs the agent to proceed), the purpose of the adviser would on normal principles be attributed to the individual, whether they understood the implications of the advice or not. For example, if evidence emerged that an individual's adviser or agent had devised a particular structure or recommended or arranged the creation or use of a particular non-resident entity for the purpose of saving United Kingdom tax, that purpose should be taken into account in determining, from all the circumstances of the case, the purposes for which the transactions were effected. That is the case whether or not the adviser had expressly informed the client of the purposes behind the transactions. It would be sufficient for example if evidence emerged from third parties or from the agent's working papers.

32.16 Avoidance/mitigation distinction

This section sets out the most important judicial and other statements on the avoidance/mitigation distinction, which is at the core of the concept of "tax avoidance".

I would first of all note a widespread misconception. It is the misconception that the term "tax avoidance" has a single, relatively clear-cut referent; that subject perhaps to some borderline cases, to classify a transaction as tax avoidance is as straightforward and unproblematic as to identify the colour of a dye. This may relate to a wider misconception about the nature of language, namely the mistake that the meaning of

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96 This is a loose paraphrase of the relevant statutory test, which is whether obtaining a tax advantage was the main purpose, or one of the main purposes, of the arrangements: s.207(1) FA 2013.

97 HMRC, "GAAR Guidance" (Approved by the Advisory Panel, April 2013) *http://www.hmrc.gov.uk/avoidance/gaar-part-abc.pdf*.

words is given by the existence of things in the world to which they correspond, so that, with any contested term, one can always find a core referent and establish what the word really means.

32.16.1 *Intention of Parliament*

IRC v Willoughby is now the authoritative general statement on the subject:

> Tax avoidance within the meaning of section 741 ICTA is a course of action designed to conflict with or defeat the evident intention of Parliament.[98]

The Tax Law Review Committee used a similar definition of "avoidance":

> We have regarded tax avoidance as action taken to reduce or defer tax liabilities in ways that Parliament plainly did not intend or could not possibly have intended had the matter been put to it.[99]

HMRC have also adopted this approach:

> Tax avoidance is any action taken to obtain a tax advantage in a way that Parliament did not intend or would not have intended had the matter been put before it. This definition is based upon the report on tax avoidance produced by the Tax Law Review Committee in 1997.[100]

There have been some attempts to be more specific.

32.16.2 *Special tax regime*

Morritt LJ said:

> The genuine application of the taxpayer's money in the acquisition of a species of property for which Parliament has *determined a special tax regime* does not amount to tax avoidance merely on the ground that the taxpayer might have chosen a different application which would have subjected him to less favourable tax treatment.
> (*IRC v Willoughby* [1995] STC at 183, emphasis added)

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98 70 TC 57 at p.117.

99 Tax avoidance: A Report by the Tax Law Review Committee (1997) para 1.13, citing *IRC v Willoughby*.

100 IR152 Trusts: An Introduction (withdrawn on 30/09/04) accessible *webarchive.nationalarchives.gov.uk/20070402085841/hmrc.gov.uk/pdfs/ir152.htm*. HMRC have altered the nuance by deleting the words "plainly" and "possibly" from the TLRC formulation, but that does not alter its essential nature.

This repeats the test of the intention of Parliament (what Parliament has "determined" is, I think, the same as what Parliament has intended). It brings the added refinement of identifying the "special tax regime" which Parliament intended to apply. Professor Willoughby's offshore bonds seem a reasonably clear[101] example of a "species of property for which Parliament had determined a special tax regime".

This approach can be generalised into all occasions where Parliament has determined a "special tax regime" (regardless of whether there is any particular "species of property" involved):

> The adoption of a course of action which avoids[102] tax should not fall within section 99 if the legislation, upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way.[103]

The existence of a special relieving regime is neither a necessary nor a sufficient condition of tax mitigation. It is only a factor to consider. There is no relieving provision for bed and breakfast transactions, which are accepted as mitigation.[104] Conversely, as the Special Commissioner rightly said in *Carvill v IRC*:

> It is not enough to say that if you find a relieving provision then it is the evident intention of Parliament that the taxpayer should be entitled to use it whatever the circumstances. As *Furniss v Dawson* [1984] AC 474 shows it is quite possible to mis-use a relieving provision. To give an example in the same area as this case, suppose the Appellant had formed [the non-resident company] solely to give him a non-resident employer in order to obtain the foreign emoluments deduction. If that company had been funded entirely by the UK companies and had done nothing other than employ the Appellant, it might be the case that the Appellant would have been avoiding tax because he was misusing a relieving provision. ... the taxpayer must do more than point to the existence of a relieving provision; he must be using, rather than misusing, the relieving provision in a way consistent with Parliament's evident intention.[105]

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101 It might be argued that Parliament had intended the chargeable events regime for normal bonds but not for personal portfolio bonds.

102 Lord Hoffmann has here used "avoid" in the loose etymological sense (to include mitigation). Section 99 provided that an arrangement was void as against the Commissioner for Income Tax if its purpose or effect was "tax avoidance".

103 *O'Neil v IRC* [2001] STC 742.

104 See 32.16.4 (Other indicia of tax avoidance).

105 [2000] STC (SCD) 1543 at [91].

32.16.3 *Economic consequences*

Lord Nolan said in *Willoughby*:

> The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the *economic consequences* that Parliament *intended* to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the *economic consequences* that Parliament *intended* to be suffered by those taking advantage of the option.[106]

This repeats the test of the intention of Parliament with the added refinement of identifying "economic consequences". This is based on two Templeman judgments:

> The material distinction in the present case is between tax mitigation and tax avoidance ... Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income ...Income tax is avoided ... when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.[107]

The non-recourse loan in *Ensign Tankers* is an example of a transaction without economic consequences and in *Challenge* Lord Templeman gave another example which will be particularly relevant to the practical examples considered below:

> When a taxpayer makes a settlement, he deprives himself of the capital which is a source of income and thereby reduces his income. If the settlement is irrevocable and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The

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106 70 TC 57 at p.116 (emphasis added).

107 *IRC v Challenge* [1986] STC 548 cited in *Ensign Tankers v Stokes* [1992] STC at p.240. Lord Millett (whose decision in the High Court was reversed in *Ensign Tankers*) took the opportunity in *Collector of Stamp Revenue v Arrowtown Assets* [2003] HKCFA 46 accessible *http://www.ird.gov.hk/eng/pdf/facv4_2003.pdf* to cast doubt on the correctness of *Ensign Tankers*, but that does not affect the point here.

> tax advantage results from the reduction of income.[108]

These are transactions with obvious economic consequences.

Professor Willoughby's investment in his bond had some "economic consequences" as compared to a direct investment in the underlying assets though one might have thought they were not very substantial.[109]

The GAAR also uses an "economic" criteria. Section 207(4) FA 2013 provides:

> Each of the following is an example of something which might indicate that tax arrangements are abusive—
>
> (a) the arrangements result in an amount of income, profits or gains for tax purposes that is significantly less than the amount for economic purposes,
>
> (b) the arrangements result in deductions or losses of an amount for tax purposes that is significantly greater than the amount for economic purposes...

Incidentally, one wonders what economists would think of the terms "economic consequences" and "economic purposes". Lawyers are not economists, and there is some risk in what John Kay derides as "DIY economics".[110]

32.16.4 *Other indicia of tax avoidance*

It is suggested that "economic consequences" and "special tax regime" are categories of tax saving steps which do accord with the intention of

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108 *IRC v Challenge* [1986] STC at p.554–555.

109 Lord Nolan identified the following economic consequence:
"The reality in truth is that the bond holder has a contractual right to the benefits promised by the policy, no more and no less. It is therefore quite wrong to describe the bond holder as having, in the words of the Appellants' printed case 'in substance all the advantages of direct personal ownership without the tax disadvantages'. The significance of this misdescription would become all too apparent if—perish the thought—Royal Life were to become insolvent and unable to meet its obligations to the bond holders."
Before 2008 I described this as unconvincing, as the insolvency of Royal Life seemed so remote a possibility as to be discounted. But the 2008 recession showed that Lord Nolan was right.

110 See Kay, *The Truth About Markets* (2003). "Economic consequences" is, I suggest, a form *v* substance distinction under a more appealing name. This is a classification and not a criticism. There is nothing necessarily wrong with a form *v* substance distinction if it is recognised for what it is.

Parliament but are not an exhaustive categorisation of mitigation. They should be regarded as indicia or "badges" of mitigation (like the badges of trade). One can think of others. The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations are interesting series of attempts to identify indicia of tax avoidance for the purposes of disclosure obligations. The fact that the regulations (originally made 2004) were amended in 2006, 2009, 2010 and 2013 shows that the exercise was not an easy one. The indicia in the Regulations include:

(1) confidentiality from other promoters; and

(2) premium fees (typically linked to tax savings).

The OECD also identified secrecy[111] as a common characteristic of avoidance:

> Secrecy may also be a feature of modern avoidance. In some cases tax advisers sell ready-made avoidance devices, one term of the contract of sale being that the taxpayer keeps the facts secret for as long as possible. It is in the interest of the avoiders to keep the administration from learning about new schemes because official and public knowledge may be followed by legislation to counter that kind of avoidance.[112]

Neither secrecy nor premium fees are normally associated with the commonplace transactions discussed below. But if, exceptionally, that was the case then it would be a factor suggesting that the transaction should be characterised as tax avoidance.

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111 There are different types of secrecy:

(1) Secrecy (better described as confidentiality) against other tax advisers (the scheme vendor wishing to keep the profits of a scheme to himself).

(2) Secrecy against HMRC (as the OECD envisage) in order to postpone the time when HMRC are informed for as long as lawfully possible.

(3) Secrecy against HMRC in order to avoid or frustrate any investigation. Of course dishonest breach of a duty of disclosure marks a point where avoidance becomes evasion.

Concealment in category (3) is not primarily characteristic of tax avoidance schemes. It is a problem which may affect all aspects of tax collection (whether or not involving avoidance). The Keith Committee recognised this: Enforcement Powers of Revenue Departments (1983) Cmnd 8822 para 7.3.5. By contrast, lawful concealment in category (1) and (especially) category (2) is an indicia of tax avoidance.

112 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD International Tax Avoidance and Evasion (1987), p.17.

32.16.5 *Established practice*

An important indicia is familiarity and use. Once a tax avoidance arrangement becomes common, it is almost always stopped by new legislation within a few years. If something commonly done is contrary to the intention of Parliament, it is only to be expected that Parliament will stop it. So that which is commonly done and not stopped is not likely to be contrary to the intention of Parliament. It follows that tax reduction arrangements which have been carried on for a long time are unlikely to constitute tax avoidance.

There are arguments against this view.

(1) It may seem strange that an act might be stigmatised as tax avoidance if challenged by HMRC or Parliament promptly after it is first done; but if such acts become the general practice over a period of time then the intention of Parliament is decided differently.

(2) Common practice may not be easily identified, It may be quickly forgotten (especially given a swift turnaround of HMRC staff).[113] Whether it is recorded may be a matter of chance.

Nevertheless, the better view is to have close regard to this factor. Judges have a strong intuitive sense that that which everyone does, and has long done, should not be stigmatised with the pejorative term of "avoidance". This, I suggest, is the true reason why the courts classify bed-and-breakfast transactions and back-to-back loans as mitigation and not tax avoidance.[114] An example in this category is a transfer to an offshore company to avoid IHT, a standard practice since the inception of CTT.

This is consistent with the approach of the GAAR. Section 207(5) FA 2013 provides:

> The fact that tax arrangements accord with established practice, and HMRC had, at the time the arrangements were entered into, indicated its acceptance of that practice, is an example of something which might indicate that the arrangements are not abusive.

Professor Sandford drew another categorisation of tax savings which offers a related indicia of avoidance. He refers to:

(1) Tax savings offered by government to induce a certain kind of

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113 For an example, see 22.16.9 (Dual contract rules: commentary).

114 *Ensign Tankers (Leasing) v Stokes* 64 TC 617 at 739. Back-to-back loans have been accepted by HMRC for decades: International Tax Handbook, para 1201.

behaviour or to fulfill what it feels to be an obligation.

(2) Methods of saving that a government dislikes, but allows to remain for administrative reasons.

(3) Tax savings deriving from technical loopholes unforeseen at the time of drafting.[115]

Category (1) is obviously mitigation and category (3) is obviously avoidance. It is suggested that category (2) should be classified as mitigation rather than avoidance. An example is a transfer of a land-owning company (instead of its land) to reduce the rate of stamp duty from land rates (in short, 7%) to share rates (0.5%). The Government considered imposing stamp duty at land rates on shares in land-owning companies to prevent this, but decided not to proceed with the idea.[116] ATED is said to be aimed at these transactions, but is restricted to residential property. Transfers involving other property should be considered mitigation rather than avoidance. This category is particularly important to the practical examples considered below. An example is the use of offshore companies to hold UK assets to save IHT (even though the suggestion to impose IHT on such companies did not reach the level of formal discussion).

32.16.6 *Relationship between tax avoidance and tax abuse*

Section 207(2) FA 2013 provides the statutory definition of tax abuse, for the purpose of the GAAR:

> Tax arrangements are "abusive" if they ... cannot reasonably be regarded as a reasonable course of action...

32.17 Failed indicia of tax avoidance

32.17.1 *Spirit of the statute*

Other approaches in distinguishing tax avoidance and tax mitigation are to seek to identify "the spirit of the statute" or "misusing" a provision. I take this to mean exactly the same as the "evident intention of Parliament" properly understood. If that is right, the expression adds nothing but rhetoric and confusion. If it means anything vaguer or more intuitive than

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115 *Tax Avoision* (1979, IEA) p.81.

116 Modernising Stamp Duty (HMRC, Consultative Document 2002) para 2.34. Contrast Australia where the transfer of shares in "land-rich" companies is subject to stamp duty at the rates applicable to land.

that, then the concept deserves the ridicule expressed in *Norglen v Reeds Rains Prudential*.[117] Either way, the expression is best avoided in this context (and indeed in any context).

32.17.2 *"Artificial" transactions and devices*

Another approach is to seek to identify "artificial" transactions. This raises a number of difficulties.

First, while tax avoidance frequently involves transactions that can be described as "artificial", this is not always the case. You can have tax avoidance without much (if any) artificiality[118] and, of course, artificiality without tax avoidance. That in itself would not be a fatal objection if we are merely seeking badges of avoidance and not a test which will work every time.

However, the unlawyerlike term "artificial" is too vague to be useful even as a badge of tax avoidance. The 1955 Royal Commission on the Taxation of Profits and Income commented on s.44 F(No. 2)A 1915 ("A person shall not, for the purpose of avoiding payment of excess profits duty, enter into any fictitious or artificial transaction ..."):

> A transaction is not well described as "artificial" if it has valid legal consequences, unless some standard can be set up to establish what is "natural" for the same purpose. Such standards are not readily discernible.[119]

The Royal Commission is right. The problem is not that the word "artificial" is meaningless. But it can only be used where there are standards of what is non-artificial (or "natural" or "normal").

For a striking illustration, see the comment of a MP opposing the proposal in the Married Women's Property Bill 1868, that a married woman should own property, as creating:

> an *artificial* and an unnatural equality between men and women.[120]

The Courts have recognised this:

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117 "It is not that the statute has a penumbral spirit which strikes down devices or strategies designed to avoid its terms or exploit its loopholes. There is no need for such spooky jurisprudence." [1999] 2 AC 1 at p.14.

118 eg an appointment of non-resident trustees or a transfer to a non-resident company.

119 Cmd. 9474 para 1024.

120 Cited in Holford, "Victorian Wives and Property" in Vicinus, *A Widening Sphere* (1980). The proposal did not become law until 1882.

> 'Artificial' is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsmen of the subsection is pleonastic, that is, a mere synonym for 'fictitious'. A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. 'Artificial' as descriptive of a transaction is, in their Lordships' view a word of wider import.

No further definition was attempted:

> Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as 'artificial' within the ordinary meaning of that word.[121]

In *Commissioner of Taxpayer Audit and Assessment v Cigarette Company of Jamaica* the Privy Council cited this and continued:

> 22. ... a transaction is an abstract construct. Every transaction is in a sense artificial in that it is put together by two or more parties in order to create or alter legal rights and obligations as between them. While mindful of Lord Diplock's warning against too much judicial exegesis the Board consider that in this context a transaction is "artificial" if it has, as compared with normal transactions of an ostensibly similar type, features that are abnormal and appear to be part of a plan. They are the sort of features of which a well-informed bystander might say, "This simply would not happen in the real world." Recognising a transaction as artificial in this sense is an evaluative exercise calling for legal experience and judgment. It is certainly not an ordinary question of primary fact....
> 23. A transaction is not artificial merely because it is not commercial, or not fully commercial. Income tax affects transactions by way of

121 *Seramco Superannuation Fund Trustees v IT Commissioner* [1977] AC 287.

> bounty as well as commercial transactions. But if a transaction effected in a commercial context is attacked as uncommercial that may be a reason for looking at it closely. To repeat what Lord Diplock said in the passage quoted above, it is necessary to examine the particular transaction and the circumstances in which it was made and carried out.[122]

A distribution of profits to a shareholder by interest-free loan (rather than dividend) was held not to be artificial. I think one could have written an equally convincing judgment in favour of the opposite view (which had been upheld by the court at first instance.) The word "artificial" is of no use in marginal cases because there are no clear standards. It is of no use in determining whether any of the practical examples considered below are tax avoidance.

In practice the word "artificial" is often used to describe a transaction carried out for tax avoidance purposes. A transaction is not categorised as tax avoidance because it is artificial: it is described as artificial because it is tax avoidance. For instance:

> such elaborate arrangements would not have been entered into other than for the purpose of tax avoidance. The arrangements had no genuine commercial purpose. ... The arrangements can, therefore, correctly be described as artificial.[123]

The same objection applies to that particular obstacle to clear thinking, the term "device".[124]

32.17.3 *"Genuine"*

The word "genuine" is used in three distinct senses.

(1) It is used to describe a transaction which is not a sham (in the strict legal sense of the term). For instance:

> It was thought that if the steps were genuine, ie. not sham or simulated documents or arrangements, the court was not entitled to go behind the form of the individual transactions.[125]

(2) "Genuine" is often used to describe the antithesis to a tax avoidance

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122 [2012] STC 1045, [22]-[23].

123 *R (oao Huitson) v HMRC* [2010] STC 715 at [11].

124 *Norglen v Reeds Rains Prudential* [1999] 2 AC 1 at 13: "I do not think that it promotes clarity of thought to use terms like stratagem or device."

125 *McGuckian v IRC* 69 TC 1 at p.78.

transaction. For instance:

> Genuine commercial transactions (i.e. those where gaining or obtaining a tax advantage was not a main purpose, or one of the main purposes) ...[126]

A transaction is not categorised as tax avoidance because it is non-genuine: it is described as non-genuine because it is tax avoidance.

(3) "Genuine" in expressions such as "genuine commercial transaction". The word here reflects the drafter's sense of a risk that (because of the vagueness of the word *commercial*) a transaction which is not actually commercial may wrongly be presented as if it was. The word might be regarded a slight intensifier (a term applied to round Anglo-Saxon expletives as well as words such as *very*) but it seems to me that is no difference between "commercial transaction" and "genuine commercial transaction" even as a matter of indefinable nuance. The word is (more or less) otiose. In this context the older expression *"bona fide* commercial", and the new expression "*real* commercial (reason)" have the same connotation.

In none of these senses is the word or concept "genuine" of any assistance in drawing the line between what is and is not tax avoidance. In this respect it is like the word "real" which requires serious unpacking: see App 3 (What do we mean by "real"?)

32.18 Intention of Parliament v intention of Government

I suggest two broad approaches to "tax avoidance" can usefully be distinguished:

(1) "Tax avoidance" as politicians, civil servants (and perhaps most non-tax lawyers) use the term. This means a tax reduction arrangement which is contrary to the intention or wish of the *Government of the day* (ministers or civil servants, primarily HMRC). For a revealing example of this usage see the National Audit Office Report (Countering VAT Avoidance, 1992):

> Avoidance involves complex issues and the position is constantly changing. A policy change in the UK, or a ruling from the European

126 HMRC Consultation Document, *Simplifying Transactions in Securities Legislation* (July 2009) para 3.3. For another example see 32.25 (UK settlor and UK beneficiaries).

> Commission or European Court of Justice, can easily result in today's unacceptable avoidance becoming tomorrow's acceptable tax mitigation, and vice versa.

This is "tax avoidance" for the purposes of politics and administration.[127] For example, accumulation & maintenance trusts[128] which between 1974 and 2006 were a paradigm example of mitigation, suddenly became tax avoidance in the political vocabulary of the Blair Government when it imposed new IHT charges in 2006.

Similarly when lobbyists (particularly those in favour of higher taxation) use the term tax avoidance to mean any tax behaviour of which they disapprove, often including behaviour which neither government nor HMRC regard as objectionable.

(2) "Tax avoidance" in the sense used by tax lawyers. This means a tax reduction arrangement which is contrary to the intention of *Parliament*. The view of the Government or HMRC should not come into it.

This lawyer's concept of "tax avoidance" is better in law because it is consistent with the rule of law: the rule of law requires that tax liabilities are to be determined by settled rules derived from statute and other sources of law, and not by the opinion or decision of a civil servant or politician. This concept is also less volatile. It is right, indeed necessary, for it to be so. If the meaning of "tax avoidance" were "constantly changing" as a result of a mere "policy change in the UK or ruling from the European Commission" then the concept is unworkable for tax.

My distinction was openly accepted in the former ITH:

> **103. Avoidance in international context**
> *Within the Revenue we do not categorise avoidance in quite the narrow way that the Courts have done.* Of course we make a distinction between mitigation and avoidance. However, if a taxpayer takes advantage of the law to get a tax advantage which is not, *in our understanding*, within the spirit of the legislation, we tend to look on

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127 A purist may say this usage is incorrect or debased; that takes us to the debate as to whether or not there is such a thing as "correct" English usage (where different groups use English differently) and how one determines it if there is. But the purist cannot stop the word being used in this political sense.

128 These trusts qualified for IHT relief under s.71 IHTA 1984.

> that as avoidance.[129]

The avoidance/mitigation distinction is not self-explanatory, it is not a given. It is a construct defined and determined by reference to values and attitudes of the tax culture in which we live. The difference between the approaches (1) and (2) is partly: *whose* values and tax culture does one apply, and: *to what materials* does one refer to ascertain these values?

The taxation of PETs offers an example. In 1973, C.T. Sandford wrote:

> At present gifts made more than seven years prior to death pay no tax (with the possible exception of capital gains tax). ... Is there evidence that such gifts are contrary to the intention of Parliament? Both circumstantial evidence and logic point to this conclusion. Thus if Parliament were indifferent to the making of gifts prior to death, would there have been successive increases in the gifts *inter vivos* period, which, since 1894, has risen in four successive stages from one to the present seven years?

Sandford considered and dismissed some policy arguments in favour of an estate duty and concluded:

> A reasonable interpretation would be that the gifts *inter vivos* provision was intended to prevent as many gifts as possible from circumventing estate duty.[130]

The repeal of CTT and return to an estate duty under the name of Inheritance Tax shows that lifetime giving since 1986 cannot now be regarded as "tax avoidance". I suggest that even in 1973 lifetime giving was not "avoidance" of estate duty (in the strict sense). If Parliament intended to tax all lifetime gifts it would *not* have increased the lifetime gift period to seven years. It is obvious that such an increase would not stop tax-free lifetime giving. Parliament would certainly not have enacted a taper relief under which gifts made more than four years before death pay a reduced rate! How then did Professor Sandford reach the wrong conclusion? Perhaps because he wished to advocate the imposition of a capital transfer tax. When one wishes to support a tax reform, the temptation to describe the old law as permitting "avoidance" is irresistible (as a tool of advocacy) and also has a certain underlying logic. There is

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129 Emphasis added.

130 IFS, *Hidden Costs of Taxation*, 1973, p. 113.

tax avoidance in a political if not a lawyer's sense. If some future Government abolishes PETs, and returns to some form of CTT, it seems safe to predict that those supporting the reform will castigate lifetime giving as tax avoidance.

One point to note is that a comment from the Government (or any proponent of a tax reform) that existing law permits "avoidance" needs special scrutiny because it is easy to conflate the intention of Parliament (tax avoidance in the strict sense) with the intention of Government (or of the proponent), which I would call tax avoidance in a political sense.

Understood strictly, the term "tax avoidance" is still vague but not, I think, hopelessly so, as, for instance, the currently popular phrase "the right amount of tax".

32.19 How to ascertain "the evident intention of Parliament"?

This is the problem at the heart of the concept of "tax avoidance". If this term means an action contrary to the intention of Parliament, one must identify that intention. C.T. Sandford addressed the problem:

> But here we meet the major difficulty. ... As individuals we may feel certain that a particular action is contrary to the intention of the law; but the *objective* interpretation of that intention can only be found in the words the law uses.[131]

Sandford was right. The issue is statutory interpretation and the principles of statutory interpretation should be applied. The intention of Parliament should be decided primarily from the words of the statutes. Other material may be relevant on the usual principles of statutory interpretation: White and Green Papers, Royal Commission Reports, Hansard on *Pepper v Hart* principles, textbooks and the occasional learned article.

Lord Nolan refers to the *evident* intention of Parliament. Unless there *is* an "evident" intention, there is no tax avoidance. This qualification does not remove a penumbra of uncertainty, but perhaps it helps to reduce it.

32.19.1 *Two levels of intention*

It has been said that a concept of "tax avoidance" based on what is contrary to "the intention of Parliament" is not coherent. The object of statutory construction is always said to be to find "the intention of

131 IFS, *Hidden Costs of Taxation*, 1973, p.114 (emphasis in original).

Parliament".[132] A successful tax avoidance scheme, even as blatant a scheme as *Fitzwilliam v IRC*[133] or *Mayes v HMRC*[134] is a scheme where a Court has concluded that the intention of Parliament was not to impose a tax charge in the circumstances which the tax avoiders had placed themselves. A.A. Shenfield made this point:

> What is meant by the intentions of the law and in what sense does avoidance circumvent them? Courts of law in our system seek to find the intention of a law in the words it uses. In this sense the avoider does not circumvent its intentions but abides by them.[135]

The answer is that the expression "intention of Parliament" is being used in two senses. It is perfectly consistent to say that the *Fitzwilliam* scheme:
(1) escapes IHT (there being no provision to impose an IHT charge); and yet
(2) constitutes the avoidance of IHT.
One is seeking the intention of Parliament at a higher, more generalised level. A statute may fail to impose a tax charge, leaving a gap that even a court cannot fill even by purposive construction, but nevertheless one can conclude that there would have been a tax charge had the point been considered. An example is the notorious case of *Ayrshire Employers Mutual Insurance Association v IRC* 27 TC 331 where the House of Lords held that Parliament had "missed fire".[136] A.A. Shenfield

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132 See *Cross on Statutory Interpretation*, Oxford University Press (3rd ed., 1995), Chapter 2.

133 67 TC 614.

134 [2011] STC 1269.

135 A.A. Shenfield, *The Political Economy of Tax Avoidance*, Institute of Economic Affairs, Occasional Paper 24, 1968, pp.20–21. Lord Hoffmann made the same point in "Tax Avoidance" [2005] BTR 197 at p.206: "tax avoidance in the sense of transactions successfully structured to avoid a tax which Parliament intended to impose should be a contradiction in terms. The only way in which Parliament can express an intention to impose a tax is by a statute which means that such a tax is to be imposed."

136 It might be objected that this case is wrongly decided by modern standards of statutory interpretation: "I venture respectfully to suggest that if, as in this case, the Courts can identify the target of Parliamentary legislation their proper function is to see that it is hit: not merely to record that it has been missed"; "The Courts as Legislators", Presidential Address of Sir Kenneth Diplock, The Holdsworth Club, 1965 accessible *http://www.kessler.co.uk/tfd-archive*. However, in *Cooper v Billingham* 74 TC 139 para 35 the Court of Appeal was prepared to say that the same result could happen today (albeit rarely).

recognised this (perhaps grudgingly):

> What the complainant against avoidance means by the intentions of a law is not what may be deduced from what it says, but what parliament intended it to say, or what parliament ought in the complainant's opinion to have intended it to say, or what in his opinion it would have been equitable for it to say. Now I do not say that this can never have substance. We all know that, quite apart from outright errors of draftsmanship, there is a distinction between the letter and the spirit of a law. But the spirit of a law is elusive. It is tempting to believe that one has grasped the spirit of a law when in truth one is moved by prejudice or preconception. We ought to be extremely careful ...[137]

32.20 Reduction, deferral and unsuccessful avoidance

32.20.1 *Reduction*

The motive defence provisions refer to "avoidance" alone but comparable statutory provisions refer to "avoidance *or reduction*" of tax.[138] In this expression it could be that avoidance is used in the strict sense and reduction is referring to mitigation, but that is anachronistic (since the distinction was not known at the time). The word "reduction" was probably added to forestall an argument that the mere reduction of tax was not avoidance as long as some tax remained payable.[139] But nowadays a court would not be so literal and there is no doubt that (for the purposes of the motive defence) a reduction of tax from £10 to £6 amounts to the avoidance of £4.

32.20.2 *Deferral*

Arrangements to defer tax may constitute "avoidance".[140] Indeed the classic avoidance case *Furniss v Dawson* might be characterised as involving mere "deferral" of tax. However, the fact that tax is merely deferred, and will or may later be paid, may be a factor which supports the conclusion that the arrangement is to be characterised as mitigation and

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137 *Ibid*, note 94.

138 The earliest of these was s.35 FA 1941 (Excess Profits Tax); the formula is found in modern provisions: s.773(2)(b) ITA and as part of the more lengthy formula in s.732 CTA 2010.

139 Contrast the statutory expression "mitigate or remit" a penalty.

140 The Special Commissioner so held in *IRC v Willoughby* 70 TC at p.84. There was wisely no appeal on this point.

not avoidance.

32.20.3 *Unsuccessful avoidance*

A purpose may exist independently of its success. HMRC correctly say:

> ... even if the transaction does not achieve its expected result, there may still be a tax avoidance purpose.[141]

The OECD agree:

> Successful tax reduction is neither a sufficient nor a necessary test of tax avoidance. It is not sufficient because this would cover acceptable tax planning [ie mitigation] and it is not necessary because an avoidance scheme designed to reduce tax may not succeed.[142]

32.21 Practical examples: Introduction

We can test these general principles by trying to apply them in some practical cases. There is no test like the test of practice. I first consider transfers to six types of non-resident trust (here called "trust transfers"):

(1) Trusts where settlor is excluded:[143]
   (a) Foreign settlor: UK and foreign beneficiaries;
   (b) Foreign settlor: only UK beneficiaries;
   (c) UK settlor: UK beneficiaries;
   (d) UK settlor: foreign beneficiaries.

("Foreign" here refers to someone not resident or domiciled in the UK and not expecting to become resident or domiciled.)

(2) Trusts where the settlor is a beneficiary:
   (a) Settlor foreign domiciled but UK resident;
   (b) Settlor foreign domiciled and non-UK resident.

This by no means covers all the possible circumstances of trust transfers, but one can extrapolate from these to others which may arise.

It may be helpful to summarise the questions that arise on a trust transfer. One must ask: Is the purpose to avoid (1) income tax? (2) CGT? (3) inheritance tax? It is obviously necessary to consider each tax separately; I will consider CGT and IT first, and then IHT. Thus what seemed like a single issue (is there tax avoidance?) raises 3 sub-issues; that is an

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141 Draft guidance to unallowable purpose tests para 10050.

142 OECD Report by Committee of Fiscal Affairs (1980) cited in OECD's International Tax Avoidance and Evasion (1987), p.17.

143 It is assumed that the spouse of the settlor is also excluded.

inevitable consequence of the rule that taxation includes any tax.[144]

However, a tax charge does not arise in isolation, but is charged in different ways on the settlor, trustees[145] or beneficiaries. It is best to consider these three classes of taxpayer separately, though the issues partly overlap. So in the case of a trust transfer one must ask whether the purpose is avoidance of IT/CGT/IHT liabilities of (1) the settlor; (2) the trustees; (3) the beneficiaries. Thus what seemed like three issues raises nine sub-issues. Further, post-*Willoughby* one must consider whether there is a factual subjective purpose to reduce any of these tax liabilities and then whether the purpose (if present) is to be classified as avoidance or mitigation. So what seemed like a single issue (is the purpose of a trust transfer to avoid taxation?) actually turns out to raise 18 sub-issues (is the purpose to save IT/CGT/IHT by settlor/trustees/beneficiaries and, if so, is it mitigation or avoidance?).

32.22 Trust transfers where settlor excluded

Transfers to a trust from which the settlor is excluded have two common features which are relevant for the motive defence:

32.22.1 *No avoidance of settlor's tax liabilities*

The trust transfer will usually bring a tax advantage to the settlor (compared to the position if there is no transfer). As far as the settlor's tax liabilities are concerned, since she is excluded from the trust, any tax advantage she might obtain in this way is mitigation not avoidance. It is not in principle the intention of Parliament that she should pay tax in respect of income/gains/capital from which she is excluded.[146] However, HMRC rightly say that the purpose of a trust transfer may be to avoid tax liabilities of the trustees and beneficiaries and here closer investigation is needed.

32.22.2 *Non-tax reason for creating trust*

There will usually be non-tax reasons for the settlor to make a trust, rather

144 See 32.9 (Meaning of "taxation" in the motive defence).

145 Although trustees are in economic reality paying tax on behalf of beneficiaries, the rules for taxation of trustees are distinct from the rules for taxation of beneficiaries so it is best to consider trustees separately.

146 See Lord Templeman's dictum in 32.16.3 (Economic consequences). The exceptional case of s.86 TCGA is discussed below.

than making absolute gifts. The advantages are asset protection in the broadest sense: protecting the trust fund from profligate beneficiaries, divorcing spouses, and sometimes forced heirship or foreign exchange control. These are good reasons but not commercial ones. So a trust transfer must pass Condition A, not Condition B, but it does so in the context of a transaction which is not usually wholly tax driven. In the absence of tax considerations the usual form would normally be (and in practice generally is) a discretionary trust.

32.23 Foreign settlor; UK and non-UK beneficiaries

This section considers a transfer to a trust whose beneficiaries include (but are not primarily) UK resident and domiciled beneficiaries, and exclude the settlor.

32.23.1 *Avoidance of trustees' tax*

In deciding whether the trust transfer yields a tax advantage for the trustees, one obviously cannot compare the actual position (appointment of foreign trustees) with the position if the transfer had not taken place. One must compare it with something else the settlor might have done (which in this context must be the appointment of UK trustees). That seems a reasonable comparable; the settlor has a choice: to transfer to trustees in the UK or elsewhere and they must do one or the other. In the absence of UK tax, there will often be no reason to prefer the one to the other.

The choice of UK trustees (rather than foreign trustees) would not in principle yield any greater CGT before 2007/08.[147] There is no question of CGT avoidance for dispositions before the FA 2006.

The position is slightly more complicated for dispositions after 2006. The choice of exclusively UK trustees of a discretionary trust will yield CGT (and income tax on foreign source income) not due from non-resident or mixed resident trustees.[148] However, if one trustee (even a minority trustee) is resident outside the UK, the trustees are not (in short) subject to CGT or income tax on foreign income. Does that mean that the

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147 As long as the UK trustees were professionals: see the 4th edition of this book at 5.8 (Professional trustees treated as non-resident).

148 See 5.4 (Trustee residence for income tax and CGT). The IT position for trustees before 1989 was thought by HMRC to be the same, and was held in *Dawson v IRC* 62 TC 301 to be only slightly (and for present purposes not materially) different.

choice of non-resident trustees is income tax avoidance? It is submitted that the answer is plainly no. Section 475 ITA assists in the appointment of non-resident trustees, suggesting that this cannot be contrary to the intention of Parliament. To hold otherwise would be to suggest that the settlor has a duty to maximise UK income tax and CGT liability. Any tax saving here must be mitigation. It is relevant to note that the reason for the abolition of the rule that professional trustees should be regarded as non-resident was not to prevent avoidance: it was to satisfy a requirement of EU law.[149]

32.23.2 *Avoidance of beneficiaries' income tax liabilities*

In deciding whether the trust transfer yields an income tax advantage for the beneficiaries, one obviously cannot compare the actual position (transfer to trust) with the position if the transfer had not taken place. One must compare it with something else the settlor might have done.

The actual position of UK resident and domiciled beneficiaries is that they will pay tax on income distributions from the trust, but no tax on accumulated income and (in the absence of s.731 ITA) no income tax on capital payments. This is a clear income tax advantage if the transfer to a discretionary trust is compared with a transfer to the beneficiaries or to a transfer to an interest in possession trust.

Is the purpose of the transferor to obtain this advantage? Normally their purpose will be to obtain non-tax advantages, and even foresight of the tax advantage may not constitute purpose, but it depends on the facts.[150]

The actual position of UK resident foreign domiciled beneficiaries is that they will pay tax on remitted income distributions from the trust, and (in the absence of s.731 ITA) no income tax on capital payments even if remitted. This could be an income tax advantage if the transfer to a discretionary trust is compared with a transfer to the beneficiaries or to a transfer to an interest in possession trust, but the advantage may be small or nil.

Is the purpose of the transferor to obtain this advantage? Normally their purpose will be to obtain non-tax advantages, and even foresight of this somewhat attenuated tax advantage will not constitute purpose.

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149 HMRC announcement 23 March 2006.

150 See 32.13 (Foresight and purpose).

32.23.3 *If there is a tax saving purpose is it avoidance or mitigation?*

Returning to the practical example of a transfer to a trust by a foreign settlor, with both UK and foreign beneficiaries. Is the purpose (if it exists) of saving income tax by the beneficiaries to be classified as avoidance? The difference between being a beneficiary of a discretionary trust and owning capital outright is normally[151] a difference with "economic consequences". On an economic consequences test this should be mitigation.

There is another indication that the intention of Parliament is not infringed. If s.731 ITA applies, in this class of case, the result is unfair and sometimes extremely unfair. The UK beneficiaries will pay income tax on capital payments on an amount by reference to relevant income which may greatly exceed their "share" of the income of the trust computed on any just and reasonable basis.

If there is avoidance of UK tax there is likely to be avoidance of tax in every other jurisdiction where beneficiaries are resident;[152] it is impossible for the settlor to make a discretionary trust anywhere without tax avoidance elsewhere – which, if not absurd, is somewhat startling.

32.23.4 *Avoidance of beneficiaries' CGT liabilities*

The CGT position is complicated by tax reforms. Before 1998, capital payments from the trust would be free of tax to the beneficiaries (because the usual charge did not apply to a trust with a foreign domiciled settlor). This was expressly set out in s.87 TCGA.[153] One must take that as a special tax regime intended by Parliament. Pre-1998 transfers cannot be regarded as involving CGT avoidance by the beneficiaries.

After 1998, capital payments to UK domiciled beneficiaries give rise to CGT by reference to trust gains regardless of the domicile of the settlor and in 2008 the charge was extended further. This could be taken to suggest that post-1998 transfers constitute CGT avoidance by the beneficiaries. But the points made in relation to IT avoidance/mitigation apply here too. For dispositions before 2006, s.69(2) TCGA is even stronger than it is now. So the better view is that any CGT saving is

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151 It would be different if the trustees (perhaps guided by a strongly worded letter of wishes) closely follow the wishes of a beneficiary.

152 Assuming they are in a jurisdiction with a tax system comparable to the UK.

153 And in the predecessor legislation: s.17 Capital Gains Tax Act 1979.

mitigation.

32.24 Foreign settlor; only UK beneficiaries

The next case to consider is a transfer to a trust whose beneficiaries are all UK resident and domiciled. A trust transfer primarily motivated by non-tax advantages (asset protection) should not normally be regarded as having the purpose of tax reduction.

In an unusual case, however, that might be one of the settlor's purposes. Indeed, it could be their primary purpose. It can happen be that the settlor creates a trust primarily for a UK beneficiary, and the only reason they do this is tax considerations. Asset protection does not concern every settlor. They would make an absolute gift to a UK beneficiary but for UK tax reasons only they make a transfer to a trust for their benefit. The transfer is solely UK tax driven.[154]

In these (factually unusual) circumstances the question arises whether the tax saving purpose is avoidance or mitigation. Section 69(2) TCGA and s.475 ITA show the intention of Parliament to be that the choice of foreign trustees by a non-resident and non-domiciled settlor should not be regarded as avoidance of trustees' IT or CGT. These sections apply regardless of the residence and domicile of the beneficiaries. The inference should probably be carried across that there is likewise mitigation not avoidance of beneficiaries' IT and CGT liabilities; but the point is arguable.

32.25 UK settlor and UK beneficiaries

Contrast now a settlor who is UK resident and domiciled, making provision for UK beneficiaries. Assume the settlor is not to be a beneficiary. Again, they will often prefer a trust to outright gifts, for non-tax reasons, and the choice is UK or non-resident trustees. If they choose the latter, their purpose (or one of their purposes) is likely to be to reduce CGT or Income Tax and this purpose will be tax avoidance rather than mitigation. This is not an invitation to partake in a statutory regime; we all know that this income tax saving is what s.731 is intended to stop.

The distinction is therefore between:

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154 This might be made evidentially clear by contemporary correspondence, or if, perhaps, the settlor's gift to a UK child is settled and their gift to other children outside the UK is absolute; but such details only go to identify the settlor's purpose, and are not otherwise significant for tax.

(1) foreign settlors (whose offshore trusts are not in principle regarded as tax avoidance), and
(2) UK settlors (whose offshore trusts are in principle regarded as tax avoidance).

This distinction is clearly drawn in the 1974 Green Paper on Wealth Tax:

> **Overseas trusts**
> 22. Trusts where the trustees are not resident in the UK and the administration of the trust is ordinarily carried on outside this country fall into two broad categories.
> **"Genuine" overseas trusts**
> 23. The first category includes all those trusts set up with non-resident trustees by settlors who have little or no connection with this country. *In such a case even if there are one or more beneficiaries or discretionary objects resident in this country there are no grounds on which it would be right to bring the trustees or the whole of the trust assets within the charge to the tax.* But a UK resident individual with an interest in such a trust, whether in possession or reversion, has a realisable asset which should be included in his personal wealth at its actuarial value. If such a trust is discretionary however its objects generally have no interests in the trust assets on which they should be assessed.
> **"Artificial" overseas trusts**
> 24. The second category includes those trusts where a *UK settlor* arranges for the trustees to be non-resident or where the administration of an existing resident trust passes overseas. The legal ownership of the settled property is thus vested in persons outside UK jurisdiction and *the arrangement is very frequently prompted by tax avoidance considerations*. Accordingly, where settled funds are provided directly or indirectly by a person who at the time the funds were provided was domiciled or ordinarily resident in the UK, the trustees will be liable to the same extent as if the trust had been resident.[155]

While the Paper was addressing the issue of what the Wealth Tax should cover, this passage illustrates very well the general understanding of the concept of tax avoidance in the context of offshore trusts.

Note the terminology of genuine *v.* artificial to describe tax avoidance. The author of the Green Paper had sufficient intellectual rigour to

155 Wealth Tax, Cmnd 5704, 1974 paras 22–4 (emphasis added). The fact that the Wealth Tax proposal was abandoned does not affect the relevance of the passage.

recognise the difficulties in these words and put them in quotation marks accordingly.[156] If only this were done more often!

32.26 UK settlor; foreign beneficiaries

Now consider a UK settlor making a trust (from which they are excluded) for foreign beneficiaries.

What about liabilities of the beneficiaries? Since they are not UK resident, they are largely outside the scope of IT and CGT, so there is no avoidance.

In deciding whether the trust transfer yields a tax advantage for the trustees, one can again compare the actual position (appointment of foreign trustees) with the appointment of UK trustees. UK trustees would pay IT if the trust were discretionary but not (for all practical purposes) if it were interest in possession. Any IT saving must be mitigation. CGT is different: UK trustees will pay the tax, and foreign trustees will not. However, trustees are in economic reality paying tax on behalf of the beneficiaries. Where the beneficiaries are not within the scope of the tax then any tax saving by the trustees must be mitigation. This is consistent with the rule that the anti-avoidance provisions of s.87 TCGA and s.731 ITA will not in principle apply on payments to beneficiaries outside the scope of CGT and IT.

32.27 UK settlor; UK and foreign beneficiaries

Where there is a mixture of UK and non-UK beneficiaries I suggest the starting point is that one would expect the settlor to make their trust here, so a transfer to foreign trustees would be regarded as avoidance. (In such a case there is something to be said in income tax terms for the creation of two separate trusts for two separate classes of beneficiaries, the residents and the non-residents, so one at least qualifies for the motive defence. But CGT considerations point the other way.)

32.28 Transfer to trust; settlor a beneficiary

32.28.1 *Remittance basis taxpayer settlor-beneficiary*

The next case concerns remittance basis taxpayer settlor who transfers assets to a non-resident trust under which they are the principal beneficiary.

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156 See 32.17.2 ("Artificial" transactions and devices); 32.17.3 ("Genuine").

Income tax is not avoided since trust income continues to be taxed on a remittance basis under s.624 ITTOIA. There may be an IT reduction after the death or exclusion of the settlor but it will not (normally) be the purpose (or even one of the purposes) of the settlor to obtain that (normally very long term) advantage, quite apart from the question of whether the advantage is avoidance or mitigation.

There is in principle a CGT advantage that the settlor moves from the remittance basis to the s.87 capital payment remittance basis. To obtain that advantage may well one of the purposes of the trust. If so, is it CGT "avoidance"? It must have been a decision of Parliament *not* to apply s.86 TCGA to a foreign domiciled settlor and the decision was confirmed in 2008 (where a proposal to extend s.86 to foreign domiciled settlors was contained in FD Draft Clauses (January 2008) and dropped in the Finance Bill). It is suggested that there is no CGT "avoidance". This is a "statutory invitation" in plain terms.

32.28.2 *Non-resident non-domiciled settlor-beneficiary*

Where the settlor is the principal beneficiary and neither domiciled nor resident then UK tax saving is not likely to be a purpose during the life of the settlor, because no saving in fact arises. After the death of the settlor there may be a saving if there are UK beneficiaries. The position then becomes like that of a trust where the settlor is excluded, and the discussion above is relevant.

32.29 Appointing non-UK trustees of UK trust: Avoiding IT or CGT?

Similar principles apply. One case is where the settlor and beneficiaries are wholly UK based, the settlor has created a UK trust, and foreign trustees are later appointed. The inference that the appointment has the purpose of saving UK income tax or CGT is very strong and this purpose is avoidance not mitigation.

At the other end of the scale is the case where the settlor and the principal beneficiaries have gone to live abroad permanently and local trustees are appointed. One reason for the export of the trust is that the settlor may (or may continue to be) a trustee. If so, the appointment may have no tax saving purpose at all. But if (as is likely) it has a tax saving purpose, that is mitigation and not avoidance.

What if all the beneficiaries are abroad but the settlor remains in the UK? The same tax savings could in principle be had by winding up the trust with outright appointment to beneficiaries, and that transfer is not likely

to constitute avoidance. So the appointment of foreign trustees should not be avoidance.

What if the settlor goes abroad and the beneficiaries remain in the UK? It is tentatively suggested that a tax saving purpose (if it exists) is likely to be avoidance.

A more borderline case is where the settlor and beneficiaries go to live abroad for a medium term period (say five years[157]). Non-UK resident trustees are appointed with the intention that the trust will continue to be non-resident even after the settlor returns to the UK. This is probably to be classified as tax avoidance, albeit long-term tax avoidance, but views may differ, especially if the time spent abroad is longer than five years.

32.30 When is a trust transfer made for the purpose of avoiding IHT?[158]

32.30.1 *Change of situs without alteration of ownership*

The transfer of money by a foreign domiciled person from a UK bank to a foreign bank in order to make the money excluded property, is an act of tax mitigation, not avoidance. See *Beneficiary v IRC* [1999] STC (SCD) 134 at p.145. The same would apply if the transfer is made by trustees of a trust with a non-domiciled settlor. The same would apply to a sale of UK situate property and re-investment in non-UK situate property.

32.30.2 *Transfer to trustees*

The residence of trustees is almost wholly irrelevant for IHT.

A gift by a settlor to a trust from which they are excluded is mitigation of their own IHT[159] but it is also necessary to consider the IHT savings of trustees and beneficiaries.

If a foreign domiciled settlor gives, and the trustees retain, non-UK property, any IHT saving purpose which may exist is mitigation. This is so even if the beneficiaries are UK domiciled (so an absolute gift to them would have brought the trust property into the scope of IHT). Section 48 IHTA provides that foreign property in a trust made by a foreign domiciliary is excluded property. Any IHT advantage conferred by the

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157 There is no particular significance in selecting five years as illustrative of a medium term period, but it is consistent with the CGT temporary non-residence rules; see 9.1 (Temporary non-residence).

158 For transfers before 27 March 1974 it would be necessary to consider Estate Duty.

159 See 32.22.1 (No avoidance of settlor's tax liabilities).

trust, so far from being contrary to the evident intention of Parliament, would appear to be in accordance with Parliament's evident intention. The argument to the contrary amounts to an argument that the settlor has a duty to maximise IHT liabilities.[160]

A gift by a settlor to a trust from which they are not excluded, in circumstances where the settlor is anticipating becoming UK domiciled, is borderline. Section 48 IHTA makes it plain that such a gift carries substantial IHT advantages. But is it "contrary to the evident intention of Parliament" to enjoy these advantages? The author tentatively suggests that such a gift should be regarded as IHT mitigation not avoidance. This is consistent with the rule that the GWR provision does not apply here.[161]

32.31 Transfer from non-resident trust to underlying company

I use the term**"underlying company"** to mean a company wholly owned by trustees, which holds beneficially what might in substance be regarded as trust assets. The company would not be UK resident.

32.31.1 Is the transfer a commercial transaction?

Transfers to underlying companies arise in a wide variety of circumstances and may be made for the purpose of obtaining non-tax advantages:

(1) Advantages of trust administration:
   (a) Segregation of trust funds of trustee (or occasionally combining trust funds) for ease of management.
   (b) Avoiding conflict of law and other problems of trustees holding assets (especially land) in foreign jurisdictions. (The problem is most serious in civil law jurisdictions which may not understand or even recognise trusts, but problems could also arise in common law jurisdictions.)

(2) In the case of land (or other onerous property), avoiding personal liabilities of trustees arising from direct ownership.

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160 The avoidance/mitigation issue did not arise in connection with the gift to a trust in *Beneficiary v IRC*, because reducing tax was not a purpose in the mind of the transferor/settlor, even though it was a consideration for his advisers, and even though the principal beneficiary was UK resident at the time; see [1999] STC (SCD) 134 at [145h] - [146].

161 See 63.14 (GWR death charge: excluded property rules for settled property).

(3) In the case of interest in possession trusts, to allow retention of income (to avoid distributing income to life tenant).

It is a question of fact in each case whether the purpose of a transfer to a company is to obtain these non-tax advantages and a question of law whether they should be regarded as commercial.

Purpose (1) is commercial: it arises in the ordinary course of managing investments. A transfer from trustees to a company is more often than not a commercial transaction, and for the motive defence one applies Condition B and not Condition A. Purpose (2) is rarer but certainly commercial when it occurs. Purpose (3) is not commercial. Where it is the policy of trustees that all its trust funds should be held in separate underlying companies,[162] the conclusion that the transfer has a commercial purpose seems factually likely. But if one is looking at New Condition B, the additional statutory requirements must be met, in particular, the trustees must carry on a business.

32.31.2 *Is the transfer for tax avoidance?*

Transfer of UK assets[163] from trustees to an underlying company may offer significant tax advantages. It is a question of fact whether any of these advantages are purposes of the transfer and a question of law whether the purpose is avoidance or mitigation.

I begin with a case where s.624 ITTOIA does not apply. There are three possible tax advantages

(1) Obtaining IHT excluded property status (where the settlor was not domiciled in the UK).

This should normally[164] be regarded as mitigation. There is of course no economic difference between owning a UK asset directly (non-excluded property) and holding it via a company (effectively converting it into

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162 The Edwards report suggests that 80–90% of Jersey trusts hold their assets through underlying companies: *Review of Financial Regulation in the Crown Dependencies* Cm 4109 (1998) para 12.5.2 accessible *http://www.archive.official-documents.co.uk/document/cm41/4109/4109-i.htm*. Trusts managed in Switzerland generally use underlying companies for Swiss law reasons.

163 Similar considerations apply to a transfer of foreign assets with a view to realisation and re-investment in UK assets.

164 An exceptional case would be if the property was put in the company shortly before a ten year anniversary and taken out shortly thereafter.

excluded property). But the principle that companies are not transparent for tax purposes is very deep in the tax system. Planning of this kind has been possible since the repeal of the Mortmain Acts (which were enacted to prevent tax avoidance by vesting land in companies) and cannot be regarded as contrary to the intention of Parliament.

The transfer to a company also has a likely CGT disadvantage,[165] and a possible income tax disadvantage,[166] so any tax reduction may be regarded as part of a "package deal", with advantages and disadvantages. This does not savour of tax "avoidance".

The contrary view is taken in *Burns v HMRC*:

> I would certainly accept that if a non-domiciled person arranged to hold foreign situs, rather than UK situs, assets, and then died, no tax advantage would have been sought. Thus if a UK house was sold, and a French house purchased, that would simply be a case of genuinely changing the assets held, and were some [ToA] point to hinge on whether the change was effected for the purpose of avoiding UK tax, the answer would be that it was not. And if UK bank deposits were withdrawn and deposits placed elsewhere, then again, that would be a pure investment switch, and not a step the purpose of which would involve the purpose of achieving a UK tax advantage. Indirectly retaining a UK real property, and simply achieving the technical change in status by putting the property into a non-UK resident company in a case where one of the purposes is to achieve the potential Inheritance Tax advantage, implicit by effecting those steps, does seem to me to cross the border between mitigation and tax avoidance. This is because it has involved no real change of investment, as in the two previous examples, but the retention of the UK property, accompanied by a step to change the normal tax consequences of that. Thus where it is shown that the CTT or IHT considerations were one of the purposes of the transfer, or other where the appellants have not displaced the reasonable presumption that UK advantages were one of the purposes, I conclude that those purposes involve tax avoidance and not merely mitigation.[167]

This is obiter (for on the facts of the case there was clearly income tax avoidance). The Commissioner has confused tax avoidance with tax

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165 See 51.33.4 (Should trustees hold assets through an underlying company?)

166 Loss of tax credits and double taxation relief; sometimes, possible charge under income tax benefit in kind rules.

167 [2009] STC (SCD) 165 at [59].

advantage.

The opposite view was taken on comparable facts in *Mehjoo v Harben Barker*[168] where tax planning involved converting UK registered shares to bearer shares and removing them from the UK, in order to make then non-UK situate. That was described as tax mitigation, not tax avoidance, I think rightly, as any tax advantages is inherent in the scheme of the legislation. The decision to legislate on the point for CGT but not for IHT rather confirms the point.

The relevant cases and materials were not discussed in either of these cases. At some time the point will need to be judicially considered in more depth.

(2) Escaping additional rate income tax (on UK source income of discretionary trust)

The striking thing about this tax is that there is generally[169] no effective method for HMRC to collect it and in practice no one expects it to be paid in cases where all the beneficiaries are outside the UK.[170] Perhaps this supports a conclusion of mitigation.

(3) Escaping higher rate income tax (on income of interest in possession trust).

I suggest that a distinction should be drawn between UK resident life tenants (tax advantage is avoidance) and non-residents (tax advantage is mitigation). In many circumstances, however, non-residents do not pay income tax at the higher rate.

In *Burns v HMRC* [2009] STC (SCD) 165 at [58] the Special Commissioner said:

> I deal first with the feature of trying to cap the level of charge to income tax at the basic rate. This advantage seems to me to be in the category of tax avoidance. ... it seems to me to be difficult to argue that a transaction designed to reduce income tax by the mechanism of the transfer of UK property to a non-resident person (virtually a paraphrase of the opening wording of section 739) is mere mitigation.

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168 [2013] EWHC 1669 (QB) at [447]; the point was not considered on appeal.

169 Except in the case of UK land.

170 It is considered that non-payment is not in principle dishonest, and so not a fraud on HMRC, though this conclusion depends to some extent on the facts of the case.

32.31.3 *Transfer by trust to which s.624 applies*

If the purpose of the transfer to an underlying company is to avoid a charge under s.624 ITTOIA, this is considered to be avoidance and not mitigation.

32.31.4 *Transfer of non-UK assets to underlying company*

When non-UK assets are transferred to an underlying company, the UK tax advantage may be less or nil or there may only be tax disadvantages in the loss of double taxation reliefs. In the absence of an intention to re-invest in the UK the purpose cannot as a matter of fact be a tax reduction purpose.

32.32 Non-resident foreign domiciled individual transfers UK property to offshore company

A foreign domiciled non-UK resident individual who transfers UK assets to a non-resident foreign incorporated company may also enjoy comparable tax advantages:

(1) Obtaining IHT excluded property status.

(2) Avoiding higher rate income tax.

Such transfers also give significant advantages which have nothing to do with tax. In particular, in the case of UK land, avoiding personal liabilities arising from direct ownership. In such cases, the motive defence may well apply. But if a purpose of the transfer is to reduce IHT or IT, it is considered that this is mitigation not avoidance; the arguments are the same as above.

32.33 Transfer by UK resident foreign domiciled individual to offshore company

Suppose a foreign domiciled UK resident individual transfers UK assets to a non-resident foreign incorporated company.

If a purpose was to reduce IHT, the transfer is considered to be IHT mitigation. A transfer to reduce income tax (because the company pays only basic rate income tax) is considered to be IT avoidance.

32.34 Transfer to UK resident foreign incorporated company

There are many reasons why assets may be transferred to UK resident foreign incorporated companies.

A foreign domiciliary starting a new UK resident company for trade or

investment would prefer a non-UK incorporated company so as to own non-UK situate property. This is a commercial transaction and clearly satisfies Old Condition B. New Condition B is (almost) a dead letter,[171] but in an appropriate case there is a reasonable case that New Condition A (or A and B) is satisfied.

A foreign domiciliary (F) wishing to sell a UK unincorporated business may enter into an arrangement under which:

(1) F gives the business to a UK resident foreign incorporated company.
(2) F sells the company (not UK situate property).

If the purpose is to avoid CGT (by utilising s.162 TCGA relief) then the claim for the motive defence is weak.

32.35 Transfer from one trust to another trust

There are many reasons why funds may be transferred between trusts. It is impossible to generalise as to whether such transfers are made for tax avoidance: one must look at the reason for the transfer.

One reason such transfers are made is where a single trust holds several sub-funds for different branches of a family. The transfer avoids the unfairness which arises under a single trust, that gains accruing to one share are taxable on a beneficiary of another share who receives a capital payment. It is considered that a transfer for this reason does not have the motive of CGT "avoidance".

32.36 Time to ascertain purpose of transferor

What matters is the purpose of the transferor at the time of the transfer.[172] It is quite common that a transfer is made by a foreign settlor for foreign beneficiaries, unimpeachably for non-UK tax reasons, and later some of the beneficiaries move to the UK. Then they will find the trust qualifies for the motive defence and is a useful vehicle for income tax purposes. There are three possibilities:

(1) The change of purpose may be accompanied by a new transfer of assets carried out for a tax avoidance purpose. In that case the transfer of asset provisions may apply in relation to the new transfer.
(2) There may be no further transfer of assets but there may be associated operations carried out for a tax avoidance purpose. The question

171 See 32.12.3 (New Condition B).

172 The point was made in *Herdman v IRC* 45 TC 394; but it is plain from the terms of the statute.

whether this brings the transfer of asset rules into operation is discussed in para 32.38 (Associated operations: introduction).

(3) There may be a change of purpose without any new transfer or associated operation. In that case the motive defence remains available and the transfer of assets provisions do not bite at all.

32.37 Time to ascertain intention of Parliament and changes in law

The concept of tax avoidance as an act contrary to the intention of Parliament raises the question of *at what time* Parliament's intention is to be ascertained. The intention of Parliament may change and the same act could be tax avoidance at one time but not at another. Of course, it needs an Act of Parliament to make this change. For the purpose of the motive defence, tax avoidance must mean an act contrary to the intention of Parliament at the time the transfer took place. This is consistent with the rule that one examines the purpose of the transferor at the time of the transfer.[173] Otherwise changes in the intention of Parliament would often have considerable retrospective effect: a transfer which was not tax avoidance when it was made would retrospectively be treated as made for a tax avoidance motive (or indeed vice versa).

Of course this rule may also favour HMRC. A transfer to avoid (say) Selective Employment Tax would fail the motive defence and that would continue to be the case even after the abolition of that tax.

A distribution or disposal made in 2007/08 to avoid the new rules in the FA 2008 from 2008/09 is not tax avoidance because (1) it is not contrary to the intention of parliament to avoid *future* tax laws: the intention of Parliament is to be determined at the date of the transfer;[174] (2) Parliament clearly anticipated and accepted that such disposals and appointments would be made and took no steps to counteract them.

32.37.1 *Transfer by non-resident before 1996*

Parliament decided in 1936 not to apply s.720 ITA to transfers made by non-resident transferors, and that was (after some vacillation) held to be the law.[175] In principle, a transfer of assets by a non-resident between 1936 and 1996 could not be said to be contrary to the intention of

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173 See 32.36 (Time to ascertain purpose of transferor).

174 See 32.37 (Time to ascertain intention of Parliament and changes in law).

175 See 29.9.2 (Transferor not resident when transfer made).

Parliament, and so it could not constitute income tax avoidance.[176] However, the legislation which reversed *Willoughby* and brought transfers by non-residents into the scope of the transfer of asset provisions applies to pre-1996 transfers.[177] The explanation is that a transfer by a non-resident before 1996 does not normally involve income tax avoidance. However, there are special circumstances where a transfer by a non-resident may be for income tax avoidance[178] and, of course, a pre-1996 transfer made for CGT or IHT avoidance would also be caught.

32.37.2 *Transfer before 1981; transferor having no power to enjoy*

Similar considerations apply to a transfer before 1981 to which s.720 ITA did not apply (because the transferor had no power to enjoy the income of the asset transferred). Parliament decided in 1936 not to apply the transfer of asset provisions to transfers unless the transferor had power to enjoy, and that was (again after some vacillation) held to be the law.[179] So such a transfer should not constitute income tax avoidance. In 1981 Parliament brought in s.731 ITA which applied to pre-1981 transfers.[180] The better view is that a transfer outside s.720 made before the 1981 reforms is not to be regarded as income tax avoidance in the absence of special circumstances. A pre-1981 transfer may be within s.731 where it was made for IT avoidance (one example would be where the settlor did have power to enjoy but later died) or where it was made for CGT or IHT avoidance purposes.

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176 Contrast pre-1936 transfers by UK resident individuals; these were caught by the new 1936 legislation, but Parliament had never made a decision that such transfers should not be taxed so it would be correct to regard such transfers as made for tax avoidance purposes.

177 s.81 FA 1997. There is an exemption only for income arising before 1996.

178 Examples of special cases are:

(1) a transfer in anticipation of becoming UK resident or

(2) a transfer made just before the enactment of the new legislation (when the change of the law was predictable).

Another view could be that such transfers constitute tax avoidance from after the 1952 and 1970 consolidations, which Parliament enacted on the basis of the *Congreve* and *Herdman* decisions (later reversed) that transfers by non-residents were caught. But that offends common sense and the principle that a consolidation does not alter the law.

179 See 27.3 (Meaning(s) of "settlor-interested").

180 s.45 FA 1981; there is an exception for income arising before 1981.

32.38 Associated operations: Introduction

The motive defence is relatively straightforward when there is a single transfer. It becomes more complicated if there are also associated operations to consider. It is necessary to consider separately the cases where:

(1) The transfer and associated operations are all made before 5 December 2005 (see the next section).
(2) The transfer and the associated operations are all after 4 December 2005.[181]
(3) The transfer is before 5 December 2005 and the operation is on or after that date.[182]

32.39 Associated operations and motive defence before 5 December 2005

Section 739 ITA provides:

> (1) This section applies if all the relevant transactions are pre-5 December 2005 transactions.
> (2) An individual is not liable for income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs that condition A or B is met.
> (3) Condition A is that the purpose of avoiding liability to taxation was not the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.
> (4) Condition B is that the transfer and any associated operations—
> (a) were genuine commercial transactions, and
> (b) were not designed for the purpose of avoiding liability to taxation.

Old Condition A refers to any "relevant transactions" and Old Condition B refers to "the transfer and any associated operations" (which comes to the same thing).[183] I will use the expression "any associated operations".

The transfer and associated operations in issue must each separately satisfy the motive test if the motive defence is to apply. One does not

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181 See 32.40 (Transfer and associated operations all after 4 December 2005).

182 See 32.44 (Transfer before and operation after 5 December 2005).

183 Because the term "relevant transactions" is defined to mean the transfer and associated operations; see 28.10 (Significance of associated operations). The difference in the wording of old condition A and B is just a quirk of the drafting, there is no difference in meaning.

group the transfer and the associated operations together, and look for a single main purpose of the group.

32.39.1 *Associated operations subject to motive test: Critical operations*

The first task to identify the associated operations to which the motive test must be applied. For pre-2005 transactions (which are not affected by the 2006 reforms) the statute refers to "*any* associated operations" but this is a reference only to associated operations as a result of which a charge arises under s.720 or s.731 ITA. That is, in other words, the associated operations which must be relied on in order to satisfy the conditions set out in those sections. That is, the transfer and operations as a result of which:

(1) (in any case) income accrues to the person abroad; and
(2) (a) (in a s.720 case) the transferor has power to enjoy; or
(b) (in a s.731 case) the individual receives a benefit, or income can be used to benefit them.

I refer to an associated operation which meets these criteria as a "**critical operation**".

There may and generally will be many operations associated with the transfer, but unless they are critical operations they are irrelevant and should be ignored.

In *Herdman v IRC* 45 TC 394:

(1) T transferred shares to an Irish company (the person abroad) in consideration of an issue of new shares and a loan. This was an innocent transfer (the purpose was to avoid Irish tax).
(2) The company accumulated income. This was (arguably) an operation associated with the transfer, and the purpose was (then) regarded as UK tax avoidance.[184]

The motive defence was upheld. Lord Reid said:

> [1] It was admitted by Counsel that [what is now s.720] can only apply if [T] has "by means of" these operations "acquired any rights by virtue of which" he had "power to enjoy" this income during the relevant period. I think that Counsel was clearly right in making this admission.[185]

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184 After *Willoughby* the purpose should be regarded as mitigation and not avoidance.

185 Section 412 ITA 1952 then provided (so far as relevant):
"For the purpose of preventing the avoiding by individuals ordinarily resident in the UK of liability to income tax by means of transfers of assets by virtue or in

> [2] I cannot see how it can be said that [T] acquired any rights at all by means of these associated operations. By means of the transfer of the shares to the new company he acquired two rights. He acquired shares in the new company in the Republic and he became an unsecured creditor of that company for over £76,000. Neither right gave him any right in or to particular assets of the new company. The way in which that company dealt with its assets did not alter either of these rights. It may have made them more valuable and it may have made it easier for the company to pay its debts, but it did not change [T's] rights.[186]

Point [1] states the law (only critical operations need pass the motive test) and point [2] applies it to the facts of the case (the operations in that case were not critical).

The statement of law at [1] needs to be translated to reflect the revised statutory wording, which was recast in 1969, and rewritten in 2007, but the principle (that only critical operations need pass the motive test) survived the 1969 reforms.[187] In fact, perhaps the principle was (slightly) more clearly stated under ITA than it was under ICTA, because of the words in s.739(2): An individual is not liable for income tax under this Chapter ... *by reference to the relevant transactions* if condition A or B is met. It is only the transactions *by reference to which the ToA provisions apply* which need to meet old condition A and B.

In *Carvill v IRC:*[188]

(1) T transferred assets to a Bermudian company (B Ltd) in exchange for its shares, so T was a majority shareholder in B Ltd ("the original transfer").
(2) T became a 100% shareholder in B Ltd by (a) purchasing shares from other shareholders and (b) B Ltd purchasing its own shares.
(3) B Ltd entered into arrangements to remunerate T via a personal

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consequence whereof, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled out of the UK, it is hereby enacted as follows:- (1) Where *such an individual has by means of any such transfer, either alone or in conjunction with associated operations, acquired any rights by virtue of which he has ... power to enjoy* ... any income of a person resident or domiciled out of the UK ... that income shall, ... be deemed to be income of that individual ...."

186 45 TC 394 at p.413.

187 See 32.40.1 (The 1969 reforms).

188 [2000] STC (SCD) 143 at [80]–[85], 75 TC 477 (Special Commissioners).

services company and a brokerage sharing agreement.

Steps (2) and (3) were held not to be associated operations, but if they had been associated operations it would not have mattered as they were not critical operations. No income arose to B Ltd because of the operations and T did not acquire a power to enjoy because of them.[189]

HMRC accept this. RI 201 provides:

> The law was amended in 1969 following a decision of the Courts (in *IRC v Herdman* 45 TC 394) that only the transfer and any associated operations giving a power to enjoy at the outset were relevant for determining whether the terms of [the motive defence] were satisfied. The amendment to the legislation sought to bring all associated operations into consideration when [the motive defence] was invoked. Because of doubts[190] expressed as to the effectiveness of this amendment, it has been the Revenue's practice in considering whether a defence under [the motive defence] is available to *consider only the transfer and any associated operations which directly establish a power to enjoy the income of the overseas person under any particular sub-head in [s 723 ITA]*.

The last sentence goes too far and is not to be taken literally. Suppose:

(1) T transfers assets to a UK trust by an innocent transfer, and
(2) Foreign trustees are appointed (an associated operation)[191] for tax avoidance purposes.

It may be said that the associated operation does not establish a power to enjoy the income of the trust. But the associated operation is a critical one (since it causes income to accrue to the person abroad) so the motive defence does not apply.

Suppose:

(1) T transfers assets to a non-resident company in return for shares in that company ("the first transfer"). Suppose the first transfer is innocent (no tax avoidance purpose). Income accruing to the company is not caught by the ToA provisions as the motive defence applies.

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189 See [81]-[83].

190 The "doubts" were in fact a decision of the Special Commissioners on the point; see 32.40.1 (The 1969 reforms).

191 See 28.11.4 (Transfer to UK trust followed by migration of trust before 6 April 2006) and 28.11.6 (Transfer to company followed by migration of company).

(2) T transfers the shares in that non-resident company to a non-resident trust ("the second transfer"). The second transfer has a tax avoidance purpose.

The second transfer is an operation associated with the first. But that associated operation is not a critical operation. Income accrues to the non-resident company as a result of the first transfer. It does not accrue as a result of the first transfer in conjunction with associated operations.[192]

Take the same transactions, but assume that the first transfer (to the company) had a tax avoidance motive, and the second transfer (to the trust) was innocent. Income of the company is within the ToA provisions. The motive defence does not apply. It is not enough to find an innocent associated operation. Dividends from the company to its shareholders are caught since the income arises by virtue of the tainted transfer to the company and an associated operation (the dividends).

The ToA draft guidance provides:

> **INTM602720 By reference to transactions**
> ...Taking each of the potential charges this can perhaps be summarised as:-
> Income charge – power to enjoy; the transactions to be taken into account are those that result in income becoming payable to a person abroad together with those other associated operations, if different, which result in the individual having the power to enjoy the income.
> Income charge – receipt of/entitlement to capital sums; the transactions to be taken into account are those that result in income becoming payable to a person abroad together with those other associated operations, if different, which result in the individual receiving or being entitled to receive a capital sum.
> Benefits charge - the transactions to be taken into account are those that result in income becoming payable to a person abroad together with those other associated operations, if different, which result in the individual receiving a benefit provided out of assets available for the purpose by reason of such transactions.
> From this it can be seen that in some instances the same transactions

192 Of course income arising to the trustees as a result of the second transfer is caught by the ToA provisions. The fact that the first transfer was innocent does not help. This is self-evident but if authority is needed see the decision of the Special Commissioners in *IRC v McGuckian* [1994] STC 900. There was (wisely) no appeal on that point.

may result in income becoming payable and also give the power to enjoy the income, the entitlement to a capital sum or result in receipt of a benefit. In other instances there may be two sets of transactions one leading to the income that becomes payable, the other to the power to enjoy, entitlement to capital sum or receipt of benefit. Whichever circumstance applies the individual will need to have regard to all of the transactions in showing how the particular test is met.

In examining the actual conditions for exemption at INTM602760 and forward it will be seen that there may also be further associated operations apart from those described above that fall to be taken into account in considering whether particular conditions are met. Where that is the case, then the individual will need to satisfy HMRC in relation to all those transactions.

Although constructed differently the former legislation also took a transactional approach to the avoidance purpose exemption test requiring the individual to show that the conditions were met in relation to the transfer of assets or associated operations or any of them or in relation to the transfer of assets and any associated operations. There is more about this at INTM602760 onwards, which consider the conditions for exemption.

Not every transaction will however necessarily fall to be taken into account. Normally it will only be those that contribute to an outcome that falls within the conditions for a charge, such as those transactions which result in income becoming payable or those which give the power to enjoy income, entitlement to capital sum or receipt of a benefit. For those that are within the provisions the individual will be required to show that the conditions for exemption are met.

The principle that it is only transactions that lead to the particular outcomes which fall to be considered is demonstrated by the 1969 decision of the House of Lords in *Herdman v CIR* (45 TC 394). Although that case was on legislation (ITA 1952) constructed somewhat differently from that in ITA 2007 or ICTA 1988 the broad thrust of the principles demonstrated is the same as the approach set out in the bullets above. In that case the Special Commissioner had found that a transaction which brought about income becoming payable to a person abroad and which gave power to enjoy it satisfied on the evidence available the conditions for exemption. There were however further transactions whose purpose would not have satisfied the test for exemption, but those transactions neither resulted in income becoming payable to a person abroad nor gave the individual any new or additional power to enjoy income. The House of Lords accepted the reasoning of the Court of Appeal in concluding that these additional

transactions did not fall to be taken into account. Lord Chief Justice MacDermott in giving his decision, which was endorsed by the House of Lords, said (at pages 406/407) in commenting on and accepting the exposition given by Counsel for the Appellant:

> "My reasons for this view may be enumerated as follows (i) The conditions which bring subsection (1) [section 412(1) ITA 1952] into force and make the income of the non-resident person chargeable as that of the individual concerned depend upon a true alternative, upon the effect of either (i) the transfer of assets alone or (ii) that transfer in conjunction with associated operations. If (i) applies (ii) does not. (II) If subsection (1) is brought into force by the transfer of assets alone, subsection(3) [the exemption provision] must be applied accordingly and so that the taxpayer will escape from liability under subsection (1) on proving that the purpose of the transfer was not tax avoidance. In such a case any operation which is an "associated operation", in the sense of being within the definition in subsection (4), will fall outside subsection (1) and outside subsection (3) as well".

He went on to expand his reasoning into the facts of the particular case which indicated the extent of the transactions that resulted in income becoming payable and the individual having the power to enjoy that income. No other transactions fell to be considered.

HMRC confirmed the use of this principle in a Tax Bulletin article in 1999 in relation to the 'power to enjoy', saying that, "it has been the Revenue's practice in considering whether a defence under section 741 [ICTA 1988] is available to consider only the transfer and any associated operations which directly establish a power to enjoy the income of the overseas person under any particular sub-head in section 742(2) [ICTA 1988]".

But there are some instances within the specific conditions where a wider approach is required and individuals will need to take this into account in providing the information required about transactions in their tax returns. Specifically, Finance Act 2006 introduced a new provision (section 737(8) ITA 2007), which will be considered further in the detailed conditions, which means that the individual may now have to disclose to HMRC additional associated operations which may not result in outcomes that meet the requirements for a charge. It is important therefore that the individual who is seeking to show that the conditions for exemption are met properly identifies all of the transactions that must be taken into account, and provides the appropriate facts about each.

32.40 Transfer and associated operations all after 4 December 2005

32.40.1 *The 1969 reforms*

To understand the post-2005 regime, it is helpful to go back to 1969, when the first attempt at reform was made. Harold Lever (then Financial Secretary to the Treasury) argued:

> If we are to have a section [720 ITA], it has to bite on all settlements abroad which at any time are used for avoidance of tax even though originally started for innocent purpose. Supposing a man has transferred money to set-up a Bible society in Bulowayo and his heir being more sophisticated and perhaps more materialistic, finds himself with a settlement set up for unimpeachable purposes and decides that it would make a useful vehicle for the avoidance of all income tax and surtax. The *Herdman* decision meant that section [720] would not prevent this. Clause 27 [FB 1969] therefore knocks out the *Herdman* decision and I think that the hon. and learned Gentleman would be fair enough to say that that is reasonable.[193]

The example is facetious (Lever was known for his wit). The common (if less exotic) example is that:
(1) a settlement is set up by a foreign settlor for foreign beneficiaries; and
(2) subsequently beneficiaries come to the UK.
If this was not envisaged at the time of the settlement, even HMRC must concede that condition A was satisfied by the original transfer. Nothing that happened later would alter that defence. So, as Morritt LJ commented (obiter) in *IRC v Willoughby* 70 TC at p.97:

> In the FA 1969, legislation was enacted, s.33, to nullify the [Herdman] decision ... on the point.

However, the Special Commissioners rejected this in an unreported decision.[194] Thus the 1969 Act failed to achieve its intention.

32.40.2 *The 2006 reforms*

HMRC tried again in what I call **"the 2006 reforms"** (because they were introduced in the FA 2006, though with effect from December 2005).

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193 Hansard, 17 July 1969, cols 955–6.

194 If any reader could supply a copy, it would be interesting to see it (although unreported special commissioner decisions cannot be cited as precedents: *Ardmore v HMRC* [2014] UKFTT 453 at [9] - [23].

Section 737(8) ITA provides:

> If—
>
> (a) apart from this subsection, an associated operation would not be taken into account for the purposes of this section, and
>
> (b) the conditions in subsections (2) to (4) [New Conditions A and B] are not met if it is taken into account, because of—
>
> (i) the associated operation, or
>
> (ii) the associated operation taken together with any other relevant transactions,
>
> it must be taken into account for those purposes.

EN Draft Clauses (2005) explained:

> certain associated operations that might potentially be disregarded when applying the [pre-2005 motive defence] have to be taken into account for the purposes of the new test. These are associated operations that have an avoidance purpose, but might not directly affect the application of the charging provisions.[195]

A post-4 December 2005 transfer which qualifies for the motive defence loses that defence if:
(1) there is an associated operation;
(2) that operation does not satisfy New Condition A or B.
Trusts and companies which qualify for the motive defence must ensure that from 5 December 2005 any acts by them meet Condition A (or Condition B if relevant). In short, they should do no act which might be regarded as having a tax avoidance purpose. It is important that new associated operations do meet the New Conditions. The transitional rules are harsh.

These conditions are extremely difficult to apply; this may be why almost 40 years passed before the second attempt to alter law established in 1969. The Blair/Brown administrations, it seems fair to say, were unaware or unconcerned about uncertainty and complexity in tax legislation, particularly anti-avoidance legislation.

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195 Para 62.The explanation in EN FB 2006 is more curtailed. The provision alters the former law. EN Draft Clauses (2005) claimed (outrageously) that this change was "clarifying and confirming the correct interpretation of the existing statute" but that was inconsistent with RI 201 and EN FB 2006 more or less abandoned that position.

32.40.3 *Associated operations subject to motive test: Significant operations*

The first task to identify the associated operations to which the motive test must be applied. For post-2005 transactions the statute refers to "*an* associated operation" and it is clear that some operations which are not critical operations (under the old law) are now made subject to the motive test.

The task is to identify what counts as "an associated operation" for the purposes of s.737(8) ITA. The statutory definition of associated operation does not answer this as if it is read literally it is far too wide to be workable. Suppose in 1096 a Crusader transferred land to trustees to avoid feudal duties, and in 2000 the land is again transferred to trustees. At first sight the 1096 transfer is an operation associated with the 2000 transfer.[196] It cannot be that the Crusader's (arguable)[197] tax avoidance purpose would prevent the transfer in 2000 from qualifying for relief!

There must obviously be some connection between the associated operation and the transfer: the mere fact that they relate to the same property cannot be enough. The position is reminiscent of the definition of "settlement" (the settlement-arrangement definition) which includes any disposition, leaving the Courts to devise their own test for what is caught (in that case, the Courts eventually settling on a "bounty" test).

Here, it is suggested, the test that the Courts ought to impose should be that the transfer and associated operations form part of one arrangement, or are "put in train" by the transferor.[198] I refer to associated operations which meet that requirement as **"significant operations"**. Thus all significant operations must satisfy new conditions A and B, in order to qualify for the motive defence.

In short, in my terminology the effect of the 2006 reforms is to extend the motive test from critical operations to significant operations.

The ToA draft guidance provides:

> **INTM602800 all relevant transactions post-4 December 2005 transactions**

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196 See 28.9 (Associated operation: definition).

197 Feudal duties would be "taxation"; see 32.9 (Meaning of "taxation" in the motive defence). I forbear to consider the question whether the 1096 transfer should be regarded as avoidance or mitigation of feudal duties (and would that depend on attitudes to taxation in the Middle Ages or contemporary attitudes?).

198 See 28.11.1 (Transfer from A to B followed by transfer from B to person abroad).

> ...The new provisions reverse the effect of Herdman (INTM602640) which found that associated operations are in broad terms only taken into account in applying the purpose test if they involve avoidance and create either a new source of income or a new power to enjoy income. The new provision requires all associated operations with an avoidance purpose to be taken into account when applying the exemption test.
> In the past structures such as family trusts were sometimes transformed into avoidance vehicles, with the associated operations carefully designed so that they could not be said to create new income flows or new power to enjoy income. The tax planners contended that HMRC could not apply the legislation against these structures, even though they were as clearly abusive.
> Where a structure meets the requirements for exemption and an associated operation involves only a minor element of avoidance, if the associated operation producing 'tainted' income is only a small proportion of the income of the total structure it may be appropriate to charge only the income from the 'tainted' source, thus applying the legislation in a proportionate way.

32.41 When do associated operations have a tax avoidance purpose?

Note the extreme consequences of an associated operation motivated by tax avoidance. Even if the associated operation concerns only a small amount, the *entire* trust may lose the benefit of the motive defence. This unfairness ought to colour the approach of the courts to construing the section.

32.41.1 *Investment strategy*

Buying and selling investments in the ordinary course of managing investments is not tax avoidance.

Suppose trustees wish to invest in UK equities, but do so via a UK unit trust or OEIC in order to hold property which is excluded property for IHT. The acquisition of a unit trust or OEIC is not tax avoidance. It is considered that the position is the same if the trustees acquire a non-UK unit trust or OEIC to avoid UK source income.

Suppose a trust, all of whose beneficiaries are abroad, wishes to invest in UK land. The trustees invest via an underlying company in order to avoid inheritance tax and the trust rate of income tax on the rent. It is suggested that this is mitigation rather than avoidance. If this is not the case, then the effect on the UK economy could be quite remarkable. It would often be the case that well advised trustees would avoid investing

in UK land in order to retain the motive defence. On the other hand, if the land was purchased using an artificial SDLT avoidance scheme, that would be caught.

32.41.2 *Distribution strategy*

It is considered that retention of income within a company is not an "operation" but even if it is, it would not be tax avoidance. It is considered that accumulation of income in a common form discretionary trust[199] is not an "operation" but even if it is, it would not be tax avoidance.

Suppose a discretionary trust is within the motive defence. A foreign domiciled beneficiary (not the settlor) is UK resident. If the trustees pay capital to that beneficiary instead of distributing income, in order to avoid an IT charge, this is not tax avoidance. If the trustees lend to the beneficiary interest free in order to avoid an income receipt or reduce the amount of a capital payment, this is not tax avoidance. If the loan is at interest, to avoid a capital payment, this is not tax avoidance. An arrangement might be avoidance if trustees lend unsecured to a beneficiary in circumstances where the beneficiary is either insolvent or so lacking in assets that the beneficiary is not in practice ever likely to be able to repay the sum lent.[200]

An arrangement may be avoidance where the trustees accumulate income and then immediately distribute it as capital, in circumstances where the straightforward course would be to distribute as income.[201]

Suppose a discretionary settlor-interested trust is within the motive defence, and the settlor comes to the UK. The trustees retain trust income abroad (if it was remitted to the UK there would be a tax charge under the s.624 remittance basis). This is not tax avoidance.

Suppose a non-resident company owned by a non-resident individual pays a large dividend the year before the individual becomes UK resident. That is not tax avoidance.[202] But if the individual lends the proceeds back

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199 A trust to accumulate income with power to distribute. If there were a trust to distribute with power to accumulate, then accumulation would be an "operation".

200 Alternatively the loan in such a case may in fact be categorised as an outright distribution.

201 Alternatively the distribution may in fact be categorised as income.

202 That will be clearer from 2012/13 when the temporary non-resident rules govern this area.

to the company, that is a circular and artificial transaction, and the loan may be regarded as for a tax avoidance purpose.

32.41.3 *Inter-group transactions*

For company group transactions, it is useful to refer to the "white list" of transactions which HMRC accept as outside para 2(4A) Sch 7 FA 2003[203] (so they qualify for SDLT group relief). Para 23040 SDLT Manual provides:

> **23040. Restrictions on availability Paragraph 2(4A) Schedule 7 FA 2003** [June 2013]
> ... This guidance gives some examples of transactions where it is accepted that group relief is not denied by Para 2(4A) Schedule 7 FA 2003.
> It should be noted that the examples are intended only to give general guidance and do not use technical or statutory language, nor should they be interpreted as if they were a statute.
> They also assume that the transactions described do not form part of any larger scheme or arrangement which might have tax consequences....
> Examples of transactions where group relief is not denied by Para 2(4A) Schedule 7 FA 2003
> (1) The transfer of a property to a group company having in mind the possibility that shares in that company might be sold more than three years after the date of transfer
> (2) The transfer of a property to a group company having in mind the possibility that shares in that company might be sold within three years of the date of transfer, with a consequent claw-back of group relief, in order that any increase in value of the property after the intra-group transfer might be sheltered from SDLT
> (3) The transfer of property to a group company having in mind the possibility that either (1) or (2) might occur
> (4) The transfer of a property to a group company prior to the sale of shares in the transferor company, in order that the property should not pass to the purchaser of the shares

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203 This provides:
Group relief is not available if the transaction—
(a) is not effected for bona fide commercial reasons, or
(b) forms part of arrangements of which the main purpose, or one of the main purposes, is the avoidance of liability to tax.
"Tax" here means stamp duty, income tax, corporation tax, capital gains tax or [SDLT].

(5) The transfer of property to a group company in order that commercially generated* rental income may be matched with commercially generated losses from a Schedule A business
(6) The transfer of property to a group company in order that commercially generated* chargeable gains may be matched with commercially generated allowable losses
(7) The transfer of property to a non-resident group company in the knowledge that future appreciation or depreciation in value will be outside the scope of corporation tax on chargeable gains
(8) Transactions undertaken as part of a normal commercial securitisation
(9) The transfer of the freehold reversion in a property to a group lessee in order to merge the freehold and the lease, and thus prevent the lease being subject to the wasting assets rules as respects corporation tax on chargeable gains
(10) The transfer of property to a group company in order that interest payable on borrowings from a commercial lender on ordinary commercial terms may be set against commercially generated* rental income
(11) Borrowings on ordinary commercial terms
  (a) from a commercial lender, or
  (b) intra-group in circumstances which would have been commercial had they arisen between unconnected third parties

*Including income, gains and losses which are generated intra-group on transactions which would have been commercial had they been entered into by unconnected third parties

"Transfer" means the transfer of a freehold, in Scotland ownership of land, or the assignment, in Scotland assignation, of a lease.

Cases involving the grant of a lease will need to be considered on their facts.

It is difficult to take item (7) seriously, but even apart from that, it is clear that HMRC do not strain to classify ordinary tax planning as avoidance.

32.42 Consequences of tainted operation

Where there is a tainted operation associated with a transfer, all the income arising as a result of the transfer in principle comes within the scope of ss.720 and 731. If there is an innocent transfer of £10m, and a tainted operation of £10,000, all the income of the £10m comes into charge.

Section 741 ITA provides a very limited relief:

(1) Section 742 (partial exemption where later associated operations fail conditions) applies if—

(a) an individual is liable to tax[204] because of section 720 or 727 for a tax year (the "taxable year") because condition B in section 737(4) (genuine commercial transaction: post-4 December 2005 transactions) is not met, and

(b) subsections (2) and (3) apply.

The relief only applies for s.720 (and 727) and not for s.731 ITA. Section 741 continues:

(2) This subsection applies if—

(a) since the relevant transfer there has been at least one tax year for which the individual was not so liable by reference to the relevant transactions effected before the end of the year, and

(b) the individual was not so liable for that year because—

(i) condition B in section 737(4) was met, or

(ii) condition B in section 739(4) (genuine commercial transaction: pre-5 December 2005 transactions) was met.

The relief only applies if Condition B is satisfied; not if Condition A is satisfied. In practice New Condition B is hardly ever satisfied. Section 741 continues:

(3) This subsection applies if the income by reference to which the individual is liable to tax for the taxable year is attributable—

(a) partly to relevant transactions by reference to which one of those conditions was met for the last exempt tax year,[205] and

(b) partly to associated operations not falling within para (a).

Assuming the conditions of s.741 are satisfied one moves on to the relief in s.742:

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204 "Liable to tax" is defined in s.741(5) ITA:

"References in this section to a person being liable to tax for a tax year because of section 720 or 727 include references to the individual being so liable had any income been treated as arising to the individual for that year under section 721 or 728."

205 Defined in s.741(4) ITA:

For the purposes of this section a tax year is exempt if—

(a) it is one of the tax years mentioned in subsection (2), and

(b) there is no earlier tax year for which the individual was liable to tax because of section 720 or 727 by reference to the relevant transactions or any of them.

...

> (1) If this section applies, the individual is liable to tax under this Chapter only in respect of part of the income for which the individual would otherwise be liable.
> (2) That part is so much of the income as appears to an officer of Revenue and Customs to be justly and reasonably attributable to the operations mentioned in section 741(3)(b) in all the circumstances of the case.
> (3) Those circumstances include how far those operations or any of them directly or indirectly affect—
> (a) the nature or amount of any person's income, or
> (b) any person's power to enjoy any income.

The drafter has given up here. Draft ToA guidance INTM602880 has an example, not set out here as it raises more questions than answers.

32.43 Income arising before tainted operation

This section considers how the ToA provisions apply where an innocent post 4-December 2005 transfer is followed by a tainted operation subsequently.

The position where a pre-5 December 2005 transfer is followed by a tainted operation on or after 5 December 2005 raises additional issues discussed at 32.44 (Transfer before and operation after 5 December 2005).

32.43.1 *Income before tainted operation: s.720*

Suppose:
(1) an innocent transfer is made on or after 5 December 2005, and
(2) an associated operation made today fails the New Conditions ("the tainted operation").

At first sight *all* income back to the date of the transfer comes into charge under s.720 ITA.[206] HMRC say in a letter dated 7 April 2006 to the representative bodies that only income of the year in the year of the tainted operation and subsequent years is charged:

> **Transitional arrangements, whether income charged retrospectively**
> Representation: It is suggested that the transitional arrangements of [s.740 ITA] have the effect that income could be brought into charge retrospectively. [Section740(4) ITA] could be interpreted as meaning

206 In practice HMRC would be limited to a four year period.

> that if an associated operation after 5 December 2005 fails the exemption test in [s.737 ITA], all of the income arising from 5 December 2005 could be charged (even where the subsequent associated operation takes place many years later).
> Response: The legislation does not apply retrospectively in the manner suggested. [Section 741C ICTA][207] provides the general rule that section [720] applies in this type of case as it would apply apart from section [736 to 742 ITA]. In those circumstances section [720] would take the income arising in the relevant year of assessment.

This is far from clear in the legislation, but it is a sensible result.

32.43.2 *Income before tainted operation: s.731*

Suppose:
(1) An innocent transfer was made on or after 5 December 2005.
(2) A tainted associated operation is made subsequently.
(3) An individual (not the transferor) receives a benefit in the same year as the associated operation or subsequently.

The individual is taxable under s.731 ITA by reference to all the income which has arisen backdated to the date of the transfer.

Suppose the order of transactions were reversed:
(1) An innocent transfer was made on or after 5 December 2005.
(2) An individual (not the transferor) receives a benefit on or after 5 December 2005.
(3) A tainted associated operation is made in a tax year after the benefit is received.

That is, the benefit was received in the year before the tax motivated associated operation. Is the benefit retrospectively subject to tax? There is no indication either way but it is suggested that the answer is, no. This is consistent with how HMRC understand s.720 to work.

32.44 Transfer before and operation after 5 December 2005

Section 740 ITA provides:

> (1) This section applies if the relevant transactions include both pre-5 December transactions and post-4 December transactions.
> (2) An individual is not liable to tax under this Chapter for the tax year

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207 Now s.740(3) ITA. The wording is not quite the same, but that has not altered the position.

by reference to the relevant transactions if—

(a) the condition in section 737(2) (exemption where all relevant transactions are post-4 December 2005 transactions) is met by reference to the post-4 December 2005 transactions, and

(b) the condition in section 739(2) (exemption where all relevant transactions are pre-5 December 2005 transactions) is met by reference to the pre-5 December transactions.

Thus in principle one applies the New Conditions to post-4 December 2005 transactions and the Old Conditions to pre-5 December 2005 transactions.

An important question is whether the motive defence test must be met:
(1) by all significant associated operations; or
(2) only by critical operations (my terminology).
At first s.737(8) ITA appears to answer the question,[208] but it does not, because s.737(1) provides:

> This section applies if all the relevant transactions are post-4 December transactions.

It is suggested that the *Herdman* principle still applies to pre-5 December 2005 transfers even if the operation takes place subsequently. That is, only critical associated operations have to pass the motive test and other associated operations are ignored.[209] This does not deprive s.740 ITA of meaning, for it now governs the position where there are post-4 December 2005 critical operations. For instance, suppose:
(1) there was a transfer to a UK trust (an innocent transfer) before 5 December 2005;
(2) non-resident trustees are appointed (a critical association operation) post-4 December 2005.
In deciding whether the motive defence applies one asks whether the associated operation satisfies New Conditions A and B.

The position is not clear cut and HMRC could make the following points:
(1) Section 740(2)(b) incorporates s.737(2) the New Conditions A and B,

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208 See 32.40.2 (The 2006 reforms).

209 ICAEW agree: see response to HMRC consultation "Transfer of assets abroad: draft guidance" (October 2013) para 82, 83.
http://www.icaew.com/~/media/Files/Technical/Tax/Tax-faculty/TAXREPs/2013/taxrep-57-13-transfer-of-assets-abroad-draft-guidance.pdf

but by doing so it necessarily incorporates s.737(3) to (7) which supplement s.737(2). So it is possible to say that s.740(2)(b) also incorporates s.737(8).

(2) The transitional rules in s.740, see below, arguably make better sense if s.727(8) is applied. But the rules are so harsh that it is suggested that the taxpayer-favourable construction is to be preferred.

32.44.1 *Transitional rules*

Section 740(3) ITA provides:

> If subsection (2)(b) applies but subsection (2)(a) does not, this Chapter applies with the modifications in subsections (4) to (6).

This brings in three transitional rules where:
(1) the pre-5 December 2005 transactions met the Old Conditions; but
(2) post-4 December 2005 transactions do not meet the New Conditions.
The provision in s.740(4) ITA is not discussed because it was spent even before the ITA took effect; see the 9th edition of this work para 28.44.2.

32.44.2 *Transitional rule: s.731*

Section 740(5) ITA provides a transitional rule for s.731 ITA:

> In determining the relevant income of an earlier tax year for the purposes of section 733(1) (see Step 4),[210] it does not matter whether that year was a year for which the individual was not liable under section 731 because of section 739 or this section.

Suppose:
(1) An innocent transfer was made before 5 December 2005.
(2) A tainted associated operation is made on or after 5 December 2005.
(3) An individual (not the transferor) receives a benefit in the same year as the associated operation or subsequently.[211]
The beneficiary is taxable under s.731 ITA by reference to all the relevant income from the date of the transfer (or from 1981, if later). This harshly retrospective rule was actually intended. EN FB 2006 para 33 provides:

> [The effect of s.740(5) ITA is:] for the purposes of [s.731 ITA] where the individual receives a benefit in a year of assessment ending after 5

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210 See 30.13 (Computation of charge).

211 There is no charge if the benefit is received in a tax year before the operation: see 32.43.2 (Income before tainted operation: s.731).

> December 2005, the process of determining relevant income under the general rule for years up to and including that year must take account of relevant income that arose in years of assessment ending before that date, as well as later years.

It will often be impossible for the quantum of relevant income to be ascertained exactly, as the records will not exist. But the issue may in practice be fudged by agreement with HMRC.

Section 740(6)(7) ITA which deal with this were also spent before ITA took effect; see the 6th edition of this work para 19.48.3.

32.45 Tax return: Disclosure of motive or EU law defence claim[212]

The motive and EU law exemptions do not require a formal claim. If there has been an innocent transfer, a taxpayer is entitled and indeed required to complete tax returns on that basis.[213]

However, if an individual completes a self assessment return, it is necessary to indicate on that return that they have taken advantage of the defence.

In the 2013/14 tax return, notification that the motive defence is in point is given by completing box 46 in the Foreign pages (form SA106). The words next to box 46 state:

> If you have omitted income from boxes 11, 13 and 42 because you are claiming an exemption in relation to a transfer of assets, enter the total amount omitted (and give full details in the 'Any other information' box on your tax return)

This relates to the two reliefs which the ITA describes as exemptions[214]: the motive defence and the EU law defence.

It is only correct to put an entry in the box if the motive defence is needed. It is not correct to put an entry in the box if the ToA provisions do not apply to impose a charge for some other reason, such as the remittance basis, because that is not an "exemption".[215] If there is an entry in the

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212 See also 29.17 (Tax return: Disclosure of s.720 income) and 30.40 (Tax return – disclosure of s.731 income).

213 See 32.48 (Can an individual disclaim the motive or EU law defences?).

214 Section 736(1) ITA provides: "Sections 737 to 742A deal with exemptions from liability under this Chapter."

215 HMRC agree. SA106 Notes (2013/14) provides:
"**If you have omitted income from boxes 11, 13 and 42 because you are claiming an exemption in relation to a transfer of assets, enter the total amount omitted**

box, but the remittance basis provides a full defence, HMRC practice (understandably) is not to investigate or provide a ruling on the exemptions, as nothing turns on the issue. Otherwise the figure to enter in the box is the sum of (1) UK source income of the person abroad, and (2) foreign income which is remitted in the year.

The International Manual provides:

> **600040 - Transfer of assets abroad** [June 2014]
> **Overview of ITA2007/S736 - 742 - exemption from liability**
> ...There is no provision for a "clearance" or other advance ruling on the application of the exemption provisions. Details of the amount considered to be exempt from charge should be entered on the Foreign Pages of the Self Assessment tax return. In the "white spaces" of the return, the individual should enter particulars of transfers and associated operations that would result in a charge absent an exemption, and provide factual details about the transaction explaining the basis for considering a condition for exemption to be met.

There is strictly no obligation to give precise figures or indeed any figures for the income which (assuming the claim is valid) will not be taxable. However, a failure to give figures may lead to further enquiries. If estimated figures are given, this should be stated. On the occasion when the claim is first made, sufficient details should be given for HMRC to review the case. Once a claim is agreed, I see no reason to give any details at all in subsequent tax returns. I suggest the words "n/r" be put in box 46 (or if the tax return software does not permit that, leave it blank) and note in the additional information section that since the claim has been agreed, no figure need be provided in the relevant box as it is

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> The provisions described at boxes 10 to 13 and 42 do not apply if you can show from all the circumstances that none of the purposes of the transfer and any associated operations were to avoid tax. Or alternatively, for transactions occurring on or after 6 April 2012, income attributable to genuine transactions is exempt where any liability imposed would constitute a restriction on the EU Treaty freedoms. For example, of freedom of establishment or freedom of movement of capital. But an exemption is only due if actual income would otherwise be chargeable. If you omit income for this reason from boxes 11, 13 and 42, you must enter the total amount of income you have omitted in box 46. You must also provide relevant details and an explanation in the 'Any other information' box of your tax return, or on a separate schedule, including details of the assets transferred and any associated operations, the person abroad concerned, the circumstances of the relevant transactions and the basis for your claim to exclusion...."

irrelevant.

It often happens that the box is left blank when it should be completed, as the need to do so in this very complicated area is overlooked. There is no penalty, provided the claim is valid, as no additional tax is thereby due. It is suggested that an entry should be made in the box on the next tax return, with a note in the "additional information" box to explain the position.

32.45.1 *HMRC response when motive defence box is filled in*

RI 201 provides:

> Where such a disclosure has been made and [motive defence] exemption claimed, the Revenue will make any necessary enquiries about that exemption in the statutory period allowed, and will not seek to reopen that year's return on discovery grounds if the [motive defence] exemption has to be reconsidered in later years.

International Manual explains HMRC's administrative arrangements for dealing with a claim:

> **600050 - Transfer of assets abroad: Mandatory referral to SPT Trusts & Estates Nottingham** [July 2014]
> SPT Personal Tax International Advising Bootle is responsible for the operation of the legislation contained in Chapter 2 Part 13 ITA 2007, the provision of Technical Advice thereon and any litigation involving transfer of assets legislation.
> All enquiry work involving possible application of the transfer of assets legislation is undertaken by or in conjunction with the specialist team in SPT Personal Tax International (Individual Compliance) Bootle. Special Investigations offices and SPT High Net Worth Units also undertake review work in this area in relation to cases handled by them. The individual Self Assessment tax return will often be the first point of identification of cases where the legislation may apply, and as such those handling receipt of returns have a vital role to play in identifying potential application of this legislation. Offices should not however attempt to determine liability to the Income Charge (INTM600020) or the Benefits Charge (INTM600030) or discuss the application of the provisions with agents without first contacting **(This text has been withheld because exemption in Freedom of Information Act 2000)**. Any case in which it is identified that transfer of assets does or may apply must be referred to SPT Personal tax international Advising, (Risk) Nottingham who will arrange any necessary risk assessment of

> the case and advise on whether and how this aspect is to be taken forward.
> SPT HNWU and Special Investigations offices do not have to make a referral of their own cases in accordance with the previous paragraph but should consult with SPT Personal Tax International, Advising Bootle for advice as necessary, and in every case where litigation may be a possibility....
> **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**
> You must also submit your papers if you receive an application to exemption from liability under 'Income Charge' or 'Benefits Charge'. See INTM600640. You should not enter into correspondence with the taxpayer or his agent oao the exemption provisions. Any enquiry from a taxpayer or professional adviser about the scope and effect of the legislation, or its application to a particular taxpayer, should be referred directly to SPT Personal Tax International Advising Bootle. You may also contact SPT Personal Tax International Advising Bootle for general advice on this legislation at any time if you feel you need it.

On this basis, one should expect an enquiry to be opened, unless the issue has been resolved in earlier years, but in practice that does not always happen.

32.46 Dealing with HMRC enquiries

The individual must "satisfy an officer of HMRC" that Condition A or B is met.[216] This imposes the burden of proof on the taxpayer. That makes no difference as the burden of proof generally rests on the taxpayer, and in any event, disputes are rarely decided by the burden of proof.[217]

Contemporary correspondence and background documentation may be relevant to the factual issue of whether the transferor had the purpose of reducing tax. It will not shed much light on the issue of whether the purpose should be classified as avoidance or mitigation. Some factors such as confidentiality or tax related agreements may shed light on this, or at least, on whether the parties regarded the matter as tax avoidance.[218] In *IRC v Willoughby* 70 TC 57 for instance, the Special Commissioner reviewed sales literature relating to the offshore bonds. In practice, expect HMRC to ask for contemporary documentation. The advisors should

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216 ss.737(2), 739(2) ITA.

217 See 3.5.4 (Proof of intention).

218 See 32.16.4 (Other indicia of tax avoidance).

review it before making a claim. In the case of a transfer to a trust, this includes:

(1) Trust documentation and letters of wishes.
(2) If not evident from the above, details of intended beneficiaries.
(3) Details of assets transferred.
(4) Contemporary correspondence between trustees, accountants and settlor. (Legal advice should be privileged.)

Often the issue arises many years after the transfer of assets, and the contemporary records have been lost. That should not matter, as secondary material and inferences from common sense should suffice, but efforts should be made to recover original documentation, if only to avoid the suspicion that damaging documents may have been suppressed. The EC say:

> However, in order to ensure that genuine establishments and transactions are not unduly sanctioned it is imperative that where the existence of a purely artificial arrangement is presumed, the taxpayer is given the opportunity, without being subject to undue administrative constraints, to produce evidence of any commercial justification that there may be for that arrangement. The extent to which the onus to demonstrate that their transactions served bona fide business purposes can be placed on the taxpayer can only be determined on a case-by-case basis. In this regard the Commission considers that burden of proof should not lie solely on the side of the taxpayer and that account should be taken of the general compliance capacity of the taxpayer and of the type of arrangement in question.[219]

ToA draft guidance provides:

> **INTM602700 Show or satisfy**
> It is often the case that where transactions have taken place that result in potential liability under the transfer of assets provisions professional advice will have been taken in relation to the transactions. It is sometimes suggested that such advice cannot be disclosed to HMRC because of legal and professional privilege. More is said on this in section "information powers" (see INTM603200). But there is no specific restriction on the information that an individual can provide to demonstrate that the exemption test is met, and an individual who is

219 EC Communication "The application of anti-abuse measures in the area of direct taxation" COM(2007) 785
http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52007DC0785

> entitled to exemption can be expected freely to provide it. Where an individual chooses to hold back particulars that may contain material evidence about transactions that would otherwise result in a charge to tax it may well lead the officer of Revenue and Customs to conclude that the conditions for exemption are not met.

It is wrong for HMRC to draw any inference from a taxpayer's decision to exercise a right to privilege.

32.47 Appeals

Section 751 ITA provides:

> On any appeal that is notified to the tribunal, the jurisdiction of the tribunal includes jurisdiction to affirm or replace any decision taken by an officer of Revenue and Customs in exercise of the officer's functions under—
>
> (a) section 737 (exemption: all relevant transactions post-4 December 2005 transactions),
> (b) section 738 (meaning of "commercial transaction"),
> (c) section 739 (exemption: all relevant transactions pre-5 December 2005 transactions),
> (d) section 742 (partial exemption where later associated operations fail conditions),
> (da) section 742A (post-5 April 2012 transactions: exemption for genuine transactions),
> (e) section 743(2) (no duplication of charges: choice of persons in relation to whom income is taken into account).

The wording makes clear that jurisdiction of the tribunal is appellate and not supervisory. The wording of New Conditions A and B ("not be reasonable to draw the conclusion ...") does not impose a *Wednesbury* unreasonableness test.

A decision of the first-tier tribunal is, on ordinary principles, binding on the parties (subject to an appeal) only in relation to the assessments under appeal. It does not bind the parties in other respects, and in *Carvill v IRC* [2000] STC (SCD) 143, a Special Commissioner allowed a motive defence appeal even though a previous appeal relating to earlier years had been decided against the taxpayers. The taxpayers then sought to recover from HMRC the tax paid under the earlier assessments, but this rightly failed. There must be some finality in tax, even when wrong decisions are reached by the courts. See *Carvill v IRC (No. 2)* [2002] STC 1167 and *R (oao Carvill) v IRC* [2003] STC 1539. That issue will rarely, if ever,

arise again in practice.

A more common problem is where tax has been paid under the ToA provisions for a number of years without consideration being given to the motive defence, and then it occurs to a taxpayer that a motive defence is applicable. It is considered that the principle in *Carvill (No. 2)* only applied where a motive defence had been litigated and decided by the tribunal, and in the absence of litigation on the point it should be possible to put in an error or mistake claim under usual principles.

An appeal will be made by the individual subject to tax (not the trustees or company within s.731 ITA who have no *locus standi*). If the trustees fund an appeal by the individual against assessment under s.731, will that funding constitute a benefit? If so that benefit would be subject to income tax under s.731, if the appeal is unsuccessful. The position depends on the facts. If the reason the trustees fund the appeal is in order to sort out their tax planning for the future, or in order to benefit the entire class of UK resident beneficiaries, then no taxable benefit is received by the appellant: any benefit is received by all UK beneficiaries and there is no rational means of apportionment. At the other extreme, if the trust fund is (more or less) wound up by a capital payment, and the appeal procedure is specifically to benefit one beneficiary, then the trustees financing the appeal would constitute a benefit.[220]

32.48 Can an individual disclaim the motive or EU law defences?

There are circumstances where the application of the ToA provisions may reduce a tax charge. In particular, a UK resident transferor who receives a distribution from a non-resident company may be more lightly taxed under s.720: they are taxed on the company's income but has the benefit of tax and tax credits paid by the company, and the distribution is tax free.[221]

AIs it possible for an individual to disclaim the motive defence? It seems arguable that the words "the individual satisfies an officer of HMRC" etc., suggest that the benefit of the motive defence can be

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220 Or else it may be subject to CGT as a capital payment.

221 See 31.4 (Distribution relief).

Also, a beneficiary who received a capital payment from an offshore trust before 2008/09 would prefer to be taxed under s.731 than under s.87 TCGA, because the IT rate under s.720 (40%) was lower than the effective CGT rate under s.87 (then, 64%).

disclaimed. The individual may choose not to satisfy an officer even though there was no tax avoidance purpose. If the motive defence is compulsory, we would have the surprising result that a transfer for tax avoidance may be less harshly taxed than one which was not.

However, this view would cause considerable difficulties. Suppose a non-resident trust has relevant income of £1m and trust gains of £1m, and capital payments of £1m are made in Year 1 to beneficiary A and in Year 2 to beneficiary B. A and B are both resident and domiciled in the UK. Suppose the trust is in principle within the motive defence because the transfer to it was not for tax avoidance purposes. Before 2008/09 A would probably wish to disclaim the motive defence, if A could, so the capital payment to A was subject to income tax, and they avoided the s.87 interest surcharge. However, it would be in the interest of B to argue that the motive defence did apply, so that the payment to A "washed" the capital gain and the payment to B was tax free. It is evident that the offshore trust rules simply do not work if the motive defence can be disclaimed by one beneficiary and claimed by another. Nor do they work fairly if it can be disclaimed by one beneficiary in a manner which binds all the others. So the better view is that the motive defence (if applicable on the facts) is compulsory and binds all parties.

The same applies where it suits HMRC to argue that the motive defence is satisfied, and the taxpayer argues that it is not. This in fact happened in *Swift v HMRC*[222] and *Anson v HMRC*[223] where HMRC successfully argued that the motive defence applied. In neither case did the taxpayer seek to argue that the motive defence could be disclaimed, so the point may now be regarded as settled law.

HMRC agree. The ToA draft guidance provides:

> **INTM602660 Applying for exemption**
> ...The exemption applies automatically if the facts show that the conditions are met. It is not therefore the subject of a 'claim' under the normal claims mechanism of the Tax Acts (section 42 TMA 1970).

32.49 Motive defence: Commentary

32.49.1 *Can a satisfactory concept of tax avoidance be devised?*

Littlewood made a survey of the privy counsel cases on tax avoidance

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222 [2010] SFTD 553 at [22] - [28]. The case is not yet final.

223 [2012] UKUT 59 (TCC).

and his conclusion was gloomy:

> ... on the basic issue—what is tax avoidance?—very little progress has been made. In particular, no one (neither the Privy Council, nor the courts of Australia or New Zealand, nor anyone else) has yet devised a satisfactory definition of tax avoidance. Worse, the Privy Council (like the Australian and New Zealand courts and the various commentators who have addressed the problem) has not only failed to *define* tax avoidance; it has failed even to produce a coherent set of guidelines as to how it might be recognised. In *Newton*, Lord Denning said that ''ordinary" transactions do not count as avoidance.[224] In *Challenge*, Lord Templeman said that ''mitigation" does not count as avoidance.[225] And in *Peterson*, Lord Millett said that the obtaining of ''acceptable" tax advantages does not count as avoidance.[226] Clearly this does not constitute a complete solution.[227]
>
> Nor is that all. Of the 13 cases, some were found by the Privy Council to fall on one side of the line, and some on the other. Surely, then, it might be said, these cases must provide *some* guidance as to where the line is to be drawn? Even this, however, seems unduly optimistic. In other areas of the law, judges (and commentators) might disagree as to how particular cases should be resolved, but at least they generally agree as to what constitutes a marginal case (as with, for example, the distinction between capital and revenue). This is not so, however, of the distinction between tax avoidance and tax mitigation. Rather, the judges tend to present whichever outcome they prefer not only as correct, but as clearly so—even when they fail to agree. This is perhaps the strangest feature of these cases. For example, in *Challenge* Lord Templeman (for the majority) said ''a clearer case. . .cannot be imagined",[228] though this was evidently less clear to Lord Oliver who dissented. Similarly in *Peterson* the majority regarded it as clear that the anti-avoidance rule did not apply; and the minority as equally clear that it did: ''a clearer case", said Lord Bingham and Lord Scott in their

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224 [1958] AC 450 at p.466.

225 See 32.7.2 (Avoidance/mitigation distinction).

226 [2005] STC 448 at [35]–[37].

227 [Footnote original] *Simms, Payne* and *Townend* established that there is a difference between avoidance and evasion. This is important, but provides no guidance as to the distinction between avoidance and mitigation.

228 [Footnote original] [1987] 1 AC 155 at 164.

> joint *dissenting* judgment, ''can hardly be imagined".[229]
> The cases thus confirm what is notorious: that the idea of tax avoidance is one of the most difficult in the whole of the law. To describe the distinction between avoidance and mitigation as ''vague" is to understate the problem, for it suggests that there is general agreement as to roughly where the line lies and that the disagreement is only as to marginal cases. But none of their Lordships appear to have regarded any of the cases as marginal. It is difficult, therefore, to extract from them any guidance as to where the line lies. Notable, too, is the frequency of disagreement: of the eight cases decided after the Privy Council started permitting dissents in 1966, only two were decided unanimously (*Ashton* and *O'Neil*). Dissents tended, moreover, to be colourful. Lord Wilberforce, dissenting in *Mangin*, accused the majority of ''interpretative astigmatism".[230] Lord Oliver, in *Challenge*, described the majority view as ''eccentric".[231] And, in *Peterson*, Lord Bingham and Lord Scott said the majority view was ''extraordinary"[232] and required ''shutting one's eyes to the obvious."[233]
> It would seem reasonable to conclude that the idea of tax avoidance is simply not susceptible to coherent explication. This conclusion is not novel, but the Privy Council cases throw the dimensions of the problem into stark relief.[234]

Technical Teams Operational Guidance Manual reaches the same conclusion:

> **TTOG3435 Identification of Code 8 cases: Tax avoidance** [Apr 2014] 'Avoidance' is not defined in the Taxation Acts and attempts to define it have not in the past been successful.

32.49.2 *Should we abandon the search for a satisfactory definition?*

Littlewood continues:

> If the idea of tax avoidance is incoherent, however, it might be

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229 [Footnote original] [2005] UKPC 5; [2005] STC 448 at [96]. See also *Peate, O'Neil*, *Mobil* and the judgment of Lord Donovan and Viscount Dilhorne in the first *Europa* case.

230 [Footnote original] [1971] AC 739 at 755.

231 [Footnote original] [1987] 1 AC 155 at 173.

232 [Footnote original] [2005] UKPC 5, [2005] STC 448 at [101].

233 [Footnote original] [2005] UKPC 5, [2005] STC 448 at [78] and [101].

234 Littlewood "The Privy Council and the Australasian Anti-Avoidance Rules" [2007] BTR 175.

concluded also: that rules against it amount to taxation by discretion; that this entails a departure from the rule of law; that the search for a satisfactory anti-avoidance rule should therefore be abandoned; and that existing anti avoidance rules should be repealed. Arguments along these lines are indeed common. Perhaps they are sound. But there are nonetheless grounds upon which anti-avoidance rules might be defended.

The first of these is expediency: the rules might be radically indeterminate, but they work. Secondly, the complaint is based on a fallacy. The scope of anti-avoidance rules is obviously uncertain, but it does not follow that *not* having such a rule results in any less uncertainty: even in the absence of a rule against avoidance, the courts seem inevitably (as in the United Kingdom) to be called upon to determine whether taxing statutes should be interpreted in such a way as to give efficacy to, or to negate, taxpayers' attempts to avoid tax. The United Kingdom's experience, in particular the *Ramsay* line of cases, suggests that the degree of uncertainty might be much the same, or worse. For, although the scope of the *Ramsay* principle remains uncertain, it seems that the idea of avoidance (and presumably also, therefore, the distinction between avoidance and mitigation) is embedded in it; and yet the UK courts have made no more progress in defining avoidance than has the Privy Council, and perhaps less, for it was in the Privy Council (in *Challenge* and *Peterson*) that their Lordships formulated the distinction between avoidance and mitigation. Consequently there seems to be little reason to suppose that anti-avoidance rules *add to* the level of uncertainty from which taxing statutes suffer. In other words, the uncertainty may be a feature not of the anti-avoidance rule, but of the rules defining the scope of the tax. The effect of the anti-avoidance rule, therefore, is perhaps to tilt the field in favour of the Revenue, whilst leaving the degree of uncertainty more or less unchanged (or perhaps ameliorating it a little).

Thirdly, the unpredictable scope of general anti-avoidance rules seems appropriately selective in whom it inconveniences. Taxpayers and their representatives in Australia and New Zealand routinely complain that this unpredictability deters taxpayers from undertaking economic activity which is not tax-driven and which would be beneficial to society.[235] The 13 Privy Council cases, however, suggest that this is not so, since in every one of them (including those in which the rule was held not to apply) the taxpayer plainly went out of his way to structure

235 [Footnote original] See, e.g. *CIR v Challenge Corp Ltd* [1987] 1 AC 155 at 167.

> his affairs in a manner calculated to reduce his liability to tax. The cases thus suggest that it is only those who sail close to the wind who get wet. On this last point, however, it is necessary to acknowledge that the taxpayers who have ended up in the law reports may not be typical of all those against whom the Australian and New Zealand Revenues have invoked their general anti-avoidance rules. In particular, it is possible that the rules have been invoked in cases in which the amount of tax in dispute was too small to be worth litigating, or in which the taxpayer could not afford to litigate.
>
> In other words, it is possible that the general anti-avoidance rules *have* served as a basis for arbitrary taxation even though the law reports contain no evidence of it. It is possible that in the United Kingdom the *Ramsay* principle has functioned in this way also. It would be useful, therefore, to study the cases in which taxpayers have been assessed on the basis of a general anti-avoidance rule or the *Ramsay* principle but which have *not* proceeded to litigation. The Revenue (in all three countries) might welcome an investigation of this kind, because they might prefer to dispel any suspicion that they have been using either the statutory rules or the judge-made one in this way.[236]

32.49.3 *Abolish the 2006 rules*

This topic was never easy, but the FA 2006 made it twice as complicated: it introduced wider and more obscurer rule which apply to transactions from 2005, while retaining the old rules for earlier transactions.[237]

The reader who studies this long and difficult chapter will almost certainly agree with the author that the 2006 reforms were wrong headed in policy though (as so often) clumsy drafting adds its mite to the confusion.

What should be done? One step forward would be to return to the (relatively) simple pre-2006 position, though it would be helpful to have a statutory statement of what I take to be the pre-2006 rule, that the motive test must be satisfied by all critical associated operations.

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236 Littlewood "The Privy Council and the Australasian Anti-Avoidance Rules" [2007] BTR 175.

237 EN FB 2006 stated:

> "The new provisions recast the test for exemption in cases not involving a tax avoidance purpose to make its meaning clearer."

But no-one was intended to take that seriously.

CHAPTER THIRTY THREE

LIFE POLICIES AND CONTRACTS

33.1 Policies: Introduction

This chapter considers:
(1) life insurance policies
(2) life annuity contracts
(3) capital redemption policies
ITTOIA refers to these as "policies and contracts". I abbreviate the expression to **"policies"**. The asset is often described in the insurance industry as a bond; statute has adopted that term in the expressions "personal portfolio bond" and "guaranteed income bond". I prefer not to use the word "bond" since it is also used to describe debentures and indeed strictly includes any obligation undertaken by deed.

Policies fall within Chapter 9 Part 4 ITTOIA, sometimes called the "chargeable event" regime. This contains almost 100 sections: it is the longest chapter in ITTOIA. The reader will not be surprised if I say that a full discussion needs a very long book to itself. This chapter focuses on the matters closest to the theme of this work.

The provisions are sometimes very crude. Partial surrender is a particular trap.[1] This is the only place I have seen in the HMRC Manuals where districts are warned "not to attempt any discussion or explanation as to the equity of the treatment for tax".[2]

It is common to structure an investment in the form of a life insurance policy (with only a nominal element of life insurance). So one can effectively opt into the chargeable event regime by choosing to invest in a policy rather than in some other form.

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1 In practice this is avoided by life companies issuing a cluster of separate policies, instead of one single policy.

2 In the former Assessment Procedures Manual para 3147a (withdrawn in 2009).

Where the value of the policy is linked to specific assets or funds, this is sometimes called a life insurance wrapper, though wrapper is not a legal or technical term with any fixed or precise meaning. As far as I am aware, the Swiss Tax Agreement 2011 represents the first use of the word in tax legislation.[3]

33.1.1 *Cross references*

The following issues are dealt with elsewhere see:
59.14 (DT reliefs: policy held by trust or by company)
82.25 (Situs of insurance policy for IHT)
83.15 (Situs of Insurance policy for CGT).

The taxation of policies held by UK resident companies is not discussed.

33.2 Definitions

33.2.1 *"Policy"*

The IPT Manual provides:

> **1115 Fundamental Concepts: what is a life policy** [August 2008]
> The word policy in connection with insurance has a long history. It is the formal document in which an insurer (that is, insurance company or friendly society) sets out the terms of its obligations in consideration of the stipulated premiums. For an insurance contract to be made, or varied, between an insurer and policyholder requires the completion of the standard contract law offer and acceptance. There is no practical distinction between contract and policy; the latter simply evidences the former. Lord Donaldson confirmed this in the judgment referred to at IPTM1110. [*Scher v Policyholders Protection Bond* [1994] 2 AC 57.]

33.2.2 *"Life insurance"*

The definition of life insurance[4] needs a long chapter to itself. IPT

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3 Article 2(1)(f) STA; see 88.3.3 ("Relevant assets").

4 A note on terminology. The General Insurance Manual provides
"**1060. Legal basis of insurance: Indemnity** [January 2009]
It used to be said that there was a distinction between
[1] insurance, meaning insurance against a financial loss, and
[2] assurance, meaning the assurance of a fixed or minimum sum upon the occurrence of a specified event that is bound to occur.
The text of the [Policies of Assurance] Act 1601, however, shows that the term "assurance" was applied to what is manifestly indemnity insurance. More recently

Manual provides:

> **1115. What is a life policy?** [August 2008]
> According to the 1774 Life Assurance Act, a policy of life insurance is an insurance policy on life. There is no further definition in the Taxes Acts. If a policy pays benefits on the death of an individual, either whenever it happens, or within a specified term, then it is potentially within the scope of the chargeable event legislation.
> It is not relevant for tax purposes that such a policy may also provide insurance against other risks, such as disability and critical illness, although that might affect its regulatory or accounting treatment.
> Funeral plan contracts where a customer pays a sum to a funeral provider to provide a funeral in due course are not contracts of insurance, although similar arrangements if made with an insurer as a whole of life policy are, according to the regulatory rules of the Financial Services Authority.[5]

33.2.3 *"Capital redemption policy"*

A full discussion of the term "capital redemption policy" (defined in s.473(2) ITTOIA) is not attempted here. IPT Manual provides:

> **1120. What is a capital redemption policy?** [March 2011]
> Capital redemption policies, though issued by insurance companies, are not strictly speaking insurance products. They were once known as investment bond contracts, which is more descriptive but needs to be distinguished from the type of life policy investment bond described at IPTM1100. Under capital redemption policies, one or more fixed sums is paid to an insurer under a contract pursuant to which one or more specified amounts is paid out at some later time or times, on the basis of an actuarial calculation. Typically the contracts take the form of
> - an annuity certain, where a capital sum is used to buy an annuity for a fixed term not contingent on life, see IPTM4200, or
> - a sinking fund where regular sums are paid in to secure a capital sum at some later date, for example against the need to find a premium payment to renew a lease.
>
> The statutory definition of capital redemption business is at Section 458(3) ICTA 1988. Contracts within such business are long term insurance business but not life business. A capital redemption policy that creates a debtor/creditor relationship, with an agreement to return the sum advanced, is known as a capital

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the distinction has faded further under the influence of the EU, where the official English texts of the relevant Directives consistently use the term "life insurance". For most practical purposes therefore insurance and assurance can be treated as interchangeable terms. In the Taxes Acts, however, the term "assurance" is usually confined to life business.

5 There is also an interesting discussion in the General Insurance Manual [January 2009] para 1010, not set out here for reasons of space, and in part 7 of the Law Commission paper "Insurable Interest" (14 January 2008).

redemption bond and is similar in nature to a relevant or deeply discounted security, see SAIM3000. However, such bonds, which may only be sold by an insurer, are removed from the scope of the deeply discounted securities income tax charge of Section 427 ITTOIA onwards.[6]

33.2.4 *"Annuity"*

A full discussion of the term "life annuity" (defined in s.473(2) ITTOIA) is not attempted here. IPT Manual discusses the meaning of "annuity", a word used in many tax contexts:

> **1130. What is an annuity?** [July 2006]
> There is no single definition in the taxes acts. There is an ancient definition in Stroud's Judicial Dictionary, quoting Coke on Littleton:
>
> > An annuity is a yearly payment of a certaine summe of money granted to another in fee, for life, or yeares, charging the person of the grantor onely.
>
> From an early case called *Foley v Fletcher*[7] the judgment of Watson B at 784-5 is often quoted:
>
> > But an annuity means where an income is purchased with a sum of money, and the capital has gone and has ceased to exist, the principal having been converted into an annuity.
>
> From this and other cases, notably *Southern-Smith v Clancy*, 24 TC 1, the following factors emerge as needing to be present
> - the payments must be made under a legal obligation
> - those payments must be 'pure income profit'
> - they must be capable of being characterised as 'annual', so being capable of recurrence on a periodic basis by reference to an annual time frame
> - the purchase sum must pass absolutely to the provider
> - no debtor/creditor relationship is created in relation to that sum; it is

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6 See too the explanatory notes to the draft legislation published in the Pre-Budget Report, 5 December 2005:

> 15. A capital redemption policy is a contract, issued by an insurer, which is made in the course of capital redemption business. Under a capital redemption policy, for consideration of a sum or sums of money, the issuer of the policy guarantees to pay out a larger sum on a specified future date or to make a series of payments. Payment is independent of any contingency linked to human life.
>
> Examples of such contracts include—
> - an annuity certain - an annuity payable for a set period not contingent upon the survival of a life,
> - a leasehold redemption policy - which builds up a fund to be used in some way on the expiry of a lease, and
> - a sinking fund policy - this accumulates a fund for the eventual replacement of a wasting asset.

7 (1858) 157 ER 678; 28 LJ Ex 100; 3 H & N 769 accessible *http://www.commonlii.org/uk/cases/EngR/1858/1107.pdf*

replaced by the annuity
- the annuitant's only right is to demand payments when due
- the payments must not be instalments of pre-existing debt.

33.2.5 *"Surrender"*

In this chapter:
"A full surrender" is a surrender of all the rights under the policy.
"A part surrender" is a surrender of part of the rights under the policy.
Section 500 ITTOIA provides:

> The following events are treated for the purposes of this Chapter as a surrender of a part of the rights under the policy or contract in question—
> (a) the falling due of a sum payable as a result of a right under a policy or contract to participate in profits where further rights remain under it,
> (b) in the case of a contract for a life annuity which provides for a capital sum to be taken as an alternative in part to the annuity payments, taking the capital sum,
> (c) the making of a loan to which section 501 applies, and
> (d) the making of a payment to which section 504 applies (payments by insurers under guaranteed income bonds etc.).

33.2.6 *"Insurance year"*

Section 499 ITTOIA provides:

> (1) In this Chapter "insurance year", in relation to a policy or contract, means the 12 months beginning with—
> (a) the date on which the insurance or contract is made, or
> (b) any anniversary of that date.

Special rules apply on the termination of a policy:

> (3) An event referred to in section 484(1)(a)(i) or (iii) or (b) to (e)[8] ... is treated as ending the insurance year in which it occurs.
> (4) In this Chapter "final insurance year" means an insurance year that is ended as a result of subsection (3).
> (5) But if, as a result of subsection (3), an insurance year would begin and end in the same tax year—

8 In my terminology this is a termination-event: see 33.3.4 (Categories of chargeable event).

(a) that insurance year and the previous insurance year are treated as one insurance year, and
(b) "final insurance year" needs to be read accordingly.

The IPT Manual provides:

IPTM3505 - Chargeable events: calculating gains: 'insurance year'
[February 2014]
'Insurance year' - sometimes called policy year - begins on the day a policy is taken out and on the same date in subsequent years. It ends on the day before the anniversary of the start date and each subsequent year.
For example, a policy taken out on 1 June 2004 has an 'insurance year' ending on 31 May 2005. A part surrender giving rise to an 'excess event' taking place on 1 April 2005 would fall in tax year 2004-05. But the gain on the 'excess event' would be treated as arising at the end of the 'insurance year', on 31 May 2005, and consequently would be assessable for tax year 2005-6.
If an event brings a policy or contract to an end - full surrender of rights, death, maturity or taking a capital sum as a complete alternative to annuity payments - the 'insurance year' is treated as ended on that date. It is then referred to as the 'final insurance year'.
If that rule would result in an 'insurance year' beginning and ending within the same tax year, then the 'final insurance year' is extended to include the previous 'insurance year'.
For example, if there is an 'insurance year' running from 1 June 2004 to 31 May 2005 and the policy is fully surrendered on 30 June 2005, the 'final insurance year' runs from 1 June 2004 to 30 June 2005.
The extended period of a 'final insurance year', coupled with the requirement on the insurer to issue a chargeable event certificate broadly within three months of the event, may result in the issue of a certificate for an event that turns out not to be chargeable. This may happen where the event is swept up in a calculation for a terminal event that brings the 'final insurance year' to an end, see IPTM3570. In this case the insurer should notify the policyholder that the earlier certificate should be disregarded - see IPTM7210.

33.2.7 *Rights, parts and shares*

Section 464(3) ITTOIA provides:

If there has been a surrender or assignment of only a part of or share in rights under the policy or contract, the references in this section and

those sections to the rights are references to that part or share.[9]

ITTOIA EN comments:

417. *Subsection (3)* provides that references in sections 464 to 467 to a surrender or assignment of rights refer, where appropriate, to a surrender or assignment of a part of, or share of, the rights. A *part* of the rights means one or more discrete rights provided by the policy or contract. A *share* in the rights means part of the ownership, where there are multiple owners, of such a discrete right or rights or of all the rights in the policy or contract.

33.3 Outline of provisions

ITTOIA EN summarises the layout of the provisions:

409. The Chapter is laid out as follows-

- charge to tax under Chapter 9 (sections 461 to 463)
- person liable etc. (sections 464 to 472)
- policies and contracts to which Chapter 9 applies (ss.473 to 483)
- when chargeable events occur: general (sections 484 to 490)
- calculating gains: general (sections 491 to 497)
- part surrenders and assignments: periodic calculations and excess events (sections 498 to 509)
- transaction-related calculations and part surrender or assignment events (sections 510 to 514)
- personal portfolio bonds (sections 515 to 526)
- reductions from gains (sections 527 to 529)
- income tax treated as paid and reliefs (sections 530 to 538)
- deficiencies (sections 539 to 541)
- supplementary (sections 542 to 546)

33.3.1 *The charge*

The charge is in s.461(1) ITTOIA:

Income tax is charged on gains treated as arising[10] from policies and

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9 This is repeated in s.468(6) ITTOIA. (If s.464(3) had ITTOIA-wide application this would have been unnecessary.)

10 The general usage of the tax legislation is that chargeable gains "accrue" but income "arises". In the chargeable events legislation, gains are regarded as income and so the word used is "arise". There is no difference in meaning.
Under the chargeable events legislation gains are sometimes said to "arise" and sometimes described as "treated as arising". Again, there is no difference in meaning.

contracts to which this Chapter applies.

Section 463(1) ITTOIA provides:

> Tax is charged under this Chapter on the amount of the gains arising in the tax year.

33.3.2 *Policies and contracts to which chargeable event provisions apply*

This takes us to s.473(1) ITTOIA:

> This Chapter applies to—
> (a) policies of life insurance,
> (b) contracts for life annuities, and
> (c) capital redemption policies.

Sections 478–483 ITTOIA (not discussed here) specify various types of policies to which the provisions do not apply.

33.3.3 *When gains arise*

The time that the gain arises is particularly important for a beneficiary who becomes or ceases to be UK resident, as a gain arising to a non-resident (or in the overseas part of a split year) is not taxable.

Section 462(1) ITTOIA provides:

> For the purposes of this Chapter, a gain from a policy or contract arises when a chargeable event occurs in relation to the policy or contract (see section 484).

For full surrenders the chargeable event occurs, and the gain arises, at the time of the surrender.

For part surrenders the event occurs, and the gain arises, at the end of the insurance year[11] for the policy concerned. The reason is perhaps so that only one chargeable event computation is needed, even if there are several part surrenders during the year.

33.3.4 *Categories of chargeable event*

"Chargeable event" is a label which brings in a complex set of rules. Section 484(1) ITTOIA sets out the starting point:

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11 See 33.2.6 ("Insurance year").

Chargeable event: text of s.484	**Type**
The following are chargeable events—	
(a) in the case of any kind of policy or contract—	
(i) the surrender of all rights under the policy or contract,	
(ii) the assignment of all those rights for money or money's worth,	Termination Event[12]
(iii) the falling due of a sum payable as a result of a right under a policy or contract to participate in profits, if there are no remaining rights under it	
(iv) a chargeable event treated as occurring under section 509(1) (chargeable events in certain cases where periodic calculations show gains),	
(v) a surrender or assignment treated as a chargeable event under section 514(1) (chargeable events where transaction-related calculations show gains), and	Calculation Event
(vi) a chargeable event treated as occurring under section 525(2) (chargeable events where annual personal portfolio bond calculations show gains)	
(b) in the case of a policy of life insurance, a death giving rise to benefits under it,	
(c) in the case of a policy of life insurance or a capital redemption policy, its maturity,	
(d) in the case of a contract for a life annuity which provides for the payment of a capital sum on death, the death, and	Termination Event
(e) in the case of a contract for a life annuity which provides for a capital sum to be taken as a complete alternative to the annuity payments (or any further annuity payments), taking the capital sum.	

Thus there are ten types of chargeable event. They fall into two categories:

(1) **Calculation events:** s.491(4) ITTOIA provides the terminology:

> In this Chapter—
> "calculation event" means an excess event, a part surrender or assignment event or a personal portfolio bond event,

12 My terminology.

Thus there are three types of calculation event: Section 491(4) then defines these three types:

> [a] "excess event" means a chargeable event within section 509(1),
> [b] "part surrender or assignment event" means a chargeable event within section 514(1), and
> [c] "personal portfolio bond event" means a chargeable event within section 525(2).

The terminology of [a] is opaque, and [b] is misleading, but it is hard to think of better labels for the tortuous statutory rules. Calculation events are therefore within s.484(1)(a)(iv), (v) or (vi).

(2) Other events: that is, chargeable events other than calculation events. It is useful to have a label for these, but no short label fits the bill. I call them "**termination-events**". Termination-events are those within s.484(1)(a)(i)-(iii) and (b)-(e), in short:
(a)(i) full surrender
(a)(ii) full assignment
(a)(iii), (e) final payment
(b)(d) death giving rise to benefits
(c) maturity

Logically there should be two stages, first to ascertain whether there is a chargeable event and secondly to compute the gain. But in the three calculation event cases the two stages overlap, because the question of whether there is a chargeable event depends on whether there is a gain.

It should be noted that an assignment for no consideration is not a chargeable event. This is the opposite of the CGT position.

Sections 484-489 ITTOIA contain exemptions. These are not discussed here, but s.487 is important because it contains an exemption for inter-spouse transfers (based on the CGT spouse exemption).

33.3.5 *Computation of gains*

The computation of gains is complex and artificial and often bears no relation to the commercial gain.[13] It is not the same as the computation of gains for CGT purposes, so one must take care not to confuse chargeable gains (the CGT term) and gains under the chargeable events legislation.

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13 See *Lobler v HMRC* [2013] UKFTT 141 (TC) discussed at 2.3 (Views on morality of tax avoidance).

It is confusing that the legislation calls them both "gains". The term "**chargeable event gains**" is useful when one needs to distinguish the two types of gains.

There are five different methods of computation for different types of chargeable event. The computation rules are not discussed here.

SA904(Notes) (Notes on Trusts & Estate Foreign for the year ended 5 April 2013) comments on how to deal with foreign currency gains:

> You should calculate gains on foreign life insurance policies, life annuities and capital redemption policies in the currency in which the policy or life annuity is denominated. You should then convert the gain into sterling at the rate of exchange applicable at the time of the chargeable event (which may not be at the time the transaction occurred).[14]

This is different from method of computation of chargeable gains.

33.4 Liability of individuals and individual "creators"

Once one has identified a chargeable event, and computed the chargeable event gain, the next stage is to ascertain the person liable for the charge.

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14 Similarly, the IPT Manual provides:

9220 Calculation of gains and other amounts for policies in foreign currencies [July 2006]

Where a tax representative or insurer reports a gain in sterling, it should compute the gain by calculating the amount of the chargeable event gain in the currency in which the policy is denominated and then convert it into sterling at the conversion rate on the date of the event. This method ensures that currency fluctuations during the life of the policy are disregarded.

Where a tax representative or insurer reports other amounts in sterling, for instance the premiums paid where there has been an assignment, they should be translated at the rate applying on the date of the chargeable event.

Similarly, IPT Manual:

3700 Foreign policies: differences in treatment [February 2014]

Some policies are denominated in a foreign currency. In such cases, any chargeable event gain should be computed in the foreign currency and then converted to sterling at the rate that applies at the date of the chargeable event. This method should be adopted rather than any other method such as converting each transaction to sterling at the rate applying on the date the transaction occurred.

For instance, if premium of €10,000 was paid into a policy on 10 May 2002 and the policy was surrendered for €12,500 on 3 January 2005, the chargeable event gain on the surrender is €2,500. This should then be converted to sterling at the conversion rate applying on 3 January 2005 to arrive at the amount of taxable gain.

Section 464 ITTOIA provides an introduction:

> (1) The person liable for any tax charged under this Chapter is the person indicated by—
> section 465 (person liable: individuals),
> section 466 (person liable: personal representatives), and
> section 467 (person liable: UK resident trustees),
> according to how the rights under the policy or contract are owned or held immediately before the chargeable event in question occurs.
> (2) References in those sections to the ownership or holding of those rights are references to their ownership or holding at that time.

Section 465(1) ITTOIA provides:

> An individual is liable for tax under this Chapter if the individual is UK resident for the tax year in which the gain arises and condition A, B or C is met.

I call these conditions "**individual bond conditions A to C**".

33.4.1 *Individual bond condition A: Individual beneficial owner*

Section 465(2) ITTOIA provides:

> Condition A is that the individual beneficially owns the rights under the policy or contract in question.

Individual bond condition A – gain charged on individual if they are beneficial owner – is natural and sensible.

Sections 469–471 ITTOIA deal with joint ownership.

33.4.2 *Individual bond condition B: Trust ownership*

Section 465(3) ITTOIA provides:

> Condition B is that those rights are held on non-charitable trusts which the individual created.

There are two strange features about individual bond condition B, where a policy or contract is held in a trust. First, it does not refer to the "settlor", which is the normal tax terminology, but to trusts "created" by a person. In practice, the settlor will usually be the creator.[15]

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15 The reason for the non-standard term was, possibly, (1) to avoid the rule that a "settlor" must have provided an element of bounty or (2) a concern that a company may not be a "settlor"; see 80.34 (Pension trusts and employee benefit trusts), or

Secondly the creator is charged on the chargeable event gain arising to their trust regardless of the identity of the beneficiaries. The individual has a right of recovery against the trustees[16] so ultimately it is the beneficiaries who bear the burden of the charge, but they do so at the creator's marginal rates. At first sight this seems surprising: the approach more commonly adopted in taxation is only to charge the settlor in the case of settlor-interested trusts, ie if the settlor or (more or less) closely connected persons are beneficiaries. However:

(1) One approach is not necessarily better than the other.[17]

(2) The approach adopted for policies and contracts can only favour the taxpayer, in relation to UK resident trusts, because chargeable event gains would otherwise be taxed at the trust tax rate of 45%; so in a very rough and ready way the rule can mitigate the unfairness of taxing trusts at the top trust rate, whose beneficiaries may be lower taxpayers.

Section 545 ITTOIA provides a commonsense definition:

> "non-charitable trust" means a trust other than a charitable trust.

What if X creates a bare trust for the benefit of Y, and the trust holds a policy on which a gain arises? Condition A is satisfied, so Y is taxed on the gain: condition A refers to beneficial ownership. At first sight, condition B is also satisfied! "Trust" is not defined; the usual tax term is "settlement" or "settled property" (which excludes a bare trust). However the two conditions cannot both be satisfied, and the context shows that condition B is not intended to be satisfied. Bare trusts are invariably transparent for tax purposes. So a bare trust does not count as a trust for this purpose and "trust" has the same meaning as the usual tax term "settlement". HMRC agree. The IPT Manual provides:

> **IPTM3250 - Chargeable events: person liable to charge: summary of the position in relation to trusts** [February 2014]
> **... Rights held on a bare trust - beneficiary chargeable**
> Here the beneficiary is absolutely entitled as against the trustee and the

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(most likely) (3) a rough and ready way to deal with the two-settlor situation. That is, if A created a trust and B added property, A alone was the creator and was formerly subject to tax on the whole of the gain. But s.472 ITTOIA now provides a more sensible rule in this case.

16 Section 538 ITTOIA.

17 See App 9.9.2 (Definitions of "settlor-interested").

rights are vested in the beneficiary as beneficial owner. The bare trust is ignored and the beneficiary is chargeable by virtue of ITTOIA05/S465 (2). This applies equally where the beneficiary is a minor - however, in line with practice generally prevailing for life insurance policies, settlors remain liable for income tax on chargeable event gains arising for years up to and including 2006/07.

Section 472 ITTOIA deals with trusts with two or more settlors. The IPT Manual discusses the meaning of "creator":

IPTM3250 - Chargeable events: person liable to charge: summary of the position in relation to trusts [February 2014]
... 'Settlor' or 'creator' of a trust has a wide meaning and includes any person who settles property on the trust. So, for instance, where a person pays sums to the trustees to use as current or future premiums for a policy held in the trust, that person is a creator of the trust.

IPTM3290 - Chargeable events: person chargeable: multiple interests: trusts created by more than one person [February 2014]
... If property is contributed by different persons at different times, for instance where property is added to an existing settlement, each is treated as a creator in relation to the trust and consequently as a sole settlor.
The share is taken to be the same as the proportion of property contributed by the creator to the trust as it stands immediately before the chargeable event. Property is contributed for this purpose if it originates from the creator, meaning provided directly or indirectly by that person, unless under reciprocal arrangements with another person. A just and reasonable apportionment may be made where necessary.

33.4.3 *Individual bond condition C: Debt charged on security*

Section 465(4) ITTOIA provides:

> Condition C is that those rights are held as security for the individual's debt.

Individual bond condition C – gain charged on individual if held as security for the individual's debt – is a rough and ready solution to the problem of imposing the tax charge where the economic ownership lies. CGT has the opposite rule: s.26 TCGA.

33.4.4 *Gains arising to remittance basis taxpayer*

Section 465(5) ITTOIA provides:

> For the purposes of calculating the total income of an individual liable for tax under this Chapter, the amount charged is treated as income.

The drafting technique is that the gain is added to the individual's "total income". The gain is taxed on an arising basis. The remittance basis does not apply even if the individual is a remittance basis taxpayer and the gain arises from an offshore policy.

It follows that a policy or contract which will give rise to a gain under the chargeable event provisions is not a suitable form of investment for:

(1) an individual who is a remittance basis taxpayer or

(2) a trust whose creator is a remittance basis taxpayer[18]

unless the individual expects to be non-resident in the year that the chargeable event gain arises. If the individual has no short or medium term intention of realising a gain (ie the policy is a long term investment) then the tax disadvantage may be set against the practical convenience of the policy.

The RDR Manual correctly provides:

> **33540 - Remittance Basis: Identifying Remittances: Specific Topics: Chargeable Event gains** [June 2010]
> Gains arising on a chargeable event, for example, the surrender of all rights under a policy of life insurance are chargeable to tax on the arising basis regardless of whether the policyholder is domiciled in the UK or not. The remittance basis does not apply.
> ...
> **Withdrawals in excess of 5% or full surrenders**
> If the individual withdraws more than 5% of accumulated premiums then, the amount in excess of 5% or the actual gain if a full surrender, will be chargeable to income tax under the chargeable event legislation. It is charged on the arising basis whether it is remitted or not.

This is at first sight a surprising inconsistency with the general scheme of taxation for foreign domiciliaries.

For completeness: some might suggest the following justification for taxing chargeable event gains on an arising basis. A remittance basis taxpayer may take out a foreign policy, whose value is linked to a UK asset held by the life insurance company.[19] If the chargeable event gain was taxed on the remittance basis, then use of a policy "wrapper" would

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18 But it may be suitable if held by a non-resident company held by the trust: see below.

19 For an example, see *Foulser v MacDougall* [2007] STC 973.

allow what is in economic terms UK source income or gains to be taxed on a remittance basis. I doubt if that is the historic reason for the rule, which is probably due to oversight. However that may be, this possibility does not justify the rule. It is suggested that gains on foreign policies should be taxed on the remittance basis. The problem does not even call for a targeted anti-avoidance, for the planning which only amounts to deferral, and turns capital into income should be regarded as unobjectionable; deferral is in any case available in a number of different ways.

As with most anomalies, the current rule does not affect the well advised. Nevertheless, long term residents who pay the remittance basis charge and who have acquired foreign policies may well feel short-changed, though if the figures are large enough, there may be some scope for planning.

33.4.5 *Premiums paid out of unremitted income/gains of remittance basis taxpayer*

The RDR Manual provides:

> **33540 - Remittance Basis: Identifying Remittances: Specific Topics: Chargeable Event gains** [June 2010]
> ...Under a special rule (ITTOIA05/s507) policyholders are able to make partial surrenders or assignments of broadly up to 5% of accumulated premiums with any tax charge postponed until maturity or other later realisation. This is known as the '5% deferral rule' or the 'excess rule'. When the policy comes to an end any earlier withdrawals are taken into account in calculating the end gain.
> However when considering the position of a remittance basis user you will need to consider what income or gains they used to pay the premium due under the contract or policy. Where an individual purchases an overseas life insurance, or other income-generating, policy and subsequently part of that policy is surrendered for a cash payment and that money is brought to the UK, such payments will be treated as taxable remittances to the extent that the purchase of the original premium was made with the individual's untaxed foreign income and gains that would have been taxed on the remittance basis if remitted to the UK.
> So if the premium was paid using the individual's foreign income or foreign gains that were untaxed when they arose, because the individual was a remittance basis user in that year, then any of the 5% withdrawal will be a taxable remittance if the money is brought to, or received or used in, the UK. The amount attributable to the '5% withdrawal'

> indirectly derives from the original premium paid, so Conditions A and B of s809L apply.

For mixed fund issues where a policy is bought out of foreign income/gains, see 13.3.4 (Finding the income and capital for the year).

33.4.6 *Gains arising to non-resident individual*

The charge only applies "if the individual is UK resident for the tax year in which the gain arises": s.465(1) ITTOIA.

33.4.7 *Gains arising in split year*

Section 465(1A) ITTOIA provides the usual split year rule:

> But if the tax year is a split year as respects the individual, the individual is not liable for tax under this Chapter in respect of gains arising in the overseas part of that year (subject to section 465B).[20]

33.5 Non-resident period relief

There is a relief for the individual who is UK resident in the year that the gain arises (so they are within the charge) but who has formerly been non-resident. I refer to this as "**non-resident period relief**".

The development of the current law can be traced from a Consultation document Life Insurance - Time Apportioned Reductions (August 2012).[21]

EN FB 2013 provides:

> Clause 24 introduces Schedule 8 which amends the rules for time apportioned reductions from gains made on life insurance policies for periods when the policyholder is resident outside the UK. Current rules only provide for time apportioned reductions where a life insurance policy has been issued by a foreign insurer. Time apportioned reductions will be extended to life insurance policies issued by UK insurers. Time apportioned reductions will be calculated by reference to the residence history of the person liable to income tax on the gains and not by reference to the residence history of the legal owner of the policy.

The position, with transitional relief and provision for temporary non-residents, has become very complicated. I hope to address this in the next

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20 The words in brackets refer to the TNR rules: see 9.19 (Gains from policies and contracts).

21 *http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_032250*

edition.

33.6 Liability of UK trust

If the creator of the trust is alive and UK resident, they will be taxed on the gain.[22] Section 467 ITTOIA provides for the situations where the creator is not taxable:

> (1) Trustees are liable for tax under this Chapter if immediately before the chargeable event in question occurs they are UK resident and condition A, B, C or D is met.

I refer to **"trust policy conditions A, B, C or D"**. It is considered that these conditions must be satisfied immediately before the event, ie "immediately before" governs the phrase"they are UK resident" and "condition A, B, C or D is met".

> (1A) If trustees are liable for tax under this Chapter, the gain is treated for income tax purposes as income of the trustees.

The rate of tax is in principle 45%.[23]

An appointment to UK resident beneficiaries before the chargeable event may reduce the rate of tax and an appointment to non-resident beneficiaries may avoid tax altogether.

A trust migration may be effective if done before the chargeable event; it is not necessary to wait until the following tax year.

33.6.1 *Trust policy condition A (charitable trust)*

Section 467 ITTOIA provides

> (2) Condition A is that the rights under the policy or contract are held by the trustees on charitable trusts.

33.6.2 *Trust policy condition B (absent settlor)*

Section 467 ITTOIA provides

> (3) Condition B is that—
>
> (a) those rights are held by the trustees on non-charitable trusts, and
>
> (b) one or more of the absent settlor conditions is met.
>
> (4) The absent settlor conditions are that the person who created the

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22 See 33.4 (Liability of individuals and individual "creators").

23 Section 482 ITA type 7: see 25.2.3 (Other income taxed at top rates).

trusts—

(a) is non-UK resident,

(aa) is UK resident but the gain arises in the overseas part of a tax year that is, as respects the person who created the trusts, a split year,

(b) has died, or

(c) in the case of a company or foreign institution (see section 468(5)), has been dissolved or wound up or has otherwise come to an end.

33.6.3 *Trust policy conditions C and D*

Section 467 ITTOIA provides:

(5) Condition C is that—

(a) the rights under the policy or contract are held by the trustees on non-charitable trusts,

(b) condition B does not apply, and

(c) neither section 465 nor section 466 applies.

(6) Condition D is that the rights under the policy or contract are held as security for a debt owed by the trustees.

33.7 Non-resident trusts and companies

Non-resident trustees are outside the scope of the charge on a chargeable event because s.467 (which imposes the charge on trustees) applies only to UK resident trustees.

A non-resident company is outside the scope of the charge under ITTOIA (which does not apply to companies). It is outside the scope of the charges in CTA 2009 (which only apply to corporation tax).[24]

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24 For completeness, ESC C33 provides:

"Non-UK resident companies and chargeable event gains on life insurance policies, life annuity contracts and capital redemption policies

1 A "gain" may be treated as arising in connection with a policy of life insurance, a life annuity contract or a capital redemption policy when a "chargeable event" occurs or is treated as occurring. Chapter 2 of Part 13 of ICTA defines "chargeable events" and sets out how a "gain" is calculated where the chargeable person is a company. It also contains the other provisions relating to chargeable events referred to below. A gain may also be treated as arising on a company in connection with a personal portfolio bond under the Personal Portfolio Bond (Tax) Regulations, SI 1999/1029 reg 5.

2 This concession is about the circumstances in which a gain may be treated as part of the total income of a company.

In the absence of express provision, the chargeable event gain would not fall within the ToA provisions because the receipt by the person abroad (assuming they are non-resident) is capital and not income or (more fundamentally) the chargeable event gain is not income.[25] However, s.468 ITTOIA deals with this. It is helpful to consider trusts and companies separately.

33.7.1 *Non-resident trust*

Section 468 ITTOIA provides:

> (1) This section applies if a gain is treated as arising under this Chapter and ...
>
> (a) trustees who are non-UK resident would be liable for tax in respect of the gain as a result of section 467 if the trustees were UK resident immediately before the chargeable event in question occurs, ...
>
> (2) Chapter 2 of Part 13 of ITA 2007 (which prevents avoidance of tax where a UK resident individual benefits from a transfer of assets) applies with the modifications specified in subsection (3) or (4).
>
> (3) In a case within subsection (1)(a), Chapter 2 of Part 13 of ITA 2007 applies as if—
>
> (a) the gain were income becoming payable to the trustees, and
>
> (b) that income arose to the trustees in the tax year in which the

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These are when—
– a company is the beneficial owner of the rights conferred by a policy or contract;
– the rights are held on trusts created by an individual or a company; or
– the rights are held as security for a debt owed by a company.
3 The provisions that deem a gain to be part of the income of an individual or a company are not restricted to UK residents. Except as set out in para 4, however, HMRC will not pursue liability to tax on a gain that is treated as income of a company that is not resident in the UK at any time during the period for which the gain would otherwise have been charged.
4 A tax liability may arise if a policy or contract is held as property used by, or held by, a UK branch or agency of a company that is not resident in the UK.
5 Nothing in this concession affects—
– a gain that is treated as constituting income payable to non-resident trustees or to a company or other institution resident or domiciled outside the UK; and
– the tax treatment of a benefit that an individual ordinarily resident in the UK receives from the trustees, the company or other institution."

The concession is now redundant following the rewrite of the ICTA provisions and the rule is statutory rather than concessionary.

25 See 28.13 (Capital receipts deemed to be income).

gain arises. ...

This incorporates ss.720[26] and 731 ITA.

33.7.2 *Non-resident company or institution*

Section 468 ITTOIA provides (so far as relevant):

> (1) This section applies if a gain is treated as arising under this Chapter and ...
>
> (b) immediately before that event occurs—
>
> (i) a foreign institution[27] beneficially owns *a share* in the rights,
>
> (ii) the rights are held for the purposes of a foreign institution, or
>
> (iii) *a share* in them is held as security for a foreign institution's debt.
>
> (Emphasis added)

It is curious that (i) and (iii) refer to *shares* in rights. Contrast ss.465(2) and 467(2) ITTOIA.[28] On a traditional approach to statutory construction the (i) and (iii) do not apply if the foreign institution beneficially owns the *entire* policy. The gap is more or less filled by s.468(1)(b)(ii) as if a foreign company owns a policy, the rights are held for its purposes. If necessary a court might decide there was a slip in the drafting, which on a modern approach to construction could be corrected. Perhaps the drafting will be corrected some time.

Assuming s.468(1)(b) ITTOIA is satisfied, we read on:

> (2) Chapter 2 of Part 13 of ITA 2007 (which prevents avoidance of tax where a UK resident individual benefits from a transfer of assets) applies with the modifications specified in subsection (3) or (4). ...
>
> (4) In a case within subsection (1)(b), Chapter 2 of Part 13 of ITA 2007 applies as if—
>
> (a) the gain were income becoming payable to the institution, and

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26 Section 720 ITA is not needed here because a transferor within s.720 would normally be taxed as the creator of the settlement, but the overlap does not matter. It is similar to the overlap of s.624 ITTOIA and s.720 ITA.

27 "Foreign" is defined in s.468(5) ITTOIA: "In this Chapter 'foreign institution' means a company or other institution resident or domiciled outside the UK." The word institution is not defined.

28 See 33.4 (Liability of individuals and individual "creators") and 33.6 (Liability of UK trust).

(b) that income arose to the institution in the tax year in which the gain arises.

Section 720 ITA is needed here, as the transferor would not otherwise be taxed on the gain. The extension of the scope of s.720 in 2005 caught those described in the 4th edition of this work as "bold enough to plan on the assumption that the current law will still apply when a policy is surrendered at some time in the future".

33.7.3 *Transferor's s.731 defence: Gains arising before 5 December 2005*

Suppose:

(1) gains arose before 5 December 2005 to a foreign company or trust within s.731; the transferor was not subject to tax on those gains as they arose;[29] and

(2) the *transferor* receives a benefit.

A transferor is outside the scope of s.731: see 30.10 (Transferor's s.731 defence). Under the pre-5 December 2005 law, I suggested that the transferor's s.731 defence would not apply when s.720 did not apply. Now that s.720 does apply, the transferor's defence should apply even to pre-5 December 2005 gains. This could be something of a windfall for transferors; but since unrealised gains were brought within the s.720 charge from 5 December 2005, HMRC can hardly complain that realised gains now fall within the transferor's defence.

33.7.4 *Section 720 and s.731 remittance bases*

The s.720 remittance basis does not apply to a chargeable event gain within s.720, because the gain does not meet the requirement that the income of the person abroad "would be relevant foreign income if it were the individual's".[30]

For the same reason, a benefit which relates to the gain does not qualify for the s.731 remittance basis.[31]

33.7.5 *Income arising to life company*

So far we have considered the taxation of chargeable event gains arising to non-resident trusts or companies which hold policies.

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29 See the 4th edition of this book, para 20.5.

30 See 29.14 (Section 720 remittance basis).

31 See 30.35 (Section 731 remittance basis).

The payment to a non-resident life company (or a subsidiary of such a company) is in principle a transfer of assets within the ToA provisions. The ToA provisions would in principle apply if:
(1) income arising as a result of the payment can be identified (ie if the sum paid is segregated); and
(2) the motive defence does not apply.
In a straightforward case of the payment of a premium, the application of the motive defence is well established: *IRC v Willougby.*[32] If there were a tax avoidance purpose, however, the ToA provisions would in principle apply: the fact that a policy is taken out does not preclude the possibility of tax avoidance. As to whether this could lead to double taxation, see 31.8 (Life policies).

33.8 Section 624 and chargeable event gains

Section 624 ITTOIA never applies to a chargeable event gain. To see why, it is helpful to distinguish:
(1) UK resident settlor;
(2) non-UK resident settlor:
    (a) non-resident trustees;
    (b) UK resident trustees.

here the settlor is UK resident they are taxed on the gain under basic principles as a creator. Section 624 does not apply because the gain is not income of the trustees.

Where the settlor is non-resident and the trustees are non-resident, section 624 does not apply because the gain is not "income" and so it is not "income arising under a settlement".

Where the trustees are UK resident, but the settlor is not resident, the gain is deemed to be income of the trustees. In these circumstances the s.624 non-resident settlor defence will apply.[33]

33.9 Liability of personal representatives

Section 466 ITTOIA provides:

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32 70 TC 57.

33 That is, the gain is such that if the settlor were actually entitled thereto, they would not be chargeable to income tax by reason of being non-resident: see 27.6 (Non-resident settlor).

(1) Personal representatives are liable for tax under this Chapter if
[a] the rights under the policy or contract are held by them and
[b] the condition in subsection (2) is met
(and accordingly the gain is treated for income tax purposes as income of the personal representatives in that capacity).
(2) The condition is that if an individual were liable for tax on a gain in respect of the policy or contract, section 530(1) (individual treated as having paid tax at the basic rate) would be disapplied as a result of—
(a) section 531(1) (exceptions from section 530 for policies and contracts specified in section 531(3)), or
(b) para 109(2) of Schedule 2 (contracts in accounting periods beginning before 1st January 1992).
(3) For cases where the condition in subsection (2) is not met, see section 664 of this Act and [section 947 of CTA 2009] (under which the gain is treated as part of the aggregate income of the estate for the purposes of Chapter 6 of Part 5 of this Act and [Chapter 3 of Part 10 of CTA 2009] respectively).

The condition in subsection (2)(b) is a transitional rule now of limited scope.

In order to understand the condition in subsection (2)(a) one needs to follow a trail of statutory provisions. First, ss.530 and 531 ITTOIA:

530 Income tax treated as paid etc.
(1) An individual or trustees who are liable for tax on an amount under this Chapter are treated as having paid income tax at the basic rate on that amount.
...

I refer to this as a "**s.530 tax credit**".

531 Exceptions to section 530
(1) Section 530 does not apply to gains from the kinds of policies and contracts specified in subsection (3), except for the purposes of calculating relief under section 535 (top slicing relief).
(2) Subsection (1) is subject to—
section 532 (relief for policies and contracts with European Economic Area insurers), and
section 534 (regulations providing for relief in other cases where foreign tax chargeable).
(3) The policies and contracts are—
(a) a policy of life insurance issued or a contract for a life annuity made by a friendly society in the course of tax exempt life or

endowment business[34],

(b) a foreign policy of life insurance that does not meet conditions A and B,

(ba) a contract the effecting or carrying out of which constitutes protection business within the meaning of section 62 of FA 2012,

(bb) a contract which is not within paragraph (ba) but which, as a result of subsection (4) of that section, is treated for the purposes of that section as being made at any time,

(c) a contract for a life annuity (other than one within para (a)) which has at any time not formed part of any insurance company's or friendly society's basic life assurance and general annuity business the income and gains of which are subject to corporation tax, and

(d) a foreign capital redemption policy.

If we focus on foreign life policies, the relevant provision is (3)(b). The question is whether the foreign policy does not meet conditions A and B (which I will call "**foreign policy conditions A and B**"). Section 531(5) provides:

> Condition A is that the policy falls within para (a) of the definition of "foreign policy of life insurance" in section 476(3) (policy issued by a non-UK resident company).

So we turn to s.476(3) ITTOIA:

> In this Chapter—
> "foreign policy of life insurance" means—
> (a) a policy of life insurance issued by a non-UK resident company, and
> (b) a policy of life insurance which forms part of the overseas life assurance business of an insurance company or friendly society ...

A foreign policy will typically fall within that definition, so it will meet the condition in s.476(3)(a). The meaning of "overseas life assurance business" can be found in s.431D(1) ICTA:

> **431D Meaning of "overseas life assurance business"**
> (1) In this Chapter "overseas life assurance business" means so much of

34 Terms defined in subsection (4); the definitions need not be considered here.

> a company's relevant life assurance business as is with a policy holder or annuitant not residing in the UK (but not including the reinsurance of such business).

I think we conclude that most foreign policies will satisfy foreign policy condition A. That takes us to foreign policy condition B:

> (6) Condition B is that the conditions in para 24(3) of Schedule 15 to ICTA (conditions that are required to be met for certain policies issued by non-UK resident companies to be qualifying policies) are met throughout the period between—
>
> (a) the date on which the policy was issued, and
>
> (b) the date on which the gain arises.

It is easy to become tangled in the double double negatives, but I think the chain of reasoning goes as follows:

(1) Foreign policies will not (usually) satisfy condition B.
(2) So they fall within s.531(3)(b) ("a foreign policy of life insurance that does not meet conditions A and B").
(3) So they do not qualify for a s.530 tax credit.
(4) So they do meet the condition in s.466(2).
(5) So that PRs are liable for the chargeable event gain.

This could be avoided by an assent to a beneficiary.

Section 466 ITTOIA is not expressed to be limited to UK resident PRs. However s.368 ITTOIA provides:

> (1) Income arising to a UK resident is chargeable to tax under this Part whether or not it is from a source in the UK.
>
> (2) Income arising to a non-UK resident is chargeable to tax under this Part only if it is from a source in the UK....
>
> (3) References in this section to income which is from a source in the UK include, in the case of any income which does not have a source, references to income which has a comparable connection to the UK.
>
> (4) This section is subject to any express or implied provision to the contrary in this Part (or elsewhere in the Income Tax Acts).

Thus non-resident PRs are not chargeable. ITTOIA EN confirms that this is intended:

> 421. Chapter 1 of Part 4 of this Act provides a general territorial limitation on the scope of the Part. As regards income arising outside the UK, it limits the charge to such income arising to a UK resident. See section 368 (territorial scope of Part 4 charges) and the related commentary on that Chapter. [Section 465 ITTOIA] overlaps and

supplements that Chapter to ensure that a non-UK resident individual is not liable to tax under this Chapter on any gains, whether arising in the UK or elsewhere.

33.10 Planning for immigrant to UK

33.10.1 *Immigrant policyholder who has become resident in the UK 7 May 2014*

The advisers of a foreign domiciled person who has recently come to the UK should check whether they or any trust they have created has a policy or contract. If so, the position needs to be reviewed.

An assignment of the policy or contract from an individual to a trust (resident or not) does not help, since the individual remains liable as creator.

One simple form of planning is to arrange there is no chargeable event in a year when the individual is UK resident. The part surrender of up to 5% of the premium paid for the policy or contract per year is not a chargeable event. The surrender, assignment for money or money's worth and maturity of the policy or contract is normally a chargeable event but this can be anticipated and perhaps postponed to a year when the individual is non-resident. A death giving rise to benefits under the policy is also a chargeable event unless the policy is a qualifying policy. In such a case the individual may be at risk as death while UK resident may give rise to a tax charge.

Another course is for the individual to surrender their policy shortly after becoming UK resident; most of the gain will qualify for non-resident period relief.[35]

If a chargeable event is anticipated, the policy or contract could be assigned to a non-resident company, perhaps held by a trust. An assignment for no consideration is not a chargeable event. But the transfer of asset rules will need consideration.

33.10.2 *Planning before becoming UK resident*

There are further possibilities if the individual acts before the tax year in which they become UK resident. One possibility is to surrender the policy. A part surrender may also be a possible option.

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35 See 33.5 (Non-resident period relief).

33.11 Personal portfolio bonds

Urgent action needs to be taken if a UK resident individual (or trust created by them) holds a "personal portfolio bond" as defined in s.516 ITTOIA. The definition of "personal portfolio bond" requires a chapter to itself; it falls too far from the themes of this book to be pursued here.

33.12 CGT exemption for policies

Sections 204 and 210 TCGA provide exemptions for policies and contracts. In outline, policies are exempt unless assigned for consideration (known as secondhand policies).

33.13 DT relief on chargeable event gains

Suppose an individual who is UK resident and treaty-resident in a foreign state disposes of a policy so that chargeable event gains arise directly to them. The position is similar to OIGs: see 35.24 (DT relief on offshore income gain). It is an interesting question whether the individual claims relief under Art.13 or Art.21. At first sight chargeable event gains are "gains" which arise from the alienation of property, even though not chargeable gains and even though subject to income tax rather than CGT. But the gains are also "income" if that word is given its UK tax meaning. Of course it does not normally matter which of the articles apply, if the treaty has both. But if a particular treaty has an equivalent of art.21 (other income) but no capital gains article, then it is considered that treaty relief is still in principle available.

If a chargeable event gain arises without an alienation, relief is not available under Art.13 but may be available under Art 21.

33.14 IHT on policy held by foreign domiciliary

The IHT Manual provides:

> **30039 - Policies effected by a person who dies domiciled outside the UK** [January 2008]
> Under the proviso to the [Revenue Act][36] 1884 s.11 as amended by the [Revenue Act] 1889 s.19 a grant of representation (IHTM05001) in the UK is not necessary in order to recover money payable under a policy of life assurance effected with any insurance company by a person who

36 The Manual wrongly refers to the Customs & Inland Revenue Acts.

dies domiciled[37] outside the UK. For the purposes of this section, any policy under which a sum of money becomes payable on a death may be treated as a policy of life assurance, and any association of persons which issued policies in the ordinary course of its business, whether incorporated or not, may be treated as an insurance company.

These provisions do **not** confer any exemption from IHT. Where policy moneys are situate in the UK, tax is nonetheless payable though the moneys may be receivable without the production of a UK grant of representation.

The insurance company can however be liable for the tax where

[1] it retains policy moneys for the benefit of the beneficiary for investment purposes, outside the terms of the life assurance contract, in which case IHTA s.200(1)(c) may apply to the company as a vestee, or

[2] it received prior notice that the policy in question is subject to a statutory charge for tax under s.237 IHTA.[38]

Where there is other estate in the UK in respect of which a UK grant is necessary, but the UK representatives are only administrators acting under a power of attorney and in point of fact have not intermeddled with the policy moneys and, without knowledge of the claim for tax in respect of such moneys, have parted with the assets collected by them to their principal (the foreign executor), the claim in respect of the policy moneys should not be pursued against the UK administrators.

Similar conditions apply in Scotland to a Factor or Attorney authorised by executors abroad to give up an Inventory (in such cases it is the executors who are confirmed, not the Factor or Attorney).

Refer to TG [Technical Group] for consideration

- all enquiries on this topic
- any case where it is apparent that policy moneys have been paid out without a grant being produced.

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

The withheld text may well state that IHT in many cases is uncollectable and set out the circumstances in which no attempt should be made to collect it. In practice a well advised foreign domiciliary (not IHT deemed domiciled) will not acquire or retain a UK situate policy. However a person who is deemed UK domiciled may find this useful, as the executors

37 The IHT deemed domicile rule does not apply for this purpose.

38 In practice it is unlikely that either [1] or [2] will be the case.

can fund IHT more easily if they can first recover the money due under the policy and then pay the IHT and obtain a grant.

CHAPTER THIRTY FOUR

OFFSHORE FUNDS: DEFINITIONS

34.1 Offshore funds: Introduction

Before December 2009 I wrote that this subject needed a long book to itself. That is no longer the case: several volumes would now be needed to cover the subject properly.

I formerly added that it would be an unrewarding work because the rules are not well observed in practice. However this is true of many of the areas touched on by the FA 2008, so offshore funds are not now so different.

The background to the current law can be traced through a series of consultation papers in 2007/8[1] but these are now mainly of historic interest.

This chapter considers the definition of offshore fund and associated expressions. The following chapters consider the taxation of offshore funds.

The definitions discussed in this chapter were introduced by the FA 2009, which introduced s.40A - 40E FA 2008,[2] where they survived for one year before being rewritten into TIOPA.

The tax legislation is in the Offshore Funds (Tax) Regulations ("OFTR"). The OFTR naturally referred to the then current provisions in the FA 2008. Rewrite Acts did not update statutory references in secondary legislation so those references will remain indefinitely in the regulations. The obsolete references take effect as references to the corresponding new

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1 Offshore funds: a discussion paper (October 2007); Offshore funds: next steps (March 2008); Offshore funds: further steps (December 2008).

2 The FA 2009 sensibly jettisoned the reform in the FA 2007, which was thoroughly botched. The 2007 definition (discussed at 23.3 of the 7th edition of this work) is still relevant for transitional relief.

provisions[3] but readers need to work out for themselves what those are (I insert them in brackets). The Offshore Funds Manual is similarly out of date though eventually its references might be updated.

While the drafting in the FA 2008 was not beyond criticism, the reader may well question whether this rewrite was worthwhile, and be grateful that the rewrite project has come to an end; but there it is.

34.2 Meaning of "participant"

Section 362 TIOPA provides a commonsense definition:

> (1) In this Part references to "participant", in relation to arrangements (or a fund), are to a person taking part in the arrangements (or the arrangements constituting the fund), whether by becoming the owner of, or of any part of, the property that is the subject of the arrangements or otherwise.
> (2) In this Part references (however expressed) to participation, in relation to arrangements (or a fund), are to be read in accordance with subsection (1).

This definition only applies for the purposes of Part 8 TIOPA so it needs to be incorporated by reference when the same term is used elsewhere.

34.3 Meaning of "offshore fund"

34.3.1 *Basic definition*

Section 355(1) TIOPA provides:

> In section 354 "offshore fund" means—

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3 Para 5(1) Sch 9 TIOPA provides:
"Any reference (express or implied) in any enactment, instrument or document to a superseded enactment in its application for relevant tax purposes is to be read, so far as is required for those relevant tax purposes, as including, in relation to times, circumstances or purposes in relation to which any corresponding rewritten provision has effect, a reference to the rewritten provision."
Para 9(1) Sch 9 TIOPA provides: "In this Part—
"enactment" includes subordinate legislation (within the meaning of the Interpretation Act 1978),
"relevant tax purposes" means, in relation to a superseded enactment, tax purposes for which the enactment has been rewritten by this Act, and
"superseded enactment" means an earlier enactment which has been rewritten by this Act for certain tax purposes (whether it applied only for those purposes or for those and other tax purposes)."

(a) a mutual fund constituted by a body corporate resident outside the UK,
(b) a mutual fund under which property is held on trust for the participants where the trustees of the property are not resident in the UK, or
(c) a mutual fund constituted by other arrangements that create rights in the nature of co-ownership[4] where the arrangements take effect by virtue of the law of a territory outside the UK.

This definition only applies for the purposes of s.354, so it needs to be incorporated when the expression "offshore fund" is used elsewhere.[5]

In this work:

(1) **"a corporate fund"** means an offshore fund within (a) - a company.
(2) **"a non-corporate fund"** means an offshore fund within (b) or (c) - a unit trust or co-ownership arrangement.

34.3.2 *Residence of EU funds*

For completeness: Section 363A TIOPA provides a special residence rule for the benefit of EU offshore funds (in short, deeming such funds to be non-UK resident and thus disapplying the usual residence tests.) EN FB 2011 provides:

> The UCITS IV directive provides that an investment fund authorised under the provisions of Article 5 of that directive may have a manager which is not resident in the same State as that in which the fund is established and regulated.
> 6. [Section 363A] ensures that the affected offshore funds and their investors will not be subject to any tax consequences in the UK as a result of having a UK resident management company.

For the residence of trustees of a unit trust, see 39.3.2 (Residence of trustees of unit trust).

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4 Section 355(3) TIOPA provides:
"In this section ... "co-ownership" is not restricted to the meaning of that term in the law of any part of the UK."

5 So reg.3(1) OFTR provides:
"In these Regulations "offshore fund" has the meaning given by section 40A(2) of FA 2008 [now s.355(1) TIOPA] (read with the provisions of the relevant group of sections)."
The definition is similarly incorporated in s.378A(7) ITTOIA.

34.3.3 *Partnerships*

A general or limited partnership might fall within limb (c) of the definition but s.355(2) TIOPA takes it out:

> Subsection (1)(c) does not include a mutual fund constituted by two or more persons carrying on a trade or business in partnership.

It is assumed that a general or limited partnership does not fall within limb (b) of the definition.

A LLP might fall within limb (a) of the definition but s.355(3) TIOPA takes it out:

> In this section—
> "body corporate" does not include a limited liability partnership.[6]

Partnerships are excluded because partnership income and gains accrue to the partners: there is no scope or need for offshore fund rules.

34.3.4 *Luxembourg Fonds Commun de Placement*

Offshore Funds Manual 04400 [January 2012] provides:

> Types of mutual funds that come within the definition of an offshore fund at s.355(1)(c) TIOPA 2010 would include, for example, contractual arrangements such as Luxembourg Fonds Commun de Placement ...

On this topic see 39.7 (Luxembourg Fonds Commun de Placement).

34.3.5 *Power to vary definition*

The drafter (perhaps as a result of the lack of success of the earlier statutory definitions) did not have much confidence in the present statutory definition, and conferred wide powers to vary the rules by statutory instrument. These powers have not yet been exercised.

34.4 "Mutual fund"

The key term is "mutual fund". Section 356(1) TIOPA provides:

> (1) In section 355 "mutual fund" means arrangements with respect to property of any description (including money) that meet conditions A, B and C.

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6 This is otiose but it does not matter.

(2) Subsection (1) is subject—
(a) to the exceptions made by or under sections 357 and 359, and
(b) to sections 360 and 361.

I refer to "**mutual fund conditions A to C**".

34.4.1 *Mutual fund condition A: Mutuality*

Section 356(3) TIOPA provides:

> Condition A is that the purpose or effect of the arrangements is to enable the participants—
> (a) to participate in the acquisition, holding, management or disposal of the property, or
> (b) to receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

The intention, broadly, is that mutual funds should have the characteristics of pooled investments.

34.4.2 *Mutual fund condition B: Day-to-day management*

Section 356 TIOPA provides:

> (4) Condition B is that the participants do not have day-to-day control of the management of the property.
> (5) For the purposes of condition B a participant does not have day-to-day control of the management of property by virtue of having a right to be consulted or to give directions.

34.4.3 *Mutual fund condition C: Realisation at NAV*

Section 356(6) TIOPA provides:

> Condition C is that, under the terms of the arrangements, a reasonable investor participating in the arrangements would expect to be able to realise all or part of an investment in the arrangements on a basis calculated entirely, or almost entirely, by reference to—
> (a) the net asset value of the property that is the subject of the arrangements, or
> (b) an index of any description.

Offshore Funds Manual provides:

> **OFM05600 - Meaning of mutual fund: conditions: condition 'C': meaning of realisation of investment by reference to NAV or an index - S356(6) TIOPA 2010** [January 2012]

There is no definition within the legislation of 'almost entirely' as any sort of percentage limit of variation from NAV could be susceptible to arrangements seeking to avoid the intention of the offshore funds rules. It depends on what the arrangements are intended to provide. For example, buy-back arrangements normally take effect when there is a large discount to NAV, but may also be used in very exceptional circumstances to buy back at a very small discount or at NAV which, on its own, may not mean that the arrangements constitute a mutual fund. OFM10500 provides further guidance on share buy-backs and share issuance.

Realisation of investment on a basis calculated at or close to NAV

It is not necessary that the investor obtains NAV directly from the fund. Where a reasonable investor could expect to receive NAV on selling their interest on a secondary market the fund will be an offshore fund if all other conditions are satisfied. For example, Exchange Traded Funds (ETFs) are usually operated in such a way that the quoted prices are at NAV or very close to NAV because market makers are able to create or redeem units (and in that sense such funds are open-ended), and so ETFs would be expected to qualify as mutual funds. On the other hand, arrangements where a fund offered to buy back shares to keep a discount on the share price within a reasonable limit would not make the fund a mutual fund unless it was clear to a reasonable investor at the time that they invested (or on alteration of the terms of an investment) that there were such arrangements and that they were intended to ensure that such purchases were at NAV or almost or very close to NAV.

Where an investment is designed to produce a return for investors that equates in substance to a return on capital invested at interest none of the possible exceptions will apply (S357 (4)(c) TIOPA 2010) - see OFM06300.

Shares trading close to NAV

The mere fact that shares in a closed-ended arrangement sometimes trade at or close to NAV does not mean that Condition C is satisfied unless that is as a result of arrangements being in place such that a reasonable investor could expect to receive NAV or close to NAV on selling their interest.

Warrants and options

Warrants or options that give an investor the right to sell shares back to an issuer for a particular price will not cause Condition C to be satisfied unless the price is determined by reference to NAV so that the investment can be realised at or close to NAV. Similarly, rights that carry the option to convert to other classes of interest would only satisfy Condition C if the new rights themselves permitted an investor to realise their investment at or close to NAV.

Realisation of investment by reference an index

In some cases an investor may have a right to redeem an investment at an amount not representing the assets directly invested in, but which is expressed in terms of an index. The fund manager may then invest the assets so as to produce a return as nearly as possible matching the index which is offered. In such a case Condition C will also be met. Again, this is subject to exceptions where conditions 'E' or 'F' apply.

Offshore Funds Manual provides:

OFM04200 - Meaning of an offshore fund: Corporate entities - S355(1)(a) TIOPA 2010 [January 2012]

It is expected that relatively few fixed share capital companies will fall within the new definition. So, for example, an investment in a trading or investment company or group with fixed share capital and that was not limited life (even if local law provides for continuation votes) would not come within the definition. But under the characteristics based approach, entities that have fixed share capital and that are structured in such a way that they share characteristics of open-ended share capital arrangements will be within the definition. So, fixed share capital companies that are predicated on the basis that investors will get a net asset value return or a return which is very close to net asset value may fall within the new definition. That will also be the case where there are no redemption rights but the arrangements have a limited life and a reasonable investor could expect to get a net asset value return on winding up (unless one of the exceptions in S357 TIOPA 2010 applies).

34.5 Winding-up exemption

There are some exceptions to mutual fund condition C.

Section 357(1) TIOPA provides:

> Arrangements are not a mutual fund for the purposes of section 355 if—
> (a) condition D is met, and
> (b) condition E or F is met.

I refer to **"winding-up conditions D to F"** to avoid confusion with the other conditions.

Offshore Funds Manual provides:

OFM05600 - Meaning of mutual fund: conditions: condition 'C': meaning of realisation of investment by reference to NAV or an index - S356(6) TIOPA 2010 [January 2012]

... Open-ended and closed-ended arrangements

Condition C, when read in conjunction with section S357(2) TIOPA 2010 provides a clear distinction between a mutual fund and a company organised in the way that, for example, an investment trust company in the UK is organised. Such a company is a closed-ended company, in the sense that it does not allow investors to redeem their shares on request, nor does it issue new shares on request (but see OFM10600 onwards where such closed-ended companies have a limited life). This contrasts with an open-ended investment company which is designed to enable investors to realise NAV and does so through its ability to issue or redeem shares.

A reasonable investor in what may generally be regarded as a closed-ended company that meets Conditions A or B would normally only expect to be able to realise NAV on the liquidation of the company. So section S357(2) excludes from section S356 ('meaning of 'mutual fund' etc') any case where a reasonable investor would only be able to realise the investment in the arrangements in the

event of a winding-up, dissolution or termination of the arrangements, and where certain other conditions (condition 'E' or 'F') apply (section S357(1)(b) - see OFM06000 onwards).

Offshore Fund Manual provides:

OFM06100 - Exceptions to meaning of mutual fund: introduction - Section 357(3) TIOPA 2010 [January 2012]

...Section 357(2) has the effect that 'open-ended' arrangements (i.e. those that enable investors to realise NAV by disposing of their interest) cannot come within the exceptions provided by S357.

The conditions E or F do, however, except certain types of closed-ended arrangements from the meaning of a 'mutual fund'.

The exceptions can also apply to arrangements where a reasonable investor could expect to realise their investment at or close to NAV as a result of the intention of a fund to dispose of its assets in tranches followed by a final distribution of any remaining assets, as opposed to a liquidation of all of the fund's assets on a winding-up (see OFM05700).

34.5.1 *Winding-up condition D (no liquidation date)*

Section 357 TIOPA provides:

(2) Condition D is that, under the terms of the arrangements, a reasonable investor participating in the arrangements would expect to be able to realise all or part of an investment in the arrangements on a basis mentioned in section 356(6) only in the event of the winding up, dissolution or termination of the arrangements.....

(8) For the purposes of this section the fact that arrangements provide for a vote or other action that may lead to the winding up, dissolution or termination of the arrangements does not, by itself, mean that the arrangements are designed to wind up, dissolve or terminate on a date stated in or determinable under the arrangements.

Offshore Funds Manual provides:

OFM06200 - Exceptions to meaning of mutual fund: condition E - Section 357(3) TIOPA 2010 [January 2012]

The most important exception, provided by condition E (section 357(3)), is that a reasonable investor cannot expect the arrangements to terminate on or by a date fixed in advance.

This condition means, for example, that ordinary shares in any company with defined share capital (that is, not an open-ended company with variable share capital) and which does not have a limited life, will not be an offshore fund.

Condition E requires that the arrangements are not such that they are designed to terminate on a date that is stated or determinable under the arrangements. As elsewhere "arrangements" has a wide meaning and is not limited to the documents establishing the fund, so can include all agreements and

understandings. Similarly, "determinable" has a wide meaning. So for example, if a fund prospectus stated that the fund was intended to wind-up after it had realised all of its assets, but those assets consisted of debt instruments none of which was longer dated than 5 years then the termination date would be determinable (unless, of course, it was clear that the fund would reinvest the proceeds of asset realisations and was not 'limited life' in any other regard).

Asset realisations

It will not be sufficient to satisfy condition E for a fund to state that an intention to dispose of its assets on or by a certain date is subject to market conditions or some similar caveat where it is clear that a long-stop date exists, or there is no specific and realistic possibility that would lead a reasonable investor to conclude that the fund would not necessarily be able to dispose of its assets by the date stated. For example, if a fund's assets consist of short-dated debt instruments, or commercial leases with a life of 20 years then, unless the fund was reasonably likely to re-invest funds from disposals, condition E could not be satisfied. Where there is no such long-stop date implicit from the nature of the assets themselves then condition E may still not be satisfied if a fund stated an intention to dispose of its assets in, say, four years' time 'subject to market conditions' or some other broad statement.

HMRC will consider particular cases where a fund manager or its advisers believe that there are tangible and specific reasons why such a statement should lead to condition X being satisfied but this is expected to apply in exceptional circumstances only. An example of the circumstances when a broad statement relating to whether assets could be realised on or by a given date may be sufficient to satisfy condition X would be if a fund held significant assets in a country about which there were real and significant concerns regarding any future government's policy in respect of the assets in question (such as public declarations of an intention to nationalise particular industries or companies in which the fund holds significant investments).

Continuation votes

Where arrangements provide for a continuation vote or similar action to determine whether they will persist beyond a given date that will not, in itself, mean that condition E is not met. So, if a reasonable investor, considering all of the facts, could not have any expectation that a continuation vote would fail then, provided the continuation vote was not for a determinable period and absent any other factors, the arrangements could not be said to have a determinable life and condition E could then be satisfied. HMRC accept that it could usually be expected that condition E would be satisfied where continuation votes are provided for because continuation resolutions may well be passed if a fund is performing well, and a reasonable investor would be expected to invest on the basis that a fund would be successful. However, if arrangements or understandings are in place so that it could be expected that a continuation vote would not be passed then there would be a determinable date. Even if a date of termination is stated or determinable, so that condition E could not be satisfied, it is still necessary to consider Condition F to determine if the arrangements amount to a 'mutual fund' - see OFM06300 to OFM06600.

34.5.2 *Winding-up condition E (no fixed termination date)*

Section 357(3) TIOPA provides:

> Condition E is that the arrangements are not designed to wind up, dissolve or terminate on a date stated in or determinable under the arrangements.

34.5.3 *Winding-up condition F (no income)*

Section 357(4) TIOPA provides:

> Condition F is that—
> (a) the arrangements are designed to wind up, dissolve or terminate on a date stated in or determinable under the arrangements,
> (b) subsection (5), (6) or (7) applies, and
> (c) the arrangements are not designed to produce a return for participants that equates, in substance, to the return on an investment of money at interest.

34.5.4 *Subsection (5): No income-producing assets*

Section 357(5) TIOPA provides:

> This subsection applies if none of the assets that are the subject of the arrangements is a relevant income-producing asset (see section 358).

Section 358 TIOPA provides the definition:

> (1) This section has effect for the purposes of section 357.
> (2) An asset is a relevant income-producing asset if it produces income on which, if it were held directly by an individual resident in the UK, the individual would be charged to income tax (but see subsections (3) and (4)).
> (3) An asset is not a relevant income-producing asset if the asset is hedged, provided that no income is expected to arise from—
> (a) the asset (taking account of the hedging), or
> (b) any product of the hedging arrangements.
> (4) Cash awaiting investment is not a relevant income-producing asset, provided that the cash, and any income that it produces while awaiting investment, is invested as soon as reasonably practicable in assets that are not relevant income-producing assets (as defined by this section).

This is designed to exclude funds which invest in assets intended to give a purely capital growth based return.

Offshore Funds Manual provides:

OFM05600 - Meaning of mutual fund: conditions: condition 'C': meaning of realisation of investment by reference to NAV or an index - S356(6) TIOPA 2010 [January 2012]

Realisation of investment by reference an index

...In many cases investments designed to produce an indexed return are likely to be non-income producing (that is, they reflect capital growth only) in which case the exception provided by S357(5) - condition F - will apply (see OFM06200 onwards).

Where an investment is by reference to an index that reflects both capital growth and income returns then S357(5) would not apply, but condition F may still apply due to S357(7) - see OFM06600.

34.5.5 *Subsection (6): No entitlement to income*

Section 357(6) TIOPA provides:

> This subsection applies if, under the terms of the arrangements, the participants in the arrangements are not entitled to the income from the assets that are the subject of the arrangements or any benefit arising from such income.

Offshore Funds Manual provides:

OFM06500 - Exceptions to meaning of mutual fund: condition F: no entitlement to income or any benefit arising from income - Section 357(6) TIOPA 2010 [January 2012]

An example of an arrangement satisfying this condition might be the capital shares or units in an arrangement which splits the rights to capital and income between the holders of different classes of interest, where the holders of capital shares or units are not entitled to any of the income or any benefit arising from the income.

34.5.6 *Subsection (7): Income distributed*

Section 357(7) TIOPA provides:

> This subsection applies if—
>
> (a) under the terms of the arrangements, after deductions for reasonable expenses, any income produced by the assets that are the subject of the arrangements is required to be paid or credited to the participants, and
>
> (b) a participant who is an individual resident in the UK would be charged to income tax on the amounts paid or credited.

34.6 Share buy-backs and share issuance

Offshore Funds Manual provides:

OFM10500 - Particular arrangements: share buy-backs and share issuance
[January 2012]
The price or value of shares in fixed share capital companies may reflect either a discount or a premium to the net asset value of the underlying assets. It may also be the case in some circumstances that there is either directors' or investors' discretion to allow or require the buy-back of shares if there is a discount of a certain level between the net asset value of the arrangements and the share price. Provided the share buy-back arrangements are made to prevent the discount becoming too large by reference to net asset value, and provided a reasonable investor cannot expect to realise their investment either entirely or almost entirely by reference to net asset value (or by reference to an index), and there is no determinable termination date, then such arrangements will be outside the definition of an offshore fund for UK tax purposes (as Condition C at TIOPA2010/S356 will not be satisfied). Similar considerations apply where the shares trade at a premium.
For example, if a foreign equivalent of an investment trust was trading at a discount of 15% to NAV and bought its own shares on the open market to reduce the discount then, absent any factors that could lead to an investor being able to expect to redeem their investment at or close to NAV, this would not cause Condition C at TIOPA2010/S356(6) to be satisfied: it is clear that before the company commenced to buy its own shares that some investors would not have been able to redeem their interest at NAV and that any subsequent reduction in the discount would be due to normal operation of the market. Without any factors indicating that the company would act to reduce the discount either having been in place prior to this market activity or at some point in the future, a reasonable investor could not expect to realise their investment at or close to NAV.
However, share buy-back arrangements that are specifically designed to provide tracking to net asset value will cause the company or share class to come within the definition of offshore fund. This would include any arrangements introduced as a result of changes to the constitution of a scheme. If a change in the terms of a scheme result in it coming within the definition of an offshore fund then UK investors are treated as if they had always held an interest in an offshore fund. If the fund becomes a reporting fund then investors may be able to make an election under regulation 48(2) to crystallise any offshore income gain at that point, with any subsequent gain being subject to chargeable gains treatment (provided the fund remains a reporting fund). See OFM15200 and OFM19000 for further guidance.
When considering an investor's rights, account should be taken of all scheme documents, promotional documentation or communications to determine what guarantees or undertakings may have been given to the investor.
An undertaking or guarantee, etc, to buy back or redeem only a part of an investor's holding entirely or almost entirely by reference to the net asset value of the property or an index of any description can still constitute an expectation, so for example if the fund manager undertook to redeem or buy back an investor's shares in tranches the arrangements could still be within the definition.

Warrants or options that give an investor the right to sell shares back to an issuer for a particular price will not cause Condition C to be satisfied unless the price is determined by reference to NAV so that the investment can be realised at or close to NAV. Similarly, rights that carry the option to convert to other classes of interest would only satisfy Condition C if the new rights themselves permitted an investor to realise their investment at or close to NAV.

34.7 Companies in course of liquidation

Offshore Funds Manual provides:

OFM10630 Particular arrangements: limited life companies: company liquidations [January 2012]

An investor may have invested in a company or other arrangement which subsequently goes into liquidation, at which point the investor might reasonably expect to realise their investment at net asset value. However, if a company or other arrangement is outside the definition of an offshore fund before it goes into liquidation, then being in liquidation will not by itself bring that company or arrangement into the definition of an offshore fund. This also applies in the case of self-managed wind downs with the subsequent appointment of a liquidator to complete the liquidation.

This treatment would also extend to the purchase of shares in a company after it has entered a self-managed wind down or liquidation. This may not be the case, though, for wind downs and liquidations that are intentionally extended or contrived.

Some overseas companies can be liquidated or reconstructed at any time. If there is a decision to do so, at the point of the approval of the reconstruction or liquidation the investors may obtain net asset value. However, the relevant point is whether a reasonable investor can expect the company to be liquidated or reconstructed in order to deliver net asset value. It is necessary to consider the reasonable investor's expectation to realise their investment either entirely or almost entirely by reference to net asset value (or by reference to an index) when the company was established (or when there was a change in the investor's rights).

34.8 Umbrella arrangements

34.8.1 *Meaning of "umbrella arrangements"*

Section 363 TIOPA provides:

(1) In this Part "umbrella arrangements" means arrangements which provide for separate pooling of the contributions of the participants and the profits or income out of which payments are made to them.

(2) In this Part references to a part of umbrella arrangements are to the arrangements relating to a separate pool.

34.8.2 *Treatment of "umbrella arrangements"*

Section 360 TIOPA provides:

> (1) This section has effect for the purposes of this Part.
> (2) In the case of umbrella arrangements (see section 363)—
> (a) each part of the umbrella arrangements is to be treated as separate arrangements, and
> (b) the umbrella arrangements are to be disregarded.
> (3) Subsection (2)(a) is subject to section 361.

Regulation 5 OFTR provides:

> In these Regulations, in relation to an offshore fund constituted by a part of umbrella arrangements (within the meaning of section 40C of FA 2008)—
> (a) a reference to the assets of an offshore fund is to such of the assets of the umbrella arrangements as under the arrangements form part of the separate pool to which that part of the umbrella arrangements relates;
> (b) a reference to the income of an offshore fund is to the income arising from those assets; and
> (c) a reference to a participant in an offshore fund is to a person for the time being owning an interest in that separate pool.

Offshore Funds Manual provides:

> **OFM08000 - Definition of an offshore fund: umbrella funds & protected cell companies - Section 363 TIOPA 2010** [January 2012]
> 'Umbrella arrangements' means arrangements which provide for separate pooling of the contributions of investors and the profits or income out of which payments are made to them (S363(1) TIOPA2010). References to part of an umbrella arrangement are to the arrangements relating to a separate pool (or 'sub-fund'). Umbrella arrangements will not themselves be treated as an offshore fund. Instead -
> - Each sub-fund and each class of interest is treated as an offshore fund in its own right,
> - The umbrella fund is not treated as an offshore fund,
> - The overall arrangements are disregarded.
>
> The same approach applies to an individual cell of a protected cell company.
> For umbrella arrangements and protected cell companies, it would usually follow that each sub-fund has the same residence status as the overall arrangement. In the case of a non-resident company it would be expected that each sub-fund would also be non-resident if it was under the "central management and control" of the directors of the company which constitutes the overall arrangement. In the case of a unit trust scheme, the trustees of the overall trust arrangements will usually also be the trustees of each separate arrangement, and so their residence

status determines the residence of the fund, but where there are different trustees for each sub-fund then each must be considered separately. The "central management and control" test is also applicable to unit trusts.

34.9 Arrangements comprising more than one class of interest

Section 361 TIOPA provides:

(1) This section has effect for the purposes of this Part.
(2) Where there is more than one class of interest in arrangements (the "main arrangements")—
(a) the arrangements relating to each class of interest are to be treated as separate arrangements, and
(b) the main arrangements are to be disregarded.
(3) In relation to umbrella arrangements, "class of interest" does not include a part of the umbrella arrangements (but there may be more than one class of interest in a part of umbrella arrangements).

Regulation 6 OFTR provides:

In these Regulations, in relation to an offshore fund constituted by a class of interest in the main arrangements (within the meaning of section 40D of FA 2008)—
(a) a reference to the assets of an offshore fund is to the assets of the main arrangements;
(b) a reference to the income of an offshore fund is to such of the income of the main fund as is attributable to interests of that class under the arrangements constituting the main arrangements; and
(c) a reference to a participant in an offshore fund is to a person for the time being owning an interest of that class.

Offshore Funds Manual provides

OFM09000 - Definition of an offshore fund: classes of interest - Section 361 TIOPA 2010 [January 2012]
"Class of interest" is not limited to share classes. There may be other forms of interest which entitle an investor to realise their investment on a basis calculated entirely or almost entirely by reference to the net asset value of the scheme property or an index. For example, certain types of loan may give a return which tracks NAV or is based on an index. A class of interest may also be created as a result of new issues or conversions of existing rights.
It is possible for an entity, particularly a company, to have a class of interest such as ordinary shares which does not constitute a mutual fund and another class of interest which does constitute such a mutual fund.
However, a particular class of shares can only constitute a single class of interest even if different types of holders of those shares enjoy different rights. For

example, in the case of an exchange traded fund, the creation unit holders who act as market makers might have the right to redeem or issue shares directly but if that same class of shares were acquired by another investor on the secondary market then they would still form part of the same class of interest and satisfy Condition C (s356 TIOPA 2010) because, as a consequence of the market makers' ability to redeem or create units, all other investors would expect to be able dispose of their interest at or close to NAV. (See also OFM10200 regarding exchange traded funds).

34.10 "Reporting" and "non-reporting" funds

Regulation 4 OFTR provides:

> (1) Offshore funds consist of—
>
> (a) non-reporting funds (see Part 2 of these Regulations), and
>
> (b) reporting funds (see Part 3 of these Regulations).
>
> (2) In a period of account, an offshore fund is a non-reporting fund unless it is a fund to which Part 3 of these Regulations applies...

Regulation 50 OFTR provides:

> In these Regulations a "reporting fund" means an offshore fund to which this Part applies for a period of account.

The requirements to qualify as a reporting fund are not discussed here. HMRC provide a list of reporting funds.[7] This list is quite short. Presumably fund managers do not generally think it is worth the trouble.

7 *http://www.hmrc.gov.uk/collective/reportingfundlist.pdf.*

CHAPTER THIRTY FIVE

OFFSHORE INCOME GAINS

35.1 Taxation of offshore funds: Introduction

The next two chapters consider the taxation of offshore funds. This chapter considers offshore income gains arising on the disposal of an offshore fund (it is assumed that the relevant conditions are met, in short, that the fund is a non-reporting fund). The next chapter considers income from offshore funds.

The tax legislation is mainly in the Offshore Funds (Tax) Regulations 2009 ("OFTR"). It is unfortunate that this important matter was left to regulations, since the drafting and opportunity for consideration are of lower quality, but there it is. The ink of the regulations had hardly dried before they were amended, first in 2009, with a more substantial rounds of amendments in 2011 and 2013.

The OFTR's obsolete references to the FA 2008 take effect as references to the legislation now in TIOPA.[1]

I do not consider in full the position of offshore funds held by UK resident companies.

35.1.1 *Cross references*

For OIGs of temporary non-residents, see 9.20 (Offshore funds).

For OIGs of charities, see Kessler & Marre, *Taxation of Charities & Non-profit Organisations* (9th ed., 2013), para 3.16 (Offshore Funds) (online version *http://www.taxationofcharities.co.uk*).

35.2 Definitions

See 34.2 (Meaning of "participant"); 34.3 (Meaning of "offshore fund"); 34.4 ("Mutual fund").

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1 See 34.1 (Offshore funds – Introduction).

35.2.1 *Meaning of "interest in an offshore fund"*

Regulation 8(1) OFTR provides a commonsense definition:

> For the purposes of these Regulations the interest of a participant in an offshore fund is the investment held by a participant taking part in arrangements (or arrangements constituting a fund) to which the relevant group of sections applies.

35.3 Charge to tax on OIGs

The legislation distinguishes:

(1) Offshore income gains ("**OIGs**"), which arise on a disposal of a non-reporting offshore fund and fall within the offshore funds rules.

(2) Chargeable gains, within the scope of CGT. I refer to this for clarity as "**CGT chargeable gains**" though strictly the term "chargeable gains" is only applicable to CGT. The HMRC Manuals sometimes use the term "capital gains" which is slightly inapt, but reasonably clear.

Regulation 17(1) OFTR provides the charge to tax:

> There is a charge to tax if—
>
> (a) a person disposes of an asset,
>
> (b) either condition A or condition B is met, and
>
> (c) as a result of the disposal, an offshore income gain arises to the person making the disposal.

I refer to **"non-reporting fund conditions A and B"**.

This provision refers to a "person" so it applies to individuals, trustees, companies and PRs.

35.3.1 *Non-reporting fund condition A*

Regulation 17(2) OFTR provides:

> Condition A is that the asset is an interest in a non-reporting fund at the time of the disposal.

35.3.2 *Non-reporting fund condition B*

Condition B concerns funds changing from non-reporting to reporting fund status. Regulation 17(3) OFTR provides:

> Condition B is that—
>
> (a) the asset is an interest in a reporting fund at the time of the disposal,

(b) the reporting fund was previously a non-reporting fund (becoming a reporting fund as the result of an application under regulation 52),
(c) the interest was an interest in a non-reporting fund during some or all of the material period,[2]
(d) an election under regulation 48 was not prevented by paragraph (5) of that regulation, and
(e) no election has been made under regulation 48(2).

35.3.3 *Treatment of OIGs*

Regulation 18(1) OFTR provides:

> The offshore income gain arising is treated for all the purposes of the Tax Acts as income which arises at the time of the disposal to the person making the disposal (or treated as making the disposal).[3]

An OIG is not income for trust law purposes, for instance proceeds of sale of an offshore fund represent an OIG but are not payable to a life tenant.

> (2) The tax is charged on the person making the disposal (or treated as making the disposal).
> (3) In the case of a person chargeable to income tax, tax is charged under Chapter 8 of Part 5 of ITTOIA 2005 (miscellaneous income: income not otherwise charged) for the year of assessment in which the disposal is made ...

This incorporates s.687(1) ITTOIA:

> Income tax is charged under this Chapter on income from any source that is not charged to income tax under or as a result of any other provision

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2 Defined regulation 17(4) OFTR:
"For the purposes of paragraph (3)(c) the "material period" means a period beginning with the day on which consideration was given for the acquisition of the asset or on 1st January 1984 (whichever is the later) and ending with the day on which the fund became a reporting fund."

3 In accordance with the principles of plain English drafting, reg.18(5) (somewhat unnecessarily) flags up some cross references:
"Paragraph (1) is subject to—
(a) regulation 19 (income treated as arising under regulation 17: remittance basis);
(b) regulation 20(1) (offshore income gain arising to non-resident trustees not treated as income of settlor);
(c) regulation 20(5) (application to gains of non-resident settlements);
(d) regulation 24(6) (application of section 13 of TCGA 1992)."

of this Act or any other Act.[4]

This is the charge on miscellaneous income (in pre-ITTOIA terminology, schedule D case VI).

Regulation 18(3) continues:

> but sections 688(1) and 689 of ITTOIA 2005 (income charged and person liable) do not apply.

The disapplied sections provide (so far as relevant here):

> ***688 Income charged***
> *(1) Tax is charged under this Chapter on the amount of the income arising in the tax year.*
> *(2) Subsection (1) is subject to ...*
> *(c) Part 8 (foreign income: special rules).*
> ***689 Person liable***
> *The person liable for any tax charged under this Chapter is the person receiving or entitled to the income.*

At first sight this is worrying since the disapplied sections (among other things) incorporate the remittance basis for miscellaneous income. However these sections are only disapplied because regulations 18(2) and 19 OFTR cover the same area.

35.4 Meaning of "disposal"

It will be recalled that there is a charge to tax if a person disposes of an offshore fund. "Disposal" is defined in chapter 4 part 2 OFTR. Regulation 32 provides:

> This Chapter applies if a participant disposes of an asset and at the time of the disposal—
> (a) the asset is an interest in a non-reporting fund, or
> (b) the asset is an interest in a reporting fund and the requirements specified in paragraph (3) of regulation 17 (read, as appropriate, with paragraphs (4) and (5) of that regulation) are met.

I cannot see the point of this, as if a participant disposes of an asset which is not within (a) or (b) then there is no charge under the OFTR and the

---

4 Similarly for CT, reg.18(4) OFTR provides:
"In the case of a person chargeable to corporation tax, tax is charged under Chapter 8 of Part 10 of CTA 2009 (miscellaneous income: income not otherwise charged) for the accounting period in which the disposal is made."

question of whether there is a disposal for the purposes of the OFTR does not arise. I would be grateful to any reader who could explain. However that may be, reg.32 does no harm.

We can move on to reg.33(1) which defines disposal:

> There is a disposal of an asset for the purposes of these Regulations if there would be a disposal of an asset for the purposes of TCGA 1992.

It is considered that this incorporates the CGT rules on the timing of disposals, as well as the CGT definition of disposal.

OFTR contains four rules where the position differs from the CGT rules.[5] Regulations 35-37 relate to reorganisations and are not discussed here. Regulation 34 concerns the position on death.

35.5 Death of individual

For CGT purposes, there is no disposal on death. Section 62(1) TCGA provides:

> For the purposes of this Act the assets of which a deceased person was competent to dispose—
>
> (a) shall be deemed to be acquired on his death by the personal representatives or other person on whom they devolve for a consideration equal to their market value at the date of the death, but
>
> (b) shall not be deemed to be disposed of by him on his death (whether or not they were the subject of a testamentary disposition).

Regulation 34(1) OFTR undoes this and provides for a deemed disposal on death:

> Notwithstanding anything in paragraph (b) of subsection (1) of section 62 of TCGA 1992 (general provisions applicable on death: no deemed disposal by the deceased), where a person dies and the assets of which the deceased was competent to dispose[6] at the time of death include an interest in a non-reporting fund, then, for the purposes of these Regulations—

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5 Flagged by reg.32(2) OFTR.

6 Regulation 34(2) defines this expression by reference:

"... the reference in that paragraph to the assets of which a deceased person was competent to dispose are to be construed in accordance with [s.62(10) TCGA]."

Section 62(10) provides a commonsense definition; see 78.4 (Acquisition by PRs).

> (a) immediately before the acquisition referred to in paragraph (a) of that subsection, that interest shall be deemed to be disposed of by the deceased for such a consideration as is mentioned in that subsection; ...

For completeness, reg.34(1) concludes:

> but (b) nothing in this regulation affects the determination, in accordance with regulation 32, of the question whether that deemed disposal is one to which this Chapter applies.

I cannot see the point of that, just as I cannot see the point of regulation 32, but it does no harm.

Regulation 34(2) incorporates other rules of s.62 TCGA:

> (2) Subject to paragraph (1), section 62 of TCGA 1992 applies for the purposes of these Regulations as it applies for the purposes of that Act...,

The following provisions of s.62 therefore apply for OIGs; I set out the section highlighting the amendments that the context requires when applying the section to OIGs:

> [(2) and (2A) deal with losses and are not relevant to OIGs.]
> (3) In relation to property forming part of the estate of a deceased person the personal representatives shall for the purposes of this Act be treated as being a single and continuing body of persons (distinct from the persons who may from time to time be the personal representatives), and that body shall be treated as having the deceased's residence and domicile at the date of death.
> (4) On a person acquiring any asset as legatee (as defined in section 64)—
> (a) no ~~chargeable~~ offshore income gain shall accrue to the personal representatives, and
> (b) the legatee shall be treated as if the personal representatives' acquisition of the asset had been his acquisition of it.
> (5) Notwithstanding section 17(1) no ~~chargeable~~ offshore income gain shall accrue to any person on his making a disposal by way of donatio mortis causa.
> [Subsections (6) to (9) deal with IoVs and need not be set out here.]

The OF Manual correctly provides:

> **OFM14200 Investors in non-reporting funds: disposals of interests: death of participant – regulation 34** [January 2012]
> ...An offshore income gain arises and resulting tax becomes payable

> before the estate of the deceased person is valued for inheritance tax purposes.

There is scope for deathbed planning: a lifetime gift to charity or to a spouse avoids the OIG charge on death, because no OIG arises on the disposal (applying CGT rules which brings into effect the CGT spouse exemption and the CGT charity exemption). By contrast if there is a gift by will to charity or to a spouse the OIG comes into charge on the death.

It seems that a gift by way of donatio mortis causa also avoids the charge on death.

35.6 OIG accruing to partnership

Partnerships are transparent for IT and CGT, and this rule applies to OIGs. SAI Manual provides:

> **6370 Offshore income gains: The tax charge** [November 2011]
> Where an offshore income gain is realised by a partnership, each partner should be separately assessed in respect of his share of the ... income.

35.7 OIG remittance basis

Regulation 19 OFTR provides:

> (1) This regulation applies to income treated as arising under regulation 17 to an individual in a tax year if—
>
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
>
> (b) the individual is not domiciled in the UK in that year.
>
> (2) The income is treated as relevant foreign income of the individual.

The significance of treating the income as RFI is that the income can qualify for the remittance basis. I refer to this as "**the OIG remittance basis**".

The remittance basis applies even if the offshore fund is a UK situate asset (the CGT situs rules are not relevant) but in practice that is not likely to happen.

So long as the gain is not remitted, the foreign domiciled individual will not care if the gain is a chargeable gain or an OIG, ie they will not care whether or not the asset disposed of is an offshore fund.

Regulation 19(3) contains two rules:

> For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis)—

(a) any consideration obtained on the disposal of the asset[7] is treated as deriving from the income

At first sight it is not clear why reg.19(3)(a) is needed. It seems self-evident. There is no equivalent in the CGT charge on gains accruing to individuals. But a reason will emerge.[8]

Regulation 19(3) continues:

> For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis) ...
>
> (b) unless the consideration so obtained is of an amount equal to or exceeding the market value of the asset, the asset is treated as deriving from the income.

Regulation 19(3)(b) is the equivalent of the CGT rule for deemed gains.[9]

35.8 OIG arising to UK trust

35.8.1 *UK resident trust (not settlor-interested)*

A UK resident trust is in principle subject to income tax on its OIGs.[10] Tax is charged at the trust rate, 45%: it falls within s.482 type 3, see 25.2.3 (Other trust income taxed at top rates).

35.8.2 *UK resident settlor-interested trust*

An OIG arising to UK trustees is not "income" in the general sense and in the absence of express provision it would not fall within s.624 ITTOIA which only applies to income. However reg.18 OFTR directs that the OIG is "treated for all the purposes of the Tax Acts as income" so it does fall within s.624 ITTOIA.

If the settlor is a remittance basis taxpayer the s.624 remittance basis applies, ie an unremitted OIG is not taxed on the settlor but on the trustees.[11]

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7 Reg 19(4) provides two somewhat unnecessary definitions:
"In paragraph (3)—
(a) "the asset" means the asset the disposal of which causes the income to be treated as arising, and
(b) "the disposal" means the disposal mentioned in sub-paragraph (a) of that paragraph."

8 See 35.13.6 (OIG s.87 TCGA remittance basis).

9 See 11.30 (CGT disposal not for market value).

10 See 35.3 (Charge to tax on OIGs).

11 See 27.4 (Section 624 remittance basis).

The rate of tax in the absence of s.624 is the trust rate (2013/14 = 45%), so s.624 can only reduce the tax rate (or make no difference).

35.9 OIG non-residence defence

Regulation 22(1) OFTR provides a territorial limitation for non-residents:

> The following enactments have effect in relation to income tax or corporation tax in respect of offshore income gains as they have effect in relation to capital gains tax or corporation tax in respect of chargeable gains—
>
> (a) section 2(1) of TCGA 1992 (persons chargeable to capital gains tax) ...

Amended as reg. 22(1) directs, s.2(1) TCGA provides (so far as relevant):

> ... a person shall be chargeable to *income tax* in respect of *offshore income gains* accruing to him in a year of assessment if the residence condition is met.

This incorporates the CGT territorial limitations by reference.[12] By implication, a person not resident is not chargeable to IT on offshore

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12 See 49.1.2 (CGT residence condition). For completeness: Regulation 22 OFTR also incorporates s.10 TCGA which would apply if a non-resident carried on a trade through a branch or agency and used the offshore funds for the purposes of the trade. This gives a neat symmetry with the CGT rules but it is hard to imagine that this will ever apply in practice. The regulation provides:

"(1) The following enactments have effect in relation to income tax or corporation tax in respect of offshore income gains as they have effect in relation to capital gains tax or corporation tax in respect of chargeable gains—

(a) section 2(1) of TCGA 1992 (persons chargeable to capital gains tax) ...

(b) section 10 of TCGA 1992 (non-resident with a UK branch or agency);

(c) section 10B of TCGA 1992 (non-resident company with UK permanent establishment).

(2) Paragraph (1) is subject to paragraphs (3) and (4).

(3) In the application of section 10 of TCGA 1992 in accordance with paragraph (1), paragraphs (a) and (b) of subsection (1) (assets on the disposal of which chargeable gains are taxable) have effect with the omission of the words "situated in the UK and".

(4) In the application of section 10B of TCGA 1992 in accordance with paragraph (1), paragraphs (a) and (b) of subsection (1) (assets on the disposal of which chargeable profits arise for the purposes of corporation tax) have effect with the omission of the words "situated in the UK and"."

Section 1015 ITA could also restrict the territorial scope of the OIG charge, but the rules discussed here leave it no room to operate.

income gains. I refer to this rule as "**the OIG non-residence defence**".

35.10 OIG arising to non-resident trust

Where an OIG arises to a non-resident trust, the trustees are not subject to tax on the gain because of the OIG non-residence defence.

35.10.1 *Non-resident settlor-interested trust*

An OIG arising to a non-resident settlor-interested trust is not within s.624 ITTOIA, unlike a UK resident trust. Regulation 20(1) OFTR provides:

> If an offshore income gain arises to a settlement in a tax year and the trustees of the settlement are not resident in the UK in the tax year, the gain is not regarded as income for the purposes of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor).

The consequence is that a settlor (if liable under s.720) does not have an indemnity against the trust for the tax. One wonders if this has been thought through.

The whole of chapter 5 is disapplied, so where a capital payment is made to a minor child of the settlor, the settlor is not taxable under s.629 ITTOIA (instead the child would be taxable at the appropriate rate. This could lead to a significant saving).

35.11 Outline of OIG anti-avoidance provisions

The rule that non-resident trusts and companies are not subject to tax on OIGs presents an obvious means of tax avoidance. HMRC might have applied either the income tax ToA provisions or the CGT anti-avoidance provisions to deal with this. In fact they have applied both:

(1) The ToA provisions apply: reg.21
(2) The CGT anti-avoidance provisions apply (with some amendments):
    (a) Regulation 20 applies s.87 TCGA.
    (b) Regulation 24 applies s.13 TCGA.

Further rules are needed to deal with the many possible ways in which the anti-avoidance provisions may interact:

(1) Interactions between these IT and CGT anti-avoidance provisions potentially applying to the same OIG; and
(2) Interactions between:
    (a) the applicable anti-avoidance provision relating to an OIG and
    (b) s.731 or CGT s.87 TCGA (where a beneficiary receives a benefit and there is also relevant income or a CGT s.2(2) amount).

35.11.1 *Commentary*

The result of applying two sets of overlapping anti-avoidance provisions is so complicated that no-one could expect the rules which I seek to explain below to be applied in practice, except by the largest trusts with a large budget for UK professional advice. It also introduces a full set of anomalies and scope for tax planning.

Although it was the case before 2008 that both the ToA and the CGT anti-avoidance provisions applied, the 2008 reforms made both sets of provisions very much more complicated, so that the dual application presents much more complexity than before.

The drafting of the OIG provisions was even more rushed than the rest of the 2008 legislation, leaving no time even for HMRC to properly consider the issues, let alone for consultation. There was an opportunity to rethink in the 2009 regulations, but HMRC had no desire to take it up. It seems to me that there can be no more devastating criticism of the rules than an attempt to explain them. The reader who labours through this chapter is likely to agree that the law ought to be simplified by applying either the income tax or the CGT anti-avoidance rules – CGT would be the better of the two, as OIGs are more like capital gains – but not both.

35.12 OIG ToA provisions

An OIG arising to a non-resident is not "income" so in the absence of express provision it would not fall within the ToA provisions even if it arose to a person abroad within s.720 or s.731. Regulation 21(1) OFTR deals with this and thus applies the ToA provisions to OIGs:

> Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.

It is helpful to distinguish the ordinary transfer of asset rules and the rules as they apply to OIGs. I use the following terminology:

(1) **"OIG s.720"**: the provisions of s.720 ITA which apply when:
   (a) a person abroad receives OIGs, treated as income within the scope of s.720, and
   (b) the transferor is deemed to receive income (**"OIG s.720 income"**).

(2) **"OIG s.731"**: the provisions of s.731 ITA which apply when:
   (a) a person abroad receives OIGs, treated as relevant income within

the scope of s.731, and

(b) a non-transferor is deemed to receive income **("OIG s.731 income")**.

Regulation 21(2) OFTR provides:

> Income treated as arising under that Chapter by virtue of paragraph (1) is regarded as "foreign" for the purposes of section 726, 730 or 735 of that Act.

This feeds into s.726 and 735 ITA which impose a remittance basis for OIG s.720 income and OIG s.731 income. The motive and EU law defences may also apply.

There are only limited differences between the way that sections 720 and 731 work for OIGs and for ordinary income.

35.13 OIG s.87 TCGA charge

An OIG is not a chargeable gain, and so not a s.2(2) amount (trust gain), so in the absence of express provision it would not give rise to a charge under s.87 TCGA. Regulation 20(3) OFTR deals with this and applies the s.87 rules with modifications. Because there are modifications, there are significant differences between OIG s.87 TCGA and CGT s.87 TCGA.

35.13.1 *OIG s.87 TCGA charge*

Regulation 20(3) OFTR incorporates the s.87 TCGA rules in this manner:

> Sections 12,[13] 87 to 90A and 96 to 98 of, and Schedule 4C to, TCGA 1992 apply in relation to OIG amounts as if—
>
> (a) references to section 2(2) amounts (except those in paragraph 7B(2)(b) and (4) of Schedule 4C) were to OIG amounts,
>
> (b) references to chargeable gains (except the one in paragraph 1(5) of Schedule 4C) were to offshore income gains,
>
> (c) references to anything accruing were to it arising[14] (and similar references, except the one in paragraph 1(5) of Schedule 4C, were read accordingly),

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13 The reference to s.12 TCGA in regulation 20(3) makes no sense, and must be a drafting error. However no great harm is done by the error. What matters is the incorporation of s.87 ff TCGA.

14 The terminology of the Taxes Acts is that CGT chargeable gains *accrue;* but OIGs *arise.* There is no difference in meaning so it seems slightly pedantic to make the change of terminology when incorporating the CGT s.87 TCGA provisions for OIGs; but it does no harm.

(d) sections 87(4), 88(2) to (5) and 97(6) and paragraphs 1(3A), 3 to 7 and 12 of Schedule 4C were omitted, and
(e) regulation 21 did not apply.

In this section I consider the application of s.87-98 TCGA to OIGs.

I do not set out all of s.87-98 TCGA, as amended, because the text would be too long for the exercise to be useful. The key provision is s.87(2)(3) TCGA which (amended as reg.20(3) directs) provides:

[2][a] *Offshore income gains* are treated as *arising* in the relevant tax year to a beneficiary of the settlement
[b] who has received a capital payment from the trustees in the relevant tax year or any earlier tax year
[c] if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the *OIG amount* for the relevant tax year or any earlier tax year.
(3) The amount of *offshore income gains* treated as *arising* is equal to—
(a) the amount of the capital payment, or
(b) if only part of the capital payment is matched, the amount of that part.

It is necessary to distinguish CGT s.87 TCGA and OIG s.87 TCGA because the rules are not identical. I use the following terminology:

(1) "**CGT s.87 TCGA**", the provisions of s.87 TCGA which apply when:
(a) a trust has a "**CGT s.2(2) amount**" (trust gains) and
(b) a beneficiary is deemed to receive a CGT chargeable gain ("**the s.87 CGT gain"**).
(2) "**OIG s.87 TCGA**", the provisions of s.87 as amended, which apply when:
(a) a trust has "**OIG amounts**"; and
(b) a beneficiary is deemed to receive an OIG ("**the s.87 OIG"**).

For a discussion of CGT s.87 TCGA, see 51.1 (Gains of Non-resident Trusts: section 87). I concentrate here on points where OIG s.87 TCGA is different from CGT s.87 TCGA. But note one area where the two rules are the same. If a trust with OIG amounts makes a capital payment to a non-resident beneficiary, a s.87 OIG is treated as accruing to the beneficiary under OIG s.87 TCGA(2). But no income tax charge arises since the beneficiary qualifies for the OIG non-residence defence.[15] Thus capital payments to non-resident beneficiaries reduce (or "wash") OIG

15 See 35.9 (OIG non-residence defence).

amounts, as they do for CGT s.2(2) amounts.

35.13.2 *"OIG amount"*

Regulation 20(2) OFTR defines the term "OIG amount":

> If—
>
> (a) offshore income gains arise to the trustees of a settlement in a tax year, and
>
> (b) section 87 of TCGA 1992 (gains of non-resident settlements) applies to the settlement for that year,
>
> the OIG amount for the settlement for that year is the amount of the offshore income gains.

"OIG amount" is the OIG equivalent of the CGT concept "s.2(2) amount" (formerly called trust gains).

The definition is not identically worded.[16] It is necessary to have a different definition, since the definition of s.2(2) amounts (trust gains) caters for losses, and for CGT chargeable gains within s.86 TCGA; the definition of OIG amounts does not do this because there is no relief for OIG losses and s.86 does not apply to OIGs.

One (I expect, unintended) consequence of the difference in drafting is that there is no double taxation relief where the OIGs are subject to a foreign capital gains tax.[17]

The drafter has correctly provided in reg. 20(3)(d) OFTR that s.87(4) TCGA does not apply for OIG s.87 TCGA, because it has no role in that context.

35.13.3 *"Capital payment"*

"Capital payment" is defined in s.97(1) TCGA. The OFTR does not amend this. It provides:

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16 Section 87 TCGA provides:

> "(4) The section 2(2) amount for a settlement for a tax year for which this section applies to the settlement is—
>
> (a) the amount upon which the trustees of the settlement would be chargeable to tax under section 2(2) for that year if they were resident in the UK in that year, or
>
> (b) if section 86 applies to the settlement for that year, the amount mentioned in para (a) minus the total amount of chargeable gains treated under that section as accruing in that year.
>
> (5) The section 2(2) amount for a settlement for a tax year for which this section does not apply to the settlement is nil."

17 See 59.12 (DT reliefs: s.87 TCGA).

> In sections 86A to 96 and Schedule 4C and this section "capital payment"—
> (a) means
> [i] any payment which is not chargeable to income tax on the recipient
> [ii] or, in the case of a recipient who is not resident in the UK, any payment received otherwise than as income...

Suppose a trust within OIG s.87 TCGA makes a capital payment (or what appears to be a capital payment) to a UK resident beneficiary. The definition does not actually work for OIG s.87 TCGA, since what would otherwise be a capital payment falling within OIG s.87 TCGA *is* chargeable to IT under OIG s.87 TCGA! But for the purposes of OIG s.87 TCGA the definition must be taken to read that "capital payment" means:

> [i] any payment which is not chargeable to income tax on the recipient *[apart from OIG s.87 TCGA]*
> [ii] or, in the case of a recipient who is not resident in the UK, any payment received otherwise than as income...

I refer to a capital payment which is subject to income tax under OIG s.87 TCGA as an **"OIG capital payment"**.

35.13.4 *Deemed disposal*

If OIG s.87 TCGA applies, a beneficiary receives a s.87 OIG. OIG s.87 TCGA does not directly impose a charge on the s.87 OIG: the deeming feeds into reg.17 which imposes the charge when an OIG arises to the person making the disposal of an offshore fund.[18] A further deeming is needed, because the beneficiary who receives the s.87 OIG does not make a disposal. Therefore reg.20(5) OFTR provides for a deemed disposal, to bring the s.87 OIG into charge under reg.17:

> If this regulation applies, the person to whom the offshore income gain arises is treated as the person making the disposal.

(The same rule applies for OIG s.13.)

35.13.5 *OIG s.87 TCGA: Miscellaneous points*

The deemed disposal rules of Schedule 4B TCGA do not apply to OIGs,[19]

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18 See 35.3 (Charge to tax on OIGs).

19 See 52.12.1 (Chargeable asset).

but the harsh provisions of Schedule 4C TCGA may apply.

The interest supplement rule in s.91 TCGA applies only to CGT s.87 TCGA and not to OIG s.87 TCGA.

A capital payment from a trust with OIG amounts does not give rise to an IHT exit charge as the exit charge income exemption applies.[20]

I deal with the 2008 transitional rules elsewhere because they are best considered together with the CGT s.87 TCGA transitional rules.[21]

For sch 4C, see 52.27 (OIG sch 4C).

35.13.6 *OIG s.87 TCGA Remittance basis*

If a remittance basis taxpayer receives a s.87 OIG, s.87B TCGA applies to bring in a remittance basis just like the CGT s.87 TCGA remittance basis.

Reg.19(5) OFTR provides:

> This regulation does not apply for the purposes of regulation 20.

That disapplies the ordinary OIG remittance basis.[22] That is needed because the OIG s.87B remittance basis applies instead.

35.13.7 *HMRC views*

HMRC agree with the above. The OF Manual provides:

> **OFM09315 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: section 87 (and 87A) TCGA attribution rules: effect of residence and domicile status of beneficiary** [January 2012]
>
> **... Beneficiary is UK resident but non-UK domiciled**
>
> Where attributions are made to a beneficiary who is UK resident or ordinarily resident but non-UK domiciled then, under section 87 (and 87A) TCGA rules, the full amount attributed may not be chargeable to income tax for the following reasons
>
> - Such an individual will not be chargeable to income tax on offshore income gains attributed to them to the extent that in the matching process
>   - a capital payment received before 6 April 2008 is matched, or
>   - an OIG amount for the tax year 2007-08, or earlier, is matched

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20 See 30.12.5 (Interaction with IHT exit charge income exemption).

21 See 51.21.1 (Pre-2008 OIG amounts); 51.24 (Pre-2008 inter-trust transfer); 51.31 (Rebasing - OIG amounts).

22 See 35.7 (OIG remittance basis).

(paragraph 100 Schedule 7 FA 2008).

- If the trustees have made a "rebasing" election under paragraph 126 Schedule 7 FA 2008 then such an individual will not be chargeable on the pre-6 April 2008 element of the offshore income gain attributed to them (paragraph 101 Schedule 7 FA 2008).
- If such an individual is a remittance basis user they can have the benefit of the remittance basis via the rules in section 87B TCGA.

The full amount of the offshore income gain attributed to the individual reduces the OIG amount of the non-resident settlement structure that is available to match with future capital payments. That is so even though less than the full amount may be chargeable to income tax on the individual.

Beneficiary is non-UK resident

Offshore income gains can still be attributed to a beneficiary who is not resident or ordinarily resident in the UK using the section 87 TCGA attribution rules. This applies even though they may not be chargeable to tax on such an individual. Any such attribution reduces the OIG amount of the non-resident settlement structure that is available to match with future capital payments.

35.14 OIG s.13 charge

An OIG is not a chargeable gain, so in the absence of express provision it would not fall within s.13 TCGA. Regulation 24(1) OFTR deals with this and applies s.13 TCGA to OIGs with modifications:

> (1) Section 13 of TCGA 1992 (chargeable gains accruing to certain non-resident companies) applies for the purposes of this Part with the following modifications.
> (2) The section applies as if—
> (a) for any reference to a chargeable gain there were substituted a reference to an offshore income gain; and
> (b) for any reference to anything accruing there were substituted a reference to it arising[23] (with similar references being read accordingly).
> (3) The section applies as if, in subsection (5), paragraphs (b) and (c) were omitted.
> (4) The section applies as if, in subsection (7), for the reference to

23 The terminology of the Taxes Acts is that CGT chargeable gains *accrue;* but OIGs *arise.* There is no difference in meaning so it seems slightly pedantic to make the change of terminology when incorporating the CGT s.13 provisions for OIGs; but it does no harm.

capital gains tax there were substituted a reference to income tax or corporation tax.

(5) The section applies as if subsection (8) were omitted. ...

I refer to this as **"the OIG s.13 charge"**. It is necessary to distinguish the CGT s.13 rules and the OIG s.13 rules because the rules (though similar) are not identical. I refer below to:

(1) "**CGT s.13**", the provisions of s.13 TCGA which apply when:
   (a) a non-resident close company receives CGT chargeable gains, and
   (b) a participator is deemed to receive the gain ("**the s.13 CGT gain"**).

(2) "**OIG s.13**", the provisions of s.13 as amended, which apply when:
   (a) a non-resident close company receives OIGs, and
   (b) a participator is deemed to receive the OIGs ("**the s.13 OIG"**.)

Amended as reg.24 directs, s.13 TCGA provides:

Attribution of [OIGs] to members of non-resident companies

(1) This section applies as respects *offshore income gains arising* to a company—

(a) which is not resident in the UK, and

(b) which would be a close company if it were resident in the UK.

(1A) [Interaction with ATET-CGT; not relevant here]

(2) Subject to this section, every person who at the time when the *offshore income gain arises* to the company is resident in the UK, and who is a participator in the company, shall be treated for the purposes of this Act as if a part of the *offshore income gain* had *arisen* to him.

(3) That part shall be equal to the proportion of the gain that corresponds to the extent of the participator's interest as a participator in the company.

(3A) Subsection (2) does not apply in the case of a participator who is an individual if—

(a) the tax year in which the *offshore income gain arises* to the company is a split year as respects the participator, and

(b) the *offshore income gain arises* to the company in the overseas part of that year.

(4) Subsection (2) above shall not apply in the case of any participator in the company to which the *offshore income gain arises* where the aggregate amount falling under that subsection to be apportioned to him and to persons connected with him does not exceed one quarter of the gain.

(5) This section shall not apply in relation to—

~~(b) *an offshore income gain* accruing on the disposal of an asset used,~~

~~and used only—~~

~~(i) for the purposes of a trade carried on by the company wholly outside the UK, or~~

~~(ii) for the purposes of the part carried on outside the UK of a trade carried on by the company partly within and partly outside the UK, or~~

(ca) *an offshore income gain arising* on the disposal of an asset used, and used only, for the purposes of economically significant activities carried on by the company wholly or mainly outside the United Kingdom, or

(cb) *an offshore income gain arising* to the company on a disposal of an asset where it is shown that neither—

(i) the disposal of the asset by the company, nor

(ii) the acquisition or holding of the asset by the company,

formed part of a scheme or arrangements of which the main purpose, or one of the main purposes, was avoidance of liability to capital gains tax or corporation tax, or

(d) to *an offshore income gain* in respect of which the company is chargeable to tax by virtue of section 10B.

[*Subsections 5A to 7A relate to company distribution relief and company disposal relief and need not be set out here.*]

~~(8) So far as it would go to reduce or extinguish chargeable gains accruing by virtue of this section to a person in a year of assessment this section shall apply in relation to a loss accruing to the company on the disposal of an asset in that year of assessment as it would apply if a gain instead of a loss had accrued to the company on the disposal, but shall only so apply in relation to that person; and subject to the preceding provisions of this subsection this section shall not apply in relation to a loss accruing to the company.~~

(9) If a person who is a participator in the company at the time when the *offshore income gain arises* to the company is itself a company which is not resident in the UK but which would be a close company if it were resident in the UK, an amount equal to the amount apportioned under subsection (3) above out of the *offshore income gain* to the participating company's interest as a participator in the company to which the gain *arises* shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned, and so on through any number of companies.

(10) The persons treated by this section as if a part of an *offshore income gain arising* to a company had *arisen* to them shall include the trustees of a settlement who are participators in the company, or in any

> company amongst the participators in which the gain is apportioned under subsection (9) above, if when the gain *arises* to the company the trustees are not resident in the UK.
> (10B) [*This relates to pension schemes and need not be set out here*]
> (11) [*This confers relief where tax is paid by the non-resident close company and need not be set out here]*
> (11A) For the purposes of this section the amount of the gain or loss[24] *arising* at any time to a company that is not resident in the UK shall be computed (where it is not the case) as if that company were within the charge to corporation tax on *offshore income gains*.
> [*Section 13(12) to (14) contain definition and administrative provisions which need not be set out here*]

For a full discussion of CGT s.13, see 53.1 (Gains of Non-resident companies). I concentrate here on areas where OIG s.13 is different from CGT s.13.

The most important difference is that a s.13 CGT gain is subject to CGT at CGT rates; a s.13 OIG is subject to IT at IT rates.

The deletions in s.13(5)(8) make sense as those CGT rules would not be appropriate for OIG s.13.

DT relief may apply where a UK resident trustee holds a treaty non-resident company to which an OIG applies: s.79B TCGA disapplies the relief for CGT[25] but not for OIG.

Offshore group relief does not apply to OIG s.13 because reg.24 does not incorporate s.14 TCGA.

35.14.1 *Deemed disposal*

If OIG s.13 applies, a participator receives a s.13 OIG. OIG s.13 does not directly impose a charge on the s.13 OIG: the deeming feeds into reg.17 which imposes the charge when an OIG arises to the person making the disposal of an offshore fund.[26] A further deeming is needed, because the participator who receives the s.13 OIG does not make a disposal. Therefore reg.24(6) OFTR provides for a deemed disposal, to bring the s.13 OIG into charge under reg.17:

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24 The words "or loss" are otiose here. Presumably the drafter overlooked the need to delete them as the legislation takes the trouble to delete them elsewhere. But nothing turns on that.

25 See 59.8 (Disallowance of DT relief for trust participator).

26 See 35.3 (Charge to tax on OIGs).

> If this regulation applies, the person to whom the offshore income gain arises is treated as the person making the disposal.

(The same rule applies for OIG s.87 TCGA.)

35.14.2 *OIG s.13 remittance basis*

Section 14A TCGA provides the CGT s.13 remittance basis, but that section does not apply for the purposes of OIG s.13. Instead the ordinary OIG remittance basis in reg.19 applies,[27] but the end result is the same. This explains reg.19(3)(a) which provides:

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007(10) (remittance basis)—
>
> (a) any consideration obtained on the disposal of the asset is treated as deriving from the income. ...

This is the equivalent of s.14A(3)(a) TCGA which similarly provides:

> (3) For the purposes of Chapter A1 of Part 14 of ITA 2007 (remittance basis)—
>
> (a) treat any consideration obtained by the company on the disposal of the asset as deriving from the deemed chargeable gain. ...

35.15 OIGs and s.86 TCGA

An OIG is not a chargeable gain so it does not fall within s.86 even if it arises to a non-resident trust. There is no provision which extends s.86 to apply. So a settlor of a non-resident trust is not subject to tax on trust OIGs under s.86 TCGA; but s.720 may apply where the settlor has power to enjoy.

35.15.1 *Planning: Settlor excluded but children included so trust is within s.86*

Suppose a non-resident trust where:

(1) the settlor and spouse are excluded, but

(2) s.86 applies (because the settlor is UK domiciled and the settlor's children are beneficiaries)

It may be attractive for a trust to invest in offshore funds (which give rise to OIGs outside s.86) rather than other assets (which give rise to CGT

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27 See 35.7 (OIG remittance basis).

chargeable gains within s.86). Similarly, the trustees may invest for income and not capital growth. It may however be a balancing exercise, as to do so does increase the rate of tax on capital payments from CGT rates to IT rates.

35.16 Interaction of anti-avoidance provisions

35.16.1 *Priority between OIG s.87 TCGA and CGT s.87 TCGA*

Suppose a capital payment is made to a UK beneficiary from a trust with OIG amounts and CGT s.2(2) amounts. This would in principle give rise to a charge under OIG s.87 TCGA and CGT s.87 TCGA, or at least it might not be clear which of the two applied.

It matters which applies because in one case the OIG is taxed at income tax rates and in the other the CGT chargeable gain is taxed at CGT rates.

Regulation 20(4) OFTR deals with this:

> Section 87A of TCGA 1992 applies for a tax year by virtue of paragraph (3) before it applies for that year otherwise than by virtue of that paragraph.

In short, OIG s.87 TCGA has priority to CGT s.87 TCGA. Where OIG s.87 TCGA applies to a capital payment, there is no "capital payment" for the purposes of CGT s.87 TCGA as the payment is subject to income tax.

The OF Manual offers the following example:

> **OFM15640 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: section 87 (and 87A) TCGA attribution rules: example regulation 20** [January 2012]
> **Allocating capital payments between offshore income gains and chargeable gains arising in non-resident settlements – regulation 20(4)**
> **Example where both offshore income gains and capital gains received**
> A settlement with non-UK resident trustees has never been settlor interested and has never received any income.

This simplifies matters as it is not necessary to consider the ToA rules or s.86 TCGA. In real life, the position would generally be much more complicated.

> The following OIG amounts and capital gains have been received by the settlement:

	OIG amount	Chargeable gains
2008-09	£30,000	
2009-10		£40,000
2010-11	£50,000	£60,000
Total	£80,000	£100,000

> The first capital payment out of the settlement is made in 2010-11. That is a capital payment of £70,000 to a UK resident and domiciled beneficiary.

The HMRC analysis for 2010/11 is as follows:

> Regulation 20(4) tells you that you match any capital payments with OIG amounts arising in the non-resident settlement before matching with chargeable gains. This applies even if the OIG amount arose in an earlier year than the capital gain.
> Using the section 87A TCGA attribution rules the capital payment is matched first with the entire £50,000 OIG amount arising in 2010-11. Then the remaining £20,000 (£70,000 - £50,000) is matched with £20,000 of the £30,000 OIG amount arising in 2008-09.
> The beneficiary is treated as receiving £70,000 offshore income gains chargeable to income tax in 2010-11.

HMRC note that the £70k capital payment is matched with (1) the £50k OIG in 2010/11 and (2) £20k of the OIG in 2008/09. But it does not matter, as on the facts of the example, it makes no difference to which OIG the capital payment is matched. It matters for CGT chargeable gains, because of the interest surcharge, but that does not apply for OIG.

HMRC do not seek to argue that s.731 OIG applies.

HMRC then turn to consider the position going forward:

> There are unmatched OIG amounts and chargeable gains in the settlement to carry forward at 5 April 2011 of:
> 2008-09 OIG amount £10,000 (£30,000 less £20,000 matched with capital payment)
> 2009-10 Capital gains £40,000
> 2010-11 Capital gains £60,000.

The HMRC example is an easier case as there was one capital payment which was less than the total OIGs. Suppose there was more than one capital payment, and the total amount exceeded the OIGs. For instance, on the facts of the above example, suppose in the same year but on different days:

Capital payment 1: £80k
Capital payment 2: £20k.

Does one say:
(a) Capital payment 1 is matched with the OIG and capital payment 2 is matched with the CGT chargeable gains? or
(b) Each capital payment is matched with 80% of the OIG and 20% of the CGT chargeable gains?

It is considered that solution (b) is correct. That is consistent with the rule for s.2(2) amounts (trust gains).

35.16.2 *Priority between OIG s.13 & ToA provisions: Company not held by trust*

Suppose an OIG arises to a non-resident company (the company not being held by a trust). This could give rise to a charge under OIG s.720 (on the transferor) and under OIG s.13 (on the participators), or at least it might not be clear which of the two charges applies.

It may not matter which applies, as the OIG is taxed at income tax rates in either event, but it could matter eg if the transferor is not the sole participator.

Regulation 21(3) OFTR deals with this but it needs to be read with reg.21(1) to follow the sense:

> (1) Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person...
> (3) Paragraph (1) does not apply in relation to an offshore income gain if (and to the extent that) it is treated, by virtue of regulation 24 [OIG s.13], as arising to a person resident in the UK.

In short, a s.13 OIG charge has priority over the OIG ToA provisions. Regulation 24(7) OFTR provides:

> To the extent that an offshore income gain is treated, by virtue of this regulation [reg 24 = OIG s.13], as having accrued[28] to any person resident in the UK, that gain shall not be deemed to be the income of any individual for the purposes of Chapter 2 of Part 13 of ITA 2007 (transfer

28 The terminology of the Taxes Acts is generally that CGT chargeable gains *accrue;* but OIGs *arise.* There is no difference in meaning so it does not matter that the wrong word is used here.

of assets abroad).

35.16.3 *Priority between OIG s.13 and ToA provisions: Company held by trust*

Suppose an OIG arises to a company held by a settlor-interested trust. Suppose the company is within s.720. The trustees make a capital payment to a UK resident beneficiary. This could give rise to:

(1) a charge under OIG s.720 on the transferor and
(2) under OIG s.87 TCGA on the beneficiary, on the basis that the OIGs arise to the trustees under s.13(10) and constitute OIG amounts which are matched to the capital payments.

Is relief available under reg. 24(7) OFTR? That provides:

> To the extent that an offshore income gain is treated, by virtue of this regulation [reg 24 = OIG s.13], as having accrued to any person resident in the UK, that gain shall not be deemed to be the income of any individual for the purposes of Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad).

One would have to argue that the gain accruing to the individual is the same gain as that accruing to the company. It is suggested that this is the case, since otherwise there would be a strange anomaly between this case and the simple case where the OIG arises to the trust directly (without a company). The purpose of s.13 is to put the taxpayer in the same position as if there were no company.

35.17 Priority between OIG s.87 TCGA and OIG ToA provisions

Suppose an OIG arises to a non-resident trust which makes a capital payment to a beneficiary. This could give rise to a charge under OIG s.87 TCGA and the ToA provisions, or at least it might not be clear which of the two applies.

It matters which applies because:

(1) OIG s.87 TCGA qualifies for:
  (a) rebasing relief
  (b) 2008 transitional relief.
(2) Different remittance basis rules apply.

Regulation 21(5) deals with this but one first needs to read reg.21(4) OFTR which provides:

> The following provisions apply if regulation 20 [OIG s.87 TCGA] applies in relation to an offshore income gain (the "relevant offshore

income gain").

In short, the two provisions which follow – reg.21(5)(6) – apply where an OIG arises to a non-resident trust.

Regulation 21(5) needs to be read with reg.21(1) to follow the sense:

> (1) Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person...
> (5) If—
> (a) by virtue of regulation 20 [OIG s.87 TCGA] an offshore income gain is treated as arising in a tax year to a person resident in the UK, and
> (b) it is so treated by reason of the relevant offshore income gain (or part of it),
> for that and subsequent tax years paragraph (1) does not apply in relation to the relevant offshore income gain (or that part).

In short, the OIG s.87 TCGA charge has priority over the ToA provisions if the OIG amount is matched to a capital payment to a *UK resident*. I refer to this provision as "**The OIG s.87 priority rule**". This applies even if the s.87 OIG is matched to a remittance basis taxpayer and (un)taxed on the s.87 OIG remittance basis, because an OIG is nevertheless treated as arising to a UK resident.

The OIG s.87 priority rule applies for Chapter 2 of Part 13 of ITA 2007 but it is necessary to consider s.720 and s.731 separately.

35.17.1 Priority between OIG s.720 and OIG s.87

The following examples are based on this situation:

(1) A non-resident settlor-interested trust is within s.720. The transferor/settlor (for the purposes of these examples the terms are interchangeable) is UK resident. The motive defence does not apply.
(2) The trust has realised an OIG in year 1 of £1m.
(3) The trust has no relevant income. (It would be unusual for a trust within s.720 to have relevant income.)

Example 1 (no capital payment)
The trustees make no capital payment to any beneficiary in the year that the OIG arises.
The settlor as transferor is taxed on the OIG under OIG s.720 (subject to the s.720 remittance basis if applicable).

Regulation 21(6) OFTR prevents a double charge to tax under OIG s.87 TCGA, if there is a capital payment in a subsequent tax year. It provides:

> If, by virtue of paragraph (1) [OIG s.720] as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year, the OIG amount in question must be reduced (with effect from the following tax year) by the amount of the income.

Example 2 (capital payment to settlor)
The trustees make a capital payment of £1m to the settlor in year 1.
The settlor is taxed on the capital payment under OIG s.87 TCGA (subject to the s.87 OIG remittance basis).
The ToA provisions are disapplied for OIG because the OIG s.87 priority rule applies.
It may make no difference whether it is OIG s.720 or OIGs.87 which is used to tax the settlor but it may matter for the following reasons:
(1) rebasing relief
(2) 2008 transitional relief
(3) mixed fund rules.

Example 2a (capital payment of part of OIG to settlor)
The trustees make a capital payment of £0.5m to the settlor in year 1.
The settlor is taxed on the £0.5m capital payment under OIG s.87 TCGA (subject to the s.87 OIG remittance basis).
The settlor is taxed on £0.5m under OIG s.720.

Example 3 (capital payment to UK beneficiary)
The trustees make a capital payment of £1m to a UK resident beneficiary (not the settlor) in year 1.
The beneficiary is taxed on the capital payment under OIG s.87 TCGA (subject to the s.87 OIG remittance basis if applicable).
The ToA provisions are disapplied because the OIG s.87 priority rule applies.
So the result of the capital payment is to shift the tax charge from the settlor to the beneficiary. This would be particularly important if the beneficiary was a remittance basis taxpayer and the settlor was not. In such a case a capital payment to the beneficiary would save tax. The capital payment also affects the quantum of the charge if rebasing relief applies or 2008 transitional relief.

If the capital payment had been to a non-UK resident beneficiary, the settlor would be taxed on £1m under OIG s.720.

Example 3a (capital payment of part of OIG to beneficiary)
The trustees make a capital payment of £0.5m to a UK resident beneficiary (not the settlor) in year 1.
The beneficiary is taxed on the capital payment under OIG s.87 TCGA (subject to the s.87 OIG remittance basis if applicable).

Planning for trust within s.720 which realises an OIG
In short, where an OIG arises to a trust within s.720, it is advantageous for the trustees to make a capital payment equal to the OIG amount to a UK beneficiary, if:
(1) the settlor is not a remittance basis taxpayer and the beneficiary is a remittance basis taxpayer; or
(2) rebasing relief or 2008 transitional relief applies.
This planning point will often require a distribution to be made in the year that the OIG arises. The sum distributed need not be the proceeds representing the OIG. Other capital payments (eg the use of living accommodation) may suffice as that capital payment may be matched with the OIG.

If there is no time to make a payment in the form of a bank transfer, a resolution of the trustees to exercise their power to make a distribution will suffice. If the figures are not available, a resolution to distribute an amount equal to the offshore income gains will suffice. In order to make a distribution, it may be necessary to make a deed of appointment, or obtain consent of a protector: that depends of course on the terms of the trust.

35.17.2 *Priority between OIG s.731 and OIG s.87 TCGA over same OIG*

I turn to consider whether OIG s.87 TCGA takes precedence over OIG s.731.

The effect of the OIG s.87 priority rule is that if the OIG amount is matched to a capital payment to a UK resident then:
(1) an OIG is treated as arising in the year to that beneficiary and
(2) this disapplies OIG s.731.
In this situation, the OIG s.87 TCGA charge has priority over OIG s.731. This applies even if the OIG s.87 TCGA charge is (un)taxed on the s.87 OIG remittance basis because the s.87 OIG is nevertheless treated as arising.

Examples

The following examples are based on this situation:

(1) A non-resident trust is within s.731 (UK resident beneficiaries) but not within s.720 (transferor has no power to enjoy or is not UK resident.) The motive defence does not apply.
(2) The trust has realised an OIG in year 1 of £1m.
(3) The trust has no relevant income (leaving aside the OIG).

Example 1 (capital payment to UK beneficiary in year 1)
The trustees make a capital payment of £1m to a UK resident beneficiary in year 1.
The beneficiary is taxed on the capital payment under OIG s.87 TCGA (subject to the s.87 OIG remittance basis).
The ToA provisions are disapplied, ie, the OIG does not count as relevant income for s.731.

Example 1a (capital payment of part to UK beneficiary)
The trustees make a capital payment of £0.5m to a UK resident beneficiary in year 1.
It is considered that the beneficiary is taxed on the capital payment under OIG s.87 TCGA (subject to the s.87 OIG remittance basis). HMRC agree: see the HMRC example set out in para 34.16.1 (Priority between OIG s.87 TCGA and CGT s.87 TCGA), where a trust with an OIG amount of £80k made a capital payment of £70k and the capital payment was said to fall within OIG s.87. It is not entirely clear from the wording of the OIG s.87 priority rule that this is the case. That provides:

> (5) If—
> (a) by virtue of regulation 20 [OIG s.87 TCGA] an offshore income gain is treated as arising in a tax year to a person resident in the UK, and
> (b) it is so treated by reason of the relevant offshore income gain (or part of it),
> for that and subsequent tax years paragraph (1) [applying the TOA rules] does not apply in relation to the relevant offshore income gain (or that part).

Now, the position is clear if a capital payment is equal to the entire OIG amount (as in example 1). But if the capital payment is equal to half the OIG amount, one might say that half the OIG remains to count as relevant income so the capital payment falls within s.731 OIG. But that would be

an anomalous inconsistency with the position which applies when the capital payment equals the entire OIG. It would be particularly difficult to apply if the capital payment is more than half the OIG. So the better view is that OIG s.87 applies. If that is correct, then OIG s.731 will never apply.

Example 2 (capital payment to UK beneficiary in year 2)
(1) The trustees make no capital payment in year 1.
No-one is subject to tax in year 1 as:
(a) OIG s.87 TCGA only applies if there is a capital payment.
(b) OIG s.731 only applies if there is a benefit (which means (more or less) the same as a capital payment).
(2) *The trustees make a capital payment of £1m to a UK resident beneficiary in year 2.*
The beneficiary is taxed on the capital payment under OIG s.87 TCGA (subject to the s.87 OIG remittance basis). The beneficiary is not taxed under OIG s.731 as the OIG s.87 priority rule applies.

I have considered whether reg. 21(6) OFTR overrides this rule. Reg 21(6) OFTR provides:

> If, by virtue of paragraph (1) as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year, the OIG amount in question must be reduced (with effect from the following tax year) by the amount of the income.

Does this apply in year 1? Only if *income is treated under Chapter 2 of Part 13 of ITA as arising* in year 1. Chapter 2 part 13 uses the expression *income is treated as arising* in s.731 (income treated as arising to a non-transferor) and in s.720 (income treated as arising to a transferor). However these sections do not apply in year 1. So reg.21(6) does not apply.

I have considered the argument that income is treated as arising in year 1 to the *person abroad* (the OIG) because of reg.21(1). But this is not correct, for such income is not treated as arising under Chapter 2 Part 13. This is confirmed, I think, by reg. 21(2) OFTR which uses the expression "treated as arising" where the reference is clearly to income treated as arising to the transferor under s.720 or to a beneficiary under s.731.

It follows that if capital payments are made only to UK resident beneficiaries, they are all taxed under OIG s.87 TCGA and not OIG s.731.

Example 2a (capital payment of part of OIG to UK beneficiary in year 2) The facts are the same as example 2, but the trustees make a capital payment of only £0.5m to a UK resident beneficiary in year 2.
It is considered that the beneficiary is taxed on the capital payment under OIG s.87 TCGA (subject to the s.87 OIG remittance basis). The beneficiary is not taxed under OIG s.731 as the OIG s.87 priority rule applies.

Example 3
(1) Year 1: The trustees make a capital payment of £1m (ie an amount equal to the OIG) to a non-resident beneficiary
No-one is subject to tax in year 1 as OIG s.87 TCGA and OIG s.731 only apply if there is a capital payment or benefit to a UK resident beneficiary.
(2) *Year 2: The trustees make a capital payment of £1m to a UK resident beneficiary.*

(a) The UK beneficiary is not taxed on the capital payment under OIG s.87 TCGA because the trust's OIG amount is matched to the capital payment in year 1.
(b) As the OIG constitutes relevant income, the UK beneficiary may be taxed under OIG s.731 as the OIG s.87 priority rule does not apply:
(i) If the capital payment to the non-resident beneficiary in year 1 distributed the relevant income, there is no OIG s.731 charge.
(ii) If the capital payment to the non-resident beneficiary in year 1 did not distribute the relevant income, the UK beneficiary is subject to tax under OIG s.731.

35.17.3 *OF Manual example: OIG s.87 TCGA: 2008 transitional relief*

The OF Manual provides:

> **OFM15650 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: attribution rules: example of non-UK domiciled beneficiary not chargeable on offshore income gain arising prior to 6 April 2008** [January 2012]
> **Example showing how a UK resident but non-UK domiciled beneficiary may not be chargeable to tax on an offshore income gain arising in a non-resident settlement prior to 6 April 2008 – paragraph 100 Schedule 7 FA 2008**
> **Example of effect of paragraph 100 Schedule 7 FA 2008**
> A settlement with non-UK resident trustees has never been settlor interested. The trustees own all the share capital of a non-UK resident company. Neither the trustees nor the company has received any income

nor made any chargeable gains.
The non-resident company held a material interest in an offshore fund. When that was disposed of in 2005-06 an OIG amount of £60,000 arose.
The first capital payments to beneficiaries were made in 2010-11 which were:
£40,000 to a UK resident and domiciled beneficiary
£40,000 to a UK resident but non-UK domiciled beneficiary
£40,000 to a non-UK resident beneficiary.

The HMRC analysis is as follows:

There is a matching of £20,000 of each of these capital payments with the 2005-06 OIG amount. Each beneficiary has £20,000 of offshore income gain attributed to them via section 87 TCGA rules. There are no unmatched OIG amounts to carry forward within the non-resident settlement structure.
The UK resident and domiciled beneficiary is chargeable to income tax in 2010-11 on the £20,000 offshore income gain attributed to them.
The UK resident but non-UK domiciled beneficiary is not chargeable to income tax on any of the £20,000 offshore income gain attributed to them. This is because the OIG amount used in the section 87 matching process arose before 6 April 2008 - paragraph 100(2)(b) Schedule 7 FA 2008.
The non-UK resident beneficiary is not chargeable to income tax on any of the £20,000 offshore income gain attributed to them.
There are unmatched capital payments of £20,000 to each beneficiary to carry forward at 5 April 2011.

What is the position for OIG s.731? Para 21(5) OFTR (the OIG s.87 priority rule) provides:

If—
(a) by virtue of regulation 20 [OIG s.87 TCGA] an offshore income gain is treated as arising in a tax year to a person *resident in the UK*, and
(b) it is so treated by reason of the relevant offshore income gain (or part of it),
for that and subsequent tax years paragraph (1) does not apply in relation to the relevant offshore income gain (or that part).

Of the £60k OIG, only £40k is treated as arising to persons resident in the UK, so one might think that £20k remained as relevant income, taxable on the UK resident beneficiaries. That is a surprising result, for contrast the situation where the same payments are made to the UK beneficiaries and

no payment to the non resident. The UK domiciled resident is taxed on £30k and the foreign domiciled resident is not taxed. It seems strange if the tax should be more because of the payment to the non-resident. The author of the OF Manual presumably thought so. Presumably the reason is that the payment to the non-resident is regarded as distributing the relevant income.

The same point applies to the next example.

35.17.4 *OF Manual example: Non-settlor interested trust; OIG s.87 rebasing relief*

The OF Manual provides:

> **OFM15660 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: attribution rules: example of effect of 'rebasing' election** [January 2012]
> **Example showing how a UK resident but non-UK domiciled beneficiary may benefit from a 'rebasing' election – paragraph 101 Schedule 7 FA 2008**
> **Example of effect of 'rebasing' election - paragraph 101 Schedule 7 FA 2008**
> A settlement with non-UK resident trustees is settlor interested because the settlor can benefit. The trustees own all the share capital of a non-UK resident company. Neither the trustees nor the company has received any income nor made any chargeable gains. The trustees have made a 'rebasing' election under paragraph 126 Schedule 7 FA 2008.
> The non-resident company purchased a material interest in an offshore fund in 2000-01. This is disposed of in 2010-11 resulting in an OIG amount of £60,000. The post 5 April 2008 element of that OIG amount is £15,000.
> The first capital payments made to beneficiaries were made in 2010-11. They were:
> £40,000 to a UK resident and domiciled beneficiary
> £40,000 to a UK resident but non-UK domiciled beneficiary
> £40,000 to a non-UK resident beneficiary.

The HMRC analysis is as follows:

> There is a matching of £20,000 of each of these capital payments with the 2010-11 OIG amount. Each beneficiary has £20,000 of offshore income gain attributed to them via section 87 TCGA rules. There are no unmatched OIG amounts to carry forward within the non-resident settlement structure.

The UK resident and domiciled beneficiary is chargeable to income tax in 2010-11 on the £20,000 offshore income gain attributed to them.
The UK resident but non-UK domiciled beneficiary (where the remittance basis is used) is only chargeable to income tax on £5,000 (£20,000 × £15,000/£60,000) of the £20,000 offshore income gain attributed to them. That is the post 5 April 2008 element of the £20,000 offshore income gain attributed to them. This is by virtue of paragraph 101 Schedule 7 FA 2008.[29]
The non-UK resident beneficiary is not chargeable to income tax on any of the £20,000 offshore income gain attributed to them.
There are unmatched capital payments of £20,000 to each beneficiary to carry forward at 5 April 2011.

35.17.5 *OF Manual example: OIG s.720: Loss of rebasing relief*

The OF Manual provides:

OFM15670 Non-reporting funds: charge to tax on disposal of an interest: non-resident settlements: attribution rules: example of 'rebasing' election having no effect [January 2012]
Example showing how a UK resident but non-UK domiciled beneficiary may not benefit from a 'rebasing' election – paragraph 101 Schedule 7 FA 2008
Example of 'rebasing' election having no effect - paragraph 101 Schedule 7 FA 2008
This example has similar facts as that in OFM15650 with the exception that capital payments are not made to beneficiaries until a year after that in which the OIG amount arises in the offshore trust structure. In such a case there may be no benefits of a 'rebasing' election to a non-UK domiciled beneficiary in respect of any offshore income gain attributed to them.
A settlement with non-UK resident trustees is settlor interested because the UK resident and ordinarily resident, but non-domiciled, settlor can benefit. The trustees own all the share capital of a non-UK resident company. Neither the trustees nor the company has received any income nor made any capital gains. The trustees have made a 'rebasing' election under paragraph 126 Schedule 7 FA 2008.
The non-resident company purchased a material interest in an offshore fund in 2000-01. This is disposed of in 2010-11 resulting in an OIG amount of £60,000. The post 5 April 2008 element of that OIG amount is £15,000.

29 [Author's note:] it is assumed that the remittance basis does not apply.

The first capital payments made to beneficiaries were made in 2011-12. They were:

- £40,000 to a UK resident and domiciled beneficiary
- £40,000 to a UK resident but non-UK domiciled beneficiary (who was also the settlor)
- £40,000 to a non-UK resident beneficiary.

In 2010-11 there have been no capital payments in that year, or earlier years, to beneficiaries. So there can be no attribution of the OIG amount to beneficiaries under the section 87 attribution rules in regulation 20.

We then have to consider if there can be an attribution under the transfer of assets rules in regulation 21 for 2010-11. The entire £60,000 OIG amount can be attributed to the settlor as an offshore income gain for that year. The non-UK domiciled settlor is chargeable to income tax in 2010-11 on the £60,000 offshore income gains attributed to them, subject to any remittance basis considerations. The 'rebasing' election has no effect on the amount chargeable to income tax as the attribution has not been made via the section 87 attribution rules.

The OIG amount is reduced to Nil (regulation 21(6)). There are no unmatched OIG amounts to carry forward to 2011-12. There is nothing to match with the capital payments made in 2011-12 so the full amount of those payments are unmatched capital payments to carry forward at 5 April 2012.

Was this result intended in 2008? Since HMRC gave no indication of their thinking, it is hard to tell.

35.18 Interaction of OIG s.87 TCGA and OIG ToA provisions where motive defence applies

EN FB 2008 provides:

> 46. Offshore income gains that are not matched in that year [the year they arise] will be chargeable to tax by reason of the provisions relating to the transfer of assets abroad legislation in Chapter 2 of Part 13 of the Income Tax Act 2007. *There is an exception to this rule where the motive or purpose defence in sections 736 to 742 applies to the gain.*

The legislation has not however achieved this result. Regulation 21(6) disapplies OIG s.87 TCGA:

> If, by virtue of paragraph (1) as it applies in relation to the relevant offshore income gain, income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year,...

We must ask whether "income is treated under Chapter 2 of Part 13 of ITA 2007 as arising" if the motive defence applies. In fact even where the motive defence does apply, income is treated as arising *to the person abroad*. Regulation 21(1) OFTR provides:

> Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) applies in relation to an offshore income gain arising to a person resident or domiciled outside the UK as if the offshore income gain were income becoming payable to the person.

But reg.21(6) is perhaps intending us to ask if income is treated as arising *to the transferor or to a non-transferor* under s.720 or s.731. Section 739(2) ITA provides the relief where the motive defence applies to pre-2006 transactions:

> An individual is not liable for income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs that condition A or B is met.

Section 737(2) ITA is identically worded for post-2006 transactions. Now, even though the individual is not liable for IT, the terms of reg.21(6) are still satisfied: "income is treated under Chapter 2 of Part 13 of ITA 2007 as arising in a tax year" even if the individual is not liable for income tax on that income. The result is not absurd, especially since the motive defence may be retrospectively lost by a tainted associated operation.

A court may find this too literal an approach. But as the legislation becomes more and more complex (and the OFTR is as complex as tax can get), it is less and less appropriate to apply anything but a literal interpretation to find what it means.

35.19 Computation of OIGs

Regulation 38 OFTR provides:

> (1) An offshore income gain arises to a person on the disposal of an asset if a basic gain arises on the disposal.
> (2) The disposal gives rise to an offshore income gain of an amount equal to the basic gain on the disposal.
> (3) The following provisions of this Chapter explain how the basic gain is computed.

35.19.1 *"Basic gain"*

So we move on to reg.39(1) OFTR:

> In the case of a participant chargeable to income tax,[30] the basic gain is a gain of the amount which would be the gain on that disposal for the purposes of TCGA 1992 if the gain were computed without regard to any charge to income tax arising under this Part.

The amount of the "basic gain" is the same as the amount of a CGT chargeable gain would be had the asset not been an offshore fund.

There is no relief for tax credits or foreign tax paid by the offshore fund (except that such tax reduces the value of the fund and so reduces the OIG). But this is also the case for CGT.

Regulation 39(3) flags up eight special cases:

> The computation of the basic gain is subject to—
> (a) regulation 34 (provisions applicable on death);[31]
> (b) regulation 35 (application of section 135 of TCGA 1992);
> (c) regulation 36 (application of section 136 of TCGA 1992);
> (d) regulation 37 (exchange of interests of different classes);
> (e) regulation 40 (earlier disposal to which the no gain/no loss basis applies);
> (f) regulation 41 (modifications of TCGA 1992);
> (g) regulation 42 (losses);
> (h) regulation 43 (special rules for certain existing holdings).

In these cases the amount of the OIG may exceed the basic gain.

I do not discuss regulations 35-37.

Regulation 41(1) disapplies rollover relief:

> If the disposal forms part of a transfer to which section 162 of TCGA 1992 (roll-over relief on transfer of business) applies, the basic gain arising on the disposal is computed without regard to any deduction which falls to be made under that section in computing a chargeable gain.

It would be a rare case where rollover relief would be in point.

Regulation 41(2) OFTR disapplies holdover relief:

> If the disposal is made otherwise than under a bargain at arm's length and a claim for relief is made in respect of that disposal under section 165 or 260 of TCGA 1992 (relief for gifts), the claim does not affect the computation of the basic gain arising on the disposal.

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30 Also see 35.19.2 (Computation of OIGs for company within corporation tax).

31 See 35.5 (Death of individual).

35.19.2 *Computation of OIGs for company within corporation tax*

For completeness: reg.39(2) OFTR provides:

> In the case of a participant chargeable to corporation tax, the basic gain is a gain of the amount which would be the gain on that disposal for the purposes of TCGA 1992 if the gain were computed—
>
> (a) without regard to any charge to corporation tax arising under this Part, and
>
> (b) without regard to any indexation allowance on the disposal under TCGA 1992.

Separate provision is needed to disapply the indexation allowance (which is available to companies but not to individuals).

Regulation 40 OFTR prevents indexation relief creeping in by the back door:

> (1) This regulation applies if—
>
> (a) a participant is chargeable to corporation tax, and
>
> (b) the amount of any chargeable gain or allowable loss which would arise on the disposal would fall to be computed in a way which, in whole or in part, would take account of the indexation allowance on an earlier disposal to which section 56(2) of TCGA 1992 (disposals on a no gain/no loss basis) applies.
>
> (2) The basic gain on the disposal is computed as if—
>
> (a) no indexation allowance had been available on any such earlier disposal, and
>
> (b) subject to that, neither a gain nor a loss had arisen to the person making such an earlier disposal.

35.20 Computation of CGT chargeable gain on disposal of offshore fund

A disposal for the purposes of the offshore funds rules is generally also a disposal for CGT.[32] The OFTR provides relief against a double charge. Regulation 44 sets the scene and provides terminology:

> (1) This Chapter applies if—
>
> (a) a material disposal[33] gives rise to an offshore income gain, and
>
> (b) that disposal also constitutes the disposal of the interest

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32 See 35.4 (Meaning of "disposal").

33 Defined in reg.15OFTR: "In these Regulations a 'material disposal' means a disposal to which this Part applies." Since the expression "material disposal" is only used once in reg.44, it could have been more concisely expressed, but the meaning is clear.

concerned for the purposes of TCGA 1992.
(2) In this Chapter the disposal specified in paragraph (1)(b) is called the "TCGA disposal".

Regulation 45 OFTR provides:

(1) This regulation applies for the purposes of the computation of the chargeable gain arising on the TCGA disposal.
(2) The provisions of this regulation have effect in relation to the TCGA disposal in substitution for section 37(1) of TCGA 1992 (deduction of consideration chargeable to tax on income).
(3) In the computation of the gain arising on the TCGA disposal, a sum equal to the offshore income gain shall be deducted from the sum which would otherwise constitute the amount or value of the consideration for the disposal.

Regulation 45(2) disapplies s.37(1) TCGA which normally avoids a double charge of IT and CGT. In its place, reg45(3) introduces its own rules. I am not sure why, because s.37 would seem to have had the same effect.[34] I would be grateful to any reader who could explain.

35.20.1 *Part disposals*

Regulation 45(5)(6) OFTR deals with part disposals:

(5) Paragraph (6) applies if the TCGA disposal is of such a nature that, by virtue of section 42 of TCGA 1992 (part disposals), an apportionment falls to be made of certain expenditure.
(6) No deduction is to be made by virtue of paragraph (3) in determining the amount or value of the consideration for the purposes of the fraction in section 42(2) of TCGA 1992.

The OF Manual provides:

OFM18200 Investors in non-reporting funds: deduction of offshore income gains in computing capital gains: treatment of the disposal - general – Regulation 45 [January 2012]
Where there is a part-disposal so that section 42 of TCGA applies to determine the apportionment of acquisition costs to the disposal then the full amount of disposal consideration is taken into account for the

34 Section 37(1) TCGA provides: "There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth charged to income tax as income of, or taken into account as a receipt in computing income or profits or gains or losses of, the person making the disposal for the purposes of the Income Tax Acts."

> purposes of the calculation required by that section – that is, the offshore income gain is not deducted from the disposal consideration for the purposes of calculating the part disposal fraction at section 42(2).

Why is that?

35.21 Losses

Regulation 42 OFTR provides:

> (1) If the effect of any computation under regulations 39 to 41 would be to produce a loss, the basic gain on the disposal is nil.
> (2) Paragraph (1) applies notwithstanding section 16 of TCGA 1992 (losses determined in like manner as gains).
> (3) Accordingly, for the purposes of these Regulations, no loss is to be treated as arising on the disposal.

An offshore income gain is charged to IT but where a loss arises on the disposal, there is no income tax relief.[35] The loss will be allowable for CGT if ordinary CGT principles permit. HMRC agree. The OF Manual provides:

> **OFM 09050 Investors in non-reporting funds: charge to tax on disposal of an interest: overview** [January 2012]
> ...Losses
> Where there is a loss on disposal then the gain for the purposes of tax on an offshore income gain is nil, that is there is no recognition of losses for the purposes of the regulations (regulation 42). Accordingly, in a case where there is also a disposal for the purposes of TCGA, any loss made (calculated in accordance with that Act) may be treated as a capital loss for the purposes of TCGA.

This means that remittance basis taxpayers and non-residents will generally have no loss relief.[36]

The allowable loss (if there is one) is computed on CGT principles (not the OIG computation rules) but the amount is the same.

35.22 Exemptions

Chapter 3 part 2 OFTR set out 11 exemptions from the charge to tax on OIGs. The following are only mentioned here:

(1) UK companies owning offshore funds which are:

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35 Section 152(8) ITA prevents miscellaneous losses being set against OIGs.

36 See 54.1 (Capital losses).

(a) loan relationships (the loan relationship rules prevail)
(b) derivative contracts (the derivative rules prevail)
(c) intangible fixed assets (the intangible rules prevail)

(2) Excluded indexed securities
(3) Policies of insurance: the chargeable events regime prevails.
(4) Trading stock
(5) Exemption for insurance companies
(6) Loan other than a participating loan
(7) Transparent funds: see 35.23 (Exemption for transparent fund)
(8) Transitional relief; see 36.8 (2009 Transitional rules)
(9) Charities: see Kessler and Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013), para 3.16 (online version *http://www.taxationofcharities.co.uk*).

35.23 Exemption for transparent fund

Regulation 29 OFTR provides an exemption:

(1) No liability to tax arises under regulation 17 if—
  (a) the disposal is the disposal of an interest in an offshore fund falling within paragraph (b) or (c) of section 40A(2) of FA 2008 [now s.355 TIOPA][37], and
  (b) the fund is a transparent fund.
  This is subject to paragraphs (2) and (3).

The regulation continues with two exceptions:

(2) But there is a charge to tax under regulation 17 if—
  (a) there is a disposal of an interest in a transparent fund, and
  (b) during a period beginning with the date the interest (or any part of it) was acquired and ending with the date of the disposal, the offshore fund has at any time held interests in other non-reporting funds which amounted in total to more than 5% by value of the offshore fund's assets.
(3) And there is a charge to tax under regulation 17 if—
  (a) there is a disposal of an interest in a transparent fund,
  (b) the fund is a non-reporting fund, and
  (c) the fund fails to make sufficient information available to participants in the fund to enable those participants to meet their tax obligations in the UK with respect to their shares of

37 See 34.3.1 (Basic definition). The wording makes sense, as a fund within para (a) of the section cannot be a transparent fund, but it could have been more simply drafted.

the income of the fund.

(4) If, on the disposal by an offshore fund of an interest in another non-reporting fund, no liability would arise under regulation 17 by virtue of this regulation, that interest is not taken into account for the purposes of paragraph (2)(b).

The OF Manual provides:

OFM16500 Investors in non-reporting funds: exceptions to the charge to tax: interests in certain transparent funds - Regulation 29 [January 2012]

... Other types of arrangements that are transparent for income purposes but not transparent for capital gains purposes (Section 99 and 103A TCGA - see OFM07000 onwards) such as, for example, certain unit trusts (following the case of *Archer-Shee v Baker*) or certain foreign contractual arrangements (such as Fonds Commun de Placement ("FCPs")) fall within the definition of an offshore fund. They are therefore subject to the Offshore Funds (Tax) Regulations 2009 (SI2009/3001) generally, with certain modifications as described below.

The purpose of the offshore fund regime is to ensure that income cannot be rolled up free of tax, with any subsequent gain on disposal being charged only as a capital gain. If a fund is transparent for income, such as would be the case for certain unit trusts and contractual funds, then any income arising to the fund is treated as arising to an investor in proportion to his rights. This means that income is charged to tax as it arises.

However, it might be the case that an income transparent fund that came within paragraph (b) or (c) of section 355(1) of TIOPA 2010 itself invested in a non-reporting fund, and if that were the case then income could be rolled up in the underlying fund, because income would only be credited to the top fund if it was distributed.

In order to prevent unnecessary administrative burdens for transparent arrangements coming within the definition of an offshore fund and for their investors, any gain on disposal of an interest in an income transparent offshore fund will not be taxed as an offshore income gain unless -

- during a period beginning on the date the interest (or any part of it) was acquired and ending on the date of the disposal, the offshore fund at any time held interests in other non-reporting funds (except for certain other transparent funds (see below) which amounted in total to more than 5% by value of the offshore fund's assets (Regulation 29(2)), or
- the transparent fund is a non-reporting fund, and the fund fails to make sufficient information available to participants in the fund to

enable those participants to meet their tax obligations in the United Kingdom with respect to their shares of the income of the fund (Regulation 29(3)).

Whilst this does mean that such 'special category' funds will have to monitor their underlying investments, it allows such funds to avoid the need to apply for reporting fund status. UK investors will be charged capital gains tax or corporation tax on a capital gain arising, rather than incurring an offshore income gain, provided the fund has complied with Regulation 29(2)).

It follows that if a transparent offshore fund is invested by more than 5% by value of its total investments in non-reporting non-transparent funds it may apply for reporting fund status in order to allow UK investors to be charged to tax on capital gains on disposal rather than to an offshore income gain. If reporting fund status is granted then the fund will be subject to the requirements of the regulations, including those relating to the calculation of income from non-reporting funds (see regulations 69 to 71).

Provision of 'sufficient information' to participants - Regulation 29(3)

If a fund is unable to provide sufficient information to its UK investors to enable them to meet their UK tax obligations then an offshore income gain will be charged on any gains realised on subsequent disposals of relevant interests. The provision of 'sufficient information' would include details of an investor's proportionate share of both income arising to the fund and reported income or offshore income gains arising to it, as well as confirmation as to whether or not the fund has invested more than 5% by value of its assets in non-reporting funds.

In practice, many existing income transparent funds with UK investors already provide vouchers to those clients detailing income arising to the fund, for example interest income, and foreign or UK dividends.

HMRC consider that, for the purposes of regulations 29 and 92D only, sufficient information will have been provided by the fund to a UK investor if the information provided would enable the UK investor to compute their final UK tax liability (arising from their interest in the offshore fund) correctly.

UK investors will still be required to complete their tax returns in the required format under self-assessment. For example a unit holder would need to know whether the source of their income is land and property income, trading income, interest, UK dividends, foreign dividends etc. Where transparent funds have complex structures and a number of sources of income, this can lead to complex tax issues arising for an individual completing their tax return.

Some UK investors may be able to sidestep the requirement to disclose

details of whether dividends are UK or foreign sourced. This may be the case if the unit holder is entitled to total dividends of less than £300 and ticks the appropriate box on their self assessment return.

If in the course of an enquiry into a UK investor, it is asserted that 'sufficient information' had not been provided by the fund to a UK investor, the caseworker should contact the CISC team (See OFM01000) as this could have an impact on other UK investors in the same fund.

Investments by transparent non-reporting funds in other transparent non-reporting funds - Regulation 29(4)

There is one important relaxation to the requirements of regulation 29(2). That is, if a transparent non-reporting fund ("TNRF1") invests in another TNRF (TRNF2) then, where a disposal of an interest in TNRF2 would not itself give rise to an offshore income gain (under regulation 17) for a UK investor, the interest held by TNRF1 in TNRF2 is ignored in determining whether TNRF1 is invested in non-reporting funds by more than 5% of the value of its assets in total. This is because in such circumstances there can be no significant roll-up of income in the underlying fund(s).

This means that a TNRF's investments could, for example, consist wholly of interests in other underlying TNRFs that themselves held only, say, UK property. Or, a TNRF could be the top layer fund in a fund of funds structure with multiple layers of other TNRFs below the top fund, provided that each of those underlying TNRFs themselves did not hold more than 5% by value of their assets in total in other non-transparent, non-reporting funds.

In deciding whether the investee fund qualifies under this regulation this rule may be applied to the investee fund and to any funds in which it, in turn, holds investments.

35.24 DT relief on offshore income gain

Suppose an individual who is UK resident and treaty-resident in a foreign state disposes of offshore funds so that OIGs arise directly to them.

Article 13(5) OECD Model provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a [treaty-resident].

Article 21(1) OECD Model provides:

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

It is an interesting question whether the individual claims relief under Art.13 or Art.21. At first sight OIGs are "gains" which arise from the alienation of property, even though not chargeable gains and even though subject to income tax rather than CGT.[38] But OIGs are also "income" if that word is given its UK tax meaning. Of course it does not normally matter which of the articles apply, if the treaty has both. But if a particular treaty has an equivalent of art.21 (other income) but no capital gains article, then it is considered that treaty relief is still in principle available.

38 See 49.9.1 (Gain subject to income tax).

CHAPTER THIRTY SIX

INCOME FROM OFFSHORE FUNDS

36.1 Introduction

This chapter considers the taxation of income distributed by offshore funds, and some subsidiary tax issues. The taxation of offshore income gains is considered in the previous chapter..

36.2 Distributed income of offshore fund

In the absence of express provision, the taxation of income distributed by funds would depend on the nature of the fund:

(1) Distributions from corporate funds would be taxed as dividends.
(2) Distributions from transparent funds would be taxed as the income of the underlying assets.
(3) Distributions from non-transparent non-corporate funds (ie non-transparent unit trusts) would be taxed as annual payments.

In each case the income will in principle be RFI and so can qualify for the remittance basis.

36.2.1 *Bond Funds*

The first dent in this position is s.378A ITTOIA which reclassifies some dividends as interest:

> (1) This section applies where—
> (a) a dividend[1] is paid by an offshore fund, and
> (b) the offshore fund fails to meet the qualifying investments test at

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1 Defined in s378A(7):
"In this section—
"dividend" includes any distribution that (but for this section) would be treated as a dividend for income tax purposes".

any time in the relevant period.[2]

(2) The dividend is treated as interest for income tax purposes.

Section 378A(3) defines the qualifying investments test:

> For the purposes of this section, an offshore fund fails to meet the qualifying investments test if the market value of the fund's qualifying investments exceeds 60% of the market value of all of the assets of the fund (excluding cash awaiting investment)...
> "qualifying investments" has the meaning given in section 494 of CTA 2009.

I refer to offshore funds within s.378A as **"bond funds"**. EN FA 2009 explains:

> Certain distributions from offshore funds are economically similar to payments of yearly interest. Section 39 [inserting s.378A] charges distributions of this type to tax as if they were yearly interest.
> ... The test in subsection (3) is similar to that which applies to corporate investors for the purposes of the loan relationships legislation. (See sections 490 and 493 CTA 2009). A distribution is treated as interest if the offshore fund, at any time during the 'relevant period', holds more than 60 per cent of its assets in the form of qualifying investments. The definition of a qualifying investment is set out in section 494 CTA 2009 and, in summary, refers to interest bearing and economically similar investments.
> ... The purpose of the clause is to prevent a tax advantage being gained by holding interest bearing assets within an offshore fund structure....
> ... where a distribution from an offshore fund takes the form of a dividend the rate will be the dividend tax rate after taking into account the dividend tax credit. However, where the offshore fund is substantially invested in interest bearing, or economically similar, assets

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2 Defined in s.378A(4)(5):

(4) "The relevant period" means—

(a) the relevant period of account of the offshore fund, or

(b) if longer, the period of 12 months ending on the last day of that period.

(5) "The relevant period of account" means—

(a) the last period of account ending before the dividend is paid, in a case in which the profits available for distribution at the end of that period (and not used since then by distribution or otherwise) equal or exceed the amount of the dividend (aggregated with any other distribution made by the offshore fund at the same time), and

(b) the period of account in which the dividend is paid, in any other case.

as described in paragraph 4 above then any distribution will be treated as interest for income tax purposes.

The OF Manual provides:

> **OFM27310 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to income tax: corporate funds - Regulation 95** [January 2012]
> **...Bond funds**
> From 22 April 2009 there is a change to the way dividends from offshore funds which are substantially invested in interest-bearing assets (commonly known as 'bond funds') are treated for tax purposes. Where an offshore fund holds more than 60% of assets in interest-bearing (or economically similar) form, any distribution or excess of reported income is treated as a payment of yearly interest (section 378A ITTOIA 2005 / regulation 95(3)). Such sums do not qualify for a dividend tax credit and the tax rates that apply are those applying to interest. Fund managers should be able to tell UK investors if a fund is a bond fund...

36.3 Undistributed income of reporting funds (deemed RF income)

In the absence of express provision, undistributed income of offshore funds would not be subject to tax. However the OFTR alters that. The legislation distinguishes between three types of funds:

(1) Non-transparent funds:
  (a) corporate funds (corporate funds cannot be transparent)
  (a) non-corporate non-transparent funds
(2) Transparent funds

36.3.1 *Meaning of "transparent"*

Regulation 11 OFTR provides:

> For the purposes of these Regulations a fund is a "transparent fund" if, in the case of holders of interests in the fund who are individuals resident in the UK, any sums which form part of the income of the fund are of such a nature that those holders—
>
> (a) are chargeable to tax under a provision specified in section 830(2) of ITTOIA 2005[3] in respect of such of those sums as are referable to their interests, or
>
> (b) if any of that income is derived from assets within the UK,

3 Section 830(2) ITTOIA specifies the list of 24 categories of RFI; see 10.3.1 (Relevant foreign income).

would be so chargeable had the assets been outside the UK.

I am not sure why the definition is expressed in such a convoluted fashion. But in practice this comes down to the usual tax sense of the word "transparent".

36.3.2 *Undistributed income of reporting non-transparent funds*

Regulation 94(1) OFTR provides:

> In the case of a reporting fund which is not a transparent fund, the Tax Acts have effect as if the excess (if any) of
> [a] the reported income of the fund in respect of a reporting period over
> [b] the distributions made by the fund in respect of the reporting period
> were additional distributions made to the participants in the fund in proportion to their rights.

I refer to this as **"deemed RF income".**

Reg.94(3) OFTR identifies the date and recipient of deemed RF income:

> The excess specified in paragraphs (1) and (2) is treated as made, on the fund distribution date,[4] to participants holding an interest in the fund at the end of the reporting period.

36.3.3 *Corporate reporting funds*

Regulation 95 OFTR provides:

> (1) This regulation applies if—
> (a) a reporting fund makes a distribution to a participant chargeable to income tax in respect of a reporting period, and
> (b) the fund falls within section 40A(2)(a) of FA 2008 [now s.355(1) TIOPA, referring to corporate funds].

In short, the regulation applies to corporate reporting funds.

> (2) This regulation also applies if some or all of the excess specified in regulation 94(1) is treated as made by such a fund to such a participant.
> (3) If section 378A of ITTOIA 2005 (offshore fund distributions)[5] applies to any amount falling within paragraph (1) or (2), the amount is

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4 This term is defined in reg.94(4) OFTR:
> In these Regulations the "fund distribution date" for a reporting period of a reporting fund means the date six months following the last day of the reporting period.

5 See 36.2.1 (Bond Funds).

charged to income tax in accordance with that section.

This does not seem to need saying for distributed income, but it is necessary to classify deemed RF income as interest. So deemed RF income of bond funds is "treated as interest for income tax purposes." If the recipient is a remittance basis taxpayer, this type of income qualifies for the remittance basis, just like ordinary interest.

What about deemed RF income of corporate non-bond funds? This is treated as "distributions" so it is treated as a dividend. Reg.54, 95(4) assumes this and confers the right to tax credits as other dividends:

> (4) If paragraph (3) does not apply to any amount falling within paragraph (1) or (2), but the participant is entitled to a tax credit on receiving a distribution falling within paragraph (1), section 397A of ITTOIA 2005 (savings and investment income: dividends from non-UK resident companies) also applies to the excess falling within paragraph (2).

This income qualifies for the remittance basis just as ordinary dividends. HMRC agree. The OF Manual provides:

> **OFM13400 Investors in non-reporting funds: income & distributions: the charge to tax: remittance basis** [January 2012]
> Where an investor in a (non-transparent) non-reporting offshore fund is taxed on the remittance basis then the remittance basis rules apply to income arising from the holding in that fund as they apply to other income from non-UK sources.
> Where the fund is transparent for tax-purposes, then the income will arise from the underlying assets and not from the fund. In such a case the income may sometimes arise in the UK (even though the fund itself is domiciled offshore). Where the income arises in the UK the remittance basis does not apply. Where the income arises offshore then the remittance rules will apply.

36.3.4 *Non-corporate non-transparent reporting funds*

Regulation 96 OFTR provides:

> (1) This regulation applies if—
> (a) a reporting fund makes a distribution to a participant chargeable to income tax in respect of a reporting period,
> (b) the fund falls within paragraph (b) or (c) of section 40A(2) of FA 2008 [now s.355(1)(b)(c) TIOPA referring to unit trusts and co-ownership funds], and
> (c) the fund is not a transparent fund.

(2) This regulation also applies if some or all of the excess specified in regulation 94(1) is treated as made by such a fund to such a participant.
(3) Any amount to which paragraph (1) or (2) applies is charged to income tax—
(a) under section 378A of ITTOIA 2005 (offshore fund distributions),[6] or
(b) (if that section does not apply) under Chapter 8 of Part 5 of ITTOIA 2005 (miscellaneous income: income not otherwise charged) for the year of assessment in which the distribution is made ...

This does not apply to a non-resident participant as such a person is not chargeable to income tax on a distribution from an offshore fund.

Regulation 96(3) continues:

but sections 688(1) and 689 of ITTOIA 2005 (income charged and person liable) do not apply.

The disapplied sections would have provided:

688 *(1) Tax is charged under this Chapter on the amount of the income arising in the tax year.*
(2) Subsection (1) is subject to ...
(c) Part 8 (foreign income: special rules).
689 *The person liable for any tax charged under this Chapter is the person receiving or entitled to the income.*

36.3.5 *HMRC views*

The OF Manual provides:

OFM27310 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to income tax: corporate funds - Regulation 95 [January 2012]
Where a reporting fund takes corporate form, any sums distributed together with any excess of reported income will be treated as foreign dividends (unless the fund is a 'bond fund' – see below). Until 22 April 2009, dividends received from offshore funds did not carry any entitlement to a dividend tax credit but from that date they will do so unless the distribution is from a bond fund (section 378A ITTOIA 2005). Any sums treated as an excess of reported income also carry an entitlement to a foreign tax credit, unless the fund is a bond fund

6 See (Bond Funds).

(regulation 95(4))...

Remittance basis users

Where individuals not domiciled in the United Kingdom are taxed on the remittance basis then the normal remittance basis rules will apply to income arising from the reporting fund.

In the case of income that is reported but is not distributed then that income has not been remitted to the UK.

OFM15670 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to income tax: other non-transparent funds - Regulation 96 [January 2012]

Arrangements that are non-transparent for income purposes and that come within the definition of an offshore fund under section 355(1) TIOPA 2010 (that is, funds that do not take corporate form) will be foreign unit trusts. Foreign unit trusts that are not transparent for income purposes are sometimes referred to as 'Garland' unit trusts (following the case of *Garland v Archer-Shee* (15 TC 693)).

Non-transparent unit trusts

UK investors in foreign unit trusts that are non-transparent for income purposes are taxable on their proportionate share of income (as ascertained after the trustees have met the expenses of administering the trust) when it is indefeasibly allocated to them, regardless of whether the income is paid to them or accumulated. Unlike the position for transparent unit trusts, that income is taxable as miscellaneous foreign income (under Chapter 8 of Part 5 of ITTOIA 2005) and the tax rates applying will be those applying to such income.

If there is an excess of reported income over the amount allocated (for example if the unit trust has invested in another reporting fund and has itself received reports of income which was not actually distributed to it) then the excess must be treated by the participant in the same way as the allocated income (that is as miscellaneous foreign income (under Chapter 8 of Part 5 of ITTOIA 2005).

Remittance basis users

Where individuals not domiciled in the United Kingdom are taxed on the remittance basis then the normal remittance basis rules will apply to income arising from the reporting fund.

In the case of income that is reported but is not distributed then that income has not been remitted to the UK.

OFM27330 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to income tax: transparent funds [January 2012]

...Income: UK tax treatment of investors

No matter what the legal form of a transparent reporting fund, for UK

tax purposes the income of an income transparent fund is treated as arising directly to its investors (UK investors are charged to tax on income arising net of a deduction for proper expenses of the management of the fund in question, and this is the case for both unit trusts and contractual arrangements). So, for example, if a fund receives interest income then UK investors are charged to tax on their proportionate share of that income as it arises, irrespective of whether or not it is actually distributed to them. Investors should receive a "voucher" or other report from the fund to tell them what proportion of the fund's income they are entitled to, and the split between interest, dividends, property income, etc. Investors should ask their fund manager for such a voucher or report if they do not receive one.

If a transparent reporting fund holds investments in other reporting funds then investors are also taxable on their proportionate share of any income reported but not actually distributed by the underlying fund (regulation 94(2)). This will become part of the excess to be reported by the transparent reporting fund. Such excess reported income is charged to tax as miscellaneous foreign income under Chapter 8 of Part 5 ITTOIA 2005 (regulation 97(2)), and it is chargeable at investors' highest tax rate.

Remittance basis users

In a case where the reporting fund is transparent for UK tax purposes then the income will arise from the underlying assets and not from the fund. In such a case the income may sometimes arise in the UK (even though the fund itself is domiciled offshore). Where the income arises in the UK the remittance basis does not apply. Where the income arises offshore then the remittance rules will apply.

OFM27400 Reporting funds: tax treatment of participants in reporting funds: participants chargeable to corporation tax - Regulation 98 [January 2012]

Corporate investors in offshore funds will be chargeable to corporation tax on any distributions received from reporting funds under general principles, and on any excess of reported income of the fund invested in under regulation 94(1) and (2). Where such investors are taxable under regulation 94(1) on excess reported income, that amount will be treated as exempt if it would be exempt had it been an actual distribution.

The bond fund rules in Chapter 3 of Part 6 CTA 2009 (relationships treated as loan relationships) may apply if a reporting fund held more that 60% by value of its investments in debt type assets at any time during an investing company's accounting period – see the Corporate Finance Manual ('CFM')).

36.3.6 *Can deemed RF income be remitted?*

Legislation frequently deems an individual to receive income or gains (eg deemed s.13 gains, deemed s.624 income, deemed s.720 income). In these cases the legislation always has a provision which deems some actual funds to be derived from the individual's deemed income. So if those actual income or gains are received by the individual (or a relevant person) there is a taxable remittance. In this case however there is no such provision. So it appears at first sight that the deemed RF income cannot be remitted. While the actual income in the hands of the offshore fund could be received in the UK, those funds do not derive from the deemed RF income. The deemed RF income perhaps derives from those funds.

This does lead to a result that might be thought too good to be true. So it is more than possible that a court might read in an implied provision that the actual income of the offshore fund is derived from the deemed RF income, though that verges on legislation rather than construction.

HMRC may not agree. The OF Manual provides:

> **OFM27950 Reporting funds: tax treatment of participants in reporting funds: remittance basis** [January 2012]
> Where individuals not domiciled in the United Kingdom are taxed on the remittance basis then the normal remittance basis rules will apply to income arising from the reporting fund.
> In the case of income that is reported but is not distributed then that income has not been remitted to the UK.
> **Transparent Funds**
> In a case where the reporting fund is transparent for UK tax purposes then the income will arise from the underlying assets and not from the fund. In such a case the income may sometimes arise in the UK (even though the fund itself is domiciled offshore). Where the income arises in the UK the remittance basis does not apply. Where the income arises offshore then the remittance rules will apply.
> **Disposals**
> The proceeds of a disposal of a reporting fund will normally constitute a 'mixed fund' for the purposes of the remittance basis rules. This is because the proceeds may have been funded by undistributed reported income as well as by the original investment and any capital growth.

36.4 Transparent reporting funds

Regulation 97 OFTR provides:

> (1) This regulation applies if—

(a) a reporting fund is a transparent fund, and
(b) some or all of the excess specified in regulation 94(2) is treated as income of a participant by virtue of that provision.

(2) Any amount to which paragraph (1) applies is charged to income tax under Chapter 8 of Part 5 of ITTOIA 2005 as relevant foreign income within the meaning given by section 830 of ITTOIA 2005 for the year of assessment in which the distribution is made, but sections 688(1) and 689 of ITTOIA 2005 do not apply.

36.5 Non-reporting fund with interest in reporting fund

Regulation 16 OFTR provides:

(1) This regulation applies if a non-reporting fund which is a transparent fund has an interest in a reporting fund.
(2) In the case of any excess specified in regulation 94(1) or (2) which is treated, under that regulation, as made to the non-reporting fund, the Tax Acts have effect as if the excess were additional income of the participants in the non-reporting fund in proportion to their rights.
(3) The additional income is treated as arising on the same date as the excess is treated as made to the non-reporting fund.
(4) If a participant in the non-reporting fund is chargeable to income tax, the additional income is charged as relevant foreign income within the meaning given by section 830 of ITTOIA 2005.

The OF Manual provides:

OFM13200 Investors in non-reporting funds: distributions: the charge to tax: 'transparent' funds [January 2012]
... **Transparent non-reporting funds with interests in reporting funds (regulation 16)**
There is a further point to consider with regard to transparent non-reporting funds that hold interests in reporting funds. That is, where the underlying reporting fund does not distribute all of its 'reportable income' (see OFM24000 and OFM27000 onwards) then the excess would, if a UK investor held a direct interest in the fund, be treated as income (regulation 94). To ensure that principle is maintained, regulation 16 provides that where the interest is held by a non-reporting fund which is transparent for income purposes then the reportable excess will be similarly treated as additional income in proportion to each investor's rights.

36.6 Fund transactions treated as non-trading

This topic is dealt with in chapter 6 part 3 OFTR. A full discussion needs

a long chapter to itself. In short, reg.80 OFTR provides:

> (1) This regulation applies if a diversely owned fund carries out an investment transaction in an accounting period.
> (2) The investment transaction is treated as a non-trading transaction.

The consequence of non-trading status is that the profit of the transaction is not income and need not be distributed by reporting funds.

The definitions of diversely owned and investment transaction are not considered here. HMRC argue that reg.80 is not to be taken to mean what it says:

> HMRC is aware that there has been recent industry speculation as to whether regulations contained within Chapter 6 of Part 3 of The Offshore Funds (Tax) Regulations 2009 (the 'regulations'), setting out when transactions by certain offshore 'reporting' funds are not treated as trading transactions for the purposes of computing 'reportable income', has any relevance to matters relating to the taxation of such funds potentially trading in the UK through a permanent establishment or agent. HMRC is therefore confirming that there is no such relevance.
> Regulation 80(2) of the regulations, which confirms that certain transactions are treated as non-trading transactions, applies only for the purposes of Chapter 5 of the regulations; that is for the purposes of computing an offshore fund's reportable income in order to establish the UK tax position of participants in the fund.
> The regulations are made under powers enabling provision to be made about the tax treatment of participants in an offshore fund (section 41 FA 2008) and they should be read in that context. Specifically, the regulations do not make or purport to make rules that affect the taxation of any of the funds referred to therein as 'offshore funds'; only to regulate the taxation of the returns from those funds to persons taxable under UK legislation. Funds that are taxable in the UK are dealt with by other legislation.
> It is a question of fact whether or not, for the purposes of that other legislation, a non-resident fund is carrying on a trade in the UK. Where such a fund is carrying on a trade in the UK through an investment manager operating here, the protection of the Investment Manager Exemption may be available in relation to any 'investment transaction' specified in the Investment Manager (Specified Transaction) Regulations 2009.[7]

36.7 Conversion from non-reporting fund to reporting fund

Regulation 48 OFTR provides:

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7 Accessible *http://www.hmrc.gov.uk/ctsa/invest-man-exempt.htm* published 2 Feb 2010.

(1) This regulation applies if an offshore fund ceases to be a non-reporting fund and becomes a reporting fund.
(2) A participant in the fund may make an election to be treated—
(a) as disposing of the interest owned by the participant in the non-reporting fund at its market value on the disposal date, and
(b) as acquiring a holding in the reporting fund at the beginning of the reporting fund's first period of account.
This is subject to paragraph (5).
(3) Chapter 5 of this Part applies to determine the offshore income gain arising on the deemed disposal referred to in paragraph (2)(a).
(4) The deemed acquisition referred to in paragraph (2)(b) is treated as made for the same amount as the deemed disposal referred to in paragraph (2)(a).
(5) An election may not be made under paragraph (2) unless the offshore income gain arising on the deemed disposal referred to in paragraph (2)(a) (determined in accordance with paragraph (3)) is greater than zero.
(6) If the participant is chargeable to income tax, the election mentioned in paragraph (2) must be made by being included in a return made for the tax year which includes the disposal date.
(7) If the participant is chargeable to corporation tax, the election mentioned in paragraph (2) must be made by being included in the participant's company tax return for the accounting period which includes the disposal date.
(8) In this regulation—
"company tax return" has the same meaning as in Schedule 18 to the Finance Act 1998(a);
the "disposal date" means the final day of the last period of account before the fund becomes a reporting fund.

36.8 2009 transitional rules

I do not attempt to discuss transitional rules in detail.[8]

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8 Note also the following HMRC statement: "HMRC regrets that ... the Statutory Instrument (SI 2009/3139) ... contained an error with respect to long periods of account.
The intention was that the transitional rules, which provide for an existing fund to apply for distributing status for periods ended on or after 1 December 2009, would not apply to any period ending after 31 May 2012 (not 2011 as provided for in the instrument).
The government intends to amend the cut-off date given in sub-paragraph 3(3B) of Schedule 1 to The Offshore Funds (Tax) Regulations (SI 2009/3001 as amended by SI 2009/3139) to read 31 May 2012.

Reg.30 OFTR provides:

(1) No liability to tax arises under regulation 17 in respect of any rights in an offshore fund to which this regulation applies if the rights are acquired by a person—
  (a) before 1st December 2009, or
  (b) in accordance with paragraph (2).

(2) Rights are acquired in accordance with this paragraph if—
  (a) the rights are acquired by the participant in accordance with a legally enforceable agreement in writing that was entered into by the participant before 30th April 2009,
  (b) in the case of an agreement which was conditional, the conditions are met before that date, and
  (c) the agreement is not varied on or after that date.

(3) Rights of a person in a fund are rights in an offshore fund to which this regulation applies if, on the date on which the person acquired the rights, those rights did not constitute a material interest in an offshore fund within the meaning of that expression given by section 759 of ICTA.

Reg.43 OFTR provides for the case where a person holds an offshore fund before 2009 and purchases more of the same fund:

(1) This regulation applies if—
  (a) a person acquired rights (the "protected rights") in an offshore fund—
    (i) before 1st December 2009, or
    (ii) in accordance with paragraph (2),
  (b) immediately before 1st December 2009 those rights did not constitute a material interest in an offshore fund within the meaning of that expression given by section 759 of ICTA, and
  (c) on or after 1st December 2009 the person acquires additional rights in the offshore fund (the "non-protected rights").

(2) Rights are acquired in accordance with this paragraph if—
  (a) the rights are acquired by the participant in accordance with a legally enforceable agreement in writing that was entered into by the participant before 30th April 2009,
  (b) in the case of an agreement which was conditional, the conditions are met before that date, and
  (c) the agreement is not varied on or after that date.

This announcement therefore gives notice of the intended amendment, which will be made at the first convenient opportunity."

(3) For the purposes of tax in respect of chargeable gains—

(a) section 104 of TCGA 1992 (share pooling: general interpretative provisions) applies as if the protected rights were assets of a different class from the non-protected rights, and

(b) all the protected rights must be treated as disposed of before any of the non-protected rights may be so treated.

CHAPTER THIRTY SEVEN

ACCRUED INCOME PROFITS

37.1 Accrued income profits: Introduction

This subject needs a book to itself. It would be an unrewarding labour since the rules are "widely ignored by both taxpayers, their advisors and within HMRC".[1] This chapter focuses on the questions closest to the themes of this book, but one can only approach those questions after understanding how the provisions operate, at least in the standard case (I do not consider specialist topics such as variable rate securities or conversions of securities).

The provisions apply on a transfer of securities. The AIP provisions do not apply for corporation tax.

37.1.1 *Cross references*

The following topic is discussed elsewhere:

1.7 Unremittable income: accrued income profits

37.2 AIP securities

Section 619(1) ITA defines "securities":

> In this Chapter "securities" includes—
>
> (a) any loan stock or similar security other than an excluded security, and
>
> (b) shares in a building society which are qualifying shares for the purposes of section 117(4) of TCGA 1992 (qualifying corporate bonds),

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1 Responses to Consultation Exercise on Reform of the AIP, Inland Revenue, December 2004; consistent with that, several of the worked examples in the SAI Manual are difficult to justify.

Reform was promised in 2006 but radical change was rejected and the matter was dropped.

but (subject to para (b)) it does not include any shares in a company.[2]

I refer to securities within this definition as "**AIP securities**". Section 619(3) ITA sets out seven categories of "Excluded securities":

> (3) In this section "excluded securities" means—
> (a) national savings certificates (including Ulster Savings Certificates as defined in section 693(7) of ITTOIA 2005),
> (b) war savings certificates,
> (c) uncertificated eligible debt security units as defined in section 986,
> (d) certificates of deposit (see section 1019),
> (e) a security which is a right falling within section 552(1)(c) of ITTOIA 2005 at the time of the transfer in question,
> (f) a security that meets the redemption conditions (see subsection (5))[3], and
> (g) a security that is a deeply discounted security within the meaning of Chapter 8 of Part 4 of ITTOIA 2005.[4]

Thus deeply discounted securities are not AIP securities: (subject to the 2003 transitional rule) the DDS rules take priority over the AIP rules.

37.2.1 *Securities "of the same kind"*

This expression is strictly understood. Section 619(6) ITA provides:

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2 Section 619(2) ITA adds:
"(2) For the purposes of subsection (1)(a), it does not matter—
(a) whether the security is of the government of the UK, any other government, any public or local authority in the UK or elsewhere, or any company or other body,
(b) whether or not the security is secured,
(c) whether or not the security carries a right to interest of a fixed amount or at a fixed rate percentage of the nominal value of the security, or
(d) whether or not the security is in bearer form."
This can only be for the avoidance of doubt, because it only expresses the usual meaning of "security".

3 Defined s.619(5) ITA:
"The redemption conditions are that—
(a) the security is redeemable,
(b) the amount payable on its redemption exceeds its issue price, and
(c) no return other than the amount of that excess is payable on it."

4 Section 619(4) ITA contains a transitional exception: "But subsection (3)(g) does not include a security if, on its transfer, Chapter 8 of Part 4 of ITTOIA 2005 would apply subject to the rules in sections 454 to 456 of that Act (listed securities held since 26 March 2003)."

Securities are treated as being of the same kind for the purposes of this Chapter if they—

(a) are treated as being of the same kind by the practice of a recognised stock exchange, or

(b) would be so treated if dealt in on such an exchange.

SAI Manual provides:

4040 Accrued Income Scheme: what are "securities" [October 2008] ... For example, Treasury 5% 2004 is not the same kind as Treasury 5% 2012. This is similar to the capital gains tax concept of securities of a particular class.

37.3 "Transfer"

In outline, the definition is in s.620(1) ITA:

References in this Chapter to the transfer of securities are—

(a) to the transfer of securities by way of sale, exchange, gift or otherwise,

(b) to the conversion of securities in any case where there is no transfer of the securities within para (a),

(c) to the redemption of variable rate securities in any case where there has been a transfer of the securities at any time before redemption, or

(d) to a transaction or event treated as a transfer under—

(i) section 648(1) or (3) (strips of gilt-edged securities),

(ii) section 649(4) (new securities issued with extra return),

(iii) section 650(2), (4) or (6) (trading stock appropriations etc),

(iv) section 651(2) (owner becoming entitled to securities as trustee), or

(v) section 652(2) (securities ceasing to be held on charitable trusts).

Thus there are altogether eight types of transfer. In this book I consider only the first type, which are transfers in the normal sense of the word. Section 620(2) provides one exception:

But subsection (1)(a) does not include—

(a) the vesting of securities in personal representatives on death...[5]

5 Paragraph (b) is a transitional rule for pre-2003 DDS (not discussed here).

37.4 Transfer "with accrued interest"

37.4.1 *The commercial background*

The Debt Management Office explains the terminology **"clean"** and **"dirty"** price:

> The following example is taken from the DMO website for 30 November 2004 and shows close of business data for 5% Treasury Stock 2014:
> **5TY145 | Treasury 2014 | GB0031829509 | 103.17 | 104.344033 | 4.592604**
> The first three fields are all means of identifying the gilt. The first is the DMO's internal identifier code and the second a shortened form of the gilt's name. The third field is the ISIN number (the International Security Identification Number – an identifier number used by the London Stock Exchange).
> The next three fields give price and yield information. The two prices shown of £103.17 and £104.344033 are known as the 'clean' and 'dirty' price respectively. Clean prices do not include accrued interest whereas dirty prices do (see the section on accrued interest on page 15). The clean price is typically the price, which is quoted when agreeing a purchasing or selling price. However, the actual amount of money which will change hands is based on the dirty price and will reflect settlement on the business day after the transaction.
> So, on the basis of the reference price on 30 November 2004, every £1,000 nominal of 5% Treasury Stock 2014 was worth £1,043.44.[6]

Note that for tax purposes the consideration for a gilt is "the actual amount of money which will change hands" - the dirty price.

SAI Manual explains the terminology ex-dividend and cum-dividend:

> **4020. Transfers "with accrued interest" and "without accrued interest"** [July 2007]
> **... Sales with accrued interest ("cum div")**
> Most sales of marketable securities are "cum div". That is, the buyer is entitled to the next interest due. As an interest payment date on a security approaches, its market price increases to reflect the increase in value of the buyer's right to the interest. In other words, the price reflects accrued interest.
> For example, £100,000 8% Treasury Stock 2002–06 is transferred cum div on 19 April. 14 days' interest has accrued since interest was last paid

6 A Private Investor's Guide to Gilts, Dec 2004, accessible *http://www.dmo.gov.uk*.

on 6 April. Accrued interest is £307 (14/365 × 8% × 100,000)...

Sales without accrued interest ("ex div")

Not all sales of securities are "cum div". This is because gilt-edged securities, and some corporate bonds, have an "ex div" or "ex coupon" date. The next interest coupon is paid to the person who is registered as the holder of the security at that date. So if the security is sold in the "ex div" period, the seller collects and keeps the next interest due after the sale. For gilts, the "ex div" period is 7 business days before the coupon date (except for 3 ½% War Loan stock, for which it is 10 business days). Other securities may have a similar, or shorter, "ex div" period.

Consequently the market price of a security sold "ex div" reflects the fact that the purchaser will own the security for a short period from the date of purchase to the next interest payment date. This is a period over which interest accrues but for which the interest is received not by him but by the seller. The interest accrued over such a period is known as rebate interest. It is treated in the opposite way to the more normal accrued interest associated with a "cum div" sale.

For example, £100,000 8% Treasury Stock 2002–06 is transferred ex div on 29 March. 7 days' interest has accrued from the day after the transfer to the next interest date, 6 April. Accrued interest is £153 (7/365 × 8% × 100,000). ...

37.4.2 *Definition of with/without accrued interest*

Section 623(1) ITA provides a commonsense definition:

> The general rule is that securities are transferred with accrued interest for the purposes of this Chapter if they are transferred with the right to receive interest payable—
>
> (a) in a case where the settlement day is an interest payment day, on the settlement day, and
>
> (b) in any other case, on the first interest payment day after the settlement day.

Section 624(1) ITA provides the corresponding definition of a transfer "without accrued interest":

> The general rule is that securities are transferred without accrued interest for the purposes of this Chapter if they are transferred without the right to receive interest payable as mentioned in section 623(1)(a) or (b).

The definitions are comprehensive so every transfer must be either with or without accrued interest, and they are simply English paraphrases of the

technical expressions *cum dividend* and *ex dividend* (or cum-div and ex-div).

The terms "interest" "settlement day" and "interest period" are defined but the definitions are not considered here.

Thus whether a market sale is with or without accrued interest depends only on the date of the sale, whether it is before or after the ex div date. Vendors and purchasers have no choice in the matter except by timing the sale. Whether an off-market sale is with or without accrued interest is a matter for the parties to agree.

37.5 Deemed interest payment, credit and debit

Section 632(1) ITA provides:

> In the case of a transfer of securities with accrued interest, for the purposes of this Chapter a payment is treated as made by the transferee to the transferor in the interest period in which the settlement day falls.

It is useful to have some terminology to describe this. I refer to this payment as "**a deemed interest payment**". The transferor (deemed to receive the payment) has **"a deemed interest credit"**. The transferee (deemed to make the payment) has **"a deemed interest debit"**.

Section 632 then defines the amount of the deemed payment. In outline:

> (2) The amount of that payment depends on whether the transfer is under an arrangement by which the transferee accounts to the transferor separately—
>
> (a) for the consideration for the securities, and
>
> (b) for gross interest accruing to the settlement day.
>
> (3) If the transfer is under such an arrangement, the amount of the payment is the amount of gross interest which the transferee accounts for.
>
> (4) If—
>
> (a) the transfer is not under such an arrangement, and
>
> (b) the settlement day is itself an interest payment day for the securities,
>
> the amount of the payment is the amount of interest payable on the securities on that day.
>
> (5) If—
>
> (a) the transfer is not under such an arrangement, and
>
> (b) the settlement day is not an interest payment day for the securities,
>
> the amount of the payment is an amount equal to—
>
> $I \times (A \div B)$
>
> where—
>
> I is the interest payable on the securities on the first interest payment day after the settlement day ("the payment day"),
>
> A is the number of days in the period beginning with the first day on which that interest accrues and ending with the settlement day, and

B is the number of days in the period beginning with the first day on which that interest accrues and ending with the payment day.

Why are there two alternative methods of ascertaining the amount of the deemed interest payment, in subsections (3) and (4)(5)? SAI Manual provides:

> **4140. Payments on transfers with accrued interest** [July 2007]
> **...** The [deemed interest] payment is the amount of the gross interest accruing to the settlement day, which in most cases is shown separately from the consideration for the securities, under the arrangement (that is, the contract note) by which the transferee accounts to the transferor. This is commonly known as the "clean price" basis.
> In exceptional cases – for example, sales off market, gifts, settlements, and deemed transfers – there will be no contract note and it will it be necessary to compute the amount of the [deemed interest] payment. Where this is done, the formula I × A/B is used...

The Manual offers a straightforward example of the two methods of computation on a single sale with accrued interest:

> *Example*
> Harriet sells corporate bonds to Howard on 15 March 2005. Interest is paid on the bonds on 31 March, 30 June, 30 September and 31 December. Howard will receive the interest coupon due on 31 March 2005, that is, the sale is cum div. The interest Howard receives is £200.
> If Harriet agrees to sell the bond to Howard for a "clean price" of £10,000 plus an additional £165 for accrued interest, she is taxable on accrued income profits of £165 in 2004–05. Howard will reduce his accrued income profits by £165.
> Suppose that, instead, Harriet simply agrees to sell the bond to Howard for £10,165. The relevant interest period is 1 January to 31 March 2005, so B is 90 days. The number of days up to and including 15 March (A) is 74. So the "accrued amount" is £200 × 74/90 = £164.44. Again, Harriet's taxable accrued income will be £164, and Howard's reduced by £165 (following the principle of rounding in the taxpayer's favour).

In practice the two methods normally give the same result (as is the case in the HMRC example) though there could be cases where the parties account for accrued interest in some manner which is not the same as the formula I × A/B.

It is possible for the amount of the deemed interest payment to be nil, eg in the case of a transfer on the interest payment day.

Section 633 ITA contains corresponding rules on a transfer without

accrued interest.

The SAI Manual gives a straightforward example of a sale with accrued interest:

> **4160. Examples of transfers with and without accrued interest** [July 2007]
> *Example 1*
> Anthony has a holding of £100,000 Treasury Stock 8¼% 2007, a British Government security which pays interest on 16 January and 16 July each year. He arranges for his holding to be sold on the Stock Exchange on 19 March 2006. The contract note from his stockbroker, dated 19 March 2006 contains the following information:
>
> | | |
> |---|---|
> | £100,000 Treasury Stock 8¼% 2007 sold @ 114 | £114,000 |
> | Plus 56 days' accrued interest | £1,315 |
> | Payable to you on 20 March 2006 | £115,315 |
>
> The contract note contains all the information that is needed for the purposes of the AIS.
> - Treasury Stock 8¼% 2007 falls within the definition of "securities" – Section 619 ITA 2007
> - the securities have been transferred, and the transfer is treated as taking place on 19 March because there was a contract for their sale made on that date – Section 620 ITA 2007
> - the settlement day for the transfer is 20 March because under Stock Exchange rules bargains in gilt-edged securities are settled on the next business day – Section 674 ITA 2007
> - the transfer is with accrued interest because the purchaser gets the right to the interest payable on 16 July 2006, the next interest payment day to fall after 20 March 2006 – Section 623 ITA 2007
> - under Stock Exchange rules, accrued interest on gilts is accounted for separately from the bargain price, so the accrued amount is £1,315 – Section 632 ITA 2007
> - the interest period in which the settlement day falls is the period 17 January 2006–16 July 2006 – Section 673 ITA 2007.
>
> Accordingly in this interest period Anthony (the transferor) is treated as having received a payment £1,315 and the transferee as having made a payment of £1,315 (Section 632 ITA 2007).

The Manual then gives a straightforward example of a sale without accrued interest (ex-div):

> *Example 2*
> Facts as in Example 1, except that the sale takes place on 1 July 2006 which falls within the "ex-dividend" period for the stock.[7] The contract note from the

7 This is not factually correct: a sale 15 days before the interest payment date would not be ex dividend. That does not spoil the illustrative force of the example but using correct figures would emphasise the triviality of the amounts involved, even in

stockbroker shows:

£100,000 Treasury Stock 8¼% 2007 sold @ 114	£114,000
Minus 15 days' rebate interest	- £352
Payable to you on 2 July 2006	£113,648

The transfer of securities is treated as made on 1 July 2006. The settlement day is 2 July 2006. The transfer is without accrued interest because this is an "ex-div" sale where the seller retains the right to the interest payable on 16 July 2006 (Section 633 ITA 2007). The rebate amount is £352 and the relevant interest period is that from 17 January–16 July 2006

Accordingly in this interest period Anthony (the transferor) is treated as having made a payment of securities of £352 and the transferee as having received a payment of £352.

The Manual then gives a straightforward example of an off-market sale with accrued interest (cum-div):

Example 3

Stuffed Dodos Ltd is a UK company which has issued unquoted unsecured loan stock paying interest each year on the Tuesday following Easter Day. Thus in 2005 interest is payable on 5 April and in 2006 interest is payable on 18 April. Joe Smith owns £10,000 nominal of this stock and agrees to sell £4,000 to his aunt Matilda. Under the agreement, which was made on 8 July 2005, Matilda is to pay £5,000 for the stock on 19 August. The interest payable on 18 April 2006 is at the rate of £5.50 per £100 nominal (5.5%).

Even though the loan stock is unsecured, it constitutes "securities" for the purpose of the scheme. The securities are treated as transferred on 8 July 2005 – Section 620(3) ITA 2007.

The settlement day is 19 August because that is the day Matilda has agreed to pay for the securities and it falls before the next interest payment day following the agreement – Section 674(3) ITA 2007. The transfer is with accrued interest (Section 623 ITA 2007).

Because the accrued interest is not accounted for separately, in calculating the accrued amount, the formula in Section 632(5) ITA 2007 is used. A is the period from 5 April 2005 to 19 August 2005. B is the period from 5 April 2005 to 18 April 2006. I is the interest applicable to the securities for the period (5.5% × £4,000 = £220). The accrued amount is thus 137/379 × £220 = 79.

The interest period in which the settlement day falls is that from 5 April 2005 to 4 April 2006. Accordingly in that interest period Joe is treated as receiving as payment of £79 and Matilda as having made a payment of £79.

37.6 Accrued income profits and losses

Tax is *not* charged on deemed interest credits. But armed with the concept of deemed interest payments, we can turn to the terms "accrued income

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substantial transactions.

profits" (and "accrued income losses") which are defined in ss.628 and 629 ITA:

> **628 Making accrued income profits and losses: general rule**
> (1) This section sets out the general rule for determining whether a person is treated as making accrued income profits or accrued income losses where securities are transferred by or to the person. ...
> (3) A separate calculation is to be made for each kind of security that is transferred by or to the person and for each interest period of each such kind of security.
> (4) Each such calculation is to find—
> (a) the total amount ("A") of the payments treated under this Chapter as made to the person in the interest period in question in respect of transfers of securities of the particular kind, and
> (b) the total amount ("B") of the payments treated under this Chapter as made by the person in that period in respect of such transfers.
> (5) A person is treated as making accrued income profits in an interest period as a result of transfers of securities of a particular kind if A exceeds B.
> (6) A person is treated as making accrued income losses in an interest period as a result of transfers of securities of a particular kind if B exceeds A. ...
> **629 Calculating accrued income profits and losses where section 628 applies**
> (1) If section 628(5) applies, the amount of the accrued income profits treated as made is equal to the excess mentioned in section 628(5).
> (2) If section 628(6) applies, the amount of the accrued income losses treated as made is equal to the excess mentioned in section 628(6).

Thus deemed interest debits are first set against deemed interest credits of the interest period for securities of the same kind. If or so far as they cannot be set against those interest credits, they constitute accrued income losses.

37.7 Charge on AIP income

I refer to the accrued income profits treated as made under s.628 ITA as "**AIP income**".

Section 616 ITA imposes the charge on AIP income:

> Income tax is charged on accrued income profits.

37.8 Relief for accrued income losses

Section 679 ITA allows accrued income losses to be set against interest from securities of the same kind:

> (1) This section applies if—
>
> (a) a person is liable for income tax on interest on securities of any kind which is due at the end of an interest period of the securities,
>
> (b) in that period accrued income losses are made as a result of transfers of those securities, and
>
> (c) the period ends with an interest payment day.
>
> (2) No liability to income tax arises in respect of the interest to the extent that it does not exceed the losses.

SAI Manual provides:

> **4120. Calculating accrued income profits and losses: relief for losses** [July 2007]
>
> **...** In other words, the losses always reduce the interest subsequently received on those securities, and cannot be used to offset accrued income profits for earlier interest periods or arising on securities which have different interest periods. Where the interest period spans the tax year, losses are therefore not allowed until the interest on the securities is taxed in the following tax year.

For the interaction of loss relief and DTR, see 37.15 (Double taxation relief).

37.8.1 *HMRC examples*

SAI Manual provides 3 examples. The first example is a straightforward sale and purchase of one kind of security with accrued interest, looking at the position of the seller:

> **4130 Calculating accrued income profits and losses: examples** [July 2007]
>
> Antoinette has £100,000 Treasury Stock 7¾ % 2006, which has interest dates of 8 March and 8 September. She makes the following transactions in the stock.

Transaction	**Profit/loss**[8]
19 March 2006 sells £100,000	£2,107
21 March 2006 buys £50,000	(£1,361)

8 This refers to deemed interest credits/debits, not the commercial profit/loss but I am unable to see how the figures of 2107, 1361 and 131 are derived: can any reader explain?

12 May 2006 sells £50,000	(£131)
	£615

The aggregate [accrued income] profit is £615, taxable for 2006–07, the tax year in which the interest period ended, even though two of the transactions occur in 2005–06.

The second example includes purchases and sales, with and without accrued interest, and involving two different kinds of security, looking at the position of the seller:

Jean made the following transactions in securities between 28 February 2005 and 5 April 2006:

19 Mar 2005	bought £100,000 Treasury Stock 7½% 2006 (interest payment dates 7 June and 7 December)
26 May 2005	bought £50,000 Treasury Stock 7½% 2006 ex div
15 Sept 2005	sold £20,000 Treasury Stock 7½% 2006
22 Sept 2005	bought £50,000 Treasury Stock 4½ % 2007 (interest payment dates 7 March and 7 September)

The [accrued income] profits and losses arising on these transactions are:

Transaction date	**Interest period**	**Profit/loss**
19 March 2005	08/12/04–07/06/05	(£1,395)
26 May 2005	08/12/04–07/06/05	£82
15 Sept 2005	08/06/04–07/12/05	£271
22 Sept 2005	08/09/04–07/03/05	(£778)

The profits and losses for 2005–06 are:

- Loss of £1,313 (1,395 minus 82) against interest of £3,750 (£100,000 × 7½% × ½) received on Treasury Stock 7½% 2006 on 7 June 2005.
- Profit of £271 (Treasury Stock 7½% 2006, interest period 8 June 2005–7 December 2005)
- Loss of £778 against interest of £2,250 received on Treasury Stock 4½ % 2007 on 7 March 2006.

The third example is a straightforward sale of a security with accrued interest, looking at the position of the purchaser:

Example 3

See Example 3 in SAIM4160 [set out below]. Joe Smith sells £4,000 unsecured loan stock in Stuffed Dodos Ltd to his Aunt Matilda on 19 August 2005. Interest is payable on 5 April 2005 and 18 April 2006. Neither Joe nor Matilda had any other transactions in securities.

The settlement day falls within the interest period 5 April 2005 to 4 April 2006. Joe is taxable on £79 for 2005–06 in respect of this interest period.

Matilda's loss of £79 is carried forward to 2006–07 to be set against the interest receivable for the period 5 April 2005 to 18 April 2006 (Section 637 ITA 2007 – see SAIM4120).

37.9 AIP remittance basis

Section 670A ITA provides:

> (1) This section applies if—
>
> (a) accrued income profits are made by an individual as a result of a transfer of foreign securities, and
>
> (b) section 809B, 809D or 809E (remittance basis) applies to the individual for the tax year in which the profits are made.
>
> (2) Treat the accrued income profits as relevant foreign income of the individual. ...
>
> (4) For the purposes of this section securities are "foreign" if income from them would be relevant foreign income.

This brings in the remittance basis. AIP income is fictional, deemed income, which could not be remitted. This is dealt with by s.670A(3) ITA which provides different rules depending on whether the individual receiving the AIP income is the transferor (the usual case of a sale with accrued interest) or the transferee. It is helpful to consider these two cases separately.

For the transferor, s.670A(3) ITA provides:

> For the purposes of Chapter A1 of Part 14 (remittance basis)—
>
> (a) if the individual[9] is the transferor—
>
> (i) treat any consideration for the transfer as deriving from the accrued income profits...

Thus the proceeds of sale of the securities are treated as containing the AIP income.

> (ii) if on the transfer the individual does not receive consideration of an amount equal to or exceeding the market value of the securities, treat the securities as deriving from the accrued income profits

Section 670A(3)(a)(ii) is the equivalent of the CGT rule for deemed gains on non-market value disposals.[10]

For the transferee, s.670A(3) ITA provides:

> (b) if the individual[11] is the transferee, treat the securities as deriving from the accrued income profits.

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9 That is, the individual who makes the accrued income profits.

10 See 11.30 (CGT disposal not for market value).

11 That is, the individual who makes the accrued income profits.

If the taxpayer is the transferee, the AIP securities in the hands of the transferee are deemed to contain the AIP income. It makes no difference whether or not the sale is for market value.

The SAI Manual provides:

> **4380 - Accrued Income Scheme: remittance basis** [January 2010]
> ... In some cases, a remittance basis taxpayer will make an accrued income profit on a transfer of securities, but will not receive consideration equal to the market value of the securities.
> [1] This may happen when the securities are transferred 'ex-div' and the taxpayer is the transferee.
> [2] It may also happen where the taxpayer is the transferor, and makes a gift of the securities, or where the AIS rules treat an event as a transfer (for example, an appropriation of securities to trading stock).
> In such cases s.670A(3) ITA 2007 provides that the securities themselves are treated as deriving from the accrued income profits. This means that a charge will arise on the taxpayer when they, or some other 'relevant person', either bring the securities to the UK (if they are held in bearer form) or remit money or property deriving from the securities.

37.9.1 *Relief for losses*

What about accrued income losses accruing to a remittance basis taxpayer? The SAI Manual provides:

> **4380 - Accrued Income Scheme: remittance basis** [January 2010]
> ... Remittance basis taxpayers are able to obtain relief for accrued income losses. Losses arising on transfers of securities of a particular kind are set against interest received on securities of the same kind at the end of the relevant interest period, and will therefore reduce the amount of an individual's interest on those securities. There is an example of the interaction of the accrued income loss rules and the remittance basis rules at SAIM4390.

37.9.2 *Mixed funds and separating income/capital: Sale with accrued interest*

The consideration received by the transferor (vendor) for the sale of AIP securities with accrued interest will be a mixed fund, consisting in part of AIP income, and the mixed fund rules will apply. In strict law one cannot separate the AIP income from the other proceeds of sale. There are three reasons for this.

First, assume that:

(1) P will pay a single sum for the security to V's broker (the total price).

(2) The broker will then divide the total price into two parts (accrued interest and clean price) and pay the two parts into two separate accounts of the vendor.

There is already a mixed fund on receipt of the payment by the broker on behalf of the client at stage (1), and the broker's act in transferring the single payment into two accounts is an offshore transfer under the mixed fund rules. In theory one might avoid this difficulty if P could pay two separate sums, one in respect of accrued interest and one in respect of the clean price; but in practice on a market sale that would not be possible.

Secondly, the AIP income is a fictional, notional amount which is distinct from the sum paid for the accrued interest. It is like the CFC income in *Brikom*.[12]

Even if that were wrong, however, there is a third obstacle in s.670A(3) ITA, which provides:

> For the purposes of Chapter A1 of Part 14 (remittance basis)
> (a) if the individual is the transferor –
> (i) treat *any* consideration for the transfer as deriving from the accrued income profits.

Thus even if (contrary to my view) the amount that V, the transferor, received for the accrued interest could in principle be separated and did in principle constitute the AIP income, the effect of s.670A(4) is that any consideration for the securities sold by V is treated as deriving from the AIP income.

However HMRC do not take that view. The RDR Manual provides:

> **33550 - Remittance Basis: Identifying Remittances: Specific Topics: Accrued Income Scheme** [July 2010]
> Where a security is sold with accrued income and the proceeds paid into an account, the part of the proceeds representing accrued income will be taxable as income and subject to income tax under the Accrued Income Scheme (AIS)....
> Where an individual is chargeable on the remittance basis, accrued income profits arising from on transfers of a 'foreign security' are treated as relevant foreign income...
> For consistency of treatment between the AIS and the remittance basis regime, HMRC will follow the tax treatment delivered by the AIS and accept that an 'income amount' can be transferred to a separate 'income

12 See 59.2 (Characterisation).

> account' immediately upon transfer, that is, the proceeds are 'split' into two separate accounts immediately upon receipt into the individual's account. This 'income' could then be identified and taxed as such, without creating a mixed fund....
> To the extent that the remainder of the proceeds consist of capital or UK or non-taxable income (as opposed to, say, untaxed foreign income or gains) originally used in the purchase of the security ... the remainder of the proceeds could therefore be separately identified and remitted as such.[13]

37.9.3 *Mixed funds & separating income/capital: Sale without accrued interest*

The Manual does not expressly consider the alternative situation where a security is sold without accrued interest and the transferee makes an accrued income profit. There is no difference between the two situations, so the purchaser (transferee) could divide up the purchased securities into an AIP income fraction and a clean capital fraction and hold the two in separate security accounts. However the amounts involved will generally be trivial.

37.9.4 *Mixed funds and separating income/capital: Actual interest payment*

A similar problem arises on receipt of the interest payment after the sale. I refer to this as **"the actual interest payment"**. The recipient will be the purchaser (on a sale with accrued interest) or the seller (on a sale without accrued interest). Either way, the recipient will not normally be subject to income tax on the full amount of the interest as an deemed interest debit will normally generate an accrued income loss which can be set against the interest. The actual interest payment will therefore be a mixed fund. It is suggested that one can separate the actual interest payment on receipt

---

13 Similarly SAI Manual:

> "**4400. Remittance basis: Further examples** [January 2010]
> The disposal of a bond may be structured such that separate payment is made for the capital and the accrued income elements which may be paid into separate accounts. In this situation Section 632 ITA 2007 provides that the taxable amount shall be taken as the amount of gross interest accruing to the settlement day, which is separately identified as such.
> An individual who has received separate payments into two separate accounts in this way will not be regarded as having two mixed funds. In this situation a remittance of the capital element will not be regarded as a remittance of relevant foreign income."

into income and capital elements.

37.9.5 *HMRC examples*

The SAI Manual provides:

> **4390 - Accrued Income Scheme: remittance basis: examples**
> [January 2010]
> The application of the remittance basis to the AIS is not without complication.

The problem is identifying what is or represents the AIP income where there are deemed interest debits (in the statutory terminology, amount B's) to set against deemed income credits (amount A's.) There is no statutory solution.

> The following examples set out line HMRC takes in particular circumstances.
> *Example 1*
> Ann holds foreign securities 'of the same kind' X and Y which are disposed of in an interest period. They realise the following A and B amounts.

Security	**Proceeds**	**Amount A**	**Amount B**
X	100,000	10,000	
Y	60,000		(5,000)

> There is an accrued income profit of £5,000 which will be treated as deriving from the proceeds of sale of security X. Assuming the proceeds are paid into a new bank account, there will be a mixed fund comprising capital of £95,000 and an accrued income profit of £5,000.
> *Example 2*
> Isabelle has 3 holdings of the same kind of foreign security, X, Y and Z. They are disposed of in an interest period and the proceeds are paid into separate accounts. They realise the following A and B amounts.

Security	**Proceeds**	**Amount A**	**Amount B**
X	100,000	7,000	
Y	200,000	-	(10,000)
Z	70,000	4,000	

> In this situation there is an accrued income profit of £1,000. If the proceeds of disposal of all 3 bonds are paid into a single account there will be a mixed fund with capital of £369,000 and an accrued income profit of £1,000.

That is the easy case as there is only one possible answer.

> If the proceeds were paid into separate accounts HMRC would expect

> the accrued income profit to be allocated pro rata in proportion to the Amount A of securities X and Z or, if this would create an unreasonable result, by any reasonable method.

Careful time of purchases and sales would avoid the problem. The last example is somewhat theoretical and I set it out for completeness only:

> **4400. Remittance basis: Further examples** [January 2010]
> It is unlikely that there are many situations where UK and foreign securities will be 'securities of the same kind' for the purposes of the AIS scheme. It may, however, happen in the case of bearer securities. The following example outlines such a situation.
> Sam has both overseas and UK bonds 'of the same kind' and they are disposed of in the same interest period with the following results.
> *Example 3*

Security	**Proceeds**	**Amount A**	**Amount B**
X (overseas)	100,000	7,000	
Y (overseas)	200,000	-	(10,000)
Z (UK)	70,000	4,000	

> In this case the accrued income profit of £1,000 does not arise as the result of a transfer of foreign securities. There is a net Amount B of £3,000 as the result of the transferred foreign securities. There is therefore no relevant foreign income which Sam might remit to the UK. There is a UK accrued income profit of £1,000 which is taxable on an arising basis.

There are several odd things in this example. First it is assumed that if the bearer security is in the UK, the interest is UK source. That is not the test of the location of a source of interest. Perhaps it is assumed that the income is received in the UK. Secondly, one would have expected the deemed interest debit (amount B) to be set against the deemed interest credits pro rata, not set against foreign income first. But since in practice the point will never arise, it is not necessary to pursue that further.

37.9.6 *Position before 2008 and transitional rules*

Until 2008/09 a foreign domiciled individual was wholly outside the scope of the AIP rules on foreign securities.

Para 160 Sch 7 FA 2008 provides:

> The amendments made by paras 156 to 159 have effect in relation to transfers of securities where the settlement day is on or after 6 April 2008.

The new rules therefore catch all AIP securities even if held before the law changed in 2008.

37.9.7 *Commentary*

When one contemplates the complications of the AIP remittance basis, one appreciates the wisdom of the rule, which applied from the inception of the accrued income scheme in 1985 until 2008, under which the accrued interest scheme did not apply to foreign securities of remittance basis taxpayers. CGT filled the gap. The problems were not discussed, and as far as is known were not even considered, when the law was changed in 2008.

Most if not all readers who have studied the text to this point will agree that the current rule does not give sufficient weight to the desiderata of simplicity and administrative workability. The pre-2008 rule ought to be restored.

37.10 Excluded persons

The AIP exemptions use the concept of excluded transferor/transferee. Section 638 ITA provides:

> (1) This section applies if there is a transfer of securities in relation to which a person ("P") is an excluded transferor or excluded transferee.
> (2) In determining whether P has made accrued income profits or accrued income losses under section 628 (making accrued income profits and losses: general rule) and the amount of any such profits or losses, no account is to be taken of any payment treated as made by or to P on the transfer.

A person is not an excluded transferor/transferee in isolation. One is excluded in relation to a transfer of securities. An excluded person is broadly outside the AIP scheme.

37.11 AIP non-residence defence

Section 643 ITA provides:

> (1) A person is—
> (a) an excluded transferor in relation to a transfer by the person, and
> (b) an excluded transferee in relation to a transfer to the person,
> if the person is non-UK resident throughout the tax year in which the

transfer occurs.

The exemption avoids the AIP charge on UK and foreign AIP securities.[14] It also withholds the AIP relief. EN ITA explains the policy behind the rule:

> 1897. In practice it would be very difficult to apply the scheme to such non-residents consistently. While non-residents could take the benefit of relief for accrued income losses to get repayments of tax suffered if tax is deducted at source, it would be difficult to enforce the charge to tax on accrued income profits.

A person coming to or leaving the UK might time disposals to obtain AIP relief while UK resident, while making disposals on which a charge would apply while non-resident.

The temporary non-residence rules do not apply. However CGT may fill some of the gap left by the AIP non-residence defence. The gain on the disposal of AIP securities may be subject to CGT if the CGT temporary non-residence rules apply.

37.12 Trusts

37.12.1 *Application to trustees*

The TSE Manual provides:

> **3325. Do AIS provisions apply to trustee or beneficiary?**[March 2013]
>
> ***Accrued Income Scheme charge***
>
> If trustees (other than bare trustee – TSEM3320) transfer securities, any Accrued Income Scheme charge is that of the trustees. The trustees are chargeable at the trust rate, under Sections 481 and 482 ITA.
>
> The Accrued Income Scheme profit on a transfer of securities does not form the income of any beneficiary.
>
> ***Accrued Income Scheme allowance***
>
> The treatment of the loss depends on who received the income against which relief is due. If the trustees received the interest, they are entitled to the relief.
>
> The trustees may have mandated the interest to a beneficiary. The beneficiary should claim the loss against the interest.

14 Section 1015 ITA (if needed) could also restrict the territorial scope of the AIP charge, but the rules discussed here leave it no room to operate.

37.12.2 *Transfer to trust*

The TSE Manual provides:

> **3330.Securities go into trust: Accrued Income Scheme** [March 2013]
> When securities go into trust there is a transfer, for Accrued Income Scheme purposes. The transfer is from the settlor to the trustee.
> This includes
> - a settlor creates a new trust by transferring securities to the trustee
> - a person who holds securities for his own benefit declares he will in future hold them as trustee
> - at the end of an administration period, a personal representative starts to hold securities as trustee of a will trust.

37.12.3 *Transfer from trustees*

The TSE Manual provides:

> **3335. Beneficial interest in trust changes: Accrued Income Scheme** [March 2013]
> ***Change results from the terms of the trust***
> The terms of a trust may often result in changes in beneficial interests. For example, on the death of a life tenant the trust assets may pass absolutely to another beneficiary. Such changes in beneficial interest have no accrued income scheme consequences. Either there is no actual transfer, or the transfer simply produces self-cancelling deemed sums and reliefs.

SAI Manual makes the same point:

> **4050. What is a transfer?** [October 2007]
> ... The AIS is based on transfers of the legal ownership of securities, not the transfer of the underlying beneficial ownership. Thus, for example, there is no transfer for the purposes of the AIS if a beneficiary under a trust becomes absolutely entitled as against the trustees to securities forming part of the trust fund.

Returning to the TSE Manual:

> **3335. Beneficial interest in trust changes: Accrued Income Scheme** [March 2013] ...
> ***Change follows an action by the trustees***
> Sometimes a change is not a direct result of the terms of the deed. Trustees can use their powers to advance interests or appoint property. The exercise of these powers can amount to a transfer.

That seems inconsistent with what was said above.

> ***'Stranded' Accrued Income Scheme Allowance***
> A change in beneficial owner can result in an Accrued Income scheme allowance being 'stranded'. It is no longer available to set against the interest. For example, the trustee could have bought securities 'cum dividend' (with a right to the dividend). Shortly afterwards a beneficiary could become absolutely entitled to the trust assets following a contingency. The contingency does not involve any transfer for Accrued Income Scheme purposes. This means the trustee's Accrued Income Scheme loss is lost. The beneficiary was never entitled to the loss, so cannot set it against subsequent interest.

37.12.4 *Appointment of new trustees*

The TSE Manual provides:

> **3340. Accrued income scheme: change of trustees** [March 2013]
> ***Trustees remain resident in the UK***
> There are no accrued income scheme consequences when trustees change, but the trustees of the settlement (see TSEM1461) remain resident in the UK. The change simply produces self-cancelling deemed profits and losses.
> ***Trustees change from resident to non-resident***
> As the new trustees are not resident, they do not satisfy the 'residence requirement' of the accrued income scheme. The appointment of non-resident trustees is a transfer of the securities by the resident trustees. ...
> ***Trustees change from non-resident to resident***
> As the old trustees were not resident, they do not satisfy the 'residence requirement' of the accrued income scheme. The change of trustees is a transfer of securities to the resident trustees.

This may have been right before 2006, but now that trustees are treated as a single person (distinct from the actual trustees) it is considered that the appointment of new trustees (wherever resident) is not a transfer for AIS purposes.

37.13 Settlor-interested trusts

37.13.1 *UK resident settlor-interested trusts*

Section 667(1) ITA provides:

> If the trustees[15] of a settlement are treated as making qualifying accrued income profits,[16] those profits are to be taken to be income arising under the settlement for the purposes of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor).

I am not sure if this is necessary, but perhaps it could have been argued that although "tax is charged on accrued income profits" (s.616) such profits are nevertheless not "income arising under a settlement". Perhaps the provision is just for symmetry with the provision which follows for non-resident trusts.

The rate of tax in the absence of s.624 is 45%, so s.624 can only reduce the tax rate (or make no difference).

37.13.2 *Non-resident trusts*

In the absence of express provision, AIP income of non-resident trustees would not fall within the settlement provisions because the trustees would qualify for the AIP non-residence defence. Section 667 ITA provides:

> (2) Subsection (3) applies if the trustees of a settlement—
>
> (a) are non-UK resident or domiciled outside the UK throughout a tax year in which an interest period or part of an interest period falls, and
>
> (b) would have been treated as making an amount or an additional amount of qualifying accrued income profits in the interest period if the trustees had been UK resident or domiciled in the UK during a part of each such tax year.
>
> (3) The amount or additional amount of qualifying accrued income profits that the trustees would have been treated as making is to be taken to be income arising under the settlement for the purposes of Chapter 5 of Part 5 of ITTOIA 2005.

Thus the AIP income of a settlor-interested trust is within the scope of s.624 ITTOIA. However, the s.624 remittance basis can apply.

---

15 Defined in s.667(4)(b) ITA.

16 Defined in s.667(4)(a) ITA:

> "'qualifying accrued income profits' means accrued income profits which are treated as made—
>
> (i) under section 628(5), or
>
> (ii) under section 630(2) in respect of a transfer of variable rate securities."

The drafting is misleading: as far as I can see, all accrued income profits are "qualifying" accrued income profits.

Non-resident trustees would not qualify for AIP loss relief,[17] so s.680 ITA extends the relief:

> (1) This section applies if—
>
> (a) the trustees of a settlement are non-UK resident or domiciled outside the UK throughout a tax year in which an interest period or part of an interest period of securities falls,
>
> (b) the trustees' income is or includes interest from those securities,
>
> (c) the interest falls due at the end of that interest period, and
>
> (d) had the trustees been UK resident, or domiciled in the UK, during a part of each such tax year the interest would have been wholly or partly exempt from income tax under section 679.
>
> (2) No liability to income tax arises as a result of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor) in respect of so much of the interest as would have been exempt from income tax under section 679.

The references to domicile in ss.667 and 680 ITA is otiose because after the 2008 reforms domicile of trustees is irrelevant. The reference to "an additional amount" is also otiose. But no harm is done by these infelicities.

37.14 Transfer of assets abroad

In the absence of express provision, AIP income would not fall within the ToA provisions because the person abroad would qualify for the AIP non-residence defence (assuming the person abroad is non-resident). However, s.747 ITA deals with this:

> (1) This subsection applies if a person—
>
> (a) would have been treated as—
>
> (i) making qualifying accrued income profits, or
>
> (ii) making qualifying accrued income profits of a greater amount,
>
> in an interest period, but
>
> (b) is not so treated because of being resident or domiciled outside the UK throughout any tax year in which the interest period (or part of it) falls.
>
> (2) If subsection (1) applies, this Chapter applies as if the amount which the person would be treated as making or, as the case may be, the additional amount were income becoming payable to the person.

---

17 See 37.8 (Relief for accrued income losses).

(3) Accordingly, any reference in this Chapter to income of (or payable or arising to) a person abroad must be read as including a reference to such an amount.

It has been suggested that this leaves a gap where AIP securities are held by a non-resident company. Section 747(1) ITA applies only if the company would have fallen within the AIP rules but did not do so "because of being resident outside the UK". But if the company had been UK resident, it would be within the charge to corporation tax and outside the scope of AIP. That is correct on a literal construction. However, the context shows that the deeming is not intended to be applied that way, and a comparable argument in a CGT context was resoundingly dismissed in *de Rothschild v Lawrenson* 67 TC 300 ("I do not believe that our processes of statutory construction are so wanting in technique and imagination ...").

The reference to domicile is otiose from 2008 but it does no harm.

The person abroad (if non-resident) would not qualify for AIP loss relief, so s.747(4)(5) ITA extends the relief:

(4) This subsection applies if income consisting of interest which falls due at the end of an interest period—

(a) would have been income as respects which a person is entitled to an exemption, or an exemption of a greater amount, from liability to income tax under section 679 (interest on securities involving accrued income losses: general), but

(b) is not such income because it is income of a person who is resident or domiciled outside the UK throughout any tax year in which the interest period (or part of it) falls.

(5) If subsection (4) applies, for the purposes of this Chapter the interest is treated as reduced by the amount of the exemption or, as the case may be, the additional exemption.

37.14.1 *Definitions*

Section 747 ITA provides definitions for s.747:

(6) In this section—

(a) expressions which are also used in Chapter 2 of Part 12 (accrued income profits) have the same meaning as in that Chapter (but see subsection (7)), and

(b) "qualifying accrued income profits" means accrued income profits which are treated as made—

(i) under section 628(5), or

(ii) under section 630(2) in respect of a transfer of variable rate securities.

(7) In the case of qualifying accrued income profits within sub-paragraph (ii) of the definition of that expression in subsection (6)(b)—

(a) references in subsection (1)(a) to making qualifying accrued income profits in an interest period are to be read as making them in the tax year in which the settlement day falls, and

(b) the reference in subsection (1)(b) to the interest period is to the period—

(i) beginning with the day after the last day of the only or last interest period of the securities, and

(ii) ending with the settlement day.

The expression "qualifying" accrued income profits is misleading: as far as I can see, all accrued income profits are qualifying.

For the interaction with s.731, see 30.16.2 (Stock dividends and accrued income profits).

37.15 Double taxation relief

In the absence of express provision there would be no double taxation relief, as the AIP income is not taxable in the other state.

Section 10 TIOPA provides relief:

(1) Subsection (2) applies if—

(a) a person is treated under section 628(5) of ITA 2007 as making accrued income profits in an interest period,

(b) the person would, were the person to become entitled in the relevant tax year[18] to any interest on the securities concerned, be liable in respect of the interest to tax chargeable under ITTOIA 2005 on relevant foreign income, and

(c) the person is liable under the law of the territory to tax in respect of interest payable on the securities at the end of the interest period or the person would be so liable if the person were entitled to that interest.

I cannot see the need for (b) as it will be satisfied whenever (a) is satisfied. Section 10(2) provides the relief:

(2) Credit is to be allowed against income tax calculated by reference to

18 Defined subsection (5): "In subsection (1)(b) 'the relevant tax year' means the tax year in which, under section 617(2) of ITA 2007, the accrued income profits are treated as made."

the accrued income profits.

(3) The amount of the credit allowed under subsection (2) is given by—

AIP × FTR

where—

AIP is the amount of the accrued income profits, and

FTR is the rate of tax to which the person is or would be liable as mentioned in subsection (1)(c)...

Section 39 TIOPA restricts DT relief where there is relief for accrued income losses.[19]

The SAI Manual provides:

4370. Double taxation relief [January 2010]

Where an AIS charge arises on a foreign stock on which the interest would have suffered foreign tax eligible for credit relief if interest had been received, credit for foreign tax is allowable for the lower of

- the rate of UK tax charged on the accrued income profit, and
- the rate of foreign tax suffered on the interest payable at the end of the interest period for which the charge arises.

If there is an accrued income loss to be set against foreign interest, reduce the credit for foreign tax in the proportion which the allowance bears to the interest.

Example

Taxpayer holds foreign stock on which the interest suffers tax eligible for credit at 15%. Interest paid on 30 June and 31 December.

In the interest period to 30 June 2005, the taxpayer makes transactions resulting in an AIS loss of £200. He receives interest (gross) of £1,000 less £150 foreign tax.

In August 2006 he sells the entire holding and there is an AIS profit of £300. He is liable to UK tax at 22%. His double taxation relief is as follows

Foreign interest		£1,000
Less Accrued Income relief		– £200
		£800
Foreign tax deducted	£150	
Credit restricted to	£1000 – £200 × £150/£1000	= £120
Accrued income profit		£300
Allow credit for foreign tax on AIS charge £300 @ 15%		= £45
Total double taxation relief £120 + £45		= £165

19 See 37.8 (Relief for accrued income losses).

The double taxation relief given can exceed the foreign tax suffered (£165 exceeds the £150 suffered).

37.16 Interaction with CGT

Section 119(1) TCGA disapplies the normal CGT rules in ss.37 and 39 TCGA:

> (1) Where there is a transfer of securities within the meaning of Chapter 2 of Part 12 of ITA 2007 (accrued income profits)—
>
> (a) if a payment is treated as made to the transferor under section 632 of that Act or by the transferor under section 633 of that Act, section 37 shall be disregarded in computing the gain accruing on the disposal concerned;
>
> (b) if a payment is treated as made by the transferee under section 632 of that Act or to the transferee under section 633 of that Act, section 39 shall be disregarded in computing the gain accruing to the transferee if he disposes of the securities;
>
> but subsections (2) and (3) below shall apply.

Section 119 TCGA goes on to set out its own rules:

> (2) Where the securities are transferred with accrued interest (within the meaning of that Chapter)—
>
> (a) if a payment is treated as made to the transferor under section 632 of ITA 2007, an amount equal to the amount of that payment shall be excluded from the consideration mentioned in subsection (8) below;
>
> (b) if a payment is treated as made by the transferee under that section, an amount equal to the amount of that payment shall be excluded from the sums mentioned in subsection (9) below. ...
>
> (8) The consideration is the consideration for the disposal of the securities transferred which is taken into account in the computation of the gain accruing on the disposal.

Section 119(3)(9) contains corresponding rules for a transfer without accrued interest:

> (3) Where the securities are transferred without accrued interest (within the meaning of that Chapter)—
>
> (a) if a payment is treated as made by the transferor under section 633 of ITA 2007, an amount equal to the amount of that payment shall be added to the consideration mentioned in subsection (8) below;
>
> (b) if a payment is treated as made to the transferee under that

section, an amount equal to the amount of that payment shall be added to the sums mentioned in subsection (9) below...

(9) The sums are the sums allowable to the transferee as a deduction from the consideration in the computation of the gain accruing to him if he disposes of the securities.

37.17 Foreign currency securities

SAIM provides:

4310. Special calculations: Foreign currency securities [July 2007]
Foreign securities: Translation into sterling
Section 664 ITA 2007 provides rules for translation into sterling of the payments made on the transfer of securities where the interest on securities is payable in a currency other than sterling.
If the interest is accounted for separately between transferor and transferee, and the parties specify in their contact what the sterling equivalent of the accrued or rebate interest is, the sterling amount so specified is to be used in the AIS calculations. Otherwise, the amount is to be determined in the foreign currency according to the usual rules, and then translated into sterling at the rate of exchange prevailing on the settlement day for the transfer, calculated by reference to the London closing rate of exchange for the day concerned.
The nominal value of foreign securities is also determined (under Section 677 ITA 2007) as the sterling equivalent of that value on any day, calculated by reference to the London closing rate for that day.
Where unrealised interest is payable in a foreign currency, Section 665 ITA 2007 provides that the amount the accrued income profits under Section 631 ITA 2007 is the sterling equivalent on the settlement day, or in the case of interest in default (SAIM4290), the value on the day of receipt.
Although the London closing rate should in strictness be used in all the above cases, figures of rates of exchange supplied by taxpayers or their agents should normally be accepted, provided that they come from a reputable source (for example, an exchange rate quoted by the taxpayer's bank for the day in question) and the basis is used consistently.

CHAPTER THIRTY EIGHT

DEEPLY DISCOUNTED SECURITIES

38.1 DDS: Introduction

A full discussion of this topic would need half a book. The following is a general outline with a focus on the issues closest to the themes of this work.

In outline, the profits arising on the disposal of a deeply discounted security ("DDS") are subject to income tax (rather than CGT). The rules only apply to a holder of a DDS who is subject to income tax. They do not apply to the issuer and they do not apply for the purposes of corporation tax.

The following specialist aspects are not discussed:

- securities issued in tranches
- earn-out rights
- strips
- exchanges and conversions

38.2 Meaning of "deeply discounted security"

38.2.1 *"Security"*

SAI Manual states:

> **3010 Introduction** [July 2013]
> ... The term 'security' is not defined in the legislation. It may be taken to have a broad meaning comparable to the definition in TCGA s.132(3)(b) (CG53420) ...

The word "security" is often used in tax legislation. The CG Manual provides:

> **CG53420 - Securities: debts: definition of debt on a security** [February 2006]
> TCGA92/S251 (1) refers to '... the debt on a security (as defined in Section 132).' In fact TCGA92/S132 does not define the phrase 'the debt on a security.'

But it does define the word 'security', as including any loan stock or similar security whether of the Government of the United Kingdom or of any other government, or of any public or local authority in the United Kingdom or elsewhere, or of any company, and whether secured or unsecured.'

CG53421 - Securities: debts: definition of debt on a security [February 2006]
This definition is of limited use because there is no statutory guidance on the meaning of 'loan stock or similar security.' However, the final words make it clear that the debt does not have to be secured to be the debt on a security. Therefore 'debt on a security' is not the same as 'secured debt.'

CG53422 - Debt on a security: Tax Case guidance [February 2006]
The meaning of debt on a security has been considered by the Courts a number of times. The leading case is *Ramsay v CIR* 54TC101. In that case the House of Lords acknowledged this is a difficult subject. Lord Wilberforce said 'Many learned judges have found it baffling both on the statutory wording and as to the underlying policy'. These instructions approach these problems by looking at the decision in Ramsay and considering what guidance can be drawn from the speeches of Lords Wilberforce and Fraser.

CG53423 - Debt on a security: Ramsay v CIR 54TC101 [February 2006]
The Ramsay case involved a company which had incurred an agreed gain on the sale of a farm. It then entered into an avoidance scheme designed to produce an allowable loss to set off against the gain. The scheme removed value from a chargeable asset (shares) to produce an allowable loss on their disposal. The value passed into a loan, known as L2. This loan was also disposed of. If L2 was not a debt on a security, it would not be a chargeable asset. Therefore the gain on the disposal of the loan would not have been chargeable. However, the House of Lords held that the loan L2 did amount to a debt on a security. The gain on the disposal of L2 was thus a chargeable gain and the scheme failed.

CG53424 - Debt on a security: House of Lords decision: marketability [February 2006]
In Ramsay the House of Lords considered the underlying purpose of the distinction between debts and debts on a security in TCGA92/S251 (1). Both Lord Fraser and Lord Wilberforce suggested the essential feature of the debt on a security is that it should be marketable.

At page 194 Lord Fraser says 'the distinction in [Section 251(1)] is, I think, between a simple unsecured debt and a debt of the nature of an investment, which can be dealt in and purchased with a view to being held as an investment.' Later having analysed the essential features of the loan he says 'it possessed the characteristic of marketability.'

At page 189 Lord Wilberforce says 'it can be seen, however, in my opinion, that the Legislature is endeavouring to distinguish between mere debts, which normally (though there are exceptions), do not increase but may decrease in value, and debts with added characteristics such as may enable them to be realised, or dealt with at a profit.'

CG53425 - Debt on a security: essential characteristics of [February 2006]
Both speeches in the House of Lords emphasised that for a debt to be the debt on a security it should be capable of being

- held as an investment; and

- realised at a profit.

These conditions are, to some extent, interrelated, but it is important that both should be satisfied. For example, a debt may be regarded as a good investment. But if it cannot be realised at a profit it cannot be a debt on a security. These points are discussed in the following paragraphs.

CG53426 - Debt on a security: essential characteristics of: held as an investment [February 2006]

For a debt to be held as an investment it should either

- carry a commercial rate of interest; or
- carry a premium on repayment, equivalent to the interest which would have been paid; or
- be issued at a discount, so that repayment at face value again reflects the interest which would have been paid on the debt.

Where these criteria are not met and the return on the investment is clearly uncommercial, debt on a security status should not be accepted.

CG53427 - Debt on a security: essential characteristics of: sold at a profit [February 2006]

Whether a debt can be realised at a profit will depend, in part, on the premium, or rate of interest which the debt carries. But even if a debt carries an attractive rate of interest, it may not be regarded as a worthwhile investment by a potential purchaser. For example, the terms of the loan may enable the borrower to repay the debt early. A potential purchaser would need to consider whether the loan would last long enough to cover the costs of acquisition, and obtain a worthwhile return on the investment.

CG53428 - Debt on a security: essential characteristics of: structure of permanence [February 2006]

This point was made by Lord Wilberforce, in Ramsay, where he commented (at page 190) that the relevant loan had 'a structure of permanence such as fitted it to be dealt in ....' In fact, the loan in that case was repaid early. But it had been issued on terms which meant that a large penalty would be payable in the event of early repayment. It is not possible to set any precise limits for the 'life' of a debt, which would enable it to be regarded as a debt on a security. The attractiveness of any particular debt will depend upon the other terms of the loan, and on the type of market in which the debt would normally be traded. You can accept that any loan which could not be terminated by the borrower within a year from the date of commencement will have the required 'structure of permanence'. But a debt will not have a 'structure of permanence' merely because the borrower is not in a position to repay the debt in the foreseeable future.

CG53429 - Debt on security: essential characteristics of: repayment at short notice [February 2006]

You cannot say that a debt is not a debt on a security simply because it can be repaid at short notice. But it is reasonable to suggest that in such cases there should be some compensation for the creditor to counterbalance the uncertainty as to the term of the loan. For example, a penalty can turn an otherwise uncertain, and therefore inherently unattractive, loan into a worthwhile investment. If a loan can be repaid at short notice, but there is no compensating

benefit for the creditor, this would count against accepting the loan as a debts on a security.

CG53430 - Debt on security: essential characteristics of: events of default [February 2006]

Some agreements include standard clauses requiring the debt to be repaid immediately if certain events happen. For example, if the borrower defaults on repayment, or goes into liquidation. These standard clauses should not be taken as displacing any stated terms for repayment for the debt set out in the agreement.

CG53431 - Debt on security: when conditions satisfied [February 2006]

You should consider whether any debt amounts to the debt on a security by reference to the circumstances prevailing at the time the debt was created. For example, you should consider whether a rate of interest is commercial by reference to the market conditions at the time the debt was created. Thus, you may take into account any market opinion, at the time the debt was created, as to the likely future changes in the market rate of interest. Changes in the rate of interest which were not anticipated at the time the debt was created cannot be taken into account.

CG53432 - Debt on security: when conditions satisfied: changes in terms [February 2006]

You should not accept that a debt can be regarded as the debt on a security because the terms of the loan could have been amended to make the debt marketable. If the terms of the debt have changed this cannot affect the status and tax treatment of the debt prior to the changes. You may, however, need to consider whether or not the changes had the effect of bringing to an end the original debt, and creating a new one, to which a different tax treatment may apply.

CG53433 - Debt on security: exchange gains [February 2006]

If a debt is denominated in a foreign currency, exchange gains (or losses) can arise if the currency fluctuates against the pound. You should consider whether any such debt is the debt on a security purely in terms of the currency in which the debt is denominated. Neither realised, nor potential, exchange gains or losses should be taken into account in deciding whether a debt is the debt on a security.

CG53434 - Debt on security: documentation [February 2006]

The existence of a formal document constituting or evidencing the debt is not an essential feature of the debt on a security. At page 194 in Ramsay Lord Fraser says 'Further consideration has satisfied me that the existence of a document or certificate cannot be the distinguishing feature between the two classes of debt'. However, cases where debt on a security status is claimed for debts where no documentation exists need to be examined carefully to check whether or not the required features are present. Equally you should resist any suggestion that a debt MUST be a debt on a security if it is acknowledged by a document described as loan stock. This would be inconsistent with the approach taken in Ramsay, that the marketability test will be appropriate in deciding in ANY case whether a debt amounts to the debt on a security.

CG53435 - Debt on security: loan stock or similar security [February 2006]

In Ramsay Lord Wilberforce did not regard it as necessary to decide whether the

loan L2 was, in fact, within the meaning of 'loan stock'. He observed that TCGA92/S132 (3)(b) 'includes within 'security' any 'similar security' to loan stock: in my opinion these words cover the facts. This was a contractual loan, with a structure of permanence such as fitted it to be dealt in ...' (page 190). Lord Fraser took a similarly broad approach in his judgment (page 194).

CG53436 - Debt on security: loan accounts [January 2010]

Debt on loan account, for example between associated companies, may well not amount to the debt on a security. See CTM51220 for the treatment of inter-company loan accounts under the loan relationships regimes.

38.2.2 *"Deeply discounted"*

In outline, the definition is in s.430 ITTOIA:

(1) The general rule is that a security is a "deeply discounted security" for the purposes of this Chapter if, as at the time it is issued, the amount payable on maturity or any other possible occasion of redemption ("A") exceeds or may exceed the issue price by more than A×0.5%×Y,
where Y is the number of years in the redemption period or 30, whichever is the lower.
(2) If the redemption period is not a number of complete years, for the purposes of subsection (1) the incomplete year is expressed as twelfths, treating each complete month and any remaining part of a month as one-twelfth.
(3) In this section "redemption period" means the period between the date of issue and the date of the occasion of redemption in question.
(4) Interest payable on an occasion of redemption is ignored in determining for the purposes of this section the amount payable on that occasion.

SAI Manual gives three examples:

3020 Meaning of deeply discounted security [July 2007]

Example 1

Company A issues securities for £1,000 which are redeemable in 10 years time for the subscription amount increased by the percentage movement in the Retail Price Index over the same period. As the linkage to the RPI may give more than a 5% increase in value (10 years × 0.5%) over that period, the securities are deeply discounted securities.

Example 2

Company B issues a 12-month security for £950. It is redeemable for £950 at maturity or, depending on events, for £1,000 after 6 months. The occasion of early redemption is not disregarded under Section 431 ITTOIA 2005 (SAIM3030). The difference between the issue and early redemption prices is more than £2.50 (£1,000 × 0.5% × 6/12). The

security is therefore a DDS.

Example 3

Bank C issues a 5-year security that is linked to the FTSE 100 share index. Each security has a nominal value to £100. If the index rises, the investor receives on redemption £100 multiplied by the percentage rise in the index. For example, the index has risen to 150% of its starting value, the investor receives £150. If the index falls, the investor is guaranteed to receive back his or her £100, so the security is not an excluded indexed security (SAIM3050). Since the security may give more than a 2.5% increase in value over the period (5 years × 0.5%), it is a DDS, even though there is no certainty as to the redemption amount.

38.2.3 *Securities dealt with under other regimes*

Section 432(1) ITTOIA provides:

> The following are not deeply discounted securities—
> (a) shares in a company,
> (b) gilt-edged securities that are not strips,
> (c) life assurance policies, and
> (d) capital redemption policies.[1]

38.2.4 *Securitised derivatives*

The SAI Manual provides:

> **3040. Securities which are not deeply discounted securities** [November 2011]
> ... In practice, therefore, most deeply discounted securities will be securities in the nature of debts, that is, where the issuer has an obligation to make some form of return to the investor.

The same SAI Manual entry formerly provided:

> **Securitised derivatives**
> Securitised derivatives present particular problems. These are investment products where the amount which the investor gets back at the end depends on the performance of a share index, or a particular share or shares, or (less commonly) some other asset. The capital initially subscribed by the investor may be completely or partly protected, or it may be possible for the investors to lose the whole of

1 Section 432(3) ITTOIA provides:
"In this section 'capital redemption policies' has the same meaning as in Chapter 9 of this Part (see section 473(2))."

their money.

Some such products, properly analysed, are options, for which the investor pays a premium (these are often described as 'warrants'). Others may be contracts for differences, or other derivatives. These will not be deeply discounted securities; disposal of an option, or of a financial future within Section 143 TCGA 1992, will give rise to a capital gain or allowable loss. See also SAIM7000 on the tax treatment of derivatives that generate an interest-like return.

Other securitised derivatives, however, create a debt (in technical terms, they are structured as a debt security plus one or more options or other derivatives). These will be deeply discounted securities, unless they fulfil the stringent conditions to be 'excluded indexed securities' (SAIM3050). You should seek advice from CT & VAT (Financial Products and Services Team) if it is unclear whether or not a particular instrument is a deeply discounted security.

There are some deep conceptual issues here.

38.3 Securities denominated in foreign currency

In the following discussion **"a foreign currency denominated security"** is one issued for a foreign currency and redeemable in that currency.

38.3.1 *Is a foreign currency denominated security necessarily a DDS?*

Consider for instance a US Treasury Note issued for $1,000 and redeemable on maturity at $1,000 and carrying interest at a market rate. Is a security of that kind deeply discounted? The question (in short) is whether:

> the amount payable on maturity may exceed the issue price

This raises a currency translation issue. If:

(1) "issue price" means the sterling equivalent of the issue price at the time of issue; and

(2) "the amount payable on maturity" means the sterling equivalent at the time of maturity

then a foreign currency denominated security is a DDS since currency fluctuations could lead to a gain measured by £sterling. If "issue price" means the dollar price and "the amount payable on maturity" means the dollar amount, then the two are equal and the security is not a DDS.

The statutory words could be understood either way, so the context must resolve the issue. The context shows that the second view is correct. This

is for several reasons. First, the object of the DDS rules is to tax discounts, which are commercially similar to interest. It is not to tax currency fluctuations. The absence of relief on losses would operate very unfairly. Secondly, if that were not the case, all foreign currency denominated securities would be within the DDS regime.[2] That would be surprising (and indeed contrary to EU law).[3]

HMRC agree. SAI Manual provides:

> **3020 Meaning of deeply discounted security** [July 2007]
> The test for deep discount is carried out in the currency of issue.

38.3.2 *Foreign currency denominated DDS*

The above paragraph is considering a security whose dollar issue price equals its dollar maturity price. Of course, a foreign currency denominated security would in principle be a DDS if the redemption price may sufficiently exceed the issue price. It is understood that US treasury bills (which do not carry interest) are normally DDSs. I refer to such a security as **"a foreign currency denominated DDS".**

How does one compute the profit on the disposal of a foreign denominated DDS? The profit is:

> the amount by which the amount payable on the disposal exceeds the amount paid by the person to acquire the security.

This raises another currency translation issue. Suppose a person acquires a security on issue for dollars and redeems it for dollars. Is the amount paid to acquire the security:

(1) The sterling equivalent of the purchase price at the time of issue? Or
(2) The dollar amount? If so, it is deducted from the dollar amount payable on disposal, to give a dollar profit, translated into sterling at the time of disposal.

The statutory words could be understood either way, so the context must resolve the issue. The context shows that the second view is correct. This is consistent with the approach to the definition of a DDS: see above. The same point applies: the object of the DDS rules is to tax discounts, which

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2 Unless they contained a cap to limit the gain to a sterling amount, which would not normally be the case.

3 The arguments are more fully set out in Ghosh, "Corporate Bonds: If The Cap Does Not Fit" *Taxation*, 7 Feb 2002 p.439 but since HMRC have accepted this view since the publication of Tax Bulletin 9, it is not necessary to consider that here.

are commercially similar to interest. It is not to tax currency fluctuations. The solution to the same problem for CGT is different.[4] The reason for this is explained in *Capcount Trading v Evans* 65 TC 545. One important factor in that decision was the provision in the CGT legislation that currency other than sterling is an asset for CGT. There is no similar provision for IT.

38.4 Excluded occasions of redemption

Section 431(1) ITTOIA provides:

> An occasion of redemption of a security other than maturity is ignored for the purposes of section 430(1) if the third-party option conditions or the commercial protection conditions are met.

38.4.1 *The third-party option conditions*

Section 431(2) ITTOIA provides:

> The third-party option conditions are that—
> (a) the security may be redeemed on the occasion at the option of a person other than its holder,
> (b) the security is issued to a person who is not connected with the issuer, and
> (c) the obtaining of a tax advantage by any person is not the main benefit, or one of the main benefits, that might have been expected to accrue from the provision in accordance with which the security may be redeemed on the occasion.

38.4.2 *The commercial protection conditions*

Section 431(3) ITTOIA provides:

> The commercial protection conditions are that—
> (a) the security may be redeemed on the occasion as the result of an exercise of an option that is exercisable only on the occurrence of—
> (i) an event adversely affecting the holder (see subsection (8))[5],

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4 See 55.2 (CGT: currency conversion date).

5 "(8) In this section "event adversely affecting the holder", in relation to a security, means an event the occurrence of which appears, as at the time of the security's issue, likely to have an adverse effect on the interests of its holder at the time of the event if there were no provision for redemption on its occurrence."

or

(ii) a default by any person, and

(b) as at the time of the security's issue it appears unlikely that the option will be exercisable on the occasion.

38.4.3 *Restrictions on conditions*

Section 431(4) ITTOIA provides:

> Subsection (1) does not apply to an occasion just because the occasion coincides or may coincide with an occasion meeting the third-party option conditions or the commercial protection conditions.
>
> (5) If—
>
> (a) the only reason that a security is not a deeply discounted security is that an occasion on which it may be redeemed is ignored because the third-party option conditions are met, and
>
> (b) at some time after its issue the security is acquired by, or its holder becomes, a person connected with the issuer,
>
> in relation to that time and later this Chapter applies as if the security were a deeply discounted security.
>
> (6) If a person ("P") who is not connected with the issuer acquires—
>
> (a) a security which is only a deeply discounted security because it was issued to a person connected with the issuer and so fails to meet the condition specified in subsection (2)(b), or
>
> (b) a security within subsection (5),
>
> this Chapter applies in relation to P as if the security ceased to be a deeply discounted security on the acquisition.
>
> (7) For the purposes of the application of this section to a security, the question whether persons are connected is determined without regard to the security or any other security issued under the same prospectus.

38.5 Meaning of "disposal"

Section 437(1) ITTOIA provides:

> References in this Chapter to the disposal of a deeply discounted security are—
>
> (a) to its redemption,
>
> (b) to its transfer by sale, exchange, gift or otherwise, including a transfer treated as made by subsection (3), and
>
> (c) so far as not covered by para (a) or (b), to its conversion under its terms into shares in a company or other securities (including other deeply discounted securities).

38.5.1 *"Person making a disposal"*

Section 437(2) ITTOIA provides:

> The person treated as making a disposal is—
> (a) in the case of a disposal within subsection (1)(a), the person entitled as the security's holder to any payment on the disposal,
> (b) in the case of a disposal within subsection (1)(b), the transferor, and
> (c) in the case of a disposal within subsection (1)(c), the person who would be entitled as the security's holder to any payment on the disposal, if such a payment were made.

38.5.2 *Death of holder*

Section 437(3) ITTOIA provides:

> A person who dies while entitled to a deeply discounted security is treated as transferring it immediately before death to the personal representatives.

38.6 Meaning of "profit"

Section 439 ITTOIA provides:

> (1) A person's profit on a disposal is the amount by which the amount payable on the disposal exceeds the amount paid by the person to acquire the security.
> (2) No account is to be taken of any incidental expenses incurred in connection with the disposal or acquisition.

I refer to this as the DDS profit. The DDS profit is greater than a chargeable gain on a disposal because expenses are disallowed.

38.6.1 *Deemed DDS profit*

Section 440 ITTOIA provides:

> (1) On the disposal of a deeply discounted security by a transfer of a kind specified in subsection (2), for the purposes of this Chapter an amount equal to the market value at the time of the disposal is treated as payable.
> (2) The transfers are—
> (a) a transfer made otherwise than by a bargain at arm's length,
> (b) a transfer between connected persons,
> (c) a transfer for a consideration which is not wholly in money or money's worth,

(d) a transfer treated as made by section 437(3) (death), and
(e) a transfer by personal representatives to a legatee. ...

I refer to the profit on a disposal within this section as "**deemed DDS profit**".

38.7 Charge to tax on disposal of DDS

Sections 427 and 428 ITTOIA impose the charge:

> **427 Charge to tax on profits from deeply discounted securities**
> (1) Income tax is charged on profits on the disposal of deeply discounted securities.
> (2) The profits are treated as income for income tax purposes if they would not otherwise be income.
> **428 Income charged**
> (1) Tax is charged under this Chapter on the full amount of profits arising in the tax year.
> (2) The profits on a disposal are to be taken to arise when the disposal occurs.
> **429 Person liable**
> (1) The person liable for any tax charged under this Chapter is the person making the disposal.

38.8 DDS remittance basis

Section 428(3) ITTOIA provides:

> If the profits arise on a disposal of securities that are outside the UK—
> (a) they are treated for the purposes of section 830 (meaning of "relevant foreign income") as arising from a source outside the UK, and
> (b) subsection (1) is subject to Part 8 (foreign income: special rules).

This brings in the ITA remittance basis for a DDS that is outside the UK.

The section uses the words "treated as" because DDS income does not have a source, at least in the traditional sense.[6]

How does one decide whether a security is "outside the UK"? In the HMRC view the test is the residence of the issuer. The former Inspectors Manual para 1541 provided:

> Where the security was issued by a UK resident any profit is assessable

6 See 14.6 (Location of source of income when there is no source).

> under Case III of Schedule D. Where the security was issued by a non-UK resident, any profit is assessable under Case IV of Schedule D.

This is not obviously right, but it is as good a test as any other and (in relation to a non-resident issuer) at least we should know where we stand.[7] This passage is omitted in the SAIM but there is no indication that HMRC practice has changed.

An alternative approach is to say that a security is in the UK if income from it has a UK source and outside the UK if income from it has a non-UK source.[8] This will usually come to the same thing[9] and I doubt if the point will ever need to be decided.[10]

For completeness: another possible approach is that "outside the UK" means situated outside the UK applying common law situs rules. This too would usually come to the same thing, but it would allow some scope for tax planning. This view is less attractive since (1) common law situs is not generally relevant for IT; (2) one would have expected the drafter to use the word "situate" if it was intended to incorporate a situs rule.

Strictly, one cannot segregate income from capital (for no identifiable part of the proceeds represents the income). But since HMRC do not apply that rule for the accrued income scheme,[11] they should logically not take the point in this context either. There is however no discussion in the RDR Manual.

A deemed DDS profit (eg on a gift) cannot be remitted and so is tax free.[12]

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7 The position if the issuer changes residence is less clear, but perhaps this does not arise in practice.

8 This would be consistent with the AIP scheme, where the test is whether income from the security has a foreign source: see 37.9 (AIP remittance basis). However, the two cases are not the same, because a DDS may not yield any income, so the question whether income from the DDS has a foreign source could be a hypothetical question.

9 See 18.7.5 (Interest from securities). Because the rules concerning the location of the source of interest are so unclear, it is impossible to say in what (if any) circumstances the source of the income might be different from the residence of the issuer.

10 If it mattered, the view that income source was the test should be rejected, for if the drafter intended to apply an income-source test, one would have expected the wording to match that used elsewhere for income-source tests. The wording is not very far from the former case IV in s.18 ICTA 1988 ("income arising from securities out of the UK") but there the words "out of the UK" govern "arising" and not "securities".

11 See 37.9 (AIP remittance basis).

12 The CGT rule does not apply here; see 11.30 (CGT disposal not for market value).

38.9 UK resident trust

38.9.1 *UK resident trust (not settlor-interested)*

A UK resident trust is in principle subject to income tax on its DDS profits. Tax is charged at the trust rate, 50%: s.482 ITA.

38.9.2 *UK resident settlor-interested trust*

A DDS profit accruing to UK trustees is not "income" in the general sense and in the absence of express provision it would not fall within s.624 ITTOIA which only applies to income. However s.427(2) ITTOIA directs that the profits are "treated as income for income tax purposes" so it does fall within s.624 ITTOIA. For good measure, s.457 ITTOIA provides:

> (1) This section applies if profits are taken to arise on a disposal of a deeply discounted security by trustees.
> (2) For the purposes of Chapter 5 of Part 5 (settlements: amounts treated as income of settlor), the profits are to be taken to be income arising under the settlement from the security. ...

Thus DDS profits do fall within the settlement provisions.

If the settlor is a remittance basis taxpayer the s.624 remittance basis is available, ie the settlor is not taxed on an unremitted foreign DDS profit.[13]

The rate of tax in the absence of s.624 is 45%, so s.624 can only reduce the tax rate (or make no difference).

38.10 Non-resident individual

Section 368 ITTOIA provides the necessary exemption for non-residents.[14] In short non-resident individuals are not chargeable if the security is out of the UK. They are theoretically chargeable if the security is in the UK but non-residents IT relief is usually available.[15]

38.11 Non resident trust

In the absence of express provision, non-resident trustees would not be charged on foreign DDS profits but could be charged on UK DDS profits. However s.458(1) ITTOIA provides:

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13 See 27.4 (Section 624 remittance basis).

14 See 14.2 (Location of source of income: Territorial scope of IT).

15 See 42.1 (Non-residents IT relief).

> Tax is not charged under this Chapter if the disposal is made by the trustees of a settlement[16] and they are non-UK resident.

So non-resident trusts are not subject to tax on DDS, whether UK or foreign.

It is considered that s.624 applies to non-resident settlor-interested trusts as it applies to UK resident trusts. Section 458 does not provide relief since the charge on settlor-interested trusts is not a charge "under this chapter".

38.12 Transfers of assets abroad

A DDS profit accruing to a non-resident is not "income" so in the absence of express provision it would not fall within the ToA provisions even if it accrued to a person abroad within s.720 or 731. However s.427(2) ITTOIA directs that the profits are "treated as income for income tax purposes" so it does fall within the ToA provisions. For good measure, s.459 ITTOIA provides:

> (1) This section applies if profits are taken to arise on the disposal of a deeply discounted security by a person resident or domiciled outside the UK ("A").
> (2) For the purpose of determining whether a UK resident individual is liable for income tax in respect of the profits, Chapter 2 of Part 13 of ITA 2007 (transfer of assets abroad) has effect as if the profits, when arising, constituted income becoming payable to A.
> (3) For this purpose it does not matter if A is not liable to income tax under this Chapter because of section 458 (non-UK resident trustees).

Thus DDS profits do fall within the scope of the ToA provisions.

38.12.1 *Section 731 ITA*

The charge is on the actual profit, not a fictional profit. The proceeds of the disposal represent that profit.

How does the rule that distributed income is not relevant income[17] operate in this context? Is it necessary merely to distribute an amount

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16 "Settlement" here means settlement-arrangement: see s.458(3) which provides: "In this section 'settlement' has the same meaning as in Chapter 5 of Part 5 (see section 620)."

17 See 30.23 (Relevant income of trust distributed as income in year it arises) to 30.27 (Distributed income: HMRC view).

equal to the DDS profit or is it necessary to distribute the entire proceeds of the transfer (sale) of the security? The matter is analogous to the CGT issue which arose when a UK resident foreign domiciled beneficiary sold a non-UK situate asset and realised a chargeable gain. Prior to the 2008 mixed fund rule, if the individual remitted (say) one-half of the proceeds of sale, their were regarded as remitting one-half of the gain.

Inspectors Manual para 1567 explained:

> This is because, whilst the income content of any fund is a separate and distinguishable part of that fund, a capital gain is merely part of the whole proceeds of a disposal transaction that has no separate identifiable existence within those proceeds.

The same reasoning would apply here. Thus the only way to avoid relevant income by distribution would be to distribute the entire proceeds of an arm's length disposal. It is conceivable that HMRC will not apply the law on this point strictly, but do not rely on this without clearance.

If there are only fictional profits, because the market value rule applies[18] then s.731 does not apply because fictional income cannot be used to benefit a beneficiary, so it cannot be relevant income.

38.13 Non-resident company

Section 368 ITTOIA provides the necessary exemption for non-residents.[19] In short, they are not chargeable if the security is outside the UK. They are theoretically chargeable if the security is in the UK, but see 42.1 (Non-residents IT relief). The company DDS income is within the scope of the ToA provisions. There is no group relief so an inter-group transfer may give rise to a charge.

38.14 Interaction with CGT

A DDS is taken out of CGT by being given the status, and CGT exemption, of a qualifying corporate bond ("QCB").

Section 117(1) TCGA provides the usual definition of corporate bond. Section 117(2AA) provides:

> For the purposes of this section "corporate bond" also includes any asset
> [i] which is not included in the definition in subsection (1) above

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18 See 38.6 (Meaning of "profit").

19 See 14.2 (Location of source of income: Territorial scope of IT).

and

[ii] which is a deeply discounted security for the purposes of Chapter 8 of Part 4 of ITTOIA 2005 (see section 430).

Section 117(7) TCGA defines qualifying corporate bond as (in short) any corporate bond issued after 13 March 1984. Thus any DDS is in principle a QCB.

Section 115(1) TCGA provides exemption for QCBs:

> A gain which accrues on the disposal by any person of—
>
> (a) gilt-edged securities or qualifying corporate bonds, or
>
> (b) any option or contract to acquire or dispose of gilt-edged securities or qualifying corporate bonds,
>
> shall not be a chargeable gain.

CHAPTER THIRTY NINE

UNIT TRUSTS

39.1 Unit Trusts: Introduction

This chapter considers unit trusts and Luxembourg Fonds Commun de Placement (which are treated in a similar way).

The taxation of unit trusts needs a book to itself. This chapter focuses on the matters closest to the themes of this book.

39.1.1 *Definition(s) of "unit trust"*

The High Court of Australia rightly say:

> "unit trust" ... in the absence of an applicable statutory meaning, does not have a constant, fixed, normative meaning ... [1]

However for most tax contexts there is a statutory definition.

Section 1007(1) ITA provides:

> In the Income Tax Acts "unit trust scheme" has the meaning given by section 237 of FSMA 2000.
> This is subject to subsection (2).

CGT is effectively the same. Section 99(2) TCGA 1992 provides:

> Subject to subsection (3) and sections 99A and 151W(a) below, in this Act—
>
> (a) "unit trust scheme" has the meaning given by section 237(1) of the Financial Services and Markets Act 2000 ...

So we turn to s.237(1) FSMA, which provides:

> In this Part "unit trust scheme" means a collective investment scheme under which the property is held on trust for the participants.

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1 *CPT Custodian Pty v State Revenue* (2005) 221 ALR 196 at [15] accessible *http://www.austlii.org*.

That is pleasingly short, but the definition of "collective investment scheme" needs a book to itself and is not discussed here.

39.1.2 *Exemption for limited partnerships*

Section 99(3) TCGA 1992 provides:

> The Treasury may by regulations provide that any scheme of a description specified in the regulations shall be treated as not being a unit trust scheme for the purposes of this Act; and regulations under this section may contain such supplementary and transitional provisions as appear to the Treasury to be necessary or expedient.

The regulations are Capital Gains Tax (Definition of Unit Trust Scheme) Regulations 1988 which provide:

> 2 In these Regulations unless the context otherwise requires—
> "limited partnership" means a limited partnership registered under the Limited Partnerships Act 1907 and "general partner" and "limited partner" have the same meanings as in that Act;
> "limited partnership scheme" means a unit trust scheme of the description specified in regulation 4;
> "participant", in relation to a unit trust scheme, shall be construed in accordance with section 235 of the Financial Services and Markets Act 2000;
> "the principal Act" means the Capital Gains Tax Act 1979;
> "scheme property" means, in relation to a unit trust scheme, property of any description, including money, which is held on trust for the participants in the scheme;
> "unit trust scheme" means a scheme which, apart from these Regulations, is a unit trust scheme for the purposes of the principal Act.
> **3 Exception of certain unit trust schemes from the principal Act**
> A unit trust scheme which is—
> (a) a limited partnership scheme ...[2]
> shall be treated as not being a unit trust scheme for the purposes of the principal Act.
> **4 Description of a limited partnership scheme**
> A unit trust scheme is a limited partnership scheme when the scheme property is held on trust for the general partners and the limited partners in a limited partnership.

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2 The omitted words relate to approved profit sharing schemes and employee share ownership plans, which are not discussed here.

There is similar provision for IT. Section 1007(2) ITA provides:

> The Treasury may, in relation to a unit trust scheme within the meaning given by section 237 of FISMA 2000 whose trustees are UK resident, by regulations provide that the scheme is not to be a unit trust scheme for the purposes of the definition in section 989 of "unauthorised unit trust" if it is within a specified description. ...

The regulations are Income Tax (Definition of Unit Trust Scheme) Regulations 1988 which provide:

> **3 Exception of certain unit trust schemes from section 354A**
> Subject to the provisions of these Regulations, a unit trust scheme which is ...
>
> (c) a limited partnership scheme ... [3]
>
> shall be treated as not being a unit trust scheme for the purposes of section 354A [ICTA 1970, now s.504 ITA and s.621 CTA 2010.]
>
> **8 Description of a limited partnership scheme**
> A unit trust scheme is a limited partnership scheme when the scheme property is held on trust for the general partners and the limited partners in a limited partnership.

This does not apply in terms to a foreign law limited partnership, though in the case of an EU law limited partnership, the discrimination is in breach of EU law so it is considered that HMRC cannot tax an EU law limited partnership as a collective investment scheme.

39.2 Income accruing to unit trust

39.2.1 *Authorised unit trust*

Section 617(1) CTA 2010 provides:

> In respect of income arising to the trustees of an authorised unit trust, and for the purposes of the provisions relating to relief for capital expenditure, the Tax Acts shall have effect as if—
>
> (a) the trustees were a UK resident company; and
>
> (b) the rights of the unit holders were shares in the company.

So authorised unit trusts are not transparent for IT purposes.

---

3 The omitted words relate to enterprise zone property schemes, charitable unit trust schemes, approved profit sharing schemes and approved employee share ownership plans, which are not discussed here.

ITTOIA EN Vol II discusses the location of AUT income:

> 51. It is possible for the FSA to recognise a non-UK unit trust scheme for marketing into the UK. However, only those UK tax resident unit trusts that are "authorised" by the FSA come within section 468 of ICTA. Section 468(1) of ICTA provides that the Tax Acts apply to UK authorised unit trusts and shall have effect as if the trustees of the authorised unit trust were a company resident in the UK. Although the application of section 468(1) of ICTA is by reference to the trustees' income (and relief for capital expenditure), the treatment of the trustees as a UK resident company carries through for the purposes of taxing interest distributions treated as made to unit holders. That is because section 468L(2) of ICTA provides that the Tax Acts shall have effect as if such interest distributions were made "by the company referred to in section 468(1)". As these distributions are treated as made by such a company, that is a UK resident company, they can only be UK source income.

The taxation of AUTs is not discussed here.

39.2.2 *Unauthorised unit trust: UK trustees*

Section 504 ITA provides:

> (1) This section applies for income tax purposes in relation to an unauthorised unit trust if the trustees are UK resident.[4]
> (2) If income arises to the trustees, the income is treated as the income of the trustees and not of the unit holders.
> ...
> (5) Sections 494 and 495 and 496B do not apply in relation to payments made by the trustees.

So unauthorised unit trusts with UK resident trustees are not transparent for IT purposes. The taxation of these unit trusts is not discussed here.

39.3 Unauthorised unit trust: Foreign trustees

This leaves the question of unauthorised unit trusts with non-resident trustees. There is no statutory provision so we are thrown back to first principles. It is considered that ordinary interest in possession trust rules apply. For IT purposes, depending on the drafting and proper law, a unit

4 The CT equivalent is s.621 CTA 2010.

trust may be a transparent, *Baker* style trust or non-transparent.[5]

HMRC agree. The Offshore Funds Manual discusses *Baker* unit trusts:

> **OFM27330 - Reporting funds: tax treatment of participants in reporting funds: participants chargeable to income tax: transparent funds - Regulation 97** [January 2012]
> ***... Income: UK tax treatment of investors***
> No matter what the legal form of a transparent reporting fund, for UK tax purposes the income of an income transparent fund is treated as arising directly to its investors (UK investors are charged to tax on income arising net of a deduction for proper expenses of the management of the fund in question, and this is the case for both unit trusts and contractual arrangements). ...

The OF Manual also discusses *Garland* unit trusts:

> **OFM27320 Participants chargeable to income tax: other non-transparent funds - Regulation 96** [January 2012]
> ... Foreign unit trusts that are not transparent for income purposes are sometimes referred to as 'Garland' unit trusts (following the case of *Garland v Archer-Shee* (15 TC 693))...
> ***Non-transparent unit trusts***
> UK investors in foreign unit trusts that are non-transparent for income purposes are taxable on their proportionate share of income (as ascertained after the trustees have met the expenses of administering the trust) when it is indefeasibly allocated to them, regardless of whether the income is paid to them or accumulated. Unlike the position for transparent unit trusts, that income is taxable as miscellaneous foreign income (under Chapter 8 of Part 5 of ITTOIA 2005, or Chapter 8 of Part 10 CTA 2009) and the tax rates applying will be those applying to such income.

A Garland trust may be a reporting or a non-reporting fund.

39.3.1 *Baker or Garland?*

This depends on the applicable law[6] and the drafting. Appropriate drafting may create a *Garland*-style non-transparent unit trust even in a *Baker*

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5 See 26.1 (IIP trusts: income tax). This view is supported by *Minister of National Revenue v Trans-Canada Investment Co* [1956] SCC 49 accessible *http://www.kessler.co.uk/tfd-archive*, where the Canadian Supreme Court applied *Baker* to a unit trust arrangement.

6 See 26.8 (Baker or Garland trust jurisdiction?).

jurisdiction.

39.3.2 *Residence of trustees of unit trust*

The residence of the trustees of a unit trust is important for IT purposes, because the rules set out above depend on whether or not the trustees are UK resident. However, there is no definition of residence for this purpose. The standard IT/CGT definition of residence of "trustees of a settlement"[7] does not apply, because a unit trust is not a "settlement".[8] Ordinary rules of residence apply to determine the residence of the trustees in their private capacities.

The residence of the trustees of a unit trust is also important for determining whether the unit trust is an offshore fund, and (more or less)[9] the same principles apply.

39.4 Gains accruing to unit trust

Section 99(1) TCGA provides:

> This Act shall apply in relation to any unit trust scheme as if—
>
> (a) the scheme were a company,
>
> (b) the rights of the unit holders were shares in the company, and
>
> (c) in the case of an authorised unit trust, the company were resident in the UK,
>
> except that nothing in this section shall be taken to bring a unit trust scheme within the charge to corporation tax on chargeable gains.

There are three categories of unit trust for CGT:

(1) Authorised unit trust: gains are exempt from CGT.[10]

(2) Unauthorised unit trusts:

  (a) UK resident unauthorised unit trust: gains are subject to CGT

  (b) Non-resident unauthorised unit trust: gains not generally[11] subject to CGT.

So residence of a unit trust is therefore important for CGT purposes.

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7 See 5.1 (Residence of trustees).

8 The term "settlement" in this context is not expressly defined, but property in a unit trust is not "settled property" for the purposes of IT: s.466 ITA. It is considered that "settlement", in this context, requires settled property (as defined).

9 For an exceptional case, see 34.3.2 (Residence of EU funds).

10 Section 100 TCGA.

11 The usual exceptions apply, for UK trades with a UK PE, and residential property above £2m.

Statute states that authorised unit trusts are UK resident but does not define the test of residence for unauthorised unit trusts. Since a unit trust is treated as a company, it is considered that the test of residence for CGT is the corporate test, ie, central management and control.[12]

Gains accruing to a non-resident "close" unit trust fall in principle within the scope of s.13 TCGA, and may be attributed to UK resident unit holders.[13]

39.5 Situs of unit

39.5.1 *Situs for IHT*

The situs of a unit in an authorised unit trust is not normally relevant for IHT.[14] The situs of a unit in an unauthorised unit trust is important for IHT.

A unit is unlike an equitable interest under a conventional trust. The rights of a unit holder arise from contract as well as trust, and a unit is in many ways analogous to a share in a company.[15] One should not apply rules governing other kinds of equitable interests without considering this.

It is considered that share/security situs rules should normally be applied, so that the place of the register is normally the determining factor. HMRC accept this.[16]

Another possible view is that situs depends on the residence of the trustees. In practice a situation where the place of residence of the trustees is different from the place of the register would be rare so the priority between the two tests may never need to be decided. Trustee residence

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12 There is some relevant discussion at 6.18.2 (Comparison with "central management and control").

13 Ghosh agrees: "When is a company not a company?" PTPR Vol 7 p. 241, accessible *http://www.khpplc.co.uk/reviews*

14 See 62.3 (Non-settled property: authorised unit trusts and OEICs).

15 Thomas & Hudson, *The Law of Trusts*, (2nd ed., 2010), paras 53.28, says that the rights are *primarily* contractual, but to classify overlapping rights as "primary" and "secondary" seems to me somewhat arbitrary.

16 Press Release 16 October 2002 (OEICs and AUTs) para 9 stated (before the introduction of IHT relief for AUTs):

> "[OEICs and units in Authorised Unit Trusts] are treated as situated in the UK in the same way as other UK registered shares. That is so even if the 'underlying' assets of the collective investment fund are non-UK assets."

See too [1998] PCB 172. This conclusion is supported by *CPT Custodian Pty v Commissioners of State Revenue* (2005) 2 ALR 196 accessible *http://www.austlii.org* (unit trust holders not joint "owner" of land for purposes of Australian rating laws).

determines whether a unit trust is treated as a company or offshore fund for IT and CGT purposes.[17] It might therefore be said to be consistent with the tax legislation if situs of a unit for IHT depends upon the residence of the trustees. However, situs for IHT is based on private international law, not tax law, so the relevance of the unit trust tax provisions is very marginal.

What is reasonably clear is that situs of the unit does not depend on the situs of the underlying assets of the unit trust. The idea that one looks at the underlying assets, at first sight seems sensible, as it is consistent with the traditional test for situs of a bare trust. But it is unsound for two reasons:

(1) If the underlying assets are spread across different jurisdictions it would be impossible to ascertain the situs of the unit (if a unit is regarded as a single asset). The unit should not be regarded as several separate interests in as many assets as are held by the unit trust, looking through the unit trust like a bare trust, as this is to ignore the nature of the unit.[18]

(2) The proposal to look to the situs of the underlying assets is unworkable because the unit holder will not normally be able to ascertain what the underlying assets are at any particular moment. (Accounts of the unit trust may disclose the position at the end of an accounting period but that will not help as assets are normally bought and sold constantly by the trustees of the unit trust. The unit holder normally has no further right to information.)

Although the consequence is that one can alter situs by interposition of a unit trust, that is not so surprising: one can do the same with an OEIC.

39.5.2 *Situs of unit for CGT*

If the unit trust is not subject to UK law, registered units are situate where they are registered, because that is the rule for shares[19] and the unit is deemed to be a share. This is the same as the private international law rule.

If the unit trust is subject to UK law, a unit is probably UK situate under

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17 See 34.3 (Meaning of "offshore fund") and 39.2.2 (Unauthorised unit trust: UK trustees).

18 A similar argument applies in relation to the situs of an equitable interest under a substantive trust.

19 See 83.6 (Registered securities: non-UK company).

the UK law rule,[20] or under CGT situs rules for shares in UK incorporated companies.[21] However, a UK law unit trust will in practice have a register here, so the question of priority between the place-of-register rule and the UK law rule will not arise.

The situs of the underlying assets is not relevant. Section 99 clearly overrides s.60 TCGA. A unit is an asset for CGT purposes, rather than an interest in an asset, so that the co-ownership rule is not relevant.[22]

39.5.3 *Residence of trustees and situs*

The residence of the trustees is not relevant for situs, though non-resident trustees are required if it is desired that the units are not to be chargeable securities for SDRT purposes.[23]

39.6 Gain accruing on disposal of unit

An offshore unit trust will be an offshore fund. It may qualify as a reporting fund. If it does not, a gain accruing on a disposal of a unit will be an offshore income gain.[24]

39.7 Luxembourg Fonds Commun de Placement

Section 103A TCGA provides:

> (1) This Act applies in relation to a relevant offshore fund as if—
>
> (a) the fund were a company, and
>
> (b) the rights of the participants in the fund were shares in the company.
>
> (2) An offshore fund is a relevant offshore fund if—
>
> (a) it is not constituted by a company or by two or more persons carrying on a trade or business in partnership, and
>
> (b) it is not a unit trust scheme (see section 99).
>
> (3) In this section and section 103B, "participant", in relation to an offshore fund which is not a collective investment scheme, has the meaning given in section 362(1) of TIOPA 2010.

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20 See 83.13.4 (The UK-law rule).

21 See 83.5 (Securities of UK incorporated company). This assumes that a unit trust with a UK proper law should be regarded for CGT as a company incorporated in the UK. That seems the better view, though the contrary is arguable.

22 See 83.3 (Co-owned assets).

23 See s.99(5A) FA 1986.

24 See 34.3 (Offshore funds).

Offshore Funds Manual provides:

> **OFM07100 Application of S103A TCGA 92 to interests in arrangements that create rights in the nature of co-ownership-Section 103A TCGA 1992** [January 2012]
> Certain contractual arrangements have historically been treated as transparent for both income and capital gains purposes (for example, Luxembourg Fonds Commun de placement ('FCPs')). But whilst such funds came within the previous definition of an offshore fund, the offshore funds regime for taxing offshore income gains was not applicable as investors were treated as holding, for capital gains purposes, interests in the underlying assets rather than in the fund itself. This led to considerable difficulties for investors when they disposed of their interests, or when new investors were admitted to the fund, as capital gains computations could become very complex. This is not the case for interests in offshore unit trusts which were and are subject to section 99 TCGA 1992, so that for the purposes of tax on chargeable gains a unit trust is treated as if the fund was a company, and the rights of the participants in the fund were shares in that company.
> Section 103A TCGA 1992 was introduced by Part 2 of Schedule 22 Finance Act 2009 to align the treatment of interests in arrangements that create rights in the nature of co-ownership with that of interests in unit trusts. That is, those arrangements are treated as opaque for capital gains purposes from the operative date, so that Section 103A shifts the taxation of gains arising to UK residents to the time when they dispose of their interest in a fund.
> Section 103A does not change the tax treatment of such arrangements for income purposes – they remain fiscally transparent. Therefore, investors are entitled to income as it arises (from whatever source or country) and UK investors are taxable on such income as it arises, regardless of whether income is actually distributed. Income arising retains its character where arrangements are fiscally transparent, so for example if a fund receives income from property situated in the UK then UK investors would be chargeable to tax as if they had received that income directly. ...

CHAPTER FORTY

INTERMEDIATED SECURITIES

40.1 The securities law background

The Law Commission explain:

> 2.7 ...immobilisation entails depositing securities in paper form with a depository linked to a settlement system so that they are held indirectly. Where a new issue of securities is immobilised from the outset, the entire issue will be typically constituted by a single 'global' or 'jumbo' certificate which remains in the vaults of the depository.[1] The depository (or its nominee) becomes the owner of the securities either by registering the securities in its name with the issuer (in the case of registered securities) or by physical possession of the global certificate (in the case of bearer securities).
>
> 2.8 Participants in the settlement system keep interests in the immobilised securities by holding an account with the securities depository. These account holders are able to transfer and pledge their interests in the securities through book entries on the depository's books rather than by re-registration or by delivery of the underlying securities. Following the computerisation of settlement systems in the late twentieth century, the depository's 'books' that record ownership are now electronic records....
>
> 2.11 Recording investors' interests in securities as electronic bytes of information enables these interests to be transferred with ease from one account holder to another simply by a credit and debit in the computerised accounts of an intermediary. As long as the legal system

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1 Footnote original: Interests in the global note may be exchangeable for definitive certificates, so that the investor can acquire a direct relationship with the issuer. Usually, however, the global note is intended to be permanently immobilised and cannot be split into definitive certificates other than in extreme circumstances, such as the failure of a bond trustee to act on the instructions of the investors upon a default.

recognises this as a valid transfer of an interest in securities, traditional formalities associated with the transfer of underlying securities (for example, the execution of stock transfer forms and the issuance of new certificates) can be avoided. Greater transferability of securities enhances liquidity and consequently their value.

Pooled Accounts

2.17 ... Where an intermediary holds fungible securities for more than one investor it will typically pool these securities in a single client account. To do so, the intermediary opens an account with the issuer or intermediary above it in its own name and records in its own books each individual investor's allocation in the pooled account. In most legal systems, the only reference to an investor's specific allocation is made in its intermediary's accounts and not in the accounts of any higher-tier intermediary or in the register of the issuer...

Central Securities Depositories in indirect holding systems

2.19 The efficiencies generated by intermediation led the Group of Thirty to recommend in 1989 that each domestic market should establish a central securities depository (CSD) to hold both physical and dematerialised securities in the relevant market. Immobilisation of securities is therefore centralised in a single depository (or through a nominee of the CSD). An indirect holding system based on the immobilisation of securities in a domestic CSD is the most common model in advanced countries[2] and there are about thirty systems operating in this manner in Europe alone.

National CSDs do not usually raise issues for situs as the situs of the register of the CSD is usually the same as the situs of the underlying securities. However the issue does arise for international CSDs and other intermediaries.

2.20 In addition to national CSDs, Euroclear in Brussels and Clearstream in Luxembourg operate as international central securities depositories (ICSDs). ICSDs were originally established to manage clearing and settlement of Eurobonds for which there was no supporting market infrastructure. Since their creation over thirty years ago, the business of ICSDs has expanded to also cover most domestic and internationally traded securities. Euroclear and Clearstream maintain links to CSD counterparts in all the significant domestic financial markets, facilitating

2 Footnote original: In America, the Depository Trust and Clearing Corporation has custody, through its nominee Cede & Co, of between 60% to 80% of all publicly traded securities in the US. In 1999, this amounted to securities worth $23 trillion.

cross-border securities trading, clearing and settlement...[3]

A note on terminology. It is apparent from the above that the terms "depository" and "intermediary" may be used synonymously. I prefer the word "**intermediary**" as an asset may be held through a number of intermediaries and "depository" only seems apt for the first of the chain.

I use the word "**investor**" to describe the ultimate holder of the securities through one or more intermediaries. I refer to the investor's assets as "**intermediated securities**"; the term sometimes used (particularly in the USA) is **"depositary receipts"** but I do not think there is any difference in meaning.

I refer to the asset held by the ultimate depository as "**the underlying security**".

Securities held through CREST are not intermediated securities: see 82.9 (CREST) .

40.2 Transparent and contract-based intermediated securities

In order to determine tax treatment of an asset one must first identify the asset and its legal nature.

There are in principle two types of depository receipts:

(1) The depository may hold the underlying security in such a manner that the investors have a proprietary interest in it. In a common law jurisdiction, that will normally involve the depository holding the underlying security on trust for the investor. In a civil law jurisdiction the relationship will not be described as a trust, but the end result will be the same: the investors have a proprietary interest. I refer to that as a **"transparent"** intermediated security ("proprietary" intermediated security would be another possible term and "transparent for IT/CGT" would be a slightly more accurate label).

(2) The depository may hold the underlying investment beneficially, and have a merely contractual obligation to transfer money or assets to the investor. I refer to that as a **"contract-based"** intermediated security ("opaque" would be an alternative term.)

Where there are a series of intermediaries, each may hold their interest on the basis of transparent or contract-based obligations in favour of the next in the chain, or some may hold on one basis and others on another.

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3 Law Com., *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities Further Updated Advice to HM Treasury* (May 2008).

Whether an intermediated security is transparent or contract-based depends on the documentation and the law which governs it. This subject is made more complicated by the variety of jurisdictions which may be involved.

40.2.1 *English law*

If English law applies one would expect the underlying security to be held on trust, so the intermediated security is transparent, though that depends of course on the documentation. The position is summarised by Briggs:

> 7. ... [Dematerialized securities] are a form of intangible asset represented by an entry in the account of the legal owner of the security, recognizing the beneficial owner (or some intermediary between the legal and ultimate beneficial owner) as entitled to a stated number or fraction of an otherwise undifferentiated block of those securities held by the legal owner. There may commonly be a long chain of intermediaries between the legal and ultimate beneficial owner of a particular number of (say) ordinary shares in BP. In English law this tiered structure works, and only works for the purpose of creating proprietary interests at all levels, by the recognition of a trustee / beneficiary relationship between each member of the structure. Otherwise the separation of legal and beneficial ownership, and the creation of intermediate layers of proprietary holders, just does not work conceptually.
> 8. Lehman group companies featured in these chains, often being the first level beneficiary (or account holder) beneath the depositary holding legal title to the securities, often holding its interest as custodian for its customers on the street ("clients"), and often for one of its affiliates within the group, either for the affiliate's house account as ultimate beneficial owner, or for the affiliate as custodian (i.e. trustee) for one or more of its own clients.
> 9. But the group was not content just to hold property of this kind in safekeeping, either for street clients or affiliates, in some virtual electronic version of a vault at Gringotts, in the way that a traditional trustee might be expected to do under English law (leaving on one side duties to invest and to transpose investments). There is no reason to suppose that the Lehman group was unique, or even unusual, in having this - let's call it restless - attitude to its clients' property. It wanted to put it to work in the meantime, for itself rather than for its clients, for example by what is known as 'lending it to the street'. So it bargained with its street clients, and arranged with its affiliates, for what are called rights of use and rights of substitution, in relation to property thus held. So far did these rights or (between affiliates) practices go that in one case they came near to destroying, and in another case actually did destroy, the very substratum or essential features of a trustee beneficiary relationship, so that the client (or affiliate) risked losing (or actually did lose) any proprietary interest

in the security, in exchange for purely personal contractual rights as against the Lehman entity holding the security.

10. For as long as the Lehman group remained a going concern, good for its personal undertakings, this mattered little. The substitution of personal for proprietary rights as against the mighty Lehman entities secured for clients and affiliates the enjoyment of the economic fruits of beneficial ownership just as well. The exercise by the group of rights of use and of substitution no doubt usually swelled its profits in good times, and may even have led to a reduction in fees charged to clients (well, maybe…). But of course the onset of insolvency within the group made the difference between a personal and proprietary right of the utmost importance, not only to street customers, but also as between Lehman companies in a quasi trustee / beneficiary relationship with each other. As a result the potentially fine line in English law between derogations from the 'normal' duties of a trustee which do or do not prevent the recognition of a trust relationship altogether (or prevent it from arising in the first place) became of crucial importance. That distinction is part of the common law of trusts which originated in the context of family estates and succession, as far removed from the modern world (or jungle) of investment banking as it is possible to get.

11. ... Whether a relationship between two persons in connection with particular property is that of trustee and beneficiary is ultimately a question of intention. ... I want to illustrate the point by reference to three cases. In the first case *Lomas v RAB Market Cycles (Master Fund)* [2009] EWHC 2545 (Ch) the standard form of Lehman International Prime Broker Agreement (Charge version) gave LBIE rights of substitution and use in relation to client property which the agreement otherwise described as being beneficially owned by the client, while held by LBIE. A representative of LBIE's unsecured creditors argued with force that these rights were irreconcilable with LBIE being the client's trustee in relation to the property, so that it all fell into LBIE's insolvent estate, leaving the clients only with claims for its value as unsecured creditors. I concluded that, taken as a whole, the agreement did disclose a sufficient intention to make LBIE the client's trustee of the property or its substitute, notwithstanding the conferral of rights on LBIE in relation to it which would have made a 19th century trust lawyer turn in his grave. There was no appeal.

12. In the second case, *Pearson v Lehman Brothers Finance SA* [2010] EWHC 2914 (Ch), generally known as RASCALS (an acronym for Regulation and Administration of Safe Custody and Global Settlement), the Lehman group set up a system for the acquisition and holding by hub companies (i.e. LBIE in Europe) of all securities which any Lehman company wished to acquire in the relevant territory, so that the hub company held all the securities, between acquisition and sale, for the account of its Lehman affiliates. But the practice within the group was for the hub company to use the securities for its own purposes, including lending to the street for liquidity management, selling to

meet short positions of its own or of other affiliates, and generally acting in a comprehensively un-trusteelike manner in relation to the holding, while crediting the relevant affiliate (for whom the security was held) with both its value and with any intermediate income, such as dividends on shares.

13. Regulatory and capital adequacy concerns in the mid 1990s led to the erection of a remarkable and complex computer automated structure whereby the relevant securities were made the subject of daily repos or open ended stock loans between the hub company and the relevant affiliate (for the account of which they had been purchased) for the whole of the period between acquisition from and disposal to the street. It operated on a daily basis without any human intervention at all. This structure only made sense on the assumption that the parties intended the beneficial interest to start with the affiliate, i.e. that they were acquired by LBIE for the affiliate as its trustee. The purpose of the repos and stock loans was then to transfer beneficial ownership of the security in question back to the hub company for the whole period of its holding within the group.

14. ... The question then arose: who then beneficially owned the underlying securities, LBIE or its relevant affiliates? In the end the answer turned on the intricate mechanics of the automated scheme, coupled with the group's centralized book entries, spiced with a crucial bit of estoppel. But LBIE's administrators alleged that there had could never have been a trust between LBIE and the affiliates in the first place, so that the automated structure was both misconceived and completely unnecessary.

15. I concluded that, prior to the erection of the automated structure, that submission would have succeeded. The use which the affiliates allowed LBIE to make of the securities was inconsistent with LBIE being intended to be a trustee. All the affiliate got was a personal right against the hub company to the economic fruits of the underlying securities, which belonged from purchase until re-sale to the hub company, legally and beneficially. But since the automated structure only made sense on the assumption that the parties assumed they had transferred the beneficial interest to the affiliate, this disclosed, for the first time, a sufficient intention to create a trust so as actually to achieve that result. The Court of Appeal agreed....[4]

40.2.2 *New York law*

The position may be different under US law(s). Briggs J comments:

> 17. By contrast in the USA there has been devised a new artificial legal

4 Briggs, Denning Lecture 2012 *http://www.bacfi.org/files/Denning%20Lecture%202012.pdf*; see too *HSBC Holdings v HMRC* [2012] UKFTT 163 (TC) at [85].

> structure as the conceptual basis for the holding of dematerialized securities which does not depend upon traditional concepts of the separation of legal and beneficial interests by a trust, as part of the Uniform Commercial Code. It remains to be seen which will work best for all concerned.[5]

Until 2012 it was, I think, generally accepted that American depositary receipts used in practice were transparent, and this was the view expressed in the CG Manual.

HSBC Holdings v HMRC[6] concerned ADRs governed by the law of New York. It suited HMRC to argue that HSBC depository receipts were contract-based. The tribunal heard expert evidence and clearly preferred the view that the ADRs, which were "fairly typical",[7] were contract-based, though the conclusion is tentatively expressed:

> 148. Overall our conclusion is that we are not satisfied as a matter of fact that under the law of the State of New York the holder of an HSBC ADR has a beneficial interest in the underlying fund of HSBC shares

While in the HSBC litigation it suited HMRC to argue for contract-based ADRs, that conclusion would often favour the taxpayer. Accordingly HMRC now seek to return to what was formerly understood to be the position. The CG Manual provides:

> **50240 Depository receipts** [August 2012]
> **... DRs issued outside UK**
> Where a DR is issued outside the UK the question of whether the holder of the DR is the beneficial owner of the underlying shares will be determined by reference to the law of the territory in which the DR is issued.

More accurately, whether the holder of the DR is the beneficial owner of the underlying securities would depend on the terms of the deposit agreement construed in accordance with the law governing the agreement. The CG Manual continues:

> Information on beneficial ownership may be provided to investors by the depository.

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5 *http://www.bacfi.org/files/Denning%20Lecture%202012.pdf.*

6 [2012] UKFTT 163 (TC).

7 at [97].

That seems unlikely.

> **Beneficial ownership not conclusively determined by overseas law**
> Where beneficial ownership of the underlying shares cannot conclusively be determined by reference to the law governing the arrangements relating to the issue of the DRs, for tax purposes HMRC will continue to determine beneficial ownership according to its understanding of the principles of UK law.[8] This means that HMRC will continue to apply its longstanding practice of regarding the holder of a DR as holding the beneficial interest in the underlying shares.
> The ADRs referred to in the HSBC decision fall into this category.

Thus HMRC first disregarded their longstanding practice, and now disregard the tribunal's decision which was based on HMRC's expert evidence. The reader may think this a not very impressive display of administration. Now it is done, the genie is not so easily returned to the bottle. If it suits them, taxpayers may properly proceed on the basis that the Tribunal correctly decided that the HSBC ADRs, and any others in standard form, are contract-based.

40.2.3 *Belgium and Luxembourg*

I concentrate on Belgium and Luxembourg as they are the homes of Euroclear and Clearstream. The Law Commission say:

> **LEGAL ANALYSIS OF INTERMEDIATED SECURITIES**
> 2.24 Intermediation has had a substantial effect in transforming the legal nature of investor's rights in securities. In the UK and elsewhere, the traditional analysis of an investor's rights arising from its direct relationship with an issuer and based on its physical possession of securities or by an entry in the issuer's register no longer reflects the reality of the market place....
> 2.31 Belgium[9] and Luxembourg[10] are each home to major ICSDs

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8 Author's note: There is no such thing as UK trust law. It is possible that Scots law on this point, if applicable, is the same as English law I would be interested to hear from Scottish readers who could assist on this aspect. Perhaps Scots law is not often used in this context.

9 Footnote original: Belgian Royal Decree No. 62, as co-ordinated by Royal Decree of 27 January 2004.

10 Footnote original: Luxembourg Law of 1 August 2001 on the circulation of securities and other fungible instruments, Articles 6.7 and 15.

(Euroclear and Clearstream respectively) and both have recently clarified their respective securities laws. Investors that hold securities through an intermediary in an omnibus account are treated as having a co-ownership right in the pool of fungible securities, exercisable only against the intermediary. Should the intermediary fall insolvent, the investor is given a right of revendication, that is to say, a claim for the return of property enforceable against the intermediary and its creditors...

Direct enforcement versus indirect enforcement

2.35 In all common law jurisdictions (such as the UK and the US) and a number of civil law countries (for example Belgium and Luxembourg), an investor that holds through an intermediary is unable to exercise the rights it may have in the underlying securities directly against the issuer of those securities.[11] The investor can only enjoy the fruits of its investment by enforcing its rights against its intermediary. Furthermore, the investor will be generally prohibited from making a claim against securities held in the account of a higher tier intermediary but must rely on the contractual and fiduciary obligations of its own intermediary to pursue such claims....

2.49 The effect of commingling securities in a pooled account is generally to preclude the continuing existence of direct property rights of individual owners in the specific securities held prior to commingling...

LEGAL PROTECTION BASED ON CO-OWNERSHIP

2.51 In a number of EU Member States, account holders are given proprietary rights (or the equivalent protection) by treating their interests in a commingled account as co-ownership (or co-proprietary) interests in a fungible pool.

2.52 In Belgium[12] and Luxembourg,[13] statute converts what would otherwise be a mere contractual claim against the intermediary into an intangible co-ownership right in a pool of fungible book-entry securities held by the intermediary.[14]

That comes down to transparent intermediated securities (though not based on a common law trust).

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11 Footnote original: Unless the issuer permits otherwise by contract or provisions in a deed poll or trust deed.

12 Footnote original: Belgium Royal Decree No 62, Article 2.

13 Footonte original: [Luxembourg] Securities Act 2001, Article 7.

14 Law Com. *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities Further Updated Advice to HM Treasury* (May 2008).

40.2.4 *Denmark, Germany and the Netherlands*

The Law Commission say:[15]

> An investor may be granted a right to enforce its claim against an upper tier intermediary in circumstances where its own intermediary has acted in breach of duty or is insolvent. This is the case in Denmark and Germany[16] and possibly also in the Netherlands.[17]

Thus it seems that intermediated securities in these jurisdictions are also transparent.

40.3 Situs of transparent intermediated security for IHT

There are no relevant statutory provisions, so the common law rules apply for IHT.

The relevant principle is that an asset is situate where it can be dealt with. An intermediated security is dealt with (ie transferred) in the jurisdiction of the intermediary. That is the jurisdiction where litigation over the transfer of the intermediated security would normally take place. So that is the situs of the intermediated security; the situs of the underlying security is irrelevant.

It might be argued that in the case of a transparent intermediated security, the situs of the investor's asset (the intermediated security) must be that of the underlying security since:

(1) A simple bare trust or nomineeship is transparent for IHT situs.[18]

(2) The underlying security is held on a bare trust.

However the trust (if any) which has effect under a transparent intermediated security is not a simple bare trust since (1) it allows pooling and (2) change of title is effected by registration; in fact it is not properly

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15 See Issues Affecting Account Holders and Intermediaries para 1.239 (June 2006) accessible *http://lawcommission.justice.gov.uk/docs/Intermediated_securities_seminar_2.pdf*

16 Footnote original: If an intermediary refuses to enforce a claim against the intermediary above for the return of securities, German law permits the investor to bring a direct action for return against the upper tier intermediary under the Securities Deposit Act, sections 7-8.

17 Footnote original: Sections 7:420 and 421 of the Netherlands Civil Code which relate to agency contracts could give the investor a right against an upper tier intermediary in the event of a breach of duty or insolvency of its own intermediary.

18 See 82.31 (Interest under bare trust or nomineeship).

described as a bare trust in the strictest sense of that expression.[19]

Dicey agrees:

> ... the *situs* of immobilised securities should be regarded as the place where the depository is established and where it keeps the database in which the entitlements of the depositors are recorded.[20]

This is also supported by Canadian authority:

> The place where the central securities depository control account is located could [and should] be considered the situs of "dematerialized" securities. In a multi-tiered holding system, the account would be situated at the financial investment intermediary on whose books the interest of the debtor appears. This is the place where the record that determines title is to be found.[21]

The Law Commission agree:

> 21.6 The concentration of the investor's interests into one account *with a single situs* can also greatly simplify conflicts of laws issues. This is of particular benefit to lenders wishing to take security over a portfolio of securities. Provided that the choice of law rules applied to the different intermediated securities are clear, the lender need only concern itself with the perfection requirements of the jurisdiction in which the account is located rather than the requirements of each of the jurisdictions applicable to the various underlying securities.[22]

Thus the situs of the intermediated security (the asset held by the investor) may be different from the situs of the underlying securities. Such differences are not surprising since, as the Law Commission say, "Intermediation has had a substantial effect in transforming the legal nature of investor's rights in securities." Investors may ignore the difference between intermediated securities and underlying securities, but

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19 See 84.5.1 (Definition(s) of bare trust and associated terminology).

20 *Dicey, Morris & Collins on the Conflict of Laws* (15th ed., 2012), para 22-043 (Immobilised securities). This view is enthusiastically supported by Benjamin, *Interests in Securities* (2000), Chap 7. See too the Trusts Discussion Forum archive accessible *http://www.trustsdiscussionforum.co.uk* under the thread "Will for Shares of British Virgin Islands (IBC) Holding".

21 *Re Bloom* [2004] BCSC 70, 27 BCLR (4th) 176, accessible *http://www.canlii.org*.

22 Law Com. *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities Further Updated Advice to HM Treasury* (May 2008). *http://lawcommission.justice.gov.uk/*

if so they may be surprised on the insolvency of an intermediary, as actually happened in the Lehman Brothers litigation.

40.3.1 *HMRC view*

HMRC take a different view. HMRC regard intermediated securities which are transparent for income tax as transparent for situs; what matters is the situs of the underlying security:

> ... where a financial institution or other intermediary has purchased Eurobonds or similar fungibles through Euroclear or Cedel [now Clearstream] on behalf of a client-investor, the Revenue will treat the financial institution or intermediary as the nominee or agent of the client-investor, unless the terms of the particular issue prescribed otherwise. So, save in the excepted circumstances, the Revenue will look through the intermediary and treat the beneficiary-investor as owning the underlying Eurobonds or similar fungibles.[23]

The IHT Manual makes the same point, slightly more tersely:

> **27077 Eurobonds and American depository receipts** [January 2014] We regard the situs of securities dealt with through computerised clearing systems (for example, Euroclear; CEDEL [which became Clearstream in 2002]) as determined by the terms of issue of the particular security. ...

There is a certain common sense in (what I take to be) the HMRC view that situs of the intermediated security is determined by the situs of the underlying security. However, situs is not a matter of common sense, and that view cannot stand against the authorities set out above. The common law situs rules looks to the situs of the intermediated security, not the underlying security.

It must be frustrating for HMRC to see a significant part of the economy taken out of the scope of IHT by means of clearing systems and depository receipts. But in practice the loss of tax will be nil or next to nil, for well advised UK resident foreign domiciliaries will not hold UK situate investments, above the nil rate band, and for non-residents, IHT on such assets is largely uncollectable. Indeed the current law could aid the UK economy by encouraging UK investment, or at least it could do so if HMRC acknowledged it.

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23 [1994] PCB 139.

Curiously, the CG Manual in 2012 deleted the passage which formerly stated that the situs of the DR is the situs of the underlying security. That might reflect a hesitant change of view or just an accident. But as far as I know, HMRC practice has not changed.

40.4 Situs of proprietary intermediated security for CGT

In the absence of a statutory provision, the IHT situs rule will apply for CGT. Six statutory provisions need consideration: the co-ownership situs rules, s.60 TCGA, the UK-law rule, and three rules dealing with securities in s.275(1)(d)(da)(e).

40.4.1 *Intermediated securities of non-UK companies*

The reader will recall that s.275(1)(e) TCGA provides:

> subject to paras (d) [government securities] and (da) [UK incorporated companies] above, registered shares or debentures are situated where they are registered and, if registered in more than one register, where the principal register is situated.[24]

In this paragraph I assume we are not concerned with government securities or UK incorporated companies within paras (d) or (da).

I first consider debentures and then shares.

As far as debentures are concerned, there are two questions:

(1) are intermediated debentures (the interests held by investors) properly described as "debentures" within the meaning of s.275(1)(e)?

(2) if so are intermediated debentures "registered" debentures?

Since debenture stock count as "debentures"[25] it seems reasonably clear that the intermediated debentures are properly described as "debentures".

Intermediated debentures are registered in the sense that the investors interests are recorded on the intermediary's register.[26] At first sight one might think that the register referred to in s.275(1)(e) must be a register kept by the company which issued the debentures. However a company does not have to keep a register of its debenture holders (unlike a shareholder register). The distinguishing feature of a register is that it

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24 See 83.6 (Registered securities: non-UK company).

25 See 83.2.4 (Meaning of "debenture").

26 Benjamin, *Interests in Securities* (2000) para 2.91: "Interests in securities [Intermediated securities] may properly be characterised as a form of registered securities, even where the underlying securities are in bearer form."

determines or provides evidence of ownership.[27] So it is considered that intermediated debentures are "registered" on the intermediary's register. It follows that:

(1) If the underlying debenture is not registered, the intermediary's register is the only register, and the investors interests are situate where the intermediary's register is situated.
(2) If the underlying debenture is registered, there are two registers:
    (a) The company's register of the underlying debenture (which will record the intermediary as the registered holder).
    (b) The intermediary's register of the intermediated debenture (which will record the investor as the registered holder).

It is considered that the company's register does not come into the picture, since the asset which the investor owns is the intermediated debenture and not the underlying debenture. But even if that is not correct, the intermediary's register should be regarded as the principal register so that is the one which governs situs.

For these reasons, an intermediated debenture of a non-UK incorporated company is situate where the intermediary keeps its register.

In practice it does not often matter whether the situs of an intermediated debenture (of a non-UK incorporated company) is in the place of the intermediary's register or the situs of the underlying debenture. Either way, the asset will not usually be UK situate. But it could matter, for instance, if the debenture is a bearer debenture and the document is in the UK. In such a case it is sensible to look to the intermediary's register rather than to the place of the document of the underlying debenture, since an investor could not be expected to know where the document of the underlying debenture is situated.

The same applies when the underlying security is shares in a non-UK incorporated company, rather than debentures.

40.4.2 *Securities of UK incorporated companies*

It is considered that intermediated securities of UK incorporated companies are properly described as shares or debentures and so fall within the rules in s.275(1)(d) TCGA. If that is correct, the registered securities rule in 275(1)(e) does not apply: it does not matter whether the

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27 The intermediary's register is not open to inspection, unlike a register under s.744 Companies Act 2006, but open access is not an essential feature of a register, and there is no reason to expect foreign law to apply English company rule principles.

securities are regarded as registered. Intermediated securities of UK incorporated companies are UK situate for CGT purposes.

40.4.3 *Municipal and government securities*

For the same reason, intermediated securities of government or municipal authorities are situated in the authority concerned: s.275(1)(d) TCGA.

40.4.4 *Another view*

In the case of co-ownership interests the co-ownership situs rules[28] in s.275C TCGA provide:

> (2) The situation of the interest in the asset shall be taken to be the same as the situation of the asset, as determined in accordance with subsection (3) below.
> (3) The situation of the asset for the purposes of subsection (2) above shall be determined on the assumption that the asset is wholly-owned by the person holding the interest in the asset.

Do investors hold interests in the underlying securities as co-owners (within the meaning of the co-ownership rule)? That depends on the terms of the agreement with the intermediary but it is likely to be the case.[29] If so, it appears at first sight that these rules override the common law situs rule, so the situs of the investor's interest for CGT is that of the underlying security.

Section 60(1) TCGA provides another route to the same destination:

> In relation to property held by a person
> [a] as nominee for another person, or
> [b] as trustee
> [i] for another person absolutely entitled[30] as against the trustee,
> [ii] or for any person who would be so entitled but for being an infant or other person under disability
> [iii] (or for 2 or more persons who are or would be jointly so entitled),
> this Act shall apply as if the property were vested in, and the acts of the nominee or trustee in relation to the property were the acts of, the person or persons for whom he is the nominee or trustee ....

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28 See 83.3 (Co-owned assets).

29 See 40.1 (The securities law background).

30 Section 60(2) TCGA defines "absolutely entitled" but need not be set out here.

Does the intermediary hold for the investors as bare trustee (within the s.60 sense of that expression)? That depends on the terms of the agreement with the intermediary but it is likely to be the case. If so, it appears at first sight that the effect of s.60 TCGA is to treat the investors as co-owners of the underlying security, so the situs of the investor's interest is that of the underlying security.

It is considered however that these deeming provisions do not alter the fact that the investor's intermediated securities are "registered" so that s.275(1)(e) continues to apply. This also overrides the UK-law rule[31] even if the underlying security was subject to UK law, or if the intermediary arrangement was subject to UK law.

40.4.5 *Conclusion*

The CG Manual formerly stated that the situs of an intermediated security for CGT purposes is that of the underlying security rather than that of the intermediary's register.[32] That is correct for securities of UK incorporated companies. It is considered that situs of securities of non-UK companies depends on the place of the intermediary's register. That could be different from the situs of the underlying security, though circumstances in which the difference matters will be rare.

40.5 Other CGT aspects of transparent intermediated securities

The CG Manual discusses the issue under the heading "depository receipts". The Manual first discusses the securities law background and practice:

> **50240 Depository receipts** [August 2012]
> You may come across assets referred to as Depository Receipts (DRs). The commonest are American Depository Receipts (ADRs).
> DRs are used as substitute instruments indicating ownership of securities such as shares. Although DRs may be owned by anyone, they are designed primarily to enable investors to hold and deal in shares of companies located in countries other than their own. Such activities might otherwise be inhibited by difficulties in transferring original share certificates from one country to another. The investors hold or trade the DRs rather than the share certificates themselves.

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31 See 83.13.1 ("Intangible asset").

32 See 40.3.1 (HMRC view).

> A person holding shares for which DRs are available can convert them into DR form by depositing the share certificates with a local branch of a depository (a financial institution such as a bank). The depository issues a DR. This document certifies that the depository, or an appointed custodian in the country of the underlying shares, holds the share certificates and that the owner of the DR is entitled to the share certificates on surrender of the DR. The precise detail of the arrangements may vary, but the holder of a DR will generally have many of the benefits associated with share ownership. In particular:
> - the DR can be exchanged for the underlying shares on demand by the DR holder
> - any dividends, subject to a handling fee, flow through to the DR holder.
> - the holder of shares in DR form may at any time cancel the arrangement by asking for delivery of the share certificates in respect of their underlying shares, and surrendering the DRs at a local branch of the depository.
>
> This guidance applies to DRs that display such characteristics.
> We have been asked to clarify how holding shares via DRs will affect liability to Capital Gains Tax or Corporation Tax on chargeable gains following the decision of the First Tier Tribunal in the Stamp Duty Reserve Tax case of *HSBC v HMRC*, [2012] UKFTT 163 (TC).
> **UK-issued DRs**
> Where a DR is issued in the UK the HMRC view is that the holder of a DR is the beneficial owner of the underlying shares.

More accurately, as discussed above, whether a trust is created would depend on the terms of the deposit agreement construed in accordance with the law governing the agreement.

Assuming there is a transparent intermediated security, the CG Manual goes on to set out the tax implications:

> ... the practical implications include that:
> [1] a transfer of shares by a shareholder to a depository in exchange for an issue of DRs is not a disposal of the shares for capital gains purposes because the shareholder retains beneficial ownership of the shares
> [2] a disposal of the DRs is a disposal of both the DRs themselves and a disposal of the underlying shares.[33]

33 [Author's note]. This assumes that the investor holds two distinct assets, (1) "the DRs themselves" and (2) the underlying securities. That is not correct. A DR should be regarded as a matter of general law as one asset and not two. Admittedly a DR

> In practice the value of a DR will track the value of the underlying shares very closely and to that extent the consideration for the disposal of the DRs should be regarded as consideration for the disposal of the shares
> [3] in a share exchange or company reconstruction in which shareholders have an option to receive DRs instead of being issued with shares we accept that the shares are to be treated for the purposes of TCGA92/S135 as being issued to the shareholders, see CG52500+.
> [4] if the holder of DRs converts them back into the underlying shares there is no change of ownership of those shares and so no disposal of the shares. There will have been a disposal of the DRs and the usual computational rules will apply. If no consideration is received for the disposal of the DRs there will be no chargeable gain.

40.5.1 *Voting rights on intermediated securities*

The holder of intermediated securities may or may not have the voting rights attached to the shares: that depends on the documentation. Normally it makes no difference for tax purposes, but occasionally that matters.

Section 169S(3) TCGA defines "personal company" for the purposes of entrepreneurs' relief:

> For the purposes of this Chapter "personal company", in relation to an individual, means a company—
> (a) at least 5% of the ordinary share capital of which is held by the individual, and
> (b) at least 5% of the voting rights in which are exercisable by the individual by virtue of that holding.

So where entrepreneurs' relief may be applicable, care needs to be taken or the relief may be lost.

40.6 Taxation of contract-based intermediated securities

The CG Manual also considers the tax position of contract-based intermediated securities:

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confers a number of different rights, but that is also true of a share, a unit in a unit trust, an equitable interest, and most if not all types of property which are nevertheless regarded as single items of property and not as two or more distinct items. However, it does not matter as the Manual goes on to effectively ignore the two-asset analysis. In the view of the Manual, the beneficial interest in the underlying share is effectively the only asset.

50240 Depository receipts [August 2012]

...Beneficial ownership determined by overseas law

Where the relevant law means that the holder of a DR is not the beneficial owner of the underlying shares the practical implications include that:

[1] a transfer of shares by a shareholder to a depository in exchange for an issue of DRs is a disposal of the shares for capital gains purposes because the shareholder loses beneficial ownership of the shares

[2] a disposal of the DRs is not a disposal of the underlying shares

[3] in a share exchange or company reconstruction in which shareholders have an option to receive DRs instead of being issued with shares the conditions of TCGA92/S135 will not be met by shareholders who take DRs as they have not been issued with shares.

[4] where a holder of DRs converts them into the underlying shares there will be a disposal of the DRs and an acquisition of shares. The usual computational rules will apply.

In addition:

(1) The situs of the intermediated security for IHT purposes will be the relevant jurisdiction.

(2) The intermediated security will be UK situate for CGT purposes if governed by UK law, under the UK law rule, or if it is a future or option. Otherwise it will be non-UK situate.

(3) The income from the ADR would be foreign source income (but subject to the manufactured dividend rules, if applicable).

CHAPTER FORTY ONE

PARTNERSHIPS

41.1 Partnerships: Introduction

Before 2014 I wrote that a full discussion of partnership taxation would require a book to itself; after the FA 2014 reforms, it would now require two volumes. In this chapter I focus on aspects relevant to the themes of this book.

I do not consider losses, or the position of corporate partners within the scope of corporation tax.

41.1.1 *Cross references*

This chapter considers aspects of partnerships which are more conveniently addressed in isolation. I have generally preferred to deal with partnership issues as they arise in the context of other topics see:

11.34 (Partnerships: remittance issues)
34.3.3 (Whether partnerships are offshore funds)
35.6 (OIG accruing to partnership)
75.23 (Partnerships: ATED)
76.22 (Partnerships - POA issues)
82.34 (Situs of partnership share for IHT)
84.18 (Jersey general and limited partnerships)
84.19 (Foreign limited liability partnership).

41.2 "Partnership" "trade" and "firm"

41.2.1 *Partnership*

"Partnership" is not usually defined in tax legislation so the starting point is the general (partnership law) meaning. This is qualified by statutory definitions for LLPs,[1] SDLT[2] and ATED.

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1 See 41.8 (Limited liability partnership).

2 See 75.4.1 ("Partnership").

41.2.2 *"Trade"*

Before discussing "firm" we need to consider ITTOIA's idiosyncratic definitions of "trade". Section 847 ITTOIA provides:

> (2) The provisions of this Part which are expressed to apply to trades also apply, unless otherwise indicated (whether expressly or by implication)—
>
> (a) to professions, and
>
> (b) in the case of this section and sections 849, 850, 857 and 858 to businesses that are not trades or professions.
>
> (3) In those sections as applied by subsection (2)(b)—
>
> (a) references to a trade are references to a business, and
>
> (b) references to the profits of a trade are references to the income arising from a business.

Thus the word "trade" in part 9 ITTOIA always includes profession (it would be appropriate to simplify the law by abolishing all distinctions between professions and trades). The word "trade" sometimes includes "business". Since it is not convenient to use the same word in two different senses, when trade is used in the wider sense, I refer to it as "**trade (including business)**".

41.2.3 *"Firm"*

We can now turn to the definition of "firm". Section 847(1) ITTOIA provides:

> In this Act persons carrying on a trade [including business] in partnership are referred to collectively as a "firm".

This is the same as the definition of "firm" in the Partnership Act 1890.[3] In practice "partnership" and "firm" are used interchangeably.

41.3 Is a partnership a "person"?

The use of the word "person" always requires some care.

The starting point is that "person" has a legal sense, distinct from the

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3 The Partnership Act 1890 provides:

"1(1) Partnership is the relation which subsists between persons carrying on a business in common with a view of profit. ...

4(1) Persons who have entered into partnership with one another are for the purposes of this Act called collectively a firm ..."

ordinary meaning (if there is such a thing). This is sometimes reflected by the expression "legal person" (ie something that the law regards as a person). Garner comments:

> "So far as legal theory is concerned, a person is any being whom the law regards as capable of rights and duties. Any being that is so capable is a person, whether a human being or not..."[4] Lon Fuller, among others, has questioned whether *person* is the most desirable word for the concept. What term might be better? Fuller suggests *legal subject* or *right-and-duty bearing unit.*[5] On second thought, perhaps *person* is not quite so bad.[6]

An English[7] partnership is not a legal person, that is, it is not a legal entity distinct from the partners; the law does not regard the partnership (as opposed to the partners) as capable of rights or duties.

The rule that English partnerships are not legal persons could have been (more or less) undone by sch.1 Interpretation Act 1978 which provides that for the interpretation of statutes from 1889:

> "Person" includes a body of persons corporate or unincorporate.

A partnership is a "body of persons" in the ordinary sense of that phrase,[8] and is "unincorporate"[9] and so an English partnership is a person in the Interpretation Act sense. Although the position strictly is that references to person in statutes prima facie include even an English partnership, the rule that English partnerships are not legal persons is very deeply ingrained and in practice no-one usually takes much notice of the Interpretation Act definition; its application is more or less optional since it does not apply "where the context otherwise requires." I suspect that this definition is directed to unincorporated associations rather than partnerships.

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4 Garner cites Salmond, *Jurisprudence* (12th ed., 1966), p.299.

5 Garner cites Fuller, *Legal Fictions* (1967), p.12-14.

6 Garner, *Dictionary of Legal Usage* (3rd ed., 2011), entry under *Person*.

7 The same applies to a Northern Ireland partnership. For the purposes of this chapter, I use the expression "partnership" to include a general partnership and a limited partnership, as no difference is to be drawn between them.

8 "A partnership is, as a matter of the ordinary use of English, plainly a body of persons"; *Padmore v IRC* 62 TC 352 at p.377. However it appears that a partnership is not a body of persons within the definition in s.989 ITA: see at p.377.

9 I think "unincorporate" is just an archaic term for "unincorporated".

A Scottish partnership is a legal person.

The difference between England and Scotland is not in practice as important as might appear at first sight:

> In considering whether a partnership or a group of persons associated in partnership constitutes "a person charged" within the meaning of the Rule,[10] I think it right to lay aside any preconceptions derived either from the law of England or from the law of Scotland as to the technical legal nature of a partnership. In Scotland a firm is "a legal person distinct from the partners of whom it is composed" (Partnership Act, 1890, Section 4 (2)), but this is not so under English law. For the present purpose this distinction should, in my opinion, be disregarded. The Income Tax Acts are ... equally applicable on both sides of the border and the language which they employ ought to be construed so as to have, as far as possible, uniform effect in England and in Scotland alike.[11]

Fundamentally, the context governs the sense and may show that the word "person" in any particular provision is used in a way which does or does not include a partnership.

A LLP is a legal person, and a body corporate, but for tax purposes it is usually treated in the same way as an ordinary partnership: see 41.8.3 (Income tax treatment of LLP).

As to whether a partnership is a person for the purposes of the OECD model treaty, see 6.15.1 (Is a partnership a "person" for treaty purposes?).

In practice the starting point for the IT and CGT status of partnerships is to be found in s.848 ITTOIA and s.59 TCGA which lay down, or confirm, the principles of transparency and non-personality.

41.4 Transparency of partnership for IT

Section 848 ITTOIA provides:

> Unless otherwise indicated (whether expressly or by implication), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners.

ITTOIA EN provides:

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10 Rule 9 of the rules applicable to Schedule D cases I and II, ITA 1918; there is no equivalent in current legislation, but this does not affect the point being made.

11 *R v General Commissioners of Income Tax for The City of London ex p. Gibbs* 24 TC 221 at p.247; the point is also made at p.244.

> 1711. This section makes it clear that, for income tax purposes, a firm is not an entity distinct from the partners in the firm. It is based on section 111(1) of ICTA.
> 1712. In the case of firms established under English law this provision merely confirms their position under that law. But Scottish firms, for example, are legal entities. This provision ensures that all firms are treated in the same way.

So partnerships are transparent for IT, ie partnership income is regarded as income of the partners and not of the partnership as such.

IT transparency follows from basic principles, not from this statutory provision.[12] In England this is clearly the case. IT transparency is a necessary consequence of the partnership law rule that the partners are joint owners of the partnership assets, and that an English law partnership does not have legal personality, ie it is not itself a person. For unless partnership income accrued to the partners, it would not accrue to anyone, and the partnership income must accrue to some person or persons if it is to be taxed.

In Scotland too, IT transparency follows from basic principles and not from the statutory provision. The Law Commission Report on Partnership Law provides:[13]

> The Inland Revenue justify their approach to UK partnerships[14] by reference to the following three characteristics:
> (1) the partners carry on the business of the partnership with a view to profit;
> (2) every partner is liable jointly or jointly and severally with the other partners for all the debts and obligations of the partnership; and
> (3) the partners own the business, each having at least an indirect share

12 Section 848 ITTOIA only dates from the FA 1995. Yet the IT transparency of partnerships has been settled tax law since early times: *Dreyfus v IRC* 14 TC 560. The predecessor provision, s.111 ICTA 1988, perhaps assumed but did not prescribe IT transparency. ("Where a trade or profession is carried on by two or more persons jointly, income tax in respect thereof shall be computed and stated jointly, and in one sum, and shall be separate and distinct from any other tax chargeable on those persons or any of them, and a joint assessment shall be made in the partnership name.")

13 Law Com 283 (2003) para 4.18.

14 [Footnote original] This covers both the English law partnership and the Scots law partnership notwithstanding that the former has no separate legal personality and the latter has separate legal personality.

in the net assets of the partnership.[15]

That is, the fact that a Scots partnership does have legal personality does not entail the conclusion that income accrues to the partners and not to the partnership. Underlying this issue is some vagueness or ambiguity in what the concept of legal personality does mean or entail. The Courts' inclination to minimise taxation differences between English and Scots partnerships may have been an influence in reaching this legal analysis.

The practical reader might ask impatiently whether it matters that IT transparency follows from basic nature of a partnership or from the statutory provision. It does not matter so far as the settled rule is that partnership income or gains accrue to the partners; but identifying the nature of a partnership is the first step when any questions arise relating to partnerships, so the question often does matter.[16]

41.4.1 *Allocation of profits/losses between partners*

Section 850 ITTOIA provides:

> (1) For any period of account a partner's share of a profit or loss of a trade carried on by a firm is determined for income tax purposes in accordance with the firm's profit-sharing arrangements during that period.
> This is subject to sections 850A and 850B.
> (2) In this section and sections 850A and 850B "profit-sharing arrangements" means the rights of the partners to share in the profits of the trade and the liabilities of the partners to share in the losses of the trade.

Sections 850A and 850B concern losses and are not discussed here. Section 851 ITTOIA extends the rule to non-trading income:

> (1) This section applies if—
> (a) sections 849 and 850 apply in relation to the profits or losses of a trade carried on by a firm, and

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15 [Footnote original] See *Memec PLC v IRC* 71 TC 77 and in particular Peter Gibson LJ at pp.111-113. Neither the separate personality of the Scottish partnership nor the absence of mutual agency in Scots law prevented the conclusion that in substance the position of the partners in a Scottish partnership in relation to the profits was the same as in an English partnership (p.113B–C).
See too 84.2.2 (How to categorise an entity as transparent or opaque).

16 See 11.34 (Partnerships).

(b) the firm has other income or losses.

(2) Those sections also apply as if references to the profits or losses of the trade were references to the other income or losses.

41.5 Partnership income: remittance basis

Section 857 ITTOIA provides:

(1) This section applies if—

(a) a firm carries on a trade [including business] wholly or partly outside the UK,[17]

(b) the control and management of the trade [including business] is outside the UK, and

(c) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to a partner for a tax year.

(2) The partner's share of the profits of the trade [including business] arising in the UK is determined in accordance with sections 849 to 856.

(3) The partner's share of the profits of the trade [including business] arising outside the UK is treated as relevant foreign income.

The significance of s.857(3) – treating partnership income as RFI – is that the income can qualify for the remittance basis.

41.5.1 *Segregating partnership profits*

Suppose:

(1) profits of a partnership trade arise partly in and partly outside the UK; and

(2) a partner receives a share of those profits.

There is an apportionment to determine the profits arising in/outside the UK.[18] The profits that the partner receives constitute a mixed fund, partly RFI (mixed fund category (d)) and partly other income (mixed fund category (i)). A remittance from such a fund follows the mixed fund rule; later years before earlier, and RFI of a year before the other income of the year.

On the other hand, suppose:

(1) profits of a partnership trade arise partly in and partly outside the UK; and

(2) a partner receives a share of profits arising outside the UK only.

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17 Section 857(1)(a) appears to be otiose because if the condition in s.857(1)(b) is met the condition in s.857(1)(a) must be met. But it does not matter.

18 See 15.22 (Trade partly in UK: apportionment).

In that case all the income that the partner receives is RFI. If a partnership includes partners who are remittance basis taxpayers, it may therefore be important for a partnership, if it can, to segregate the two parts of its trade so it can identify which parts of its profits arise in and which parts arise outside the UK.

41.5.2 *Control and management*

The test is control and management of the trade, not control and management of the partnership, but that will make not usually make any difference.

Normally a remittance basis taxpayer will want to argue that a partnership trade is controlled abroad, to qualify for the remittance basis, and HMRC will want to argue that control is here. However, if the partnership makes losses the boot may be on the other foot: UK partners may argue for control in the UK, to obtain more generous loss relief.

The expression "control and management" is of course from the company residence test, and it is considered that it should be given the same meaning here. Thus the company residence case law gives guidance.[19] The former International Tax Handbook provided at para 1612:

> Generally speaking we follow the thinking on companies and look at the place of the highest level of management rather than day-to-day management. Outside textbooks follow the same line.
>
> In deciding the location of the control and management of a firm with both UK and overseas partners, we would usually regard as significant such factors as the comparative seniority of the partners in age and experience (a simple head count will not do of course), the extent of their interests in the firm, the source and control of the finance, the places of decision on policy and major transactions, the places and locations of partners' meetings and what was done at those meetings. The place of meetings incidentally is not a conclusive factor any more than it is – or ought to be – for companies. So the nature of the business done at the meeting is important. Is it really about control and management or just part of a facade to mislead us about the place of actual control and management?

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19 There was a discussion in the former International Tax Handbook at para 1614 as to whether "control and management" are two distinct tests with distinct meanings, or a composite phrase. If my approach is right, the words are a single composite phrase.

The former International Tax Handbook continued with another interesting point at para 1613:

> [Section 857 ITTOIA] refers simply to control and management being abroad and the view which we have, in general, adopted in determining whether the Section applies is that this means control etc must be wholly abroad. The strength of this view has never been tested in the Courts and the word 'wholly' does not appear in the Act. It is sometimes put to us that where control and management is partly abroad then [section 857] applies. On the other hand, we have argued that because the Section says 'is situated abroad' it means just that and if control is partly here then it is not abroad.

The Commissioners would normally adopt a broad approach, looking at the whole picture in order to identify one overall place of control where possible, and situations where control was located in the UK and abroad would be rare. If it did arise, the HMRC view seems sound.

In *Mark Higgins Rallying v HMRC* [2011] SFTD 936 the Tribunal said:

> 51. We consider the appropriate test for the location of control and management of the business of a partnership is that adopted by the courts in relation to residence of companies. We note the same conclusion was reached by HMRC and stated in their Manual; also that it was the one argued for before us by the Partnership.
>
> 52. We have found helpful the summary put forward by the Special Commissioners in *Untelrab*[20] (at [74]):
>
> > "From these authorities we have identified the following principles: that the residence of a company is where the directors meet and transact their business and exercise the powers conferred upon them; that if the directors meet in two places then the company's residence is where its real business is carried on and the real business is carried on where the central management and control actually abides; that a determination as to whether a case falls within that rule is a pure question of fact to be determined by a scrutiny of the course of business and trading; that the actual place of management, and not the place where a company ought to be managed, fixes the place of residence of a company; … and that when deciding the issue of residence one should stand back from the detail and make up one's mind from the picture which the whole of the evidence presents."

20 *Untelrab v McGregor* [1996] STC (SCD) 1.

53. Also, the views of the Tribunal in *Laerstate*[21] (at [27]-[29]):

> "There is no assumption that [central control and management] must be found where the directors meet. It is entirely a question of fact where it is found. Where a company is managed by its directors in board meetings it will normally be where the board meetings are held. But if the management is carried out outside board meetings one needs to ask who was managing the company by making high level decisions and where, even where this is contrary to the company's constitution.
>
> It is significant, we think, that Lord Loreburn (in *De Beers*[22]) referred to the test as being where central management and control 'abides'. This is a test that does not confine itself to a consideration of particular actions of the company, such as the signing of documents or the making of certain board resolutions outside the UK if, in a given case, a more general overview of the course of business and trading demonstrates that as a matter of fact central management and control abides in the UK. As Lord Loreburn said (at 212-213), the factual question must be considered 'upon a scrutiny of the course of business and trading'.
>
> This is consistent with the analogy with individual residence which was the basis on which Lord Loreburn propounded the central management and control test. Just as for an individual, for example, where a temporary departure from the UK would not of itself give rise to a change of residence, the residence of a company will not fluctuate merely by reason of individual acts of management and control taking place in different territories. The whole picture must be considered in each case."...

55. The position must be considered for each tax year under appeal but, as per *Laerstate,* the place of residence of the Partnership will not fluctuate from year to year merely by reason of individual acts of management and control taking place in different territories....

62. We find that the place where certain contracts – even important ones such as the manufacturers' works team agreements – were signed is not in itself a determining factor. It is evidence towards where decisions were being made but it is the location of the decision-making, rather than where the contracts were signed, which is important.

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21 *Laerstate BV v HMRC* [2009] SFTD 551.

22 *De Beers Consolidated Mines v Howe* 5 TC 198.

41.5.3 *HMRC practice*

The former International Tax Handbook provided:

> **1622. Normal professional partnership: foreign partnership treatment**
> In the *Frost* case[23] we tried to argue before the Commissioners that control and management was not abroad. That is our approach to any case where partnerships appear to have been set up for the purpose of avoidance and Case V is of advantage, which, as ITH1630 indicates, it may yet be though to a much lesser extent than in earlier years.
>
> **1623. Foreign partnership treatment: artificial arrangements**
> But a common situation in professions such as engineers and accountants is one where there is a UK partnership and a separate partnership formed abroad with one or more non-UK resident partners in which some or all of the UK partnership partners are members. Generally speaking where the non-resident partners are professionally qualified and the overseas partnership takes on work which is reasonably local to the place where the partnership is based, it is possible to take a fairly relaxed view and accept a claim to Section [857] treatment. That was so even when Case V was on the remittance basis. If, however, the prima facie evidence against this view were very strong, we would look much more closely.
>
> It seems obvious that in these cases there will be some control in the UK – although proving that that is so is a different matter – but usually the UK resident partners will make visits to the overseas office and there is a case for saying that the management of the partnership is abroad. (This harks back to the Solicitor's Opinion considered in ITH1614.) It may be that some of the overseas partnership work is done in the UK by the UK partnership but this normally happens – or is said to happen – through the UK partnership acting as subcontractor for the overseas partnership.
>
> **1624. Foreign partnership treatment: income that of partnership?**
> If, however, one reaches the position that the ultimate control is in the UK and the bulk of the work is actually done here – albeit under subcontract – then that would be a case for a possible challenge. Cases have been seen where the arrangements were plainly offensive and amounted to no more than attempts to park UK-earned profits in a Section [857] partnership with the admitted intention of avoiding UK tax.
>
> We would certainly want to attack these devices and argue, for example, that the work done in the UK by partners who were also members of the overseas firm was done in their capacity as members of that overseas firm. We could then establish that the profits from those activities could be assessed under Case II. Our Solicitor, on particular cases, has not been discouraging about the chances that we may succeed and in the days of the remittance basis there was some success in settling cases on Case II lines rather than Case V. However, these cases turn crucially on questions of fact and degree and there is the usual

23 *Newstead v Frost* 53 TC 525.

difficulty of obtaining information.

1625. Foreign partnership treatment: income that of partnership?

Sometimes we have had to consider whether there is in fact an overseas partnership and/or whether amounts claimed to be receipts of an overseas partnership are in fact receipts of the UK partnership which is seeking to avoid tax. We have had some success with the latter line under circumstances which gave grounds for quiet satisfaction. A firm of UK solicitors which had profited from its fees for advice about the setting up of a well-known tax avoidance scheme, sought to avoid tax on those fees by arranging to park them in a Channel Islands finance and brokerage partnership to which Section [857] was said to apply. This was insult added to injury with vengeance.

Our Solicitor's advice was that we could not challenge the view that control and management was abroad. However, there was considerable artificiality in the arrangements which led ultimately to the fees landing in the accounts of the Jersey partnership. We argued that the amounts were in fact receipts of the UK solicitor's practice and we were aided in this by the fact that it was probably improper for a UK solicitor to enter into a partnership with a non-solicitor to do what they claimed to do in Jersey. This line was eventually conceded and we got tax on the Channel Island profits accruing to the UK partners.

41.6 Partnership with resident and non-resident partners

Section 849 ITTOIA provides:

(1) If—

(a) a firm carries on a trade, and

(b) any partner in the firm is chargeable to income tax,

the profits or losses of the trade are calculated on the basis set out in subsection (2) or (3), as the case may require.

(2) For any period of account in which the partner is a UK resident individual, the profits or losses of the trade are calculated as if the firm were a UK resident individual.

(3) For any period of account in which the partner is non-UK resident, the profits or losses of the trade are calculated as if the firm were a non-UK resident individual...

(4) In calculating under subsection (2) or (3) the profits of a trade for any period of account no account is taken of any losses for another period of account.

ITTOIA EN explains:

1714. If some of a firm's partners are resident in the UK and some are not, the profits of the firm's trade must be calculated on different bases. For the resident partners, the calculation includes profits arising outside the UK; for the non-resident partners, the calculation is restricted to profits arising in the UK.

1715. Section 111 of ICTA is not explicit that the profits may have to be calculated on more than one basis. This section brings together the rules for resident and non-resident partners. Subsection (1) introduces the idea that more than one calculation may be needed.

1716. The source legislation refers to the computation of the profits from the actual trade "for any period". Profits are calculated for a period of account. So subsections (2) and (3) make it clear that the section applies to a period of account. It is possible for a partner to be both resident (for one tax year) and non-resident (for another) within a single period of account. In such a case, the firm's profit has to be calculated twice to arrive at the partner's share of the profits.

1717. Subsection (2) sets out the normal basis for calculating the profits, for an individual resident in the UK. The profits are calculated as if the firm were an individual resident in the UK.

1718. Subsection (3) sets out an additional basis for calculating the profits. If the partner (who may be a non-resident company liable to income tax) is not resident in the UK the profits of the firm are calculated as if the firm were an individual not resident in the UK.

The BI Manual provides:

BIM72235 - Partnerships - computation and assessment: individual, company and non-resident members [December 2013]

... where one or more of the partners is a non-resident individual then the share of profits allocated to any such partner must be computed as if the partnership were a non-UK resident individual. In such case the partnership may need to submit an additional set of computations.

Example (Mr Armstrong and Mrs Beeton)

Mr A, a UK resident, and Mrs B, a non-resident, are in partnership. The partnership's world-wide trade profit amount to £10,000 and included in that sum is its UK profit of £7,500. Partnership profits are shared equally. Two tax computations are required on the following lines

Computation for resident partner			
Step 1	Trade profits		£10,000
Step 2	Allocation	Mr A	£5,000
		Mrs B	£5,000
Step 3	Profit taxable on Mr A		£5,000
Computation for non-resident partner			
Step 1	Trade profits		£7,500
Step 2	Allocation	Mr A	£3,750
		Mrs B	£3,750
Step 3	Profit taxable on Mrs B		£3,750

41.6.1 *Split years*

Section 849(3A) ITTOIA provides the usual split year rule:

> For any tax year that is a split year as respects the partner, this section has effect as if the partner were non-UK resident in the overseas part of the year.

41.7 Transparency of partnership for CGT

Readers who find this topic difficult may take comfort in the opinion of the OTS: "no-one understands CGT in relation to partnerships."[24]

Section 59(1) TCGA provides:

> Where 2 or more persons carry on a trade or business in partnership—
>
> (a) tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall, in Scotland as well as elsewhere in the UK, be assessed and charged on them separately, and
>
> (b) any partnership dealings shall be treated as dealings by the partners and not by the firm as such.

This is somewhat scanty foundation for the CGT treatment of partnerships.[25] It is supplemented by SP D12:

> **Disposals of assets by a partnership**
> Where an asset is disposed of by a partnership to an outside party each of the partners will be treated as disposing of his fractional share of the asset.

So partnerships are transparent for CGT: gains on disposals of partnership assets accrue to the partners (not to the partnership). For reasons similar to those discussed above for IT,[26] this result follows from first principles, and the statutory provision merely confirms that, but it does not matter.

In determining whether gains are foreign chargeable gains (which may

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24 "Review of partnerships: interim report" (2014) para 6.1 *https://www.gov.uk/government/publications/partnerships-review*

25 The Law Commission put the point more tactfully: "The working out of this concept in practice has not been easy, and has had to be regulated by extra-statutory guidance;" Law Com 283, *Partnership Law* (2009) para 3.51.

26 See 41.4 (Transparency of partnership for IT).

qualify for the remittance basis) one has regard to the situs of the partnership assets; the situs of the partnership share is irrelevant.

The question then is to identify the fractional share of each partner, and that can be tricky as partners do not always have easily identifiable fractional shares. SP D12 continues:

> In computing gains or losses the proceeds of disposal will be allocated between the partners in the ratio of their share in asset surpluses at the time of disposal. Where this is not specifically laid down the allocation will follow the actual destination of the surplus as shown in the partnership accounts; regard will of course have to be paid to any agreement outside the accounts. If the surplus is not allocated among the partners but, for example, put to a common reserve, regard will be had to the ordinary profit sharing ratio in the absence of a specified asset-surplus-sharing ratio.

The statement then turns to base cost:

> Expenditure on the acquisition of assets by a partnership will be allocated between the partners in the same way at the time of the acquisition. This allocation may require adjustment, however, if there is a subsequent change in the partnership sharing ratios (see para 4).

Assignments of partnership interests, and changes in partnership sharing ratios, are interesting topics, but they are not discussed here.

41.8 Limited liability partnership

41.8.1 *Definition of LLP*

Section 1(2) Limited Liability Partnerships Act 2000 provides the definition:

> A limited liability partnership is a body corporate (with legal personality separate from that of its members) which is formed by being incorporated under this Act; and—
>
> (a) in the following provisions of this Act (except in the phrase "oversea limited liability partnership"), and
>
> (b) in any other enactment (except where provision is made to the contrary or the context otherwise requires),
>
> references to a limited liability partnership are to such a body corporate.

Thus in UK legislation the expression "LLP" in principle means a UK LLP (one incorporated under the LLPA 2000) and does not include a

foreign LLP.[27]

41.8.2 *Nature of LLP*

A LLP is a body corporate. A LLP (despite its name) is not a partnership in the strict sense of the word.[28] So a LLP is in principle classified as a company for tax purposes.[29] However this default position is subject to such wide exceptions that it hardly ever applies.

41.8.3 *Income tax treatment of LLP*

Section 863 ITTOIA provides:

> (1) For income tax purposes, if a limited liability partnership carries on a trade, profession or business with a view to profit—
>
> (a) all the activities of the limited liability partnership are treated as carried on in partnership by its members (and not by the limited liability partnership as such),
>
> (b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners, and
>
> (c) the property of the limited liability partnership is treated as held by the members as partnership property.
>
> References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or business with a view to profit.
>
> (2) For all purposes, except as otherwise provided, in the Income Tax Acts—
>
> (a) references to a firm or partnership include a limited liability partnership in relation to which subsection (1) applies,
>
> (b) references to members or partners of a firm or partnership include members of such a limited liability partnership,
>
> (c) references to a company do not include such a limited liability partnership, and
>
> (d) references to members of a company do not include members

27 See 84.19 (Foreign limited liability partnership).

28 The drafter assumed this in s.863(2) ITTOIA. This view is also supported by s.1(5) Limited Liability Partnerships Act 2000 ("Accordingly, except as far as otherwise provided by this Act or any other enactment, the law relating to partnerships does not apply to a limited liability partnership.")

29 See 84.4 (Meaning of "company").

of such a limited liability partnership.

Thus a LLP is treated like a general partnership (provided it is carrying on a business with a view to profit). Section 863 then deals with the position where the LLP ceases to do that:

> (3) Subsection (1) continues to apply in relation to a limited liability partnership which no longer carries on any trade, profession or business with a view to profit—
>
> (a) if the cessation is only temporary, or
>
> (b) during a period of winding up following a permanent cessation, provided—
>
> (i) the winding up is not for reasons connected in whole or in part with the avoidance of tax, and
>
> (ii) the period of winding up is not unreasonably prolonged.
>
> This is subject to subsection (4).
>
> (4) Subsection (1) ceases to apply in relation to a limited liability partnership—
>
> (a) on the appointment of a liquidator or (if earlier) the making of a winding-up order by the court, or
>
> (b) on the occurrence of any event under the law of a territory outside the UK corresponding to an event specified in paragraph (a).

41.8.4 *CGT treatment of LLP*

Section 59A(1) TCGA deals with limited liability partnerships:

> Where a limited liability partnership carries on a trade or business with a view to profit—
>
> (a) assets held by the limited liability partnership are treated for the purposes of tax in respect of chargeable gains as held by its members as partners, and
>
> (b) any dealings by the limited liability partnership are treated for those purposes as dealings by its members in partnership (and not by the limited liability partnership as such);
>
> and tax in respect of chargeable gains accruing to the members of the limited liability partnership on the disposal of any of its assets shall be assessed and charged on them separately.[30]

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30 Section 59A(2) TCGA is the equivalent of s.863(2) ITTOIA:

"(2) For all purposes, except as otherwise provided, in the enactments relating to tax in respect of chargeable gains—

This puts a LLP in the same position as a general partnership. Section 59A(3)–(5) deal with the position where a limited liability partnership ceases to carry on a business with a view to profit, or is wound up; they are equivalent to s.863(3)(4) ITTOIA.

41.8.5 *HMRC practice*

SP D12 provides:

> The enactment of the Limited Liability Partnership Act 2000, has created, from April 2001, the concept of limited liability partnerships (as bodies corporate) in UK law. In conjunction with this, new capital gains tax provisions dealing with such partnerships have been introduced through s.59A TCGA. Section 59A(1) TCGA mirrors s.59 TCGA in treating any dealings in chargeable assets by a limited liability partnership as dealings by the individual members, as partners, for capital gains tax purposes. Each member of a limited liability partnership to which s 59A(1) applies has therefore to be regarded, like a partner in any other (non-corporate) partnership, as owning a fractional share of each of the partnership assets and not an interest in the partnership itself.
> This statement of practice has therefore been extended to limited liability partnerships which meet the requirements of s.59A(1) TCGA, such that capital gains of a partnership fall to charged on its members as partners. Accordingly, in the text of the statement of practice, all references to a "partnership" or "firm" include reference to limited liability partnerships to which s.59A(1) TCGA applies, and all references to "partner" include reference to a member of a limited liability partnership to which s.59A(1) TCGA applies.
> For the avoidance of doubt, this statement of practice does not apply to the members of a limited liability partnership which ceases to be "fiscally transparent" by reason of its not being, or its no longer being, within ss.59 and 59A(1) TCGA.

(a) references to a partnership include a limited liability partnership in relation to which subsection (1) above applies,
(b) references to members of a partnership include members of such a limited liability partnership,
(c) references to a company do not include such a limited liability partnership, and
(d) references to members of a company do not include members of such a limited liability partnership."

41.9 Residence of partnership

The residence of a partnership is not often important for tax, but it matters occasionally:

(1) The provision relating to the disallowance of partnership DTR refers to a firm which resides outside the UK.[31]

(2) In order to be a "foreign employer" (and so have chargeable overseas earnings) a partnership must be resident outside the UK and not resident in the UK.[32]

(3) One may need to identify UK-law residence of a partnership in order to determine its treaty-residence.[33]

Until 1995 the position was governed by s.112(1) ICTA 1988:

> *Where a trade or business is carried on by two or more persons in partnership, and the control and management of the trade or business is situated abroad, ... the partnership shall be deemed to reside outside the UK ...*

This was absent-mindedly repealed, and now there is no statutory definition, but it is considered that the test of partnership residence is still control and management. This is consistent with the general scheme of UK taxation of partnerships. ITTOIA EN agrees, in the passage set out above ("For UK tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed. ..."). [34] HMRC agree. The former International Tax Handbook provided:

> **1609. Residence**
> In English law a partnership is not a person and it has long been assumed that it cannot in fact have a residence. Although Scottish partnerships are persons we have not made any distinction. ... But there has been some nibbling away of the principle that a partnership does not have a residence. The concept of residence and partnerships appears in other Sections of the Taxes Acts. For example in [the definition of chargeable overseas earnings] there is the concept of a partnership, 'resident outside and not resident in the UK'. The transfer pricing provisions ... apply to

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31 See 41.10 (DT relief for partnership).

32 See 22.13 (Foreign employer).

33 See 6.15 (Treaty residence: Partnerships). This is no longer relevant for UK tax because of the treaty override, but may be relevant for foreign tax.

34 See 41.10 (DT relief for partnership).

partnerships but their effect may depend on whether or not the buyer or seller is resident in the UK. It is probable that if residence of a partnership in these contexts ever had to be put to the test the criterion of control and management would be used.

More important is the case of *Padmore v IRC* 62 TC 352. This concerned the effect of the Double Taxation Agreement with Jersey on the liability of UK resident partners of a partnership controlled and managed in Jersey. Jersey law has a provision very similar to Section 112. Both the High Court and the Court of Appeal considered that it must be deduced from the respective Sections that both Jersey and UK law attach tax consequences to the residence of partnerships and that residence is determined by control and management.

41.10 DT relief for partnership

For the question whether a partnership can be a treaty-resident for DTA purposes, see 6.15 (Partnerships).

Section 858 ITTOIA disapplies DT relief on partnership income of UK residents. Section 858(1) provides:

> This section applies if—
>
> (a) a UK resident ("the partner") is a member of a firm which—
>
> (i) resides outside the UK, or
>
> (ii) carries on a trade [including business] the control and management of which is outside the UK, and
>
> (b) by virtue of any arrangements having effect under section 2(1) of TIOPA 2010 ("the arrangements") any of the income of the firm is relieved from income tax in the UK.

ITTOIA EN explains the need for s.858(1)(a)(ii):

> 1777. For UK tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed. But it is possible that, under foreign law, a firm may be considered to be resident elsewhere, for example, by reference to where the firm was established. So the section uses both the "control and management" test and the "resides" test.

Section 858(2) ITTOIA provides:

> The partner is liable to income tax on the partner's share of the income of the firm despite the arrangements.

This disapplies treaty relief. It survived an attack in *Padmore v IRC (No 2)* [2001] STC 280.

ITTOIA EN provides:

> 1774. This section ensures that a UK resident partner's share of the income of a foreign firm remains liable to UK tax even though the income of the firm as a whole is exempt from UK tax in accordance with a double taxation agreement. It is based on section 112(4) and (5) of ICTA.
> 1775. The business profits article of the UK/Jersey double taxation arrangement exempts the profits of a Jersey firm from UK tax. In the case of *Padmore v IRC* 62 TC 352, the Court of Appeal decided that the exemption extended to the share of the profits arising to a UK resident individual. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.
> 1776. Subsection (1) sets out the type of individual and firm with which the section is concerned. It goes on to identify the sort of exemption from tax that was considered in the Padmore case. ...
> 1778. Subsection (2) makes it clear that the section does no more than remove any exemption under a double taxation arrangement. It does not deny other reliefs, such as tax credit relief. See Change 145 in Annex 1.[35]

This provision dates back to 1987. Interestingly, in those days retrospective legislation and breach of treaty obligations were thought to

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35 Change 145 is as follows:
"This change enacts the Inland Revenue practice of giving a narrow interpretation to the word 'affect' in section 112(4) of ICTA.
The business profits article of the UK/Jersey double taxation agreement exempts the profits of a Jersey firm from UK tax. In the case of *Padmore v IRC* 62 TC 352 the Court of Appeal decided that the exemption covered the share of the profits arising to a UK resident partner. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.
It was intended, in the case of income tax, that the 1987 legislation should do no more than remove the exemption claimed in the *Padmore* case. The words used in section 112(4) of ICTA are 'shall not affect any liability to tax'. On the face of it, these words could deny the partner any relief, including tax credit relief, under a double taxation treaty. Section 858(2) of this Act makes it clear that it is only the partner's chargeability to tax that is preserved, overriding any provision to the contrary in a double taxation treaty. No other effect of the treaty is overridden.
This change is in principle in taxpayers' favour but is expected to have no practical effect as it is in line with current practice."

require special justification.[36]

Section 858(3) ITTOIA provides:

> If the partner's share of the income of the firm consists of or includes a share in a qualifying distribution—
>
> (a) made by a UK resident company, and
>
> (b) chargeable to tax under Chapter 3 of Part 4,
>
> the partner (and not the firm) is, despite the arrangements, entitled to the share of the tax credit which corresponds to the partner's share of the distribution.

ITTOIA EN provides:

> 1779. Subsection (3) deals with UK tax credits. A double taxation arrangement may give a non-resident person an entitlement to payment of a tax credit on a distribution by a UK company. The entitlement is restricted to the share of the distribution that arises to a UK resident partner.

41.10.1 *"Members of a firm"*

Section 858(4) defines "members of a firm":

> For the purposes of this section, the members of a firm include any person entitled to a share of income of the firm.

Section 58(4) FA 2008 provides:

> The amendments made by subsections (1) to (3) are treated as always having had effect.

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36 The former International Tax Handbook para 1660 provided:

"The retrospective nature of the legislation [in 1987] provoked comment in the professional press and in Parliament. The Government, and later the House, were persuaded as to the propriety of this action because the Section does no more than restore the general understanding of the law and retrospection prevents third parties suddenly deriving a substantial windfall benefit for six years. Although the Section protects from retrospection only those taxpayers who gained a Commissioners' or Court decision before 17 March 1987, similar treatment was allowed to a small number of other taxpayers who were told by the Revenue that their cases would follow the Padmore decision. Criticism was also made because the legislation is intended to override the effect of the Jersey Arrangement and any other treaty which the Courts might have found to have similar effect. This 'treaty override' was defended on similar grounds – that it merely puts into effect what was generally understood to be the position. It has not met with any objection from treaty partners."

Retrospective legislation without limit of time! This is aimed at a tax avoidance scheme which involved trustees of 2 IIP trusts trading in partnership.[37] The EN to the draft clause provided:

> 11. The users of the scheme claim that, under the terms of the relevant Double Taxation Treaty, the UK is not entitled to tax the partnership income of the foreign trustees. As that income is precisely the same income as that received by the UK individuals as beneficiaries of the trust, they argue that the UK is not entitled to tax the UK individuals on it.
>
> 12. Legislation was introduced in Finance (No 2) Act 1987, which provided that (as had almost universally been assumed to be the case until a High Court decision to the contrary,) a Double Taxation Treaty did not affect UK residents' liability to UK tax on their share of income or gains from a foreign partnership.
>
> This new avoidance scheme purports to get round that legislation by claiming that the foreign trustees are the partners rather than the UK individuals.
>
> 13. The Government believes that a partner for the purposes of that legislation has always included all those persons entitled to a share of income or capital gains of the partnership. As such, the UK individuals remain liable to UK tax despite the elaborate, artificial structure designed to exempt them. This clause will put it beyond doubt that the legislation has always had that effect.

This justification of the retrospective nature of the 2008 amendment raises issues of tax law, fact, policy, practice and human rights.

As a matter of tax law, was it the case (before the retrospective legislation) that "member of a firm" for the purposes of that legislation has

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37 The EN to the draft clause published 12 March 2008 provides a somewhat untechnical explanation:

"8. An avoidance scheme purports to exempt from UK tax income received by UK resident individuals by using certain provisions in the UK's bilateral Double Taxation Treaties.

9. This scheme involves the establishment of offshore trusts, (of which the UK individuals are both settlors and beneficiaries) and partnerships (of which the foreign trustees of those trusts are partners).

10. The partnerships acquire the rights to receive the UK individuals' income but the terms of the trusts are such that, as beneficiaries of the trust, the UK individuals retain beneficial entitlement to the income – with the trustees obliged to remit the income to the UK individuals as it arises."

always included all those persons entitled to a share of income or capital gains of the partnership? The answer is, no.[38]

As a matter of fact, did the Government believe that to be the case? I think it is a safe bet that if HMRC received expert and impartial advice on the point, it would have been hedged with caveats such that the terms of EN para 13 would not represent a fair and accurate summary of the position.[39]

The question of policy is whether the reasons given justify retrospective legislation.[40] One might discern two reasons from the EN. The first is that the scheme will fail (or so the Government believe). If that is true, the 2008 change is unnecessary; if false (and it is certainly debatable) it is not a good reason. The only reason worth considering is that the scheme is "elaborate and artificial", or, HMRC might fairly have said, abusive (however that flexible term may be understood). Whether that justifies retrospective legislation is ultimately a political question on which views differ depending on how one values the rule of law. It is arbitrary and unfair in that this scheme was retrospectively stopped and others – no less elaborate, artificial and abusive – were not. Pragmatists (to whom constitutional proprieties such as the rule of law are of little interest) should bear in mind that retrospective legislation increases the "legal risk", a measure under which the UK falls low on international surveys, and the lowering of the UK's reputation in that regard has a significant albeit intangible cost. I suspect a major factor in picking on this arrangement, not mentioned in the EN, was the amount of money involved.

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38 Partner is a term of partnership law, and in the partnership law sense a person who is entitled to income or gains of a partnership is not as such a partner. HMRC would have to argue that "partner" in s.858 was not used in its partnership law sense, which is a difficult line to take even in these times of purposive interpretation, though in a tax avoidance case nothing is impossible. This is confirmed in *R oao Huitson v* HMRC [2010] STC 715 at [71]; the point was not considered by the Court of Appeal.

39 In Parliament the statement was described as "disingenuous": Public Bill Cttee debate on Finance Bill, 22 May 2008 Hansard col 371. In *Huitson* HMRC wisely claimed legal professional privilege: [2010] STC 715 at [71].

40 For an illuminating discussion of the policy issues in a US context, see Shaviro, *When Rules Change*, University of Chicago Press (2000). Taxpayers may on this point look with envy to the USA, where a norm opposing retrospective legislation is "strongly rooted in popular sentiment, legislative practice, and perhaps even the Constitution as the Courts are likely to interpret it" (p.104).

Does the retrospective legislation breach the Human Rights Act and (regardless of retrospectivity) is it EU law compliant? HMRC have won these battles.[41]

The question of practice is how often retrospective legislation will be used in the future. What advice can anyone give to clients seeking to know their position? The answer of course is that one cannot give a clear answer. Much depends on the politics of the day, but I guess that retrospective legislation will continue to be a rare response; a popular scheme carried out by many taxpayers and involving larger sums is certainly more at risk than others.

A pressure group continues to lobby on the issue[42] but has not produced more than a House of Commons paper on the topic.[43] Even if it is not successful in repealing s.58 FA 2008, it may have the effect of reducing government enthusiasm for future retrospective legislation.

41.10.2 *DT relief for partnership gains*

Section 59 TCGA sets out the same rules for CGT:

> (2) Subsection (3) applies if—
>
> (a) a person resident in the UK ("the resident partner") is a member of a partnership which resides outside the UK or which carries on any trade, profession or business the control and management of which is situated outside the UK, and
>
> (b) by virtue of any arrangements that have effect under section 2(1) of TIOPA 2010 ("the arrangements") any of the capital gains of the partnership are relieved from capital gains tax or corporation tax in the UK.
>
> (3) The arrangements (so far as providing for that relief) do not affect any liability to capital gains tax or corporation tax in respect of the resident partner's share of any capital gains of the partnership.
>
> (4) For the purposes of subsections (2) and (3) the members of a partnership include any person entitled to a share of capital gains of the

41 *R oao Huitson v HMRC* [2011] STC 1860 raises the HR point and *R oao Shiner v HMRC* [2011] STC 1878 raises the EU law point, which is based on free movement of capital.

42 *http://notoretrotax.org.uk*

43 House of Commons Library, "Retrospective taxation: section 58 of the Finance Act 2008" SN06361 (2013). *http://www.parliament.uk/business/publications/research/briefing-papers/SN06361/retrospective-taxation-section-58-of-the-finance-act-2008*

partnership.

41.11 SD and SDLT position of partnerships

SD and SDLT are outside the scope of this book, but an HMRC statement **("the SD Partnership statement")**[44] is of wider importance as it discusses the nature of partnerships which is relevant for many tax purposes.

41.11.1 *LLPs*

The SD Partnership statement provides:

> **Group relief for SDLT and Stamp Duty: partnerships**
> **Stamp Duty Land Tax - a change in HMRC's view of the law**
> Where land transactions take place between members of a group, relief for Stamp Duty Land Tax (SDLT) is available (Part 1 Schedule 7 Finance Act 2003). Companies are members of the same group for the purposes of the relief if one body corporate is a 75% subsidiary of another or if both are 75% subsidiaries of a third body corporate. Broadly, the 75% relationship refers to the beneficial ownership of the subsidiary company's issued ordinary share capital.
> A 'company' for group relief purposes is defined in Schedule 7 FA 2003 as a 'body corporate'. HMRC did not consider that a 'body corporate' for the purposes of Part 1 Schedule 7 FA 2003 included a Limited Liability Partnership incorporated under the Limited Liability Partnership Act 2000 (LLP), so that LLPs were disregarded ('looked through') when considering whether a group relationship existed, the members of the LLP being treated as the beneficial owners of the LLP assets.
> This view has recently been challenged. Following legal advice, HMRC now accepts that, for the purposes of SDLT group relief, a 'body corporate' does include an LLP. An LLP can therefore be the parent in a group structure. However, as an LLP does not itself have issued ordinary share capital it cannot be the subsidiary of other companies. This also means that any subsidiaries of the LLP cannot be grouped with the companies that are the corporate members of the LLP.
> This revised view does not affect which party can claim group relief, but does affect which entities are regarded as forming part of a group. An LLP cannot claim group relief itself because its chargeable interests in land are treated as held by or on behalf of the individual members

44 *http://www.hmrc.gov.uk/so/group-rel-sdlt-sd.htm* (2010).

(Paragraph 2 Schedule 15 FA 2003), and this position is unchanged. As such, in broad terms, an LLP continues to be disregarded if it is the vendor or purchaser in a transaction. In such a transaction group relief may be, in part at least, available if some or all of its members (which are incorporated companies) are themselves grouped. It also follows that if an LLP transfers land to a company that it owns, and that is within the LLP headed group, no group relief will be available as the land is deemed to be owned by the members of the LLP, and those members are not within the same group as the company owned by the LLP.

If SDLT group relief has been incorrectly claimed solely as a result of an LLP in the group structure being disregarded or looked through for the purposes of establishing group relationships then HMRC will not seek to revisit the claim.

Stamp Duty

Group relief for Stamp Duty is available to bodies corporate that are associated (Section 42 FA 1930). Bodies corporate are associated if one is a 75% subsidiary of another or if both are 75% subsidiaries of a third body corporate. Broadly, the 75% relationship refers to the beneficial ownership of the subsidiary company's issued ordinary share capital. In general, HMRC has taken the view that an LLP, as a body corporate, can be the ultimate parent of a group for the purposes of Section 42 FA 1930. Furthermore, as an LLP does not itself have issued ordinary share capital it cannot be the subsidiary of another company.

Transfers of stock and marketable securities may be made to the parent LLP from a subsidiary body corporate in the same group and qualify for group relief and vice versa. Group relief cannot be claimed on the transfer of stock and marketable securities from a body corporate parent of an LLP to the LLP or to a body corporate subsidiary of the LLP.

41.11.2 *English and Scottish partnerships*

The SD Partnership statement provides:

English partnerships

As English limited and general partnerships do not have legal personalities separate from the persons who are the partners they must be 'looked through' when establishing bodies corporate that form a group for Stamp Duty Land Tax and Stamp Duty purposes. As such the companies that are the partners of an English general or limited partnership can, depending upon the facts, be grouped with those companies that are below the partnership in the group structure.

According to HMRC, the position is different in Scotland:

> **Scottish partnerships**
> Both Scottish limited and general partnerships have legal personalities separate from the persons who are the partners. They cannot therefore be 'looked through' when establishing bodies corporate that form a group. But they are not bodies corporate and so cannot be the parent of a group of companies.

The legal personality of a Scots partnership does not carry the implication, and the better view is that the position of a Scots partnership is the same as an English one: see 41.4 (Transparency of partnership for IT).

41.11.3 *Foreign partnerships*

The SD Partnership statement provides:

> **Non-UK partnerships**
> The principles set out in the earlier section on UK partnerships will be applied case by case to non-UK partnerships.

CHAPTER FORTY TWO

NON-RESIDENTS INCOME TAX RELIEF

42.1 Non-residents IT relief: Introduction

This chapter considers the IT relief for UK source income of non-residents. I use the following terminology:

"Non-resident individual/trustee IT relief" is the relief in s.811 ITA, which applies to individuals and trustees.

"Non-resident company IT relief" is the relief in s.815 ITA, which applies to companies.

I refer to them together as **"non-residents IT relief"**.

In accordance with the principles of the tax law rewrite, the two reliefs are written out separately, though the rules are more or less the same.

The relief is worded in a convoluted manner. In short, the relief is that UK source interest, dividend and pension income of non-residents is not subject to UK tax beyond withholding tax (where applicable).

42.2 Non-resident individual/trustee IT relief

In the absence of relief, non-resident individuals and trustees are subject to tax on UK source income at the same rates as UK residents. Thus non-resident individuals may be subject to income tax at the higher or additional rates, and non-resident trustees may be subject to tax at the trust rate. Section 811 ITA provides relief.

Section 811(1) ITA provides:

> This section applies to income tax to which—
> (a) a non-UK resident, other than a company, is liable, or
> (b) a non-UK resident company is liable as a trustee.[1]

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1 Section 811(1)(b) is otiose since a trustee is a separate person for income tax; see 5.3 Trustees treated as single and distinct person). But it does no harm.

Section 811(3) ITA sets out the relief:

> The non-UK resident's liability to income tax for a tax year is limited to the sum of amounts A and B.

There is no equivalent CGT relief but that is not needed as a non-resident is not usually subject to CGT. It is possible to envisage a case where a non-resident would be subject to CGT on gains made through an investment manager, but it would be unusual, in practice no-one would expect compliance, and HMRC probably turn a blind eye. The former International Tax Handbook stated at para 970:

> it would be very rare to find a situation where a non-resident would be liable on capital gains made through an investment manager.

42.2.1 *Split years*

Section 810(4) ITA provides:

> In relation to an individual—
>
> (a) a reference in this Chapter to a non-UK resident's liability to income tax is a reference to the liability of someone who is non-UK resident for the tax year for which the liability arises, and
>
> (b) accordingly, enactments under which income arising to a UK resident in the overseas part of a split year is treated as arising to a non-UK resident are of no relevance to this Chapter.

Thus there is no relief for a split year of an individual. This seems unfair and inconsistent with the general scheme of the split year rules. Perhaps the reason is that a tax return is needed for the split year, one object of the relief is to save the need for a tax return, so the relief is not appropriate in a split year.

The planning moral is that taxpayers should where possible defer UK source income until after the end of a split year.

42.3 Amount A (tax deducted at source)

Section 811(4) ITA defines amount A:

> Amount A is the sum of—
>
> (a) any sums representing income tax deducted from the non-UK resident's disregarded income for the tax year (see section 813),
>
> (b) any sums representing income tax that are treated as deducted from or paid in respect of that income, and

(c) any tax credits in respect of that income.

The legislation distinguishes:
(1) Disregarded income.
(2) Other income. I refer to this as **"non-disregarded income"** which is a clumsy term but I cannot find anything better.

In short, amount A is tax deducted at source on disregarded income.

42.4 Amount B (tax on non-disregarded income and reliefs)

We turn to amount B. Section 811(5) ITA provides:

> Amount B is the amount that, apart from this section, would be the non-UK resident's liability to income tax for the tax year, if the following were left out of account—
> (a) the non-UK resident's disregarded income for the tax year, and
> (b) any relief mentioned in subsection (6) to which the non-UK resident is entitled for the tax year as a result of—
> (i) section 56(3) or 460(3) of this Act (residence etc of claimants), or
> (ii) double taxation arrangements.

Thus one has a hypothetical tax computation which differs from the individual's normal tax computation by ignoring two sets of facts.

The effect of ignoring (a) is to decrease the tax liability but the effect of ignoring (b) is to increase it.

42.4.1 *Disregarded income and non-disregarded income*

Since one only ignores disregarded income in computing amount B, UK tax on non-disregarded income is included in computing amount B, ie tax on non-disregarded income remains payable in full.

Moreover although amount B is computed by ignoring disregarded income, tax deducted at source on disregarded income comes into amount A, so the effect at the end of the day is that UK tax on disregarded income is limited to withholding tax.

42.4.2 *Disallowed reliefs*

I refer to the reliefs within s.811(5)(b) as "**disregarded reliefs**". These reliefs are not disapplied. The individual can in theory claim them. But that claim increases amount B, so reduces the benefit of non-residents IT relief. A higher rate taxpayer will often be no better off at all; sometimes there may be a small saving but insufficient to justify the accountancy

costs of making the claim.

Section 811(6) ITA sets out the list of disregarded reliefs:

> The reliefs referred to in subsection (5) are—
>
> (a) an allowance under Chapter 2 of Part 3 of this Act (personal allowance and blind person's allowance),
>
> (b) a tax reduction under Chapter 3 of Part 3 of this Act (tax reductions for married couples and civil partners),
>
> (c) relief under section 457 or 458 of this Act (payments to trade unions and police organisations),
>
> (d) a tax reduction under section 459 of this Act (payments for benefit of family members), and
>
> (e) relief under section 266 of ICTA (life assurance premiums).

In general non-residents are not entitled to these reliefs but some are entitled (eg EU citizens)[2] and others are entitled by virtue of DTAs.[3]

In short, a non-resident must chose between claiming disregarded reliefs and non-residents IT relief: they cannot have both.

42.5 Trusts: UK beneficiary rule

Section 812(1) ITA provides:

> Section 811 does not apply to income tax to which non-UK resident trustees are liable for a tax year, if there is a beneficiary of the trust who is—
>
> (a) an individual who is UK resident, or
>
> (b) a UK resident company.

I refer to this as **"the UK beneficiary rule"**. One UK beneficiary may disqualify the entire trust from the relief.

Non-resident's IT relief is available if:

(1) The trust is settlor-interested and the settlor is non-UK resident as the income is treated as the income of the settlor, not the trustees.[4]

(2) The trust is an IIP trust and the life tenant is non-resident.

It does not matter if the trustees do not qualify for relief in their own capacity, due to the UK beneficiary rule. The trustees may take the benefit of the non-resident individual's IT relief applicable to the settlor or life tenant.

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2 See 47.6 (Persons entitled to IT personal allowances).

3 See 47.7.1 (Personal allowances under DTAs: Non-residents).

4 See 27.6.2 (Non-resident trust, non-resident settlor).

42.5.1 *"Beneficiary"*

Section 812 ITA defines "beneficiary":

> (2) For the purposes of subsection (1) a person is a beneficiary of the trust if—
>
> (a) the person is an actual or potential beneficiary of the trust, and
>
> (b) condition A or B is met in relation to the person.
>
> (3) Condition A is that the person is, or will or may become, entitled under the trust to receive some or all of any income[5] under the trust.
>
> (4) Condition B is that some or all of any income under the trust may be paid to or used for the benefit of the person in the exercise of a discretion conferred by the trust.
>
> (5) The references in subsections (3) and (4) to any income under the trust include a reference to any capital under the trust so far as it represents amounts originally received by the trustees as income.

This definition is the same as 18.20.3 (Non-resident discretionary trust)).

At first sight it appears that a trust with power to add beneficiaries would not qualify for relief, since UK residents are potential beneficiaries. But such powers are standard form in offshore trusts, so if that were right, offshore trusts would not normally qualify. In practice I understand that HMRC do not take that point.

42.6 Disregarded income

The definition of "disregarded income" is crucial since disregarded income qualifies for non-residents IT relief and other income does not.

In practice, the most important categories are dividends and interest.

The definition is complex. There are six categories of disregarded income. Section 813(1) ITA provides:

> For the purposes of this Chapter income arising to a non-UK resident is "disregarded income" if it is—
>
> (a) disregarded savings and investment income (see section 825),
>
> (b) disregarded annual payments (see section 826),
>
> (c) disregarded pension income,
>
> (d) disregarded social security income,

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5 Income is in turn defined in s.812(5) ITA:

"The references in subsections (3) and (4) to any income under the trust include a reference to any capital under the trust so far as it represents amounts originally received by the trustees as income."

(e) disregarded transaction income (see section 814), or
(f) income of such other description as the Treasury may by regulations designate for the purposes of this section. [No regulations have been made].

Thus we have to turn to another five definitions. But first, s.813(2) ITA brings in an important exception:

> But income in relation to which the non-UK resident has a UK representative for the purposes of Chapter 2B is not disregarded income.

See 43.3 (UK representative).

42.7 Disregarded savings and investment income

Section 825 ITA provides the definition:

> (1) For the purposes of this Chapter income is "disregarded savings and investment income" if—
> (a) it is chargeable under Chapter 3 or 5 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies and stock dividends from UK resident companies), or
> (b) it is within subsection (2) and is not relevant foreign income.
> (2) Income is within this subsection if it is chargeable under—
> (a) Chapter 2 of Part 4 of ITTOIA 2005 (interest),
> (b) Chapter 7 of that Part (purchased life annuity payments),
> (c) Chapter 8 of that Part (profits from deeply discounted securities),
> (d) Chapter 10 of that Part (distributions from unauthorised unit trusts), or
> (e) Chapter 11 of that Part (transactions in deposits).

42.8 Disregarded annual payments

Section 826 ITA provides the definition:

> For the purposes of this Chapter income is "disregarded annual payments" if it is not relevant foreign income and is chargeable under—
> (a) section 579 of ITTOIA 2005, so far as it relates to annual payments (royalties etc from intellectual property),
> (b) Chapter 4 of Part 5 of that Act, so far as it relates to annual payments (certain telecommunication rights: non-trading income), or
> (c) Chapter 7 of Part 5 of that Act (annual payments not otherwise charged).

Thus royalties which are annual payments are disregarded income, but royalties which are not annual payments are not.[6] In practice DT relief will often apply in which case the distinction will not matter.

42.9 Disregarded pension/social security income

Section 813 ITA provides:

> (3) Income is "disregarded pension income" if it is chargeable under Part 9 of ITEPA 2003 (pension income) because any of the following provisions of that Act applies to it—
> section 577 (UK social security pensions),
> section 579A (pensions under registered pension schemes) (but see subsection (4) below),
> section 609 (annuities for the benefit of dependants),
> section 610 (annuities under non-registered occupational pension schemes), or
> section 611 (annuities in recognition of another's services).[7]
> (5) Income is "disregarded social security income" if—
> (a) it is a taxable benefit listed in Table A in section 660 of ITEPA 2003, other than income support or jobseeker's allowance, and
> (b) it is chargeable under Part 10 of that Act (social security income).

42.10 Non-resident company IT relief

42.10.1 *Income tax limit*

Non-resident companies are in principle subject to income tax on UK source income at the basic rate or dividend ordinary rate. Section 815 ITA provides relief:

> (1) This section applies to income tax to which a non-UK resident company is liable, otherwise than as a trustee.
> (2) The non-UK resident company's liability to income tax for a tax year

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6 For the distinction, see 21.3 (Non-trade royalties).

7 Section 813(4) ITA provides:
"Income chargeable under Part 9 of ITEPA 2003 because section 579A of that Act applies to it is disregarded pension income only if the registered pension scheme in question—
(a) falls within para 1(1)(f) of Schedule 36 to FA 2004, and
(b) was, immediately before 6 April 2006, a retirement annuity contract to which section 605 of ITEPA 2003 applied."

is limited to the sum of amounts A and B.

So far this is the same as non-resident individual/trustee IT relief. There are slightly different definitions of amounts A and B.

Section 815(3) ITA provides:

> Amount A is the sum of—
>
> (a) any amounts representing income tax deducted from the non-UK resident company's disregarded company income for the tax year,
>
> (b) any amounts representing income tax that are treated as deducted from or paid in respect of that income, and
>
> (c) any tax credits in respect of that income.

This is the same as non-resident individual/trustee IT relief except that the reference is to disregarded company income, (and for some reason the word *sums* has become *amounts*).

Section 815(4) ITA provides:

> Amount B is the amount that, apart from this section, would be the non-UK resident company's liability to income tax for the tax year if the non-UK resident company's disregarded company income for the tax year were left out of account.

This is the same as non-resident individual/trustee IT relief except that there is no reference to the disregarded reliefs (which makes sense as those reliefs only apply to individuals).

42.10.2 *Disregarded company income*

There are five categories of disregarded company income. Section 816 ITA provides:

> (1) For the purposes of this Chapter income arising to a non-UK resident company is "disregarded company income" if it is—
>
> (a) disregarded savings and investment income (see section 825),
>
> (b) disregarded annual payments (see section 826),
>
> [(c) and (d) relate to the IME, see 44.1 (Investment manager exemptions - Introduction).]
>
> (e) income of such other description as the Treasury may by regulations designate for the purposes of this section.

This is effectively the same as the definition of "disregarded income" which applies for non-resident individual/trustee IT relief. There are two apparent differences:

(1) It omits references to pension or social security income (which do not apply to companies).
(2) There are differences in the wording of s.816(1)(c)(d) which are the equivalent of the individual's exemption for "transaction income" but I cannot see they are of any significance.

42.11 Commentary

Non-residents IT relief originated in a long standing concession, put on a statutory basis in 1995. As far as I know, no public discussion of the reasons for non-residents IT relief has taken place. Several different policy aspects can be identified.

(1) The tax competition consideration that non-residents would not invest in UK securities if they had to pay progressive IT rates and even the imposition of the basic rate would be a major deterrent.
(2) The practical difficulty in seeking to collect tax in excess of tax deducted at source. Tax collection may be practical in the EU (under the mutual assistance directive) and in some other countries (under the relevant DTAs) but it would be odd to have one rule for the those countries and another for the rest of the world.
(3) Various policy considerations tend to suggest that higher and additional rates of UK tax ("progressive rates") are not appropriate for non-resident individuals:
    (a) Progressive rates of UK tax would not be applied to all non-residents income (most of their income may be foreign source income and not subject to UK tax).
    (b) Non-resident individuals are likely to be taxed in their country of residence, with credit for UK tax.
    (c) If every country applied its own progressive rates, taxpayers would have to fill in tax returns in as many countries as they held investments, which would be an enormously difficult exercise for a worldwide portfolio.
    (d) Insofar as the right to tax is justified by the benefit principle,[8] the benefit provided to a non-resident individual is less than that provided by a UK resident.

These considerations form the basis for a general international acceptance

8 That is, the principle that in an equitable tax system, taxpayers should contribute in proportion to the benefits they receive from government expenditure.

that progressive rates are mainly a matter for the country of residence.[9]

Two important categories of UK income are not disregarded income and so do not qualify for non-residents IT relief: employment income and property income.

The treatment of employment income is understandable since (1) tax competition may be less of a concern; (2) PAYE makes collection of tax a practicality; and (3) disparity compared to other employees might be regarded as unacceptable.

The treatment of property income is strange. Deduction at source on rent is limited to the basic rate, though enforcement of progressive rates would theoretically be possible because of the situation of assets in the UK (not to mention mutual enforcement treaties). In the past, the Inland Revenue did not attempt to collect progressive rates on UK property income of non-residents.[10] This is not the current practice, at least officially. However one wonders how much tax strictly due is actually collected. Of course well advised non-residents will normally invest via non-resident companies so there will not often be much progressive rate tax even strictly due.

Logically:

(1) the collection of tax at source rules on UK property ought to be extended to progressive rates, where land is vested in an individual or a trust; or (if this is thought to be too onerous to administer)
(2) property income ought to be disregarded income and so qualify for non-residents IT relief.

This aspect of non-residents IT relief reflects a lack of consistent thinking or an unhappy compromise conflating different policy considerations.

The rule that non-residents IT relief effectively disallows personal

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9 This view is expressed in "A Platform for Consultation" (Australia) para 30.61 (2010) accessible *http://www.rbt.treasury.gov.au/publications/paper3/index.htm*.

10 The point arose in *Burns v HMRC* [2009] STC (SCD) 165 where HMRC argued that transfers of land from (supposedly) non-resident individuals to non-resident companies in 1980 and 1982 were made to avoid higher rate income tax on UK property income. The taxpayers responded that that could not be correct since the Inland Revenue did not collect higher rate tax. The Special Commissioner stated that in the 1980's there was "a certain level of expectation" that HMRC did not seek to collect higher rate tax on UK source rental income of non-residents. The practice was perhaps one of HMRC routinely turning a blind eye, rather than anything more formal; though a thorough review of Inland Revenue files would be needed to find the answer.

allowances ensures that what can be deducted at source is retained in full, and simplifies administration for HMRC and for taxpayers.

CHAPTER FORTY THREE

COLLECTION OF TAX FROM UK REPRESENTATIVES

43.1 Collection of tax directly from non-residents

The former International Tax Handbook provided:

903. Machinery of assessment: direct charge on non-residents

It always was and still is possible to assess a non-resident directly if, in the words of the Courts, he can be reached. A simple example of such a situation arose in the case of *Tischler v Apthorpe* [2 TC 89]. Mr Tischler was not resident. He was a partner in a French wine firm who spent four months or so a year in England. He lived then in a London hotel and sold wine to English customers. His firm also employed London agents and the question was whether the English profits could be assessed directly on Mr Tischler or whether such assessments should, Mr Tischler being non-resident, be made only on the English agents. The High Court held that an assessment made directly on the firm was good and that Mr Tischler was obliged to make a return served on him. In the words of Mathew J 'If the principal can be got at there is no need to have recourse to Section 41 (of the 1842 Act which was consolidated in Section 78 TMA 1970)'.

An individual, clearly, can be physically present in this country without being resident here and we used to have to rely on the principle established by the Tischler case in reaching the profits made by overseas sportsmen and women and artistes who come to this country for quite brief engagements. The modern view certainly, is that a non-resident company which trades here equally is here and that it may similarly be reached. If the company has a branch presence here with all the physical trappings of its trade it is visibly here and will have a registered place of business, an address at which it may be found and at which legal notices may be served.

The principle of direct assessment is not confined to non-residents who actually come here. There is no bar on direct assessment of non-residents who are not here whether or not they have agents in the UK. This was made clear in the case of *Werle v Colquhoun* [2 TC 402]. The difficulty with direct assessment on a person who is not here lies in recovering the tax, although now that the Supreme Court rules allow service of writs abroad this may be a little easier provided there are assets in the UK. But it is still true to say that if a non-resident company acting through an agent has no such physical presence here and has nothing here

> the Revenue cannot, in practice, impose its charge effectively without more adequate machinery including that for the service of notices and returns as well as for the actual gathering of the tax. It was in such situations – where the non-resident had only an agent here – that the original form of Part VIII was intended to come to the Revenue's aid. In practice Part VIII is normally used today even in those cases where the taxpayer can be reached directly ...

This was written before the 1995 changes and before the mutual collection of tax agreements but the point is still valid.

43.2 Collection of tax from UK representative

The rules are set out three times:

(1) For IT the rules are in chapters 2B and 2C part 14 ITA. This does not apply to companies[1] so effectively this applies to non-resident individuals and trusts.

(2) For CGT the rules are in part 7A TCGA.

(3) For CT the rules are in chapter 6 part 22 CTA 2010.

This does make a coherent discussion somewhat harder. In this chapter I set out the IT rules in full, and (in the absence of material differences) give the CGT and CT references in a footnote only.

Section 835U(1) ITA provides the basic rule:

> The obligations and liabilities of a non-UK resident are to be treated, for the purposes of the enactments to which this Chapter applies,[2] as if they were also the obligations and liabilities of the UK representative of the non-UK resident.

This is a collection provision (the metaphor often used is "machinery provision") and not a charging provision: the UK representative is only subject to tax if there is a charge to tax on usual principles on the non-resident principal. The INT Manual provides:

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1 Section 835D ITA provides:
"This Chapter does not apply in relation to income tax chargeable on income of a company otherwise than as a trustee."

2 This relates back to s.835T ITA which provides:
(1) This Chapter applies to the enactments relating to income tax so far as they make provision for or in connection with the assessment, collection and recovery of tax, or of interest on tax.
(2) Those enactments have effect in accordance with section 835U in relation to amounts in respect of which a branch or agency is to be treated as the UK representative of a non-UK resident under Chapter 2B.

268010 Introduction - What are the machinery provisions for assessment and collection? [September 2011]
The machinery provisions alone cannot create or extend a tax liability on the non-resident. There has to be a charge to tax in respect of the non-resident under the domestic provisions in the first place. The provisions work by treating the tax obligations and liabilities of the non-resident as though they were additionally the obligations and liabilities of the UK representative. This provides a practical assessment and collection mechanism for non-residents. Once either the non-resident or the UK representative has paid the liabilities both parties are treated as having met their liabilities.

Section 835U goes on to deal with the discharge of obligations:

(2) Subsection (3) applies if—
(a) the UK representative of a non-UK resident discharges an obligation or liability imposed by this section that corresponds to one to which the non-UK resident is subject, or
(b) a non-UK resident discharges an obligation or liability that corresponds to one to which the non-UK resident's UK representative is subject by virtue of this section.
(3) The corresponding obligation or liability—
(a) of the non-UK resident (in a case within subsection (2)(a)), or
(b) of the UK representative (in a case within subsection (2)(b)),
is discharged.
(4) A non-UK resident is bound, as if they were the non-UK resident's own, by acts or omissions of the non-UK resident's UK representative in the discharge of the obligations and liabilities imposed on the representative by this section. ...

43.3 UK representative

43.3.1 *Why does it matter who is a UK representative?*

A UK representative is important for the two reasons:
(1) A UK representative is liable for tax due from the non-resident principal, the topic of this chapter.
(2) Income in relation to which a non-UK resident has a UK representative falls outside non-residents IT relief: see 42.6 (Disregarded income).

43.3.2 *Definition of "UK representative"*

Section 835E ITA gives the basic definition for IT:

> (1) This section applies if a non-UK resident carries on (alone or in partnership) any trade, profession or vocation through a branch or agency in the UK.
> (2) The branch or agency is the UK representative of the non-UK resident in relation to—
> (a) the amount of any income from the trade, profession or vocation that arises (directly or indirectly) through or from the branch or agency, and
> (b) the amount of any income from property or rights which are used by, or held by or for, the branch or agency.

Thus for IT and CGT a UK representative is in short a branch or agency.

For CT, the term PE is used instead of branch/agency. Section 969(3) CTA 2010 provides:

> For the purposes of this Chapter, the following rules apply to a permanent establishment in the UK through which a non-UK resident company carries on a trade.
> *Rule 1*
> The permanent establishment is the UK representative of the non-UK resident company in relation to chargeable profits of the company attributable to that establishment.

In the following discussion "**the non-resident principal**" is the person for whom the UK representative is a representative (who the statute calls "the non-UK resident").

The question whether the non-resident principal is trading is crucial for the UK representative rules, because these rules only apply if the non-resident principal is carrying on a trade, profession or vocation.[3]

The INT Manual provides:

> **268030 Extent of UK representative's liability** [September 2011]
> A person can only be the UK representative in respect of the permanent establishment/branch or agency with which they are linked. Where a non-resident has more than one UK permanent establishment/branch or agency, then it is possible that each will have a different UK representative. In those circumstances, each UK representative would only be responsible in respect of the part of their non-resident's liabilities and obligations arising from their own permanent establishment/branch or agency [*Neilsen Andersen v Collins,* and *Tarn*

3 See 44.11 (When is there a trade in financial assets?).

v Scanlan 13 TC 91].

The former International Tax Handbook explained "directly or indirectly" in s.835E(2)(a):

> **914. General**
> Section 79 [TMA 1970] is another 1915 amendment. It provides that a non-resident shall be chargeable on profits or gains arising directly or indirectly through any branch, agency etc here. The sort of thing that was happening, before this provision was introduced, was that an agent for a non-resident would negotiate a contract here and at the end of the oral negotiations the agent and the third party would agree to sign the formal documents abroad. The view the Revenue took, and defensibly so, was that in substance all had been done here apart from signing a piece of paper and that it was wrong for liability so to be avoided.
> Problems of that sort are really problems of fact and proof as was mentioned in chapter 8 (ITH822). If the Revenue could have proved that there was an unwritten agreement made in London, it would have succeeded in a claim that the non-resident was trading here, and that is what we would argue today. Millions of pounds worth of business are done in the City of London every day on the basis of spoken agreements which are later confirmed in writing and nobody wishes to deny that the word is the contract. But, when the parties to the contract do not wish to act openly, proof is difficult to come by. What these words were meant to do was to enable the Revenue to say – "we must accept that this contract was made abroad because we cannot prove otherwise but a lot of negotiation took place in London and we want to look at the substance of the matter and the words 'directly or indirectly' will enable us to do that".

43.3.3 *Representative ceasing to act*

Rule 1 s.835E(3) ITA provides for the UK representative ceasing to act:

> *Rule 1*
> The UK representative continues to be the UK representative of the non-UK resident in relation to the amount even after ceasing to be a branch or agency through which the non-UK resident carries on the trade, profession or vocation concerned.

The INT Manual provides:

> **268040 What assessments should be raised and how is that done?**
> [September 2011]
> Where the trading activities in the UK have ceased, the UK permanent

establishment / branch or agency retains the obligations and liabilities as the UK representative even after the cessation. This provision is at ITA07/S835E Rule1 and ITTOIA05/Sch6 Para 3 (old FA95/S126 (3)) for income tax and at CTA10/S969(3) Rule 3 (old FA03/S150(2)(c)) for corporation tax. So assessments can still be raised on the UK representative subject to the usual assessing time limits. Where however the trading was conducted through a branch or fixed place of business and that presence has discontinued there may be difficulties identifying any person as the UK representative or any assets within the UK upon which recovery may rely. It is therefore recommended that assessments for such UK branches are raised and tax brought into charge at as early a stage as possible.

Additionally, by EU Directive member states of the European Union are able to seek the assistance of another member state in the recovery of direct and indirect taxes (see the guidance at DMBM560010).

43.3.4 *Separate personality*

Rule 2 s.835E(3) ITA provides for deemed separate personality:

Rule 2
The UK representative is treated in relation to the amount as a distinct and separate person from the non-UK resident (if the representative would not otherwise be so treated).

The SALF Manual provides:

704 UK representatives of non-residents chargeable under Case I and II Schedule D [February 2011]
UK representative is treated as a separate person
The UK representative and the non-resident are treated as separate persons. This allows, for example, service of notices and collection to take place at the branch or agency/permanent establishment.

43.4 Partnerships

Rule 3 s.835E(3) ITA provides:

Rule 3
If the branch or agency is carried on by persons in partnership, the partnership, as such, is treated in relation to the amount as the UK representative of the non-UK resident.

Section 835F ITA provides:

(1) Subsection (2) applies if a trade or profession carried on by a

non-UK resident through a branch or agency in the UK is carried on by the non-UK resident in partnership.

(2) The trade or profession carried on through the branch or agency is, for the purposes of section 835E and Chapter 2C, to be treated as including the notional trade or profession.

(3) Subsection (4) applies (in addition to subsection (2) if that subsection also applies) if—

(a) a trade or profession carried on by a non-UK resident in the UK is carried on by the non-UK resident in partnership, and

(b) any member of the partnership is resident in the UK.

(4) The notional trade or profession is, for the purposes of section 835E and Chapter 2C, to be treated as being a trade carried on in the UK through the partnership as such.

(5) In this section "the notional trade or profession" means the notional trade from which the non-UK resident's share in the partnership's profits or losses is treated for the purposes of section 852 of ITTOIA 2005 as deriving.

The INT Manual provides:

268020 Who can be the non-resident's UK representative? [September 2011]

Partnerships can be the UK representative of a non-resident

A partner in a partnership can be the UK representative of a non-resident. This will occur, for example, where a non-resident trades in the UK though the agency of a UK partnership (of which he or she is not a member). In such circumstances, the partners in the UK partnership will be jointly liable, as UK representative, for the tax payable by the non-resident. This provision is at ITA07/S835E and TIOPA10/S835E for income tax and is implicit in CTA10/S969 for corporation tax.

Where a business that is carried on by a partnership that includes non-resident partners is carried on in the UK through a permanent establishment / branch or agency, the permanent establishment / branch or agency is the UK representative of each non-resident partner. This provision is at ITA07/S835F and TIOPA10/S835F for income tax and is implicit in CTA10/S969 for corporation tax.

Where a business is carried on in the UK by a partnership that includes both resident and non-resident partners, the partnership is treated as the UK representative of each non-resident partner. The partners are thus jointly liable for the tax payable by the non-resident partners on their shares of the partnership profit. This provision is at ITA07/S835F and TIOPA10/S835F for income tax and is implicit in CTA10/S969 for

corporation tax.

The SALF Manual provides:

> **704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]
> *A partnership can be the UK representative of a non-resident*
> A partner in a partnership can be the UK representative of a non-resident. This will occur, for example, where a non-resident trades in the UK though the agency of a UK partnership (of which he or she is not a member). In such circumstances, the partners in the UK partnership will be jointly liable, as UK representative, for the tax payable by the non-resident.
> *Partnership, which includes non-resident partners, trading in the UK through a branch or agency/permanent establishment: the branch or agency/permanent establishment is treated as the UK representative of non-resident partners*
> Where a business that is carried on by a partnership that includes non-resident partners is carried on in the UK through a branch or agency/permanent establishment, the branch or agency/permanent establishment is treated as the UK representative of each non-resident partner.
> *Partnership trading in the UK which includes resident and non-resident members is treated as UK representative of non-resident partners*
> Where a business is carried on in the UK by a partnership which includes both resident and non-resident partners, the partnership is treated as the UK representative of each non-resident partner. The partners are thus jointly liable for the tax payable by the non-resident partners on their shares of the partnership profit.

43.5 Casual agent exemption

Section 835G ITA provides:

> (1) This section applies if a non-UK resident carries on (alone or in partnership) a business through an agent in the UK.
> (2) The agent is not the UK representative of the non-UK resident in relation to an amount within section 835E(2) arising to the non-UK resident from—
>
> (a) so much of the non-UK resident's business as relates to disregarded transactions, or
> (b) property or rights which, as a result of disregarded transactions, are used by, or held by or for, the agent on behalf of the non-UK resident.

(3) "Disregarded transactions" are transactions—
  (a) carried out through the agent in the UK, and
  (b) in respect of which the agent does not act in the course of carrying on a regular agency for the non-UK resident.

I call this "**the casual agent exemption**".

The INT Manual provides:

> **268020 Who can be the non-resident's UK representative?** [September 2011]
> Schedule 6 paragraphs 5-9 TIOPA 2010 and Subsections 835G-835K ITA 2007 (old section 127(1) FA 1995) lists the persons who cannot be the UK representative for income tax and capital gains tax:
> 1) Agents who are not regular agents. In general if a non-resident is trading in the UK through an agent that agent should be regarded as a regular agent. This was considered in the cases of *Neilsen Andersen v Collins* and *Tarn v Scanlan* (13 TC 121–2) when Scrutton LJ considered "the contrast intended to be drawn is between casual employment, temporary employment, for a transaction or few transactions, and regular appointment of a permanent agent who is there as representing the foreigner". ...

The former International Tax Handbook provided:

> **942. NRs: accepting TMA 70 s.82 exemption: regular agency**
> ... casual agents are protected from assessment. As a general rule if there is UK source income and there is an agent we would want to assess the agent. A non-resident trading here through an agent will usually clearly do so through a regular agency.
> It may be less clear whether an agent is a regular agent when he acts for his principal in only one transaction. This was the issue in the case of *Willson v Hooker* 67 TC 585. Acting for an Isle of Man company, Mr Willson instructed a firm of surveyors to bid for some land in the UK and instructed solicitors concerning the purchase and sale of the land. The Court said that a regular agency is any agency that is not a casual or occasional agency and that it was impossible to regard Mr Willson as a casual or occasional agent. He was the person through whom all the transactions of the company in the UK were carried out in the relevant period and so did not enjoy protection.

CT does not need the same exemption, as a casual agent is not within the concept of PE.

43.6 Subsidiary points

43.6.1 *HMRC procedures*

The INT Manual para provides:

> **268040 What assessments should be raised and how is that done?** [September 2011]
> As already explained above (INTM268030)) both the non-resident and their UK representative have a personal responsibility for the tax obligations and liabilities arising from the UK permanent establishment/branch or agency. Either party is able to discharge those obligations and liabilities. So we can assess either or both parties if necessary. Once one party has paid the personal responsibility on the other party lapses for that self assessment period. Obviously in cases where self assessments are returned by or for a non-resident taxpayer and tax payments are made at the appropriate times no further action would be needed. This guidance concerns the practicalities of how to handle cases where obligations and liabilities are not met.
> Because the UK representative is personally responsible for the non-residents tax obligations and liabilities, a unique tax reference should be allocated to the UK representative in that capacity. Where the UK representative is an agent (rather than a branch or fixed place of business permanent establishment) that unique tax reference should be a distinct and different reference to the one allocated to the agent for their own business. Non-resident companies intending to set up places of business in the UK are obliged to notify Companies House (see **Self assessment** at INTM261000). The consequential process in place automatically generates tax references and allocates them to the office responsible for the UK registered office address. Where that process has not happened, or for non-corporates, a taxpayer record with unique tax reference will need to be created on notification or discovery of liability.
> The High Court held in the case of *Tischler v Apthorpe* [2 TC 89] that a non-resident could be assessed directly "wherever he could be reached" including the UK branch address. The decision in that case was that an assessment raised directly on the non-resident at the UK branch address was valid, even though there was also a UK representative who could have been assessed under the machinery provisions (the TMA 1970 version *see* INTM268010). It is probably unusual for a non-resident to have both a physical UK branch and an appointed UK agent but the reasoning in that case supports the equal validity of assessments made on the non-resident either directly at their UK branch or at the overseas address. In that case, of course, the UK agent could not be responsible for the tax assessed as he had not been notified.
> So, on a practical level, assessments should be addressed in the manner most suited to the facts of the case and with the object of informing the relevant persons of the liability and securing the necessary payment of tax. Depending upon how near to expiry the assessing time limits are this could include any but possibly all of the following:
> Assessment for a branch or fixed place of business in the UK

Assessment for UK trade carried out through an agent
Partners and partnerships
Recovery action

Assessment for a branch or fixed place of business in the UK

- Assess in the name of the non-resident individual or company at the UK business address.
- Send a copy also, for information, to the non-resident's address abroad if known.
- Assess any person who clearly has the capacity of "UK representative" e.g. the manager of the UK operations, as "Mr X as UK representative of XYZ".

Assessment for UK trade carried out through an agent

- Assess in the form "Mr X as agent for XYZ" sent to the agent's address.
- Send a copy of the assessment on the agent, for information, to the non-resident at their address abroad if known.
- Assess the non-resident individual or company at their address abroad if known.

Partners and partnerships

Where the UK representative is a UK partnership the partnership itself is the UK representative. In such circumstances the partners in the UK partnership will be jointly liable for the tax payable by the non-resident. It follows that any assessment that is required should be made on the partnership as agent for the non-resident. Where a non-resident is a partner in a partnership which trades in the UK directly, typically through a UK branch or fixed place of business, the form of assessment depends on whether there is a partner resident in the UK. If there is a UK resident partner the assessment should be made on the partnership as a whole but the UK resident partner will be jointly liable for the tax payable by the entire partnership. Where there is no UK resident partner then assessments on the branch profits of the non-resident partners should be made on the UK branch of the partnership.

The SALF Manual provides:

704 UK representatives of non-residents chargeable under Case I and II Schedule D [February 2011]

General rule for the obligations and liabilities of UK representatives

The general rule is that UK representatives are jointly responsible with the non-resident for all the tax obligations and liabilities in relation to the trade, profession or vocation carried on through the branch or agency/permanent establishment.

This joint responsibility extends to all matters relating to the assessment of tax and to the collection and recovery of tax. For example, it extends to all the mechanisms of self assessment, including notification of chargeability, the obligation to make a tax return and self assessment, liability to make interim and final payments of tax, and liability to surcharges, interest and penalties in connection with those obligations and liabilities.

Either party is able to discharge the obligations and liabilities arising, but equally any acts or omissions of the non-resident are treated as acts or omissions of the UK representative (but see also the first two paragraphs under Offences below in relation to tax offences).
Where the trigger for an obligation or liability is the receipt of formal notification, then the obligation or liability only falls on the UK representative once they have received the relevant notification (or a copy).

43.6.2 *Notices and information*

Section 835V ITA provides:

(1) An obligation or liability attaching to a non-UK resident ("X") by reason of a notice or other document having been given or served on X does not also attach to the UK representative of X by virtue of section 835U unless the notice or other document (or a copy of it) has been given to or served on the representative.
(2) An obligation or liability attaching to X by reason of a request or demand having been received by X does not also attach to the UK representative of X by virtue of section 835U unless the representative has been notified of the request or demand.
(3) Subsection (4) applies to obligations relating to the provision of information that are imposed on the UK representative of X by section 835U in a case where the representative is X's independent agent.
(4) The obligations do not require the UK representative to do anything except so far as it is practicable for the representative to do so.
(5) For this purpose, the representative must act to the best of the representative's knowledge and belief after taking all reasonable steps to obtain the necessary information.
(6) An obligation of X to provide information is not discharged by virtue of section 835U in a case where the UK representative of X has discharged the obligation only so far as required by subsection (4) of this section.
(7) X is not bound by virtue of section 835U by mistakes in information provided by the UK representative of X in discharging, so far as required under subsection (4) of this section, an obligation imposed on the representative by section 835U unless—

(a) the mistake is the result of an act or omission of X, or

(b) the mistake is one to which X consented or in which X connived.

(8) In this section "information" includes anything contained in a return, self-assessment, account, statement or report required to be provided to the Commissioners for Her Majesty's Revenue and Customs or to any

officer of Revenue and Customs.

The SALF Manual provides:

> **704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]
> *Obligations and liabilities are limited where the UK representative is independent of the non-resident*
> Paragraphs 4 and 7 Schedule 23 FA 1995 & Section 148(3) and Section 150(5) FA 2003
> Where the UK representative is an independent agent of the non-resident acting in the ordinary course of business, its obligations to provide information are limited to ones within its competence to act for the non-resident.
> 'Independent agent' is defined at Paragraph 7 Schedule 23 FA 1995. The definition is based on that used in the OECD Model Tax Convention and UK double taxation agreements. Broadly, to be an 'independent agent', the agent must be both legally and economically independent of the non-resident. As an independent agent is not within the definition of permanent establishment for corporation tax purposes such an agent could not become the UK representative of a non-resident company.
> The rules recognise that, where the UK representative is an independent agent, the agent may not be able to provide complete information about the affairs of the non-resident. The agent is therefore required to provide any information requested, for example a return, to the best of its knowledge and belief after taking all reasonable steps to obtain the information. The non-resident remains responsible for completing or correcting the information where necessary.
> However, the non-resident can correct any error or omission made by the UK representative provided the non-resident did not know about it or participate in it.

43.6.3 *Criminal offences and penalties*

Section 835W ITA provides:

> (1) A person is not by virtue of section 835U liable to be proceeded against for a criminal offence unless the person— (a) committed the offence, or (b) consented to or connived in its commission.
> (2) An independent agent of a non-UK resident is not by virtue of section 835U liable to any civil penalty or surcharge in respect of an act or omission if conditions A and B are met.
> (3) Condition A is that the act or omission is not—

(a) an act or omission of the independent agent, or
(b) an act or omission to which the agent consented or in which the agent connived.

(4) Condition B is that the independent agent is able to show that the amount of the penalty or surcharge will not be recoverable out of the sums mentioned in section 835X(3) (after being indemnified for any other liabilities under section 835X).

The SALF Manual provides:

704 UK representatives of non-residents chargeable under Case I and II Schedule D [February 2011]
Offences
Paragraph 5 Schedule 23 FA 1995 & Section 150(6) FA 2003
The criminal and civil liabilities of a UK representative in respect of the non- resident's tax affairs are limited in certain circumstances.
UK representatives cannot be guilty of a criminal offence under these rules as a result of something done by the non-resident unless:
- they committed the offence
- consented to its commission, or
- connived in its commission.

The same applies for the non-resident in relation to the acts of the UK representative.
UK representatives who are independent agents are not liable to civil penalties and surcharges unless:
- they committed an act or omission or consented to, or connived in, its commission, or
- they will be able to recover the penalty out of monies of the non-resident.

43.6.4 *Indemnities*

Section 835X ITA provides:

(1) An independent agent of a non-UK resident is entitled to be indemnified for the amount of any liability of the non-UK resident which the agent has discharged by virtue of section 835U.
(2) An independent agent of a non-UK resident is entitled to retain, from the sums mentioned in subsection (3), amounts sufficient to meet any liabilities which by virtue of section 835U the agent has discharged or to which the agent is subject.
(3) The sums are those which—
(a) (ignoring subsection (2)) are due from the independent agent to the non-UK resident, or

(b) are received by the independent agent on behalf of the non- UK resident.

43.7 Independent agents, investment managers and brokers

An "independent agent" has three advantages:

(1) Lower information requirements; see 43.6.2 (Notices and information)

(2) Lower liabilities for penalties: see 43.6.3 (Criminal offences and penalties)

(3) A right to an indemnity: see 43.6.4 (Indemnities)

Section 835Y ITA provides the definition:

> (1) In this Chapter "independent agent", in relation to a non-UK resident ("X"), means a person who is the UK representative of X in respect of any agency in which the person is acting on behalf of X in an independent capacity.
>
> (2) For this purpose a person does not act in an independent capacity on behalf of X unless the relationship between them, having regard to its characteristics, is a relationship between persons carrying on independent businesses dealing with each other at arm's length.

This is based on the definition in the IME rules; see 44.6.2 (Investment manager condition C: independent relationship) and 86.6 (Independent agent exemption).

Investment managers and brokers may qualify for the IME exemptions, see 44.1 (Investment manager exemptions).

CHAPTER FORTY FOUR

INVESTMENT MANAGER EXEMPTIONS

44.1 Investment manager exemptions: Introduction

This chapter considers three related exemptions where an investment manager or broker ("**broker/IM**") acts for non-resident clients.

In order to understand the exemptions, it is helpful first to note the tax issues which a non-resident person would face (in the absence of relief) if it carried on a trade in the UK through a broker/IM. It is necessary to consider separately (1) a non-resident company and (2) a non-resident individual or trust.

In the absence of these exemptions, if a non-resident *company* carried on a trade in the UK through a UK broker/IM, the non-resident company would face a UK tax charge arising from the fact that it might be trading in the UK through a permanent establishment (e the broker/IM might be an agency PE). If so:

(1) The non-resident company would (in short) be subject to corporation tax on its profits.[1]

(2) The broker/IM would be a "UK representative" and that tax could be collected from it.[2]

Similarly, in the absence of these exemptions, if a non-resident *individual or trust* carried on a trade in the UK through a UK broker/IM, the non-resident would face a UK tax charge arising from the fact that it might be trading in the UK through a branch or agency (ie the broker/IM might be a branch or agency). If so:

(1) The non-resident individual or trust would (in short) be subject to income tax and CGT[3] on its profits.

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1 See 15.7 (Trading income of non-resident companies).

2 See 43.3 (UK representative).

3 See 49.8 (Non-resident trade with UK branch).

(2) The broker/IM would be a "UK representative" and that tax could be collected from it.[4]

Alternatively the position might be that the broker/IM was not a branch or agency or PE of the non-resident, but nevertheless the non-resident was trading in the UK. In that case (whether a company or an individual or trust) the non-resident person would in principle[5] be subject to income tax on its trading profits.

Clearly, if there were no relief, non-residents would not use a UK broker/IM (at least if there were a risk that their activities might be characterised as trading). The investment management exemptions override these tax charges. Assuming the various requirements are met the exemptions are as follows:

(1) A broker/IM is not a permanent establishment of a non-resident company. The main significance of this is:
   (a) to disapply the corporation tax charge which applies when a non-resident company trades through a UK PE.
   (a) to disapply the provisions allowing collection of tax from a PE (as its "UK representative").

   This exemption is in ss.1145-1151 CTA 2010. I refer to it as **"IME PE relief"**.

(2) A broker/IM is not a UK representative for IT and CGT. The main significance of this is to disapply the rules allowing the collection of IT/CGT from UK representatives of non-residents. This exemption is in chapter 2B part 14 ITA and chapter 7A TCGA.

   I refer to it as "**IME UK-representative relief".**

(3) UK source income generated through a broker/IM is one of the classes of income which qualifies for non-residents IT relief. This exemption is part of the code of non-residents IT relief set out in Chapter 1 Part 14 ITA.[6] I refer to it as "**IME non-residents IT relief**".

I refer to the exemptions together as "**the investment manager exemptions"** abbreviated to "**IME**". (References to investment managers in this label include brokers.) The term used in the HMRC Manuals is "investment management exemption", in the singular. They are however best regarded as three separate (though linked) exemptions.

The rules are written out *four* times in four different places. The rules

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4 See 86.13 (Why does branch/agency matter?).

5 In practice a DTA would often provide relief.

6 See 42.1 (Non-residents IT relief - Introduction)

for brokers are similar to investment managers, but are set out separately each time, so there are eight sets of rules. This does make a coherent exposition rather difficult. Where the rules repeat or overlap, I set out the text of IME non-residents IT relief, citing the statutory equivalents for the other rules in footnotes, unless there are material differences.

It would be simpler and shorter if branch/agency were abolished and the PE rules applied to non-companies as it does to companies.[7]

44.1.1 *The policy background*

SP 1/01 explains the policy considerations behind the investment management exemptions:

> 1. There are two policy objectives underlying the tax treatment of UK resident investment managers and their overseas clients. These objectives are that overseas investors should not be charged to UK tax in relation to investment transactions conducted on their behalf and that any fees earned by a UK resident investment manager for services performed for the non-resident should be fully chargeable to UK tax.
> 2. The UK tax system seeks to achieve these objectives by granting what is termed the Investment Manager Exemption. The exemption enables non-residents to appoint UK-based investment managers without the risk of UK taxation and is one of the key components of the UK's continuing attraction for investment managers. HMRC is committed to maintaining this environment by improving the exemption to meet developments in the investment management industry through providing greater flexibility and better explanations for investment managers and expanding the scope of exempt activities.

Other countries adopt the same approach:

> The highly mobile nature of the funds management business suggests that income from portfolio foreign investments flowing to non resident investors should not be taxed in Australia. Even modest amounts of Australian tax on these investors is likely to impede the growth of this business. Only the income of the Australian funds manager should be subject to Australian tax.[8]

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7 See 86.16 (Commentary: Let's abolish branch/agency).

8 This view is expressed in "A Platform for Consultation" (Australia) para 30.61 December 2010 accessible *http://www.rbt.treasury.gov.au/publications/paper3/index.htm*.

44.2 IME PE relief

I discuss IME PE relief in this chapter, though to see the topic in the round one needs to be familiar with the meanings and functions of PE, for which see 86.2 (Meaning(s) of "permanent establishment").

The key points to bear in mind for present purposes are as follows. Firstly, the term "permanent establishment" is used in different places with different definitions. It is strictly necessary to distinguish between:

(1) "**UK-law PE**" defined in s.1141 CTA 2010.

(2) "**OECD Model PE**" defined in the OECD Model.

Secondly, an independent agent is not a PE (**"the independent agent exemption"**). The wording of the independent agent exemption differs slightly between UK-law PE and OECD model PE so it is strictly necessary to distinguish between:

(1) "**UK-law independent agent exemption"** defined in s.1142 CTA 2010.

(2) "**OECD Model independent agent exemption**" defined in the OECD Model.

Section 1142 CTA 2010 provides:

> (1) A company is not regarded as having a permanent establishment in a territory by reason of the fact that it carries on business there through an agent of independent status acting in the ordinary course of the agent's business.
>
> (2) Sections 1145 to 1151 apply for the purpose of supplementing subsection (1) in relation to transactions carried out on behalf of a non-UK resident company by a person in the UK acting as—
>
> (a) a broker (section 1145),
>
> (b) an investment manager (sections 1146 to 1150)...

Section 1145 CTA 2010 provides IME PE relief for a broker:

> (1) This section applies if a transaction is carried out on behalf of a non-UK resident company in the course of the company's trade by a person in the UK acting as a broker.
>
> (2) In relation to the transaction, the broker is regarded for the purposes of section 1142(1) as an agent of independent status acting in the ordinary course of the broker's business if (and only if) each of conditions A to D is met. ...

Section 1146 CTA 2010 provides IME PE relief for an investment manager:

> (1) This section applies if an investment transaction is carried out on behalf of a non-UK resident company in the course of the company's trade by a person in the UK acting as an investment manager.
> (2) In relation to the investment transaction, the investment manager is regarded for the purposes of section 1142(1) as an agent of independent status acting in the ordinary course of the investment manager's business if (and only if) each of conditions A to E is met ("the independent investment manager conditions"). ...

If the conditions for IME PE relief are met:

(1) The broker/IM is not a UK-law PE.
(2) It will not normally matter whether the broker/IM is an OECD Model PE.[9]

If the conditions for IME PE relief are *not* met the broker/IM is not "an agent of independent status acting in the ordinary course of the investment manager's business" and does not qualify for the UK-law independent agent exemption. Thus the broker/IM may be a UK-law PE – if the general requirements of a PE are met, that is, if the broker/IM is "an agent acting on behalf of the non-resident company and has and habitually exercises there authority to do business on behalf of the company". In other words, failure to meet the conditions for IME PE relief disapplies the independent agent exemption, but does not automatically turn the broker/IM into a UK-law PE:

(a) If the broker/IM is not a UK-law PE, it will not normally matter whether the broker/IM is an OECD Model PE.
(b) If the broker/IM is a UK-law PE, it is possible that it is not an OECD Model PE, in which case treaty relief might apply.

These are the complications which arise from having distinct definitions of PE.

In short, IME PE relief offers a safe harbour, in which one can be reasonably sure of the tax position. SP 1/01 explains:

> 10. The Investment Manager Exemption legislation now only has relevance for corporation tax by providing greater clarity about what constitutes independence of investment managers in relation to the non-residents for which they act.

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9 For completeness: where the conditions for IME PE relief are met, (1) it is likely that the broker/IM qualifies for the is an OECD Model PE; (2) It is not likely that HMRC would seek to argue that the broker/IM is an OECD Model PE.

44.3 IME non-residents IT relief

I discuss the IME aspects of non-residents IT relief in this chapter, though to follow it one needs to be familiar with the background rules of non-residents IT relief, for which see 42.1 (Non-residents income tax relief). SP 1/01 explains:

> 10. ... For income tax [the investment manager exemption] raises the threshold for chargeability so that the same criteria apply when there is no treaty protection in the form of a permanent establishment article.[10]

For individuals and trustees, non-residents IT relief applies to "disregarded income".[11] This term includes "disregarded transaction income". This is where IME non-residents IT relief comes into play. For individuals and trusts, s.814(1)(2) ITA provides relief for a broker:

> (1) Subsection (2) applies if a non-UK resident carries on (alone or in partnership) a business through a broker in the UK.
> (2) Income is "disregarded transaction income", subject to subsection (6), if—
> (a) it is transaction income, and
> (b) the independent broker conditions are met in relation to the transaction in question.

For individuals and trusts, s.814(3)(4) ITA provides relief for an investment manager:

> (3) Subsection (4) applies if a non-UK resident carries on (alone or in partnership) a business through an investment manager in the UK.
> (4) Income is "disregarded transaction income", subject to subsection (6), if—
> (a) it is transaction income, and
> (b) the independent investment manager conditions are met in relation to the transaction in question.

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10 That is, IME non-residents IT relief provides roughly the same relief as article 7 OECD Model Treaty: "The profits of an enterprise carried on by a resident of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein."

11 See 42.6 (Disregarded income).

For non-resident companies the drafting is similar and the result is the same. Non-residents IT relief applies to "disregarded company income". Section 816 ITA provides:

> (1) For the purposes of this Chapter income arising to a non-UK resident company is "disregarded company income" if it is ...
>
> (c) income arising from a transaction carried out through a broker in the UK acting as an agent of independent status in the ordinary course of the broker's business,
>
> (d) income arising from a transaction carried out through an investment manager in the UK acting as an agent of independent status in the ordinary course of the investment manager's business, ...

44.4 IME UK-representative relief

I discuss IME UK-representative relief in this chapter, though to see it in the round one needs to be familiar with the UK representative rules, for which see 43.2 (Collection of tax from UK representative).

Section 835H ITA provides relief for brokers:

> (1) This section applies if a non-UK resident carries on (alone or in partnership) a business through a broker in the UK.
>
> (2) The broker is not the UK representative of the non-UK resident in relation to an amount within section 835E(2) if—
>
> (a) the amount is transaction income in relation to a transaction carried out through the broker in the UK on behalf of the non-UK resident, and
>
> (b) the independent broker conditions are met in relation to the transaction (see section 835L).

Section 835I ITA provides relief for investment managers:

> (1) This section applies if a non-UK resident carries on (alone or in partnership) a business through an investment manager in the UK.
>
> (2) The investment manager is not the UK representative of the non-UK resident in relation to an amount within section 835E(2) if—
>
> (a) the amount is transaction income in relation to an investment transaction carried out through the investment manager in the UK on behalf of the non-UK resident, and
>
> (b) the independent investment manager conditions are met in relation to the investment transaction (see section 835M).

44.5 Defined terms in IME exemptions

44.5.1 *"Investment manager"*

Section 827(1) ITA provides a commonsense definition:

> In this Chapter "investment manager" means a person who provides investment management services.[12]

An investment manager who merely gives advice would not be a PE. However an investment manager with discretionary management powers would be a PE, at least if the principal was carrying on a trade.

44.5.2 *"Broker"*

There is no statutory definition. The former International Tax Handbook provided:

> **926. NRs: Machinery of assessment: commodity markets: broker**
> A few words are called for about an important market operator, the broker. London has been a great market for centuries. Until a few decades ago vast amounts of produce were landed in, or trans-shipped in London docks and it was here and in other ports that the markets grew. They are run by Trade Associations which lay down rules designed to secure a fair, orderly and open market; to provide for membership, and to consider things like rates of brokerage. The actual constitution of the different markets varies but one would normally find as members some big producers, some major users, both of whom may have a seat in the market ring, the place of business. But the central character is the broker. A broker is a negotiator for commission, who will sell or buy for clients. Brokers have a long history, but, in modern usage, Bowstead, the writer of the standard work on agency, describes the broker in this way–
>
> "A broker is an agent whose ordinary course of business is to negotiate and make contracts for the sale and purchase of goods and other property of which he is not entrusted with the possession or control."[13]
>
> Payne, a writer on British Commercial Institutions, says this of an import broker–
>
> "The function of a broker is to bring two parties together for the purpose of concluding a contract. Brokers are generally produce brokers with whose aid very large transactions take place at the chief importing ports. They are often specialists who, through long experience of markets ... are able to buy and sell to better advantage than could the general import merchant ... he (the broker) is not associated with the physical movement of the goods, nor with clearing them through Customs. After selling a consignment by auction, or by private treaty, the broker is paid a commission or fee (brokerage) which, with the

12 The equivalent for IME PE relief is s.1150(1) CTA 2010.

13 *Bowstead and Reynolds on Agency*, (19th ed., 2013), 1.035.

other expenses of sale is deducted from the gross selling price."

Brokers are thus associated with the great commodity markets and exchanges, professional negotiators who will act for buyers and sellers and have nothing to do with the work-a-day business of handling or insuring the goods. They constitute an essential link in the market mechanism, in making the function of the market-place in determining price, available to their clients. Another odd quality of brokers is that the same broker can, by the custom of certain markets, act both for buyer and seller.

This means in practice that if A has asked a broker to sell something and B has asked the same broker to buy the same thing, the broker can match the two. The market rules would require that the broker does this business in the open (so that any other broker can step in if he wishes) and that preserves the idea of open market dealing and the natural protection which it gives to buyer and seller. Although the broker has acted for both parties the open nature of the market mechanism ensures that the price is a fair market price. ...

939 NRs: when to accept the TMA 70 s.82 broker exemption - General

Brokers and general commission agents take a very limited part in the marketing process. They are there to make the advantages of the market-place available to their clients. Whatever the terms mean, we do not accept as a broker or as a general commission agent a man who does everything the client himself would do in running the business were he himself here to do it, even if the agent acts for more than one client. Both expressions are primarily to do with commodity markets and that is what they were really intended for.

But over the years the application of the broker and general commission agent exemption has been extended. Stockbrokers, for example, will generally fall within Section 82(1) [TMA].[14] We have certainly accepted that there can be general commission agents and brokers in the field of shipping and that the exemption is sometimes appropriate. In insurance, on the other hand, we resist the suggestion that an underwriting agent can be a general commission agent. Insurance brokers will not normally be carrying on a non-resident's trade. If it seems that they do then they will arguably be acting in the capacity of underwriting agents and we would deny the exemption. If, in Districts, there are cases outside the usual commodity markets, where exemption under Section 82(1) appears to have been given but this treatment has not definitely and fairly recently, say within the last twenty years, been approved or condoned by International Division, it would be sensible to consider asking for advice on the next convenient occasion.

44.5.3 *"Transaction income"*

Section 814(5) ITA provides the definition:

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14 Section 82 (now repealed) provided: "Nothing in this Part of this Act shall render a non-resident person chargeable in the name of a broker ...In this subsection, 'broker' includes a general commission agent."

> In this Chapter "transaction income", in relation to a transaction carried out through a broker or investment manager in the UK on behalf of a non-UK resident, means income which arises to the non-UK resident from—
>
> (a) so much of the non-UK resident's business carried on (alone or in partnership) through the broker or investment manager as relates to the transaction, or
>
> (b) property or rights which, as a result of the transaction, are used by, or held by or for, the broker or investment manager on behalf of the non-UK resident.

44.5.4 *"Investment transaction"*

Section 827(2) ITA provides the definition:

> In this section "investment transaction" means any transaction of a description specified for the purposes of this section in regulations made by HMRC.[15]

The regulations are the Investment Manager (Investment Transaction) Regulations 2014.[16] A full discussion would be a lengthy affair.

The label "*investment* transaction" is not strictly appropriate because the transaction will be a *trading* transaction and the so-called investment will be trading stock;[17] but it does not matter.

44.6 Investment manager conditions

For IME non-residents IT relief, s.818(1) ITA provides:

> The independent investment manager conditions are met in relation to an investment transaction carried out on behalf of a non-UK resident by an investment manager in the UK if conditions A to E are met.

For IME PE relief, s.1146 CTA 2010 provides:

> (1) This section applies if an investment transaction is carried out on behalf of a non-UK resident company in the course of the company's trade by a person in the UK acting as an investment manager.

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15 IME PE relief equivalent is s.1150(1) CTA 2010.

16 The background can be traced in consultation and response papers "Investment Management Exemption and Collective Investment Schemes - expanding the 'white list'" (2013).

17 See 44.11.1 (Terminology).

> (2) In relation to the investment transaction, the investment manager is regarded for the purposes of section 1142(1) as an agent of independent status acting in the ordinary course of the investment manager's business if (and only if) each of conditions A to E is met ("the independent investment manager conditions").

I refer to these as "**investment manager conditions A to E**".

44.6.1 *Investment manager conditions A and B*: *Investment manager*

Section 818 ITA provides:

> (2) Condition A is that at the time of the transaction the investment manager is carrying on a business of providing investment management services.
> (3) Condition B is that the transaction is carried out in the ordinary course of that business.[18]

These are the equivalent of broker conditions A and B.

44.6.2 *Investment manager condition C: Independent relationship*

Section 818(4) ITA provides:

> Condition C is that, when the investment manager acts on behalf of the non-UK resident in relation to the transaction, the relationship between them, having regard to its legal, financial and commercial characteristics, is a relationship between persons carrying on independent businesses dealing with each other at arm's length.[19]

The requirement is equivalent to the rule that an independent agent is not a PE. According to the INTM, an agent's "legal financial and commercial characteristics" is relevant to determine whether the agent has "independent status" (so as to qualify for the independent agent exemption to the PE rule). So guidance on what is an independent agent for PE is relevant to condition C.[20]

This is imprecise, so the SP offers a bright line test which may offer a safe harbour for collective funds.[21] If the bright line test is not satisfied

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18 The equivalent for IME PE relief is s.1146(3)(4) CTA 2010.

19 The equivalent for IME PE relief is s.1146(5) CTA 2010.

20 See 86.6 (Independent agent exemption).

21 SP 1/01 provides: 36. The relationship will be considered to be independent if the non-resident has the following characteristics:
(a) the non-resident is a widely held collective fund or, if not,

one is back to the vagueness of the law:

> 41. If none of the above tests are satisfied HMRC will have regard to the overall circumstances of the relationship between the non-resident and the investment manager in determining whether they are carrying on independent businesses that

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(b) the non-resident is not a widely held collective fund but is either being actively marketed with the intention that it become one or is being wound up or dissolved.

37. A fund will be regarded as widely held if either no majority interest in the fund is ultimately held by five or fewer persons and persons connected with them, or no interest of more than 20% is held by a single person and persons connected with that person. The fund may need to establish a track record before new investors are obtained and will therefore have 18 months from the commencement of trading in the UK to meet the widely held test. Where investment management services are provided to a collective investment scheme constituted as a partnership, participants in the scheme will not be regarded as connected persons for this purpose if their only connection is membership of the partnership. This means that if the investment manager is a partner in the fund it will not be treated as connected with the other partners in the fund for the purpose only of the Independent Capacity Test, although there may still otherwise be connection under s 839 TA 1988/s 993 ITA 2007 between the participants, for example as partners in another capacity.

38. Actively marketed means there must be evidence of ongoing genuine attempts to obtain third party investment into the fund in order to meet the widely held test and that the terms on which interests in the fund are offered are not prohibitive or discriminatory for that class of business.

39. If the fund has one of the above two characteristics the independent capacity test will be met without the need to refer to any other factors.

40. In other cases the independent capacity test will be met:

(a) where the provision of services to the non-resident and persons connected with the non-resident is not a substantial part of the investment management business. Where that part does not exceed 70% of the investment manager's business, either by reference to fees or to some other measure (where that would be more appropriate), it will not be regarded as substantial. Further, if in the first 18 months from the start of a new investment management business the services provided to the non-resident exceed 70% of the business, they will not be treated as a substantial part of the business provided that they are consistently below 70% in subsequent periods.

(b) where the provision of services to the non-resident represents more than 70% of the investment manager's business 18 months after the start of a new investment management business but that was for reasons outside the manager's control and the manager had taken all reasonable steps to bring it below 70%. The investment manager will be expected to provide all relevant information to support a contention that the services are a substantial part of the manager's business for reasons beyond the manager's control and to demonstrate what steps have been taken to rectify that position.

deal with each other on arm's length terms. It is not possible to describe every scenario in which the relationship may still meet this test but the guidance in this Statement of Practice should provide certainty to the vast majority of non-residents trading in the UK through an investment manager and HMRC will also continue to provide advice for any other circumstances.

42. Some funds adopt a master/feeder structure. Where the investment manager manages an opaque master fund, eg a company, which has feeder funds then the independence test will be applied as if the master fund were transparent by looking at the beneficial ownership of each feeder fund to determine whether the master fund is independent.

43. Similarly, if the investment manager acts for one or more sub-funds owned by an umbrella fund it is the beneficial ownership of the latter that will determine whether the independence test is met.

44. It should be noted that a subsidiary may be considered independent of its parent company for the purposes of the test, notwithstanding the parent's ownership of the share capital.

44.6.3 *Investment manager condition D: 20% rule*

Section 818(5) ITA provides:

> Condition D is that the requirements of the 20% rule are met (see s.819).[22]

44.6.4 *Investment manager condition E: Customary remuneration*

Section 818 ITA(6) provides:

> Condition E is that the remuneration which the investment manager receives in respect of the transaction for the provision of investment management services to the non-UK resident is not less than is customary for that class of business.

This is the equivalent of broker condition C. It overlaps with investment manager condition C since an arm's length relationship would normally involve customary remuneration.

SP 1/01 explains the meaning of "customary remuneration":

> 60. The UK investment manager must receive remuneration at a rate that is not less than customary for the services. The legislation does not define what is "customary" nor does it specify from whom remuneration must be received although, as already explained, HMRC will not regard a UK investment manager as acting in an independent capacity on behalf of the non-resident unless the

22 See 44.7 (The 20% rule). The equivalent for IME PE relief is s.1146(6) CTA 2010.

relationship between them is that of persons carrying on independent businesses and dealing with each other at arm's length.

61. HMRC will be guided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations when determining whether a pricing structure applies the customary rate and will look at whether the net effect of any provision made or imposed by means of a transaction or series of transactions provides the UK investment manager with a level of remuneration which would have been achieved at arm's length. All circumstances will be taken into consideration, including whether that remuneration has been reduced below the arm's length rate in any way either before or after payment to the UK investment manager.

62. HMRC recognises that remuneration structures through which the non-resident pays fees in a particular class of investment management take numerous forms, with variations including, for example, investment terms intended to attract certain investors or to "lock in" an investment. The arm's length definition of customary rate for the independent investment manager means that such arrangements between unconnected parties would not jeopardise this test. Transactions made at arm's length may include directly or indirectly reduced or rebated fees for unconnected investors in the non-resident[.] Similarly, rebated, reduced or zero fee arrangements which are made between the manager and the unconnected non-resident for genuine commercial reasons, such as where the manager is receiving a separate fee in respect of the assets in which the non-resident is investing, would be regarded as transactions made at arm's length.

63. In determining whether remuneration has been reduced below the arm's length rate in any way HMRC will consider both the remuneration received by the UK investment manager and any amounts payable to any person:

– for services provided to the non-resident, or
– in connection with the non-resident, or
– that relate to the performance of the non-resident.

These amounts, which may be payable by either the non-resident or the UK investment manager, will be treated as reducing the remuneration received in the UK below the customary rate unless they can be shown to be at an arm's length rate.

64. HMRC consider that in order to meet the customary rate test fees payable to a UK investment manager should be recognised for UK tax purposes when earned. A cash payment may be deferred or reinvested in the fund but this should not affect the recognition of the fee income. As a result, the UK manager would pay tax on the fee for the period when earned and no difficulty with the customary rate test is envisaged in these circumstances. If cash settlement of management fees is deferred the manager may have effectively made a loan to, or investment in, the non-resident, as a result of which the return on that loan or investment would be attributable to the manager and may need to be taken into account for the 20% test.

Paras 64 onwards do not stand up to much examination.

65. Where a UK investment manager, a partner, director or employee of that

manager, or a person connected with any of these, acquires a security or an interest of some other kind, in the non-resident or in another entity, for services provided by the manager:

– to the non-resident, or
– in connection with the non-resident,

the customary rate test will only be met if it can be shown that the manager or partner brings the security or other interest into charge to UK tax at its market value or, in the case of a director or employee, that the security or other interest is taxed as employment income in accordance with Part 7 ITEPA 2003. The definition of "security" here will be that found in s420 ITEPA 2003. An interest is intended to apply to an interest in a security or securities and any other interest not within the s420 ITEPA definition.

66. Where an option is brought into UK tax charge at full market value at the time it is exercised HMRC will not regard this remuneration as less than the arm's length rate for the purposes of the customary rate test.

67. Preferential investment terms involving reduced or rebated fees for directors or staff of the investment manager may be a benefit provided by reason of employment and thus may give rise to an employee income tax charge under ITEPA 2003. Similarly, where the investment manager is a partnership, preferential fee terms may be offered to partners who acquire interests in the non-resident, in which case the ensuing personal tax consequences will apply. HMRC will not ordinarily regard these terms as reducing the investment manager's fees for services below the arm's length amount unless significant UK tax avoidance or evasion is suspected, in which case all the facts and circumstances will be considered to determine whether the rate of remuneration is below the arm's length amount.

68. The vast majority of non-residents easily meet the customary rate test. However, HMRC has occasionally encountered structures in which offshore arrangements have been used to evade or avoid UK tax. Commonly, such structures involve arrangements whereby fees charged to the non-resident are diverted to an offshore vehicle at a non-arm's length rate. Such arrangements represent an abuse of the exemption, place compliant[23] UK managers at a competitive disadvantage and may result in a non-resident failing to meet the terms of the exemption unless remedial action is taken.

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23 A note on terminology. The word "compliant" has become an essentially contested concept, that is, it admits of two distinct conceptions that are a battleground for profound substantive disagreements. HMRC use the term to mean those who comply with the legal rules of taxation *and* a more insubstantial spirit of the legislation (of which one suspects HMRC consider themselves the arbiter). This was a novel linguistic turn in 2001 and most practitioners would regard "compliant" as apt to describe everyone who comply with the legal requirements of taxation. Contrast the two views of the taxpayer/HMRC relationship discussed in 87.9 (Voluntary disclosure for sake of good relations with HMRC).

The SP then turns to consider what evidence may be required:

> 69. HMRC has published guidance in its International Manual on what documentation and evidence is required to demonstrate an "arm's length" reward. At the time of publication of this Statement that guidance appears at INTM483030 [August 2012] of the Manual which can be found at *http://www.hmrc.gov.uk/manuals/intmanual/intm483030.htm* and it is advisable to check that the most up to date advice is being followed.
> 70. The legislation considers the obligations and liabilities of the non-resident and whether the non-resident is exempt from UK tax on its UK trading profits. A non-resident may be a taxable person and in considering whether that is the case, and whether the UK agent has been rewarded with an arm's length rate, it may be appropriate in some circumstances for HMRC to ask for information such as statutory financial statements of the non-resident and its agents and a full and factual functional analysis of all services provided to the non-resident.
> 71. In circumstances where such information is requested to ascertain whether the remuneration has been at the customary rate HMRC would normally ask the UK investment manager, but in some circumstances may ask the non-resident, to provide such information as may reasonably be considered necessary. The information powers available to HMRC would include those relevant to the tax liabilities of the non-resident but where reasonable cooperation is provided by the UK investment manager and/or, where appropriate, the non-resident it is intended that a reasonable opportunity will be given to supply the information voluntarily before the use of information powers is considered.
> 72. Where appropriate documentation, including a factual functional analysis and an acceptable transfer pricing methodology, is in place to support a tax return, the investment manager will have an opportunity to agree an adjustment to the return to meet the customary rate test or for any other reason, or to have adjustments determined through litigation where such an agreement has not been reached, without the non-resident having thereby failed the customary rate test.
> 73. However, where the investment manager does not have the appropriate documentation and methodology in place at the time of making a return and the remuneration for that period is less than the arm's length rate, it is possible that the customary rate test has not been met. HMRC would expect the non-resident and the investment manager to ensure that adequate measures are taken to prevent the fund or its investors being exposed to UK tax and will give reasonable notice of possible action, and the reasons for it, to both the non-resident and its agents if it discovers any circumstances in which the non-resident may not have met the Investment Manager Exemption tests.
> 74. Each case will be considered on its own facts and it is possible that appropriate corrective action through adjustment to the customary rate will still enable the test to be met. It is not possible to describe every scenario but this general approach is intended to provide certainty on what the legislation requires and to reassure non-residents that a disproportionate outcome will not arise from a corrected failure to meet the test.

44.7 The 20% rule

Section 819(1) ITA provides:

> The requirements of the 20% rule are met if conditions A and B are met.[24]

I refer to these as "**20% rule conditions A and B**". Section 819(2) ITA defines condition A:

> Condition A is that in relation to a qualifying period[25] it has been or is the intention of the investment manager and the persons connected with the investment manager that at least 80% of the non-UK resident's relevant disregarded income should consist of amounts to which none of them has a beneficial entitlement.

Section 819(3) ITA defines condition B:

> Condition B is that, so far as there is a failure to fulfil that intention, that failure—
>
> (a) is attributable (directly or indirectly) to matters outside the control of the investment manager and persons connected with the investment manager, and
>
> (b) does not result from a failure by any of them to take such steps as may be reasonable for mitigating the effect of those matters in relation to the fulfilment of that intention.[26]

SP 1/01 provides:

> 48. The 20% test is treated as satisfied throughout any period, not exceeding five years, for which it is met in respect of the total taxable

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24 The equivalent for IME PE relief is s.1147(1) CTA 2010.

25 Section 820 ITA provides:

> "(1) This section applies for the purposes of this Chapter.
>
> (2) If section 819 applies for the purposes of section 813, a "qualifying period" means—
>
> (a) the tax year in which the transaction income is chargeable to income tax, or
>
> (b) a period of not more than 5 years comprising two or more tax years including that one.
>
> (3) If section 819 applies for the purposes of section 816, a "qualifying period" means—
>
> (a) the accounting period of the non-UK resident company in which the transaction in question is carried out, or
>
> (b) a period of not more than 5 years comprising two or more complete accounting periods including that one."

26 The equivalent for IME PE relief is s.1147(2)(3) CTA 2010.

income of the period arising from transactions carried out through the investment manager. It is also treated as satisfied if the manager intended to meet that test but failed to do so, wholly or partly, for reasons outside the manager's control, having taken any reasonable steps to fulfil that intention. This means that the manager must fulfil the intention to keep its beneficial entitlement within 20% of the total taxable income for the period insofar as it is reasonable to do so, but is not required to get within that figure at any cost, for instance where there are good commercial reasons for not achieving that.

44.7.1 *"Relevant disregarded income"*

For IME non-residents IT relief, s.821 ITA provides:

(1) This section applies for the purposes of this Chapter.
(2) If section 819 applies for the purposes of section 813,[27] the "relevant disregarded income" of the non-UK resident for the qualifying period is the total of the non-UK resident's income for the tax years comprised in the qualifying period which derives from the transactions mentioned in subsection (4).
(3) If section 819 applies for the purposes of section 816,[28] the "relevant disregarded income" of the non-UK resident company for the qualifying period is the total of the non-UK resident company's income for the accounting periods comprised in the qualifying period which derives from the transactions mentioned in subsection (5).
(4) The transactions referred to in subsection (2) are investment transactions—
  (a) carried out by the investment manager on the non-UK resident's behalf, and
  (b) in relation to which the independent investment manager conditions are met, ignoring the requirements of the 20% rule.
(5) The transactions referred to in subsection (3) are transactions—
  (a) carried out by the investment manager on the non-UK resident company's behalf, and
  (b) in relation to which the investment manager does not fall to be treated as a permanent establishment of the non-UK resident company, ignoring the requirements of the 20% rule.

Section 1148(4)(5) CTA 2010 provides the equivalent for IME PE relief in identical wording.

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27 This applies to individuals and trusts: see 42.6 (Disregarded income).

28 This applies to companies: see 42.6 (Disregarded company income).

44.7.2 *"Beneficial entitlement"*

For IME non-residents IT relief, s.822(1) ITA provides:

> This section applies for the purposes of this Chapter.

In fact the expression "beneficial entitlement" only appears in the 20% rule condition A, so the definition is only needed for that purpose.

> (2) A person has a "beneficial entitlement" to relevant disregarded income if the person has or may acquire a beneficial entitlement that is, or would be, attributable to the relevant disregarded income as a result of having an interest or other rights mentioned in subsection (3).
> (3) The interests and rights referred to in subsection (2) are—
> (a) an interest (whether or not an interest giving a right to an immediate payment of a share in the profits or gains) in property in which the whole or any part of the relevant disregarded income is represented, or
> (b) an interest in, or other rights in relation to, the non-UK resident.

Section 1148 CTA 2010 provides the equivalent for IME PE relief:

> (4) A person has a "beneficial entitlement" to relevant disregarded income if the person has or may acquire a beneficial entitlement that is, or would be, attributable to the relevant disregarded income as a result of having an interest or other rights mentioned in subsection (5).
> (5) The interests and rights referred to in subsection (4) are—
> (a) an interest (whether or not an interest giving a right to an immediate payment of a share in the profits or gains) in property in which the whole or any part of the relevant disregarded income is represented, or
> (b) an interest in, or other rights in relation to, the non-UK resident company.

44.7.3 *Position where 20% rule not met*

Section 823 ITA provides:

> (1) This section applies in the case of an investment transaction in relation to which the independent investment manager conditions are met, except for the requirements of the 20% rule.
> (2) This Chapter has effect as if the requirements of that rule were met in relation to the transaction but only in relation to—
> (a) so much of the transaction income of the non-UK resident as falls within subsection (3), if this section applies for the

purposes of section 813, or

(b) so much of the income of the non-UK resident company deriving from the transaction as falls within subsection (3), if this section applies for the purposes of section 816.

(3) Income falls within this subsection if it does not represent income—

(a) which is relevant disregarded income of the non-UK resident, and

(b) to which the investment manager or a person connected with the investment manager has or has had any beneficial entitlement.

SP 1/01 provides:

> 47. Where the 20% threshold is exceeded, the part of the income of the non-resident to which the investment manager and connected persons are beneficially entitled is excluded from the limitation of charge. The limitation of charge will apply to the part to which they are not beneficially entitled provided the other tests in the investment manager provisions are met.

Section 824 ITA (non-resident collective investment scheme) is not discussed here.

44.7.4 *HMRC practice on 20% rule*

SP 1/01 provides:

> 45. In essence the requirement is that the investment manager and persons connected with it, including connected charities, must not have a beneficial entitlement to more than 20% of the non-resident's chargeable profit arising from transactions carried out through the investment manager. The definition of connected persons is that in s 839 TA 1988/s 993 ITA 2007.
>
> 46. Management fees paid to the investment manager and persons connected with it are not included in the chargeable profit provided they would be allowable in computing the profit of the non-resident were it chargeable to UK tax. This applies equally to incentive fees, performance fees or incentive allocations which are calculated by reference to any increase in the net asset value or profits of the relevant non-resident. This treatment of incentive allocations is explained further below...
>
> 49. This is an example of how the test may be met throughout a period of five years:

Years	1	2	3	4	5
Taxable income of non-resident	£100	£200	£200	£250	£250
Entitlement of manager to above	£32	£58	£40	£35	£5
Expressed as percentage for each year	32%	29%	20%	14%	2%
Average % over qualifying period	32%	30%	26%	22%	17%

It may be assumed that the test is satisfied for year one because (a) in this example it was the manager's intention to have a beneficial entitlement to an average of 20% or less in aggregate over a five year period and (b) that intention was fulfilled. Had the 20% beneficial entitlement been achieved before the five years were up, then that shorter period would have been the qualifying period. A second qualifying period of up to five years could include years two, three, four, five and six and so on.

50. As with any other tests for the exemption, unless specified otherwise, the UK tax rules regard companies, including LLCs, as opaque and the FA 2003 rules apply, while partnerships are transparent and FA 1995 applies. In addition, the rule for non-resident companies at Schedule 26(5) FA 2003 treats partnership collective investment schemes in which they invest as assumed companies for the purposes of the 20% test.

51. In relation to a tax-transparent fund having overseas investors, the non-residents will be participants in the fund. In such circumstances the 20% test would be automatically broken where a non-resident participant is connected to the investment manager since this would mean that all the non-resident participants were connected under s 839(4) TA 1988/s 993(4) ITA 2007 by virtue of their being partners in the same partnership. The investment manager and connected persons would then be entitled to all the income of that non-resident. Accordingly, where the investment management services are provided to a collective investment scheme (as defined in the Financial Services and Markets Act 2000) the 20% test is applied by looking at the scheme as a whole rather than at the individual participators. It is not then relevant that the investment manager may be connected to the non-resident as partner (s 127(10) and paragraph 5 Schedule 26 FA 2003) or that the non-resident participants themselves carry on a financial trade as the availability of the exemption is instead tested solely by reference to the nature of the activities of the notional company represented by the scheme.

52. In certain circumstances the investment manager may be connected with the participants because both are partners in one or more partnerships which have an interest in the fund in question. Where the 20% test is failed as a consequence of aggregating the manager's income with that of certain partners who are not connected persons otherwise than as a result of s 839(4) TA 1988/s 993(4) ITA 2007, ie by being partners in a partnership, the failure will be regarded as a failure under s 127(4)(b) FA 1995 and paragraph 4(b) Schedule 26 FA 2003 to fulfil an intention to satisfy the test. But in certain situations that failure will be considered as—

(a) attributable to matters outside the control of the manager and persons connected with it; and
(b) as not being the result of a failure to take reasonable steps to mitigate the effect of those matters in relation to the fulfilment of that intention.

In those situations the 20% test will be met. The legislation will be applied in this way where:

– the connected persons are partners other than solely in a fund under consideration; and

– partnership is the only reason that the manager is connected with them.

This is a fudge to avoid undesirable consequences of the ultra-wide definition of connected person.[29]

> 53. Where overseas pension funds are set up under trust the trustees do not have beneficial ownership of the pension fund income although they may be the legal owners. The 20% test will not therefore apply where the trustee is connected to the UK investment manager. In practice it would be unusual for an overseas pension fund to be carrying on a financial trade. ...[30]
>
> 55. Some non-residents remunerate investment managers with profit or incentive allocations and in consultations HMRC, investment managers and advisors reached a consensus that these are performance fees in substance. As such, these are income in nature and where they are recognised by the UK manager as fee income the allocations may be treated as fees payable by the non-resident when computing the chargeable profit. Furthermore, where HMRC is satisfied that some of the allocations are due to an overseas service provider as remuneration for those services at the arm's length rate those allocations will have the same treatment in computing relevant excluded income.
>
> 56. Deferred fees, or securities or interests provided as reward, may in turn generate some form of return. The legislation draws no distinction between the forms in which the profits of the fund are attributed to deferred fees or other investments as the test is based on beneficial entitlement to the chargeable profits of the non-resident and if the manager's beneficial entitlement to those profits, including the return on the securities, interests or deferred fees, exceeds 20% the test will not have been met.
>
> 57. Options to acquire any securities or interests in the non-resident, within the meanings at s 420 ITEPA 2003, need only be considered in the context of the 20% test when the options are exercised.
>
> 58. Some investments in a non-resident may be linked to structured products issued to customers which provide a return based on the performance of the non-resident, an example of which would be a bank investing in a non-resident fund and selling a product to a customer on which the return is linked to the performance of the fund. In such circumstances the beneficial entitlement to the income of the non-resident remains with the investor in the non-resident, in this example the bank, and not the holder of the structured product, ie the customer.

44.7.5 *Interaction of the 20% test and the independence test*

SP 1/01 provides:

> 59. The independence test and the 20% test apply quite separately. For example, a UK investment manager acts for an overseas trading fund

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29 See 85.7.3 (Commentary: An excessively wide definition).

30 The paragraph omitted here discusses "control"; see 85.3.2 (Control over a company's affairs).

constituted as a company. If the investment manager is not acting in an independent capacity in relation to the fund company then the whole of the income of the fund is liable to assessment. If the independence test is satisfied, then the 20% test must be separately addressed. If the investment manager's interest in the fund company is 25% then that share of the fund's trading income is liable to assessment.

44.8 Independent broker conditions

Section 817 ITA provides:

> (1) The independent broker conditions are met in relation to a transaction carried out on behalf of a non-UK resident by a broker in the UK if—
>
> (a) conditions A to D are met, if this section applies for the purposes of section 813 [individuals/trustees], or
>
> (b) conditions A to C and E are met, if this section applies for the purposes of section 816 [companies].

I refer to these as **"broker conditions A to E"**.

44.8.1 *Broker conditions A and B: Broker's business*

Section 817 ITA provides:

> (2) Condition A is that at the time of the transaction the broker is carrying on the business of a broker.
>
> (3) Condition B is that the transaction is carried out in the ordinary course of that business.

The former International Tax Handbook provided:

> **940. NRs: accepting TMA 70 s82 broker exemption: in course of business**
>
> The exemption in Section 82(1) applies only to transactions which the broker carries out (on behalf of the non-resident) "in the ordinary course of his business as such". In modern times it has become common for brokers to extend their business beyond mere "broking" but it does not follow that, just because what they do is now customarily done by brokers, they do it in the ordinary course of their business as brokers. Thus stockbrokers and commodity brokers often provide investment management schemes for clients. But investment management does not thereby become an ordinary function of a broker. However, there are special provisions for investment managers which are considered in ITH951.

44.8.2 *Broker condition C: Customary remuneration*

Section 817(4) ITA provides:

> Condition C is that the remuneration which the broker receives in respect of the transaction for the provision of the services of a broker to the non-UK resident is not less than is customary for that class of business.

44.8.3 *Broker condition D: UK representative*

Section 817(5) ITA provides:

> Condition D is that the broker does not fall for the purposes of Chapter 2B of this Part, or of Chapter 1 of Part 7A of TCGA, to be treated as a UK representative of the non-UK resident in relation to
> [1] any other income which is chargeable to income tax, or
> [2] amounts which are chargeable to capital gains tax,
> for the same tax year as the transaction income.

This condition applies to individuals/trustees and not to companies.

44.8.4 *Broker condition E: Permanent establishment*

Section 817(6) ITA provides:

> Condition E is that the broker does not fall to be treated as a permanent establishment of the non-UK resident company in relation to any other transaction of any kind carried out in the same accounting period of the non-UK resident company as the transaction in question.

The wording is the equivalent of broker condition D for companies (using the company tax concept of PE rather than the individual/trustee concept of branch/agency).

44.9 Transactions through brokers

Section 828 ITA provides:

> (1) For the purposes of this Chapter a person is regarded as carrying out a transaction on behalf of another if the person—
> (a) undertakes the transaction, whether on behalf of or to the account of the other, or
> (b) gives instructions for it to be so carried out by another.
> (2) In the case of a person who acts as a broker or investment manager as part only of a business, this Chapter has effect as if that part were a separate business.

44.10 Relevance of financial trading to IME

The question whether the non-resident client is trading is crucial for the IME. Unless the non-resident client is trading, the three IME exemptions are not needed:

(1) In the absence of a trade, a non-resident company is not subject to CT even if it has a permanent establishment and so the company does not have to rely on IME PE relief.

(2) In the absence of a trade, there can be no UK representative and the non-resident does not need to rely on IME UK-representative relief.

(3) In the absence of a trade, non-residents may qualify for non-residents IT relief and do not have to rely on IME non-residents IT relief.

SP 1/01 acknowledges this:

> 14. The Investment Manager Exemption legislation has no relevance unless the non-resident is trading in the UK.
> 15. If the transactions carried out through the investment manager are part of the trade carried on by the non-resident then, unless the [IME] tests ... are satisfied the income from that trade, including any profit from the realisation of securities, etc, is taxable. ...

44.11 When is there a trade in financial assets?

"Trade" has no short definition and the general question of what a trade is needs a book to itself. The question discussed in this section is when there is a trade of dealing in securities, options and futures (which I shall abbreviate to securities or "financial assets" or "financial transactions"). The trading/non-trading distinction here is important, for individuals, trusts and non-resident companies, but it is elusive.

44.11.1 *"Investment": Terminology*

"Investment" or "investing" is a word with several meanings.[31]

In one sense all securities are "investments". We have investment managers, investment brokers, investment companies or trusts. This is a convenient and common usage. However various distinctions are

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31 For discussion of this terminology in a commercial context see Graham & Dodd, *Security Analysis* (6th ed., 2009), chap 4 (distinctions between investment and speculation). For discussion in a UK tax context, see Kessler and Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013), para 5.9 ("Investment") (online version *http://www.taxationofcharities.co.uk*).

sometimes drawn which narrow the meaning of "investment".

In a tax context, one ought to distinguish between:

(1) investing in securities and

(2) *trading* in securities. (In tax terminology "dealing" is an informal synonym of trading, but I think it is clearer to use the statutory term.)

In correct tax terminology a trader is not "investing" and holds securities as trading stock and not as "investments". I stress this because one sometimes finds the word "investment" used in a trading context.[32] This is not surprising because in the finance industry, the terms "investing", "trading" and "dealing" are all used as synonyms, because for brokers and investment managers this distinction is irrelevant.

A distinction is sometimes drawn between:

(1) investing in securities and

(2) gambling or speculating.

I discuss the meaning of "gambling" and "speculating" below. The important point here is that gambling or speculating (whatever that means) is not (in this sense) investing.

In the absence of trade, the matter is usually investment, and the trading/non-trading tax distinction can be described as a trading/investment distinction. This is doubted in *Wannell v Rothwell* 68 TC 719 at p.730:

> [Counsel for HMRC] mildly criticised para 11 for having posed the question 'trade or no trade?' but then, having treated that as equivalent to 'trade or investment?' I think there is some force in that criticism, since the word 'investment' has many shades of meaning, both in taxing statutes and elsewhere, and it is not used in the statutory provisions now under consideration.

This is strictly correct. It is possible to acquire financial assets in a manner which is not trading but which is not necessarily described as investment. (In particular, financial transactions have sometimes been described as "gambling" and classified as neither trading nor investment.) However, for most practical purposes that can be disregarded, and in the present context,'trade or no trade?' can be regarded as equivalent to 'trade or investment?'.

This discussion of terminology does not identify the dividing line between trading and investment, but it is an essential start if we are to

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32 See 44.5.4 ("Investment transaction").

know what we are talking about.

44.11.2 *Principles*

The principles are summarised in *Cooper v C & J Clark*:

> [1] First, marketable securities, being income-yielding assets usually capable of appreciating in value, are prima facie purchased and sold by way of investment and not by way of trade.
> [2] Secondly, a series of purchases and sales may sometimes, if carried out pursuant to a deliberate and organised scheme of profit-making, amount to a trade.
> [3] Thirdly, it is easier to characterise a series of purchases and sales as a trade in a case where they are made by a trading entity[33] as opposed to an individual.
> [4] Fourthly, in the case of a trading entity that characterisation is more easily made where the purchases and sales are substantial in relation to its other activities, all the more so where they are of frequent occurrence and extend over a long period of time.[34]

This is uncontentious and helpful as far as it goes.

44.11.3 *"Speculative" transactions*

Cooper v C & J Clark continues:

> Fifthly, it is sometimes helpful, although not decisive, to ask whether a series of sales and purchases is speculative or not. The reason why the question is sometimes helpful is that the answer may throw light *in one direction or the other,* but it is not decisive because according to the circumstances either a trade or a course of investment may be speculative.[35]

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33 By "trading entity" it is not entirely clear whether the judge had in mind:
(1) an entity actually carrying on a trade (such as the taxpayer company in *C&J Clark*, which was manufactured shoes); or
(2) any company with articles authorising it to carry on a trade, whether or not it carries on any activity apart the transactions in financial assets.
The general rule is that it is easier to characterise a series of purchases and sales as a trade in any case where they are made by any company with articles authorising it to carry on a trade. See 44.11.4 ("Gambling" and distinction between individuals and companies).

34 54 TC 670 at p.676.

35 54 TC 670 at p.676; emphasis added.

What does speculative mean? Graham and Dodd canvas various possible definitions, and suggest the following "as in harmony with the popular understanding of the term and the requirements of reasonable precision":

> An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.[36]

In particular, a financial transaction is described as "speculative" if it is risky and especially if the purchaser stands to make or lose money depending on how the market moves in the short term.

In that sense, financial transactions are often if not mostly speculative (though it is a question of degree and some transactions are more speculative than others).

The passage from *C&J Clark*, while describing the issue of whether a transaction is speculative as "sometimes helpful" does not inform us whether a positive answer supports a conclusion of trading or non-trading, which somewhat undermines the helpfulness of the question. It is considered that to ask whether a transaction is speculative in the sense of high-risk is rarely if ever going to be helpful. See *Lewis Emanuel v White*:

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36 Graham & Dodd, *Security Analysis* (6th ed., 2009), p.106.
Fred Schwed Jr gives a similar explanation of this vague word in *Where are the Customers' Yachts?* (1940) Chapter 8:
"Investment and speculation are said to be two different things, and the prudent man is advised to engage in the one and avoid the other. This is something like explaining to the troubled adolescent that Love and Passion are two different things. He perceives that they are different, but they don't seem quite different enough to clear up his problems.
Investment and speculation have been so often defined that a couple more faulty definitions should do no harm, the science of economics having reached a point where further confusion is impossible. Thus,
- Speculation is an effort, probably unsuccessful, to turn a little money into a lot.
- Investment is an effort, which should be successful, to prevent a lot of money from becoming a little.

If you take a thousand dollars down to Wall Street and attempt to run it up to $25,000 in the course of a year, you are speculating. If you take $25,000 down there and attempt to earn a thousand dollars a year with it (by buying twenty-five four per cent bonds) you are investing. ..."
Sometimes the word "speculative" is used to describe a transaction made with a view to profit (as opposed to a transaction intended to hedge a financial risk). In that sense it is relevant to ask whether a transaction is speculative, since different principles apply to hedging transactions, but hedging is a rather special case.

> The word 'speculation' is not, I think, as a matter of language, an accurate antithesis either to the word 'trade' or to the word 'investment': either a trade or investment may be speculative.[37]

44.11.4 *"Gambling" and distinction between individuals and companies*

In order to avoid confusion, it is essential to bear in mind that the word "gambling" may be used in two senses.

In the strict sense:

(1) gambling[38] contracts were unenforceable; and

(2) gambling activity is not a trade.

I refer to this as "**the gaming/wagering sense"**. The Gambling Act 2005 abolished the former contract law rule that gaming/wagering contracts were unenforceable.[39] However the rule remains that the activity of gaming/wagering is not a trade and the profits (if any) are not subject to income tax;[40] or CGT.[41]

In a loose sense, "gambling" means (more or less) the same as speculative, in the sense discussed above: that is, high-risk. I refer to this as **"the loose (high-risk) sense"**. Thus the purchase of a future or option, say, may constitute gambling in the loose (high-risk) sense, but it is not gambling in the strict (gaming/wagering) sense.

In *Lewis Emanuel v White* the Judge said:

> ... it is certainly true, at any rate in the case of an individual, that he may carry out a whole range of financial activities which do not amount to a trade but which could equally not be described as an investment, even upon a short-term basis. These activities include betting and gambling

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37 42 TC 369 at p.377; this passage was cited with approval in *Wannell v Rothwell* 68 TC 719 at p.730.

38 Also called gaming, wagering and betting.

39 Section 63 Financial Services Act 1986 had already substantially restricted the rule that bets on stock market movements were void.

40 *Hakki v Secretary of State for Work and Pensions* [2014] EWCA Civ 530.

41 Section 51(1) TCGA. The reason for IT/CGT exemption is (1) that losses are generally more likely than profits, and one could not tax profits without allowing some relief for losses; (2) betting duty may apply instead.
In relation to financial bets (as opposed to betting such as sports betting) the commercial effect of a bet is (more or less) the same as a cash settled option or future, so the existence of two separate tax regimes is somewhat odd; but there it is. For spread betting, see 11.15.14 (Betting).

> in the narrow sense. They also include, it seems to me, all sorts of Stock Exchange transactions. For want of a better phrase, I will describe this class of activities as gambling transactions.

It seems a little strange to describe "all sorts of stock exchange transactions" as gambling, but the passage makes sense if one bears in mind that it was written in 1965, when the cult of the equity had only just begun, and before it had received judicial notice.[42] Before then, the only assets recognised as investments were gilts and mortgages, and stock exchange transactions would not be regarded as investments: they were felt to be too risky. They would not naturally be regarded as trading, so they were put into the category of non-trading non-investments.

It is considered that to ask whether or not the transactions are gambling (in the loose (high-risk) sense) is the same as to ask whether or not the transactions are speculative: it can never be helpful in determining whether or not transactions are to be classified as trading.[43]

This line of thinking is however the historic basis for the rule that the test for whether a company is trading is different from the test of whether an individual is trading, and that companies are more likely to be trading than individuals. The reason for the rule is said to be that companies (unlike individuals) are usually entitled only to trade or to invest. They cannot carry on non-trading non-investment activities of the kind that the judge categorised as "gambling" (in the loose (high-risk) sense). The judge continued:

> It seems to me, however, that in general it is much more difficult to bring the activities of a company within this class of gambling transactions. An individual may do as he pleases: a corporation must act within the limitations of its memorandum of association. All companies have power to invest; many companies have power to deal [ie trade] in securities; few companies can have power to enter into gambling transactions - i.e., by [the judge's] definition, transactions otherwise than by way of investment or trade. Where a transaction can be brought within the scope

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42 *Sinclair v Lee* [1993] Ch 497 at p.512: "The cult of the equity ... did not really begin until the mid or late 1950s."

43 Of course (in the absence of trade) it does not matter for individuals whether one describes financial transactions as investment or as gambling (in the loose high-risk sense), since the tax consequence is the same: the profits are subject to CGT and not IT.

> of an authorised object - e.g., investment or dealing - one would not readily treat the transaction as having been carried out ultra vires in pursuit of an unauthorised object - e.g., gambling. In other words, one expects a trading company's activities, apart from capital investment, to be by way of trade.

The reasoning is now invalid:

(1) Nowadays one would not readily describe conventional stock exchange transactions as "gambling" even in the loose (high-risk) sense.

(2) Companies powers have increased.

The BI Manual notes point (2). It cites *Lewis Emanuel v White* and comments:

> **BIM56870 - Measuring the profits (particular trades): Financial traders - instruments and shares: case law and companies** [December 2013]
>
> **...Recent developments**
>
> Since the Lewis Emanuel case was heard, company law has been amended. S39 Companies Act 2006 now says:
>
> > 'The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution.'
>
> Furthermore, there is judicial approval for the right of a company to engage in speculative transactions. In *Hazell v Hammersmith & Fulham London Borough Council* [1991] 2 WLR 372 at p.372, Lord Templeman said:
>
> > 'There are many trading and currency and commercial swap transactions which eliminate or reduce speculation. Individual trading corporations and others may speculate as much as they please or consider prudent.'
>
> Although it is unlikely that a company would ever enter into a gambling transaction, there is no reason why its activities could not include speculative transactions which, while not being investments, might also not amount to trading.

It is considered that the rule continues to be valid that companies (assuming their articles authorise trading) are more easily held to be trading than individuals.[44] However the basis of that rule cannot now be the reason given in *Lewis Emanuel* (that the transactions carried out by

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44 See 44.11.2 (Principles) item [3].

individuals should generally be classified as non-trading non-investment transactions but companies, unlike individuals, must either trade or invest, so they are more likely to be trading). One could simply say that the rule is now established and continues to hold even if its reasons have ceased to be sound. However, if needed the rule has another, sounder basis. This is that one badge or indication of trade is "trading structure" and companies (if their articles authorise trading) have that element of "trading structure" which individuals do not.

Since different tests apply to determine whether companies and individuals are trading, I consider the cases for individuals and for companies separately.

44.11.5 *Trading by individuals*

There have been four UK cases discussing whether individuals are trading in financial assets. The first is *Salt v Chamberlain* 53 TC 143 where Oliver J said:

> Where the question is whether an individual engaged in speculative dealings in securities is carrying on a trade, the prima facie presumption would be, as Pennycuick J. suggested in the Lewis Emanuel case 42 TC 369, that he is not. It is for the fact-finding tribunal to say whether the circumstances proved in evidence or admitted take the case out of the norm.

In *Salt v Chamberlain* the individual relied on the following matters to justify a conclusion of trading. There was a relatively large number of transactions, about 50 sale/purchase transactions per annum, over a four-year period. A substantial proportion of the transactions concerned options (rather than securities yielding income). One-third of purchases and sales were within the settlement period, and many others were within a short period thereafter. The purchases were financed in part by borrowing. On these facts the General Commissioners found that the taxpayer was not trading, and on appeal the judge held that the Commissioners were entitled to reach that conclusion.

A similar approach was applied in Hong Kong Inland Revenue Board of Review Decision *Case No. D 42/90.* The following aspects of the matter might have justified a conclusion of trading. The individual's transactions were in Hang Seng Index futures contracts which had a short lifespan and produced no income. The individual ran an "active" account (the number of transactions is not recorded). The Board held that the taxpayer was not

trading.[45]

The next UK case is *Wannell v Rothwell* 68 TC 719. In this case there were about 60 sale/purchase transactions per annum. The assets traded were shares and commodities. Some of the money used was borrowed. The taxpayer was aiming at quick profits and had no intention of taking possession of the commodities or (with rare exceptions) of holding shares. The Special Commissioner did not decide whether the taxpayer was trading, but the Judge found that the Special Commissioner would have been "almost bound" to reach the conclusion that the taxpayer was trading. I think it was significant that the underlying assets included commodities as well as securities.

In assessing the significance of the turnover of assets, one should in my view take into account that it is, I think, more common now to actively manage a portfolio than it was in the past. The most recent UK case is *Manzur v HMRC* [2010] UKFTT 580 (TC) where transactions numbered between 240 and 300 for the year, and shares were sometimes held for as long as six months. This was held to be investment, not trade.

Business Income Manual provides:

> **BIM56850 - Measuring the profits (particular trades): Financial traders - instruments and shares: case law and individuals** [Dec 2013]
>
> In the past, the approach taken in deciding whether a company is carrying on a trade of buying and selling shares and other financial instruments has been different from that adopted for individuals.
>
> [The Manual cites the passage from *Lewis Emanuel v White* 42 TC 369 discussed above[46] and continues:]
>
> For companies, however, the position was different. Pennycuick J said:
>
> > 'it is much more difficult to bring the activities of a company within the class of gambling transactions. An individual may do as he pleases: a corporation must act within the limitations of its

45 Accessible *http://www.info.gov.hk/bor/eng/pdf/dv5_second/d4290.pdf*.
For completeness, I should also mention *Manzur v HMRC* [2010] UKFTT 580 where the individual carried out between 240 and 300 transactions each year; this was described as "not numerous" and held not to be trading. However no weight should be given to this brief first tier tribunal decision, in which the taxpayer was not represented by Counsel and the taxpayer's best case *Wannell v Rothwell* was not cited.

46 See 44.11.3 ("Speculative" transactions) and 44.11.4 ("Gambling" and distinction between individuals and companies).

> memorandum of association…where a transaction can be brought within the scope of an authorised object - e.g. investment or dealing - one would not readily treat the transaction as having been carried out ... in pursuit of an unauthorised object e.g. gambling. In other words, one expects a trading company's activities, apart from capital investment, to be by way of trade.'

Pennycuick's view that, for individuals, share transactions could amount to investment, trading, or speculation falling short of trading, was followed in *Salt v Chamberlain* [1979] 53TC143. Oliver J said:

> 'Where the question is whether an individual engaged in speculative dealings in securities is carrying on a trade, the prima facie presumption would be, as Pennycuick J suggested in the Lewis Emanuel case, that he is not. It is for the fact finding tribunal to say whether the circumstances proved in evidence or admitted take the case out of the norm.'

So for individuals we take the view that transactions in shares which do not amount to investment are speculative transactions falling short of trading, unless there are particular factors which take the case 'out of the norm'. There is more on this at BIM56860.

Shares which are dealt with speculatively or as investments are dealt with under the Capital Gains Tax rules. For futures, options, and contracts for difference (including swaps), see BIM56880 and BIM56900.

There is more on the treatment of companies at BIM56870.

The rule that an individuals' transactions are not generally trading is sound; see 44.11.4 ("Gambling" and distinction between individuals and companies).

The BI Manual continues:

> **BIM56860 - Measuring the profits (particular trades): Financial traders - instruments and shares: three cases involving individuals** [Dec 2013]
>
> An activity of buying and selling shares and other financial instruments undertaken by an individual will normally amount to investment or speculation falling short of trading unless there are factors which take the case 'out of the norm' (see BIM56850). Three cases where such activities have been considered are:
>
> *Salt v Chamberlain* [1979] 53TC143,
>
> *Wannell v Rothwell* [1996] 68TC719, and
>
> *Manzur v HMRC* [2010] UKFTT 580(TC).
>
> **Salt v Chamberlain**
>
> The Commissioners in this case found that Mr Salt was not trading, and

Oliver J held in the High Court that the facts entitled the Commissioners to come to this conclusion.

Mr Salt was a mathematics graduate who used his knowledge of computers to forecast the movements in share prices. In the period 11 December 1968 - 31 March 1973 he entered into approximately 200 transactions for the purchase and sale of securities, which included put and call options and settlements at the end of an account for balances only. He used his own funds as well as borrowings from the bank and against life assurance policies.

Wannell v Rothwell

Mr Wannell had previously worked for a commodity futures dealer as a trader prior to the commencement of his activity. His duties had included advising clients on long-term investments and short-term trading opportunities in commodity futures and options. He had obtained qualifications relevant to his duties and, in the course of his own activity, had access to market reports and analysis but not a full screen service. All the transactions were placed with a broker. There were 11 purchases and sales of commodities between May and October 1986 and 46 purchases and 49 sales of shares between October 1985 and August 1987. He dealt on his own account and there were no customers.

The Deputy Special Commissioner said:

> 'The essential point in the present case is that of organisation. Was the Appellant, doing two or three deals a month from home through brokers, but doing them with the benefit of experience, training and contacts which he had, organised in a way that a trader could be said to be organised? The case is very close to the borderline, and if the only question I had to decide were whether the Appellant was trading, I might be inclined to give him the benefit of the doubt and find that he fell, by a hair's breadth, on the trading side of the dividing line.'

This case considered not only the question of whether Mr Wannell was trading but whether he was trading commercially for the purposes of relief for losses (see BIM85705), and the Deputy Special Commissioner concluded that:

> 'a case which is so close to the trading borderline because of its lack of commercial organisation is bound to be on the wrong side of the [loss relief] borderline.'

When this case came before the High Court, Robert Walker J found that the Deputy Special Commissioner must be taken to have found that Mr Wannell was trading, but also that he had had sufficient evidence before him to come to the conclusion that the activity was not carried on

commercially, so the losses could not be set off against general income. There is more information on losses in this context at BIM85705.

Manzur

Mr Manzur was a retired surgeon. He used his own savings to begin acquiring stocks and shares. He made between 240 and 300 trades in a year using an online stockbroker. Some of the shares were turned over very quickly but others were retained for six months or more.

The tribunal held that Mr Manzur's buying and selling amounted to the management of a portfolio of investments rather than trading. They upheld the view in Salt v Chamberlain that the badges of trade were of limited value and said there was no definitive checklist which could be used to say whether someone was trading or not. The number and frequency of transactions, and the short-term nature of the holdings alone did not establish trading. Other factors taken into account were:

- the time spent on the activity (about two hours a day);
- the fact that Mr Manzur did not entirely rely on his own expertise but used the advice of brokers;
- that the activities were not characteristic of established share dealers, for example Mr Manzur had no customers and was dependent on market movements alone to make a profit.

Conclusion

The cases discussed above show that no one factor can determine whether an activity has been taken 'out of the norm'. Some factors may be more relevant in some cases than in others. You have to take a view after considering the relevant circumstances as a whole.

44.11.6 *Trading by trustees*

There are no tax cases on whether trustees of a private trust are trading, but it is considered that their position is in principle similar to individuals. In *Smith v Anderson* (a non-tax case discussing an early unit trust) James LJ said:

> In my opinion, nothing that is to be done under this deed by the trustees comes within the ordinary meaning of "business", any more than what is done by the trustees of a marriage settlement who have large properties vested in them, and who have very extensive powers of disposing of the investments, changing the investments, and selling them and reinvesting in other investments, according to their discretion and judgment ... That is not a business. No doubt there is power ... to dispose of the investments and reinvest in some similar securities ... This appears to me to be no more than the power of varying investments which you

would find in an ordinary trust deed ...[47]

44.11.7 *Trading by companies*

There have been two cases discussing whether companies are trading in financial assets. Each concerned a trading company using spare cash to carry out stock exchange transactions.

In *Lewis Emanuel v White* 42 TC 369 the company carried out over 100 transactions per annum (described as "a very large number"). The majority were sold in the same year, often within a matter of weeks. It was held that the only possible conclusion was one of trading.

In *Cooper v C & J Clark* 54 TC 670 the company made only 13 transactions over nine months. The commissioners findings of trade were upheld, though only just (the judge would not have found there was a trade). So I think we can say that is an example of a non-trade.

It is considered the company's own classification of its activity as trading/non trading (in the company's constitution, board resolutions and accounts) is a matter of considerable weight which in an otherwise marginal case ought to be decisive. However an activity may constitute a trade even it the activity is ultra vires the company. *Lewis Emanuel* was such a case: 42 TC at p.377.

UK resident companies also need to consider the derivative contract rules in part 7 CTA 2009, which are not discussed here.

44.11.8 *SP 1/01*

SP 1/01 provides some heavily guarded generalities, and anyone who tries to use this guidance will find that it does not take them very far.[48] For what it is worth, the material is set out here:

> 16. Whether or not a taxpayer is trading is a question to be determined by reference to all the facts and circumstances of the particular case. This applies as much to financial transactions as to other activities.
> 17. In determining the question of trading, any transactions carried out through an investment manager are to be considered in the context of the status and world-wide activities of the non-resident. It is not possible in this statement to consider every possible set of circumstances but, for example, an individual is unlikely to be regarded as trading as a result

47 15 Ch D 247 at p.276.

48 There is similar (qualified) guidance in SP 3/02.

> of purely speculative transactions.[49]
> 18. For a company, a transaction will generally be either trading or capital in nature. (This may also be the case for non-corporate collective investment vehicles whether open-ended or closed.)

The point of para 18 is that the transaction will not give rise to non-trading income; see 44.11.9 (Transaction income (former schedule D case VI)).

> If the main business of a non-resident company is a trade outside the financial area, or an investment holding business, the activities in the UK would normally amount to trading only if they constituted or were part of a separate financial trade. But if, exceptionally, activities which are an integral part of the profit earning activities of a non-financial trade are carried out through a UK investment manager (eg hedging on the London terminal markets by a non-resident dealer in physical commodities) then that might amount to trading here. The view to be taken on a particular case will depend on all the facts of that case.
> 19. The active management of an investment portfolio of shares, bonds and money market instruments such as bills, certificates of deposit, floating rate notes and commercial paper does not constitute a trade.

The use of the term "investment" (if it carries its normal tax meaning) makes para 19 tautologous. Presumably the word is used in the wider sense, in which case the sentence makes an important point. But the author adds a qualification to neutralise that:

> But every case must be considered in the light of its own facts.
> 20. HMRC view short positions as conceptually the same as long positions and synthetic positions are conceptually the same as the equivalent 'real' positions. Neither going short nor taking synthetic positions using derivatives are in themselves indicative of trading. Furthermore, synthetic positions that give exposure to part of an asset are conceptually the same as synthetic positions that give exposure to the whole of an asset. Thus a synthetic position that gives exposure only to a bond's credit risk is no more or less likely to be a trading transaction than a synthetic or real position that gives exposure to the bond's coupon, liquidity, credit and currency risks. These techniques may constitute investment in themselves or may form part of an investment activity.
> 21. Where futures and options are used by non-residents who are collective investment vehicles (whether open-ended or closed), pension

49 Likewise SP 3/02 para 8.

funds and other bodies which either do not trade or whose client trade is outside the financial area, SP 03/02 "Tax Treatment of Derivative Transactions" will be applied.

22. ... [50] The criteria for deciding whether a non-resident financial company is an investment company or a trading company are the same as those which apply to a resident company.

BI Manual expands on this:

20250 - Trade: badges of trade: income producing assets [December 2013]

... Financial assets

Normally transactions by individuals and companies in financial assets, such as shares, options and futures, do not amount to trading for tax purposes. Shares are generally held for investment, either to gain from income or capital growth. Short-term transactions, which cannot be classed as investments, usually fall short of trading, being in a class of transaction analogous to gambling or speculation.

Whether an activity of buying and selling shares, securities and other financial instruments amounts to a trade is considered further at BIM56800 onwards.

56910. Financial traders - instruments and shares: synthetic positions [December 2013]

Financial transactions include the acquisition, holding, dealing with, and disposal of financial assets such as shares and bonds. They also include taking synthetic positions in relation to such assets or corresponding indices, or discrete components of them. In our view, using synthetics is not itself indicative of trading. There is no conceptual difference between a 'real' and a synthetic financial transaction (for example, buying a share or entering into a derivative contract that replicates the risks and rewards of ownership). All of these approaches may form part of an investment strategy and some of them may constitute investment in themselves.

Short positions are conceptually the same as long positions

Buying a share because you take the view that its price will rise and shorting a share because you think its price will fall are conceptually the same. In simple terms, a view is merely being taken on the direction of movement. It follows that synthetic long and short positions are conceptually the same as one another and the equivalent real transactions.

Derivatives that give exposure to part of an asset are conceptually the same as derivatives that give exposure to the whole asset

A view may be expressed on a bundle of components embedded in an instrument, for example the coupon, liquidity, credit risk and currency of a bond, or alternatively a view may be expressed on one or a combination of these components. There is no conceptual difference between taking a view on all

50 The omitted text discusses whether the financial trade is carried on in the UK; see 15.14.2 (Buying and selling through an agent). This is distinct from the question of whether there is a trade.

components by buying the instrument or entering a derivative contract that replicates ownership, or taking a view on one or a combination of the components via derivatives. There is no conceptual difference between taking a view on the direction of movement (as with simply long and short positions) or taking a view on the magnitude or timing of movements, or other components. Multi-derivative or hybrid strategies should not be unbundled.

Given the wide range of situations this principle can apply to, three examples are set out below. These are intended to be illustrative and not a definitive list.

In all cases involving any such 'bundling' we would expect there to be evidence that the transactions were executed in pursuit of a clear prior strategy.

Two or more derivatives

Where, for example, the view is that the price will increase but only within a certain band, and the most efficient way to express that single view is via a series of derivative transactions, those transactions should be considered as a whole and not each in isolation.

A derivative and another financial asset (for example shares)

Where the view is that an asset would not be acquired at current value but would be at a set lower value, a put option is written at that lower value, i.e. as a cost efficient method of acquisition. The writing of the option and the potential acquisition of the asset should be considered as a whole and not each in isolation.

A sequential series of similar derivative strategies

A derivative that is close to maturity generally has greater liquidity than a derivative identical in every way, other than having a longer period to maturity. 'Rolling' short dated derivative strategies such that there is a sequential series of similar derivatives should be viewed as a whole and not each in isolation.

44.11.9 *Transaction income (former schedule D case VI)*

One welcome rule is that stock exchange transactions must either be trading or non-trading, and cannot fall within any other category of income. Section 779(1) ITTOIA provides:

> No liability to income tax arises as a result of Chapter 8 of Part 5 (income not otherwise charged) in respect of a gain arising to a person in the course of dealing in—
>
> (a) commodity or financial futures,
>
> (b) traded options, or
>
> (c) financial options.[51]

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51 For completeness, this continues:

(2) The reference in subsection (1) to a gain arising in the course of dealing in commodity or financial futures includes a gain regarded as so arising under section 143(3) of TCGA 1992 (gains arising from transactions otherwise than in the course of dealing on a recognised futures exchange, involving authorised persons).

(3) In this section—

This makes obsolete some difficult case law under which transactions in futures were held to be non-trading but to fall within the former Schedule D case VI. There is no scope for straightforward purchase and sale transactions to fall within this category: *Jones v Leeming* 15 TC 333.

44.11.10 *Commentary*

The trading/non-trading distinction in financial assets raises three difficulties:

(1) *Uncertainty:* The case law is old and investment practice has since changed. It does not address the many varieties of transaction carried out by hedge funds and other sophisticated investors/traders, and even in the case of straightforward transactions, it is often unclear whether or not there is a trade.

(2) *Complexity:* There are some complex and narrow exemptions which recognise and address this problem and (more or less) treat stock exchange transactions as non-trading:

(a) the IME discussed in this chapter
(b) an exemption for authorised investment funds (introduced in an attempt to stop funds relocating to Ireland or Luxembourg)[52]
(c) chapter 6 part 3 OFTR[53]

(3) *Irrationality:* The line drawn between trading/non trading in transactions in financial assets (insofar as it is discernible) is arbitrary.

These three problems follow from one underlying problem: there is no clear *economic* line to be drawn between trading and non-trading, in the context of stock exchange transactions. The distinction is not drawn for accountancy purposes. Financial Reporting Standard for Medium-sized Entities requires the use of fair value for investments in shares which are publicly traded or where the fair value can be measured reliably. Movements in this fair value are recognised in profit or loss. It is of course possible that tax and accountancy standards may define profit in different ways. But in this case the accountancy standards are right. There is an

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"commodity or financial futures" means commodity futures or financial futures that are for the time being dealt in on a recognised futures exchange,
"financial option" has the meaning given by section 144(8)(c) of TCGA 1992, and
"traded option" has the meaning given by section 144(8)(b) of that Act.

52 Authorised Investment Funds (Tax) (Amendment) Regulations, SI 2009/2036 (31 pages of regulations accompanied by 107 pages of draft guidance).

53 See 36.6 (Fund transactions treated as non-trading).

economic distinction between buying for short term and buying for long term holding[54] and to the extent that this intuition underlies the trading/non-trading distinction it is not wholly irrational. However this economic line is nowhere close to the tax trading/non-trading distinction; and there is no reason why the two activities should be taxed differently.

As far as I am aware, competing jurisdictions sensibly do not attempt to draw any comparable distinction.

It is suggested that all transactions in financial assets, defined along the lines of the IME, should in principle be deemed non-trading for tax purposes.[55] The IME, AIF and OFTR exemptions can be repealed. That would be a simplification with little if any tax loss.

54 "We believe that according the name investors to institutions that trade actively is like calling someone who repeatedly engages in one-night stands a romantic." (Attributed to Warren Buffet - I would be grateful to any reader who could supply the reference).

55 There could be some limited exceptions, eg if a company elects for trading treatment, and the hedging of trading risks.

CHAPTER FORTY FIVE

LOANS FROM NON-RESIDENT COMPANIES

45.1 Advantages of loans from non-resident companies

A dividend (or other income distribution) from a non-resident company will often cause income tax problems. If the dividend is received by a UK resident, directly or through an IIP trust, it will be taxable on the arising basis or on the remittance basis. If it is received by a non-resident discretionary trust or company, it will be income within the scope of s.624 and the ToA provisions. By contrast a loan, even if interest-free, does not constitute an income receipt and will avoid these problems. Loans therefore seem an attractive method of extracting funds from companies. However, they raise tax issues of their own.

45.1.1 *Cross references*

The following issues are discussed elsewhere.

A loan may be a benefit for the purposes of s.731 and s.87.[1]

Receipt of the loan in the UK may be a taxable remittance if the sum loaned is derived from:

(a) s.624, s.720 or s.731 income of the settlor/transferor;[2] or

(b) foreign income/gains of the individual.[3]

A loan to a transferor or settlor may bring s.727 ITA[4] and s.641 ITTOIA[5] into effect which is important if the transferor has no power to enjoy or if the company is held by a trust which is not settlor-interested.

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1 See 30.4.4 (Interest-free loan and enjoyment of asset in kind).

2 See 27.4 (Section 624 remittance basis); 29.14 (Section 720 remittance basis); 30.35 (Section 731 remittance basis).

3 See 11.15.6 (T lends income/gains to R). Remittance condition D might also apply.

4 See 29.11 (Transferor receives capital sum).

5 See 27.11 (Settlor receives capital sum).

A loan to trustees may give rise to a charge under Schedule 4B TCGA.[6]

The liability to repay the loan may not be deductible for IHT purposes.[7]

Loans *to* non-resident companies raise different issues, not discussed here.

45.2 Non-tax aspects

The loan should be documented by a written agreement made at the time of the loan. It should be recorded in the company's accounts.

Take care the loan does not accidentally become statute-barred.

Company law restrictions on loans to directors and connected persons may need to be considered. This will depend on the applicable company law.

If the company is held by a trust, the trustees need to consider whether they can properly permit the company to make the loan.

45.3 Loans to participators

Section 455 CTA 2010 imposes a charge where a close company lends money to a participator. There is no charge under this section provided the company was not UK resident (and so not "close") at the time the loan was made. It does not matter if the company later becomes UK resident.

In this chapter I assume that the company is not UK resident when the loan is made.

45.4 Benefits to participators

Section 1064 CTA 2010 imposes a charge where a "close company incurs an expense in, or in connection with, the provision for any participator of ... benefits or facilities of any kind". However a close company does not "incur expense" in making a loan or in leaving the loan outstanding, and so there will be no charge under this section. Also a non-resident company is not "close".

45.5 Employment-related loan

Section 175(1) ITEPA provides:

> The cash equivalent of the benefit of an employment-related loan is to be treated as earnings from the employee's employment for a tax year

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6 See 52.6 (Trustee borrowing).

7 See 65.1 (IHT deduction for debts).

if the loan is a taxable cheap loan in relation to that year.

This will in principle apply on a loan from a company to an employee, director, or shadow director.[8] A discussion of the meaning of "taxable cheap loan" and the quantum of the charge is outside the scope of this book. For DT relief see 22.42 (DTA defence to BiK charge).

45.5.1 *Remittance basis employee*

The BiK earnings of an employment-related loan may be chargeable overseas earnings if (in short) the duties of the employment are performed wholly outside the UK. If so, it is suggested that the earnings cannot be remitted so no tax charge can arise.[9]

45.5.2 *Loan to shadow director: HMRC practice*

Where living accommodation is provided by a company, HMRC say that they take the point that the occupier of the property may be a shadow director of the company, so that a benefit in kind charge arises.[10] In relation to interest-free loans from offshore companies, the same technical point arises. However in this case HMRC do not seem to argue the point. There are various possible explanations for this discrepancy.

One reason may be that borrowers (unlike occupiers) are less likely to be shadow directors. Of course a person who borrows interest-free from a company is not necessarily a shadow director. Perhaps the person occupying a property purchased by the company is more at risk of becoming a shadow director, because the company's acts to acquire the property and licence the individual to occupy are more likely to be at the direction of the individual. By contrast, the decision to extract funds from the company by way of loan (as opposed, say, to distribution) may be less likely to be at the direction of the individual. But it is of course a question of fact in each case.

The motivation for (purporting to) take the living accommodation point may be to discourage IHT planning on the family home, not the collection of income tax.

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8 See 74.8 (Who is a shadow director?).

9 See 74.21 (Benefit in kind: remittance basis taxpayer). If that is wrong, imponderable questions arise as to what happens if the money lent is remitted here and spent. Contrast 30.37.1 (Interest-free (or low-interest) loan).

10 See 74.7 (Shadow directors).

45.6 Meaning of "employment-related loan"

45.6.1 *"Loan"*

Section 173(2)(a) ITEPA provides:

> "loan" includes any form of credit

EIM para 26108 provides:

> **26108. Meaning of loan** [December 2006]
> Loan means more than just lending money. It includes any form of credit. It follows that any kind of advance by reason of the employment is covered. For example, any amount shown in the employer's books or records as owed by an employee will count as a loan.
> *Grant v Watton*
> The case of *Grant v Watton* (71 TC 333) concerned credit extended by a company of which Grant was a director, to his sole trade and later to a partnership in which Grant was the general partner. In the High Court Pumfrey J. considered the meaning of credit –
>
> > "... credit is granted where payment is not demanded until a time later than the supply of goods to which the payment relates. Credit is the deferral of payment of a sum which, absent agreement, would be immediately payable."
>
> Regarding the application of Section 175 ITEPA 2003 to an overdrawn director's loan account see EIM26505.

45.6.2 *"Making" a loan*

Section 173(2)(b) ITEPA provides:

> references to making a loan (and related expressions) include arranging, guaranteeing or in any way facilitating a loan.

EIM 26110 summarises this and continues:

> **Loan made by a third party – employee benefit trust** [December 2011]
> It is not uncommon for a third party, such as an employee benefit trust (EBT), to make a loan to a beneficiary who is also an employee of the employer which is associated with the EBT. It is sometimes suggested that the loan is not an "employment-related loan" (EIM26113) because the definition of that term does not include a loan provided by a third party.
> Whilst it is true that the definition includes no reference to a third party loan provider, HMRC does not accept that the loan is not an

> employment-related loan. The definition of "employment-related loan" includes a loan made by an employee's employer. As "making" a loan includes "in any way facilitating" a loan, if the employer provides the money to fund the EBT, the employer is regarded as making the loan. Consequently for the purposes of the loan benefit rules, the EBT is ignored and the loan is treated as made directly by the employer to the employee. It follows that the loan is an employment-related loan.

Suppose:

(1) A company is held by a trust, and lends funds to the trustees ("loan 1").

(2) The trustees lend funds to a beneficiary who is a shadow director ("loan 2").

At first sight this would not be an employment-related loan because it is not made by the "employer". But if loan 1 is made in order to allow the trustees to lend to the beneficiary, it might be said that the company has facilitated loan 2. The same applies to a back-to-back loan, ie if the company deposits funds with a bank, the trustees borrow from the same bank on the security of that deposit, and the trustees then lend to the beneficiary.

Section 174(4) ITEPA provides:

> References in this section to a loan being made by a person extend to a person who—
>
> (a) assumes the rights and liabilities of the person who originally made the loan, or
>
> (b) arranges, guarantees or in any way facilitates the continuation of a loan already in existence.

EIM para 26111 provides:

> **Loans taken over from another person** [February 2006]
>
> If the rights over an existing loan are taken over by another person the loan will remain within the charge if it was within the charge when it was first made.
>
> A loan within the scope of the charge cannot be removed from it by the original lender handing his or her rights over to another person.
>
> But a loan that was not within the charge when it was first made can be brought within it if it is taken over by a person mentioned in EIM26113.

45.6.3 *"Employment-related"*

"Employment-related" loan is defined in s.174 ITEPA:

(1) For the purposes of this Chapter an employment-related loan is a loan—
(a) made to an employee[11] or a relative of an employee, and
(b) of a class described in subsection (2).
(2) For the purposes of this Chapter the classes of employment-related loan are—
A A loan made by the employee's employer.
B A loan made by a company or partnership over which the employee's employer had control.
C A loan made by a company or partnership by which the employer (being a company or partnership) was controlled.
D A loan made by a company or partnership which was controlled by a person by whom the employer (being a company or partnership) was controlled.
E A loan made by a person having a material interest[12] in—
(a) a close company which was the employer, had control over the employer or was controlled by the employer, or
(b) a company or partnership controlling that close company.
(3) In this section—
"employee" includes a prospective employee, and
"employer" includes a prospective employer...

"Control" means control in the strict sense.[13]

45.6.4 *Loan to relative of employee*

Section 174 ITEPA provides:

(1) For the purposes of this Chapter an employment-related loan is a loan—
(a) made to an employee or a relative of an employee...

Section 174(6) ITEPA defines "relative" quite widely:

For the purposes of this section a person ('X') is a relative of another ('Y') if X is—
(a) Y's spouse or civil partner,
(b) a parent, child or remoter relation in the direct line either of Y or of Y's spouse or civil partner,
(c) a brother or sister of Y or of Y's spouse or civil partner, or
(d) the spouse or civil partner of a person falling within para (b) or (c).

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11 For the definition of "employee" see 22.2 ("Employer", "employee" and "employment").

12 "Material interest" is defined in s.68 ITEPA.

13 See 85.2.2 (Meaning(s) of "control").

However s.174(5) ITEPA brings in a wide exception:

> A loan is not an employment-related loan if—
> (a) it is made by an individual in the normal course of the individual's domestic, family or personal relationships, or
> (b) it is made to a relative of the employee and the employee derives no benefit from it.

In general therefore straightforward loans to relatives of employees or shadow directors are not caught.

45.6.5 *Change in employee status*

What if a loan is made to someone who is not an employee (as defined) but later becomes a shadow director? At first sight, leaving an existing loan outstanding would not give rise to a tax charge even after the borrower becomes a shadow director. However, if the loan is repayable on demand, not calling in the loan amounts to a "form of credit". Thus there will be an income tax charge on the benefit in kind of the interest-free loan if a borrower becomes a shadow director (and so becomes an "employee").

What is the position if a loan is made to a shadow director who ceases to be a shadow director? There is no charge on a loan to a former employee. This was deliberate. EN ITEPA provides:

> 76. Where the Schedule E legislation provides that an amount shall be treated as an emolument of an employment only if provided in a year when the employment is held, this Act reproduces that limitation. The sections in the benefits code make it clear that such amounts or benefits will only be treated as earnings if they are paid/provided in a year in which the employment is held. If they are paid/provided at any other time they will not be treated as earnings and will be outside the "general earnings" to which section 17 [ITEPA] applies.

45.6.6 *Employee coming to work in the UK*

The EI Manual provides:

> **26105. Loans in foreign currencies: Taxation of overseas loans** [December 2006]
> ...
> *Taxation of overseas loans in foreign currencies*
> An employment-related loan (see EIM26102) made to an employee who comes to work in the UK is within the scope of the beneficial loans rules

if:

- the loan is made at a time when the employee's earnings are already chargeable to UK income tax as employment income (for example, if a loan is made after the employee has taken up employment in the UK and is resident and ordinarily resident in the UK for the year in which the loan is made); or
- the loan is made in contemplation of the employee working or living in the UK (for example, if the loan is made as part of a package with a view to the employee working in the UK); or
- the employee, at a time when the employee's earnings are chargeable to UK income tax as employment income, in any way facilitates the continuation of a loan which was already in existence before the employee came to work in the UK.

As far as the final bullet is concerned, this is relevant where, for example, the loan is made not by the employer but by a third party such as a bank which is not connected with the employer and where the capital repayments and interest are deducted from the employee's salary. In these circumstances, the question is whether the loan continues when the employee is in the UK without any further involvement by the employer, or whether the employer does something which makes it easier for the employee to continue to have the loan.

An employer would not be facilitating the continuation of a loan merely because

- the loan is conditional on the employee continuing in the employment, or
- the employer deducts the interest and repayments of capital from the employee's salary.

If the employer pays a subsidy to the lender – for example, by paying annual interest on behalf of the employee – that would not necessarily mean that the employer was facilitating the continuation of the loan. The subsidy itself might however be taxable as an employment-related benefit under Section 201 ITEPA.

On the other hand the employer would be facilitating the continuation of the loan if

- the loan was conditional on the employer continuing to make regular payments to subsidise the interest which the employer might cease to make at any time, or
- the employer chose month by month or year by year whether to subsidise the loan.

45.7 Foreign currency loan

There is (somewhat miserly) provision for foreign currency loans. Section

181 ITEPA provides:

> (1) "The official rate of interest" for the purposes of this Chapter means the rate applicable under section 178 of FA 1989 (general power of Treasury to specify rates of interest).
> (2) Regulations under that section may make different provision in relation to a loan if—
> (a) it was made in the currency of a country or territory outside the United Kingdom, and
> (b) the employee normally lives in that country or territory, and has actually lived there at some time in the period of 6 years ending with the tax year in question.

The EIM provides:

> **26106. Official rates for certain foreign currencies** [December 2006]

Currency	Period from	Period to	Official Rate
Japanese Yen	6 June 1994		3.9%
Swiss franc	6 June 1994	5 July 1994	5.7%
	6 July 1994		5.5%

> There has been no change in either rate since 1994.
> [The Manual summarises s.181 and continues:] The intention of these rules is to give relief for employees working temporarily in the UK, where interest rates in the overseas country are lower than interest rates in the UK. The relief does not apply to employees who come to the UK and live here permanently.
> The expressions "normally lives" and "lived" have their natural commonsense meaning. An employee who came to work in the UK for four years and who returned home after the four years can be said to "normally live" in the home country. It is not necessary to maintain a residence in the overseas country during the period of employment in the UK. The terms "lives" and "has lived" connote a degree of continuance if not permanence. A holiday in the home country for an employee working in the UK would not in itself be sufficient to establish that the employee had "lived" in the overseas country within the meaning of these rules. "Living" implies more than returning for a short holiday.

45.8 Transactions in securities

The "lengthy and complicated"[14] provisions relating to transactions in securities (**"the TiS rules"**) require a book to themselves. This section

14 *IRC v Laird Group* [2003] STC 1349 at [13].

considers only whether the rules might apply to an interest-free loan. Section 684 ITA provides:

> (1) This section applies to a person where—
>
> (a) the person is a party to a transaction in securities or two or more transactions in securities (see subsection (2)),
>
> (b) the circumstances are covered by section 685 and not excluded by section 686,
>
> (c) the main purpose, or one of the main purposes, of the person in being a party to the transaction in securities, or any of the transactions in securities, is to obtain an income tax advantage, and
>
> (d) the person obtains an income tax advantage in consequence of the transaction or the combined effect of the transactions.

The loan is a transaction in securities[15] if it is a "security".[16] It has been suggested that every loan is a security (as defined).[17] In that case the lender is party to a transaction in securities.

45.9 The TiS motive defence

Section 684(1)(c) ITA requires:

> the main purpose, or one of the main purposes, of the person in being a party to the transaction in securities, or any of the transactions in securities, is to obtain an income tax advantage.

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15 Defined s.684(2) ITA: "In this Chapter "transaction in securities" means a transaction, of whatever description, relating to securities, and includes in particular—
(a) the purchase, sale or exchange of securities,
(b) issuing or securing the issue of new securities,
(c) applying or subscribing for new securities, and
(d) altering or securing the alteration of the rights attached to securities."

16 Defined s.713 ITA: "'securities'–
(a) includes shares and stock, and
(b) in relation to a company not limited by shares (whether or not it has a share capital) also includes a reference to the interest of a member of the company as such, whatever the form of that interest."
Section 685(9) ITA provides: "In this section—
"security" includes securities not creating or evidencing a charge on assets;
"share" includes stock and any other interest of a member in a company."

17 Williams v IRC 54 TC 257/

45.9.1 *"Income tax advantage"*

"Income tax advantage" is defined in s.687 ITA:

> (1) For the purposes of this Chapter the person obtains an income tax advantage if—
>
> (a) the amount of any income tax which would be payable by the person in respect of the relevant consideration if it constituted a qualifying distribution exceeds the amount of any capital gains tax payable in respect of it, or
>
> (b) income tax would be payable by the person in respect of the relevant consideration if it constituted a qualifying distribution and no capital gains tax is payable in respect of it.
>
> (2) So much of the relevant consideration as exceeds the maximum amount that could in any circumstances have been paid to the person by way of a qualifying distribution at the time when the relevant consideration is received is to be left out of account for the purposes of subsection (1)....
>
> (4) In this section "relevant consideration" has the same meaning as in section 685.

In what follows the expression is referred to as Income Tax Advantage (initial capitals) to remind readers that it is used in a defined and artificial sense.

The amount of income tax advantage is defined in s.687(3) ITA:

> The amount of the income tax advantage is the amount of the excess or (if no capital gains tax is payable) the amount of the income tax which would be payable.

HMRC say:

> The proposed legislation, through the definition of tax advantage would make it clear that the TiS legislation does not apply to TiS where an advantage in relation to tax on chargeable gains is obtained. This would be more relevant for corporation tax where the position is not clear from the existing legislation.

This is differently worded from the CT motive defence. HMRC describe the IT expression as "narrower" than the CT expression. But a UK shareholder who borrows interest-free loan will obtain an income tax advantage.

45.10 The IT circumstances

Section 685(1) ITA provides:

> The circumstances covered by this section are circumstances where condition A or condition B is met.

We refer to **"TiS circumstances A and B"**.

45.10.1 *TiS circumstance A*

Section 685(2) ITA provides:

> Condition A is that, as a result of the transaction in securities or any one or more of the transactions in securities, the person receives relevant consideration in connection with—
>
> (a) the distribution, transfer or realisation of assets of a close company,
>
> (b) the application of assets of a close company in discharge of liabilities, or
>
> (c) the direct or indirect transfer of assets of one close company to another close company,
>
> and does not pay or bear income tax on the consideration (apart from this Chapter).

45.10.2 *IT circumstance B*

Section 685(3) ITA provides:

> Condition B is that—
>
> (a) the person receives relevant consideration in connection with the transaction in securities or any one or more of the transactions in securities,
>
> (b) two or more close companies are concerned in the transaction or transactions in securities concerned, and
>
> (c) the person does not pay or bear income tax on the consideration (apart from this Chapter).

45.10.3 *"Relevant consideration"*

Section 685 ITA provides two definitions:

> (4) In a case within subsection (2)(a) or (b) "relevant consideration" means consideration which—
>
> (a) is or represents the value of—
>
> (i) assets which are available for distribution by way of dividend by the company, or

(ii) assets which would have been so available apart from anything done by the company,

(b) is received in respect of future receipts of the company, or

(c) is or represents the value of trading stock of the company.

(5) In a case within subsection (2)(c) or (3) "relevant consideration" means consideration which consists of any share capital or any security issued by a close company and which is or represents the value of assets which—

(a) are available for distribution by way of dividend by the company,

(b) would have been so available apart from anything done by the company, or

(c) are trading stock of the company.

"Consideration" has an artificial definition. Section 685(8) ITA provides:

> References in this section to the receipt of consideration include references to the receipt of any money or money's worth.

Section 685(6) ITA restricts the concept of assets:

> The references in subsection (2)(a) and (b) to assets do not include assets which are shown to represent a return of sums paid by subscribers on the issue of securities, despite the fact that under the law of the country in which the company is incorporated assets of that description are available for distribution by way of dividend.

Section 685(7) ITA restricts the concept of share capital:

> So far as subsection (2)(c) or (3) relates to share capital other than redeemable share capital, it applies only so far as the share capital is repaid (on a winding up or otherwise); and for this purpose any distribution made in respect of any shares on a winding up or dissolution of the company is to be treated as a repayment of share capital.

The excluded circumstances (fundamental change of ownership) is not relevant here.

45.10.4 *"Close company"*

Section 713 ITA provides:

> In this Chapter—
> "close company" includes a company that would be a close company if it were resident in the United Kingdom,
> "company" includes any body corporate

45.11 Discussion

45.11.1 *Loan to individual 100% shareholder*

Suppose a company is wholly owned by a UK resident individual ("B"), and the company lends interest-free to B.

B obtains an income tax advantage.

Are the TIS circumstances satisfied? B receives relevant consideration. There is a transfer of assets (the loan). However, does B receive the sum "in connection" with a transfer of assets? If the company already had the cash, then the only "transfer of assets" is the loan itself. Is the loan connected with itself? The answer must be, no. If the company had to sell assets in order to raise cash to make the loan, that sale would be a "transfer of assets" and circumstance A would be satisfied.

45.11.2 *Loan to discretionary trust*

Suppose the company is held by a non-resident discretionary trust, and lends interest-free to the trustees. The trustees do not obtain an income tax advantage. The trustees would not have been taxable on a dividend.

Suppose the trust is settlor-interested. If the settlor ("S") is UK resident and domiciled S obtains an income tax advantage. (What if S was a remittance basis taxpayer? There is no IT advantage unless the proceeds are received in the UK.)

However, S does not receive distributable consideration so the TiS circumstances are not satisfied even if S does obtain an income tax advantage.[18]

18 *Hague v IRC* 44 TC 619.

CHAPTER FORTY SIX

RATES OF TAX

46.1 IT rates: Introduction

A full discussion of rates of income tax would need a long chapter. I concentrate on two common types of income: interest and dividends.

It may be helpful first of all to list the seven possible rates of income tax on individuals for which ITA provides terminology:

Name	Rate	Effective Rate[1]	Applicable to
Non-dividends			
Starting rate for savings	10%		Savings income up to starting rate limit
Basic rate	20%		Other income up to basic rate limit
Higher rate	40%		Income above basic rate limit
Additional Rate	45%		Income above higher rate limit
Dividend income			
Dividend ordinary rate	10%	0%	Dividends up to basic rate limit
Dividend upper rate	32.5%	25%	Dividends above basic rate limit
Dividend additional rate	37.5%	30.56%	Dividends above higher rate limit

The statutory terminology is somewhat inapt. The (so called) "higher rate" is actually an intermediate rate between the basic rate and the top rate (unhelpfully named the "additional rate"). Similarly the dividend upper rate is an intermediate rate between the dividend ordinary rate (which is not "ordinary") and the top dividend rate (unhelpfully named the dividend additional rate). I reluctantly adopt the statutory terminology since anything else is even more confusing.

See sections 6-8 ITA.

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1 The effective rates on dividends are different from the formal rates because one must allow for the tax credit and grossing up. See 20.2 (Income from UK resident company); 20.3 (Income from non-resident company).

46.1.1 *Cross references*

For rates of tax on trustees, see 25.2 (Tier 1: charge on trustees on receipt of income).

Rates of tax on PRs are not considered here.

46.2 Basic/higher/additional rates

Section 10 ITA introduces the basic/higher/additional rates:

> (2) Income tax on an individual's income up to the basic rate limit is charged at the basic rate (except to the extent that, in accordance with section 12, it is charged at the starting rate for savings).
> (3) Income tax is charged at the higher rate on an individual's income above the basic rate limit and up to the higher rate limit.
> (3A) Income tax is charged at the additional rate on an individual's income above the higher rate limit.

These rates apply unless disapplied by any other provisions. Section 10(4) ITA provides:

> This section is subject to—
> [a] section 13 (income charged at the dividend ordinary and dividend upper rates: individuals), and
> [b] any other provisions of the Income Tax Acts which provide for income of an individual to be charged at different rates of income tax in some circumstances.

The important provisions for our purposes are ss.12 and 13 ITA.

46.3 Starting rate for savings income

Section 12(1) ITA provides:

> Income tax is charged at the starting rate for savings (rather than the basic rate) on so much of an individual's income up to the starting rate limit for savings as is savings income.

This replaces the basic rate with a different (more favourable) rate, the starting rate for savings.

46.3.1 *"Savings income"*

Savings income is defined in s.18 ITA:

> (1) This section applies for the purposes of the Income Tax Acts.
> (2) "Savings income" is income—

(a) which is within subsection (3) or (4), and
(b) which is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).

There are five categories of savings income within s.18(3) and (4):

(3) Income is within this subsection if it is—
(a) income chargeable under Chapter 2 of Part 4 of ITTOIA 2005 (interest),
(b) income chargeable under Chapter 7 of Part 4 of ITTOIA 2005 (purchased life annuity payments), other than income from annuities specified in section 718(2) of that Act (annuities purchased from certain life assurance premium payments or under wills etc),
(c) income chargeable under Chapter 8 of Part 4 of ITTOIA 2005 (profits from deeply discounted securities), or
(d) income chargeable under Chapter 2 of Part 12 of this Act (accrued income profits).
(4) Income is within this subsection if—
(a) it is chargeable under Chapter 9 of Part 4 of ITTOIA 2005 (gains from contracts for life insurance etc), and
(b) an individual is, or personal representatives are, liable for income tax on it (under section 465 or 466 of that Act).

"Savings income" does not properly describe these disparate categories of income, but it serves as a short label and there is no better term.

In short, the rates of tax on:
(1) UK interest; and
(2) foreign interest when the arising basis applies
are the starting/basic/higher/additional rates, 10%/20%/40%/45%.

46.3.2 *Rates of tax on interest under remittance basis*

If the remittance basis applies, foreign interest income[2] (if remitted) is taxed at the **basic**/higher/additional rates, **20%**/40%/45%. This is achieved by the clumsy but effective technique of providing that such income is not "savings income". How much is at stake? At most the difference between the starting rate and the basic rate, for income up to the starting rate limit.

2 Including the interest-like income of the other categories specified in s.18(4) ITA.

In 2014/15, this is 10% of £2,880 = £288.[3]

Before the 2008 reforms I said:

> There is a (perhaps good) reason for dealing with foreign interest income in this way. A UK resident foreign domiciled individual will often have different types of foreign income. If he remitted only some of his income, it would be necessary, in the absence of this rule, to investigate whether the remitted income represents interest (taxable at 10%) or some other source of income (taxable at 20%). Because of this rule it is not necessary to ask this question.

Now that the ITA mixed fund rule requires precisely that investigation, this has ceased to be a valid reason. But the amount of tax involved is trivial.

46.4 Rates of tax on dividend income

46.4.1 *"Dividend income"*

Dividend income is defined in s.19 ITA:

> (1) This section applies for the purposes of the Income Tax Acts.
> (2) "Dividend income" is income which is—
> (a) chargeable under Chapter 3 of Part 4 of ITTOIA 2005 (dividends etc from UK resident companies),
> (b) chargeable under Chapter 4 of that Part (dividends from non-UK resident companies),
> (c) chargeable under Chapter 5 of that Part (stock dividends from UK resident companies),
> (d) chargeable under Chapter 6 of that Part (release of loan to participator in close company), or
> (e) a relevant foreign distribution chargeable under Chapter 8 of Part 5 of ITTOIA 2005 (income not otherwise charged).
> (3) In subsection (2) "relevant foreign distribution" means a distribution of a non-UK resident company which—
> (a) is not chargeable under Chapter 4 of Part 4 of ITTOIA 2005, but
> (b) would be chargeable under Chapter 3 of that Part if the company were UK resident.

"Dividend income" does not properly describe these categories of income, but it serves as a short label. "Dividend-type income" would be slightly

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3 HMRC and HM Treasury, *Overview of Tax Legislation and Rates* (19 March 2014), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/294190/OOTLAR_19_March_2014__1_.pdf

more accurate but it seems best to adopt the statutory terminology.

46.4.2 *Rates of tax on dividend income of individuals*

Section 13 ITA provides:

> (1) Income tax is charged at the dividend ordinary rate on an individual's income which—
>
> (a) is dividend income,
>
> (b) would otherwise be charged at the basic rate, and
>
> (c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).
>
> (2) Income tax is charged at the dividend upper rate on an individual's income which—
>
> (a) is dividend income,
>
> (b) would otherwise be charged at the higher rate, and
>
> (c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005.
>
> (2A) Income tax is charged at the dividend additional rate on an individual's income which—
>
> (a) is dividend income,
>
> (b) would otherwise be charged at the additional rate, and
>
> (c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005.

The scheme of s.13 is to replace the basic/higher/additional rates with different rates. Thus the rates of tax on UK dividend income are the dividend ordinary/upper/additional rates, 10%/32.5/37.5%. After allowing the tax credit and grossing up, the effective rates on net dividends are 0%/25%/36.11%. I refer to that as **"the dividend rates"**.

Foreign dividend income is taxed at the dividend rates when the arising basis applies, and with benefit of a tax credit and grossing up if the relevant conditions are met.[4]

46.4.3 *Rates of tax on foreign dividend income under remittance basis*

Foreign dividend income taxed on the remittance basis does not fall within s.13 as it does not meet the condition in s.13(1)(c) or s.13(2)(c) or s.13(2A)(c). The (higher) non-dividend tax rates apply. This is consistent with the treatment of foreign interest income. However unlike foreign

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4 See 20.3.4 (Tax credit and grossing up).

interest income, the amounts involved may be substantial. The result is that for a remittance basis taxpayer who remits, foreign dividend income is taxed more heavily than UK dividend income.

The discrimination is contrary to EU law: it is a breach of free movement of capital, so there is a breach whether the dividends arise in a members state or a third country. The discrimination is unlawful even though a taxpayer could avoid it by (1) not electing for the remittance basis or (2) not remitting the dividend income.[5]

46.4.4 *Dividend income of non-individuals*

Section 14 ITA provides:

> (1) Income tax is charged at the dividend ordinary rate on the income of persons other than individuals which—
>
> (a) is dividend income,
>
> (b) would otherwise be charged at the basic rate, and
>
> (c) is not relevant foreign income charged in accordance with section 832 of ITTOIA 2005 (relevant foreign income charged on the remittance basis).

This applies in particular to trustees of an IIP trust and non-resident companies.

46.5 Settlor-interested trust: Rates of tax on settlor

Section 619 ITTOIA provides (so far as relevant):

> (1) Income tax is charged on—
>
> (a) income which is treated as income of a settlor as a result of section 624 (income where settlor retains an interest), ...
>
> (2) For the purposes of Chapter 2 of Part 2 of ITA 2007 (rates at which income tax is charged), where income of another person is treated as income of the settlor and is charged to tax under subsection (1)(a) ... above, it shall be charged in accordance with whichever provisions of the Income Tax Acts would have been applied in charging it if it had arisen directly to the settlor.

What about foreign dividend income which qualifies for the s.624 remittance basis, but is later remitted and becomes taxable under the s.624 remittance basis?[6] This is taxable at the dividend rates.

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5 See 60.8.14 (Option to be treated as resident).

6 See 27.4 (Section 624 remittance basis).

46.6 Rates of tax on transferor within s.720 ITA

The starting point is that s.720 income is taxed as ordinary income. Section 745(4) ITA applies the dividend rates where the income of the person abroad is dividend income. The wording is convoluted. One needs to first to read section 745(1) ITA:

> Income tax at the basic rate, the starting rate for savings or the dividend ordinary rate is not charged under section 720 or 727 in respect of any income if (and to the corresponding extent that) the income mentioned in section 721(2) or 728(1)(a) [the income of the person abroad] has borne tax at that rate by deduction or otherwise.

This is the transferor's credit.[7] With this in mind we can continue to s.745(3)(4):

> (3) Subsection (4) applies to income treated as arising to an individual under section 721 or 728 so far as subsection (1) does not apply to it.
> (4) The charge to income tax under section 720 or 727 operates by treating the income as if it were income within section 19(2) (meaning of "dividend income") if the income mentioned in section 721(2) or 728(1)(a) would be dividend income were it the income of the individual.

So there are two rules: one rule where the income of the person abroad is dividend income; and another rule where it is other income.

Dividend income is taxed at the rates applicable to dividends: the dividend ordinary/dividend upper rates, with the benefit of the tax credit. What about foreign dividends of the person abroad, taxed under the s.720 remittance basis? That is still dividend income, so is still taxed at the dividend rates.

Section 745 ITA provides a special rule for dividend income. It says nothing about interest. Accordingly, interest within s.720 is taxed at the basic/higher/additional rates of 20%/40%/45%.

46.7 Rates of CGT

Section 4 TCGA provides:

> (1) This section makes provision about the rates at which capital gains tax is charged, but is subject to section 169N (rate in case of claim for entrepreneurs' relief).
> (2) Subject to the following provisions of this section, the rate of capital

7 See 31.2.1 (Transferor's credit).

gains tax in respect of gains accruing to a person in a tax year is 18%.
(3) The rate of capital gains tax in respect of gains accruing to—
(a) the trustees of a settlement, or
(b) the personal representatives of a deceased person,
in a tax year is 28%.
(3A) [This deals with ATED-CTGT: see 75.30 (Rate of ATED-CGT).
(4) If income tax is chargeable at the higher rate or the dividend upper rate in respect of any part of the income of an individual for a tax year, the rate of capital gains tax in respect of gains accruing to the individual in the year is 28%.
(5) If no income tax is chargeable at the higher rate or the dividend upper rate in respect of the income of an individual for a tax year, but the amount on which the individual is chargeable to capital gains tax exceeds the unused part of the individual's basic rate band, the rate of capital gains tax on the excess is 28%.
(6) [This relates to entrepreneurs' relief not discussed here]
(7) The reference in subsection (5) to the unused part of an individual's basic rate band is a reference to the amount by which the basic rate limit exceeds the individual's Step 3 income.
(8) For the purposes of this section, "the Step 3 income" of an individual means the individual's net income less allowances deducted at Step 3 of the calculation in section 23 of ITA 2007 for the purpose of calculating the individual's income tax liability.
(9) Section 989 of ITA 2007 (the definitions) applies for the purposes of this section as it applies for income tax purposes.

For CGT rates on gains remitted by a remittance basis taxpayer, see 49.2 (CGT remittance basis).

46.8 Scottish rates of income tax (from 2016)

46.8.1 *Personal rates*

HMRC say:

1. The Scottish rate of income tax, as introduced by the Scotland Act 2012, will be charged on the non-savings income of those defined as Scottish taxpayers. The rate paid by Scottish taxpayers will be calculated by reducing the basic, higher and additional rates of income tax levied by the UK Government by 10 pence in the pound and adding a new Scottish rate set by the Scottish Parliament.
2. For instance, if the UK basic, higher and additional rates of income tax were 20 per cent, 40 per cent and 45 per cent respectively and the Scottish rate of income tax were 11 per cent, then the rates applied to

those defined as Scottish taxpayers for basic, higher and additional rates of income tax would be 21 per cent, 41 per cent and 46 per cent respectively. If the Scottish rate of income tax were 9 per cent, then the rates applied to those defined as Scottish taxpayers would be 19 per cent, 39 per cent and 44 per cent. A Scottish rate of 10 per cent would mean no change from the UK rates.

3. Although the Scottish Parliament sets only one rate (the Scottish rate), this effectively gives rise to three rates: the Scottish basic rate; the Scottish higher rate; and the Scottish additional rate. Together these three rates will be referred to as the Scottish main rates.

4. As the Scottish rate of income tax is not a discrete tax it remains covered by existing UK double taxation agreements.

5. The Scottish rate of income tax replaces the Scottish Variable Rate (SVR), which was introduced by the Scotland Act 1998.

6. The non-savings income of a Scottish taxpayer (as defined by Part 3 of the Scotland Act 2012) will generally be liable to the Scottish rate of income tax.

7. Savings income and dividend income (as defined in sections 18 and 19 respectively of the Income Tax Act 2007 (ITA) and to which sections 12 and 13 of ITA apply) arising to Scottish taxpayers will still be taxed at the appropriate UK rate.[8]

8 HMRC, "Clarifying the Scope of the Scottish Rate of Income Tax Technical Note" (May 2012).

CHAPTER FORTY SEVEN

PERSONAL ALLOWANCES

47.1 Personal allowances: Introduction

This chapter considers the IT personal allowances and the CGT annual exemption.[1]

The complex rules reflect a good deal of history and special lobbying. A full discussion, would need a short book. I focus on the aspects closest to the themes of this book.

47.2 CGT annual exemption

Section 3(1) TCGA provides the CGT annual exemption:

> An individual shall not be chargeable to capital gains tax in respect of so much of his taxable amount for any year of assessment as does not exceed the exempt amount for the year.

This strictly applies to resident and non-resident individuals, but non-residents do not usually pay CGT, so they are not affected.

47.3 IT personal allowances

Section 35(1) ITA provides:

> An individual who makes a claim is entitled to a personal allowance of 10,000 for a tax year if the individual—
>
> (a) was born after 5 April 1948, and
>
> (b) meets the requirements of section 56 (residence etc).

Before dealing with the requirements for IT personal allowances, it is convenient to discuss the two categories for whom the allowances are

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1 A note on terminology: the ITA refers to personal allowances, and the TCGA refers to an annual exemption; but to avoid confusion, I refer to "IT personal allowances" "and the CGT annual exemption".

withdrawn: high earners and remittance basis claimants.

47.4 Withdrawal of IT personal allowances for high earners

Section 35(2) ITA provides:

> For an individual whose adjusted net income exceeds £100,000, the allowance under subsection (1) is reduced by one-half of the excess.

"Adjusted net income" is defined in s.58 ITA, not discussed here.

This rule was a parting shot from the Blair/Brown administration. It has incurred some high level criticism from the IFS[2] but no-one seems to have taken any notice.

47.5 Withdrawal of IT personal allowances & CGT annual exemption for remittance basis claimants

Section 809G ITA disapplies IT personal allowances for remittance basis claimants:

> (1) This section applies if s.809B (claim for remittance basis to apply) applies to an individual for a tax year.
> (2) For that year, the individual is not entitled to-
> (a) any allowance under Chapter 2 of Part 3 (personal allowance and blind person's allowance),
> (b) any tax reduction under Chapter 3 of that Part (tax reductions for married couples and civil partners), or
> (c) any relief under s.457 or 458 (payments for life insurance etc).

This does not apply to remittance basis taxpayers in the de minimis categories (sub-£2k taxpayers and non-taxpayers): they retain their allowances.

The editor of *Taxation* comments acerbically on s.809G(2)(c):

> So what are these valuable reliefs which it would be unfair to allow those claiming the remittance basis to enjoy? They are relief from tax on half of the premiums paid to trade unions and police organisations for superannuation, life insurance or funeral benefits, or to the employer so that benefits can be paid after the employee's death to their dependants, but limited to £100 a year of relief in each case.
> What on earth is the point of removing a relief like that for the non-domiciles? It is pointless complexity for the sake of a few tenners in tax

2 IFS *Tax By Design* (2011) para 4.3.1. (A Straightforward Income Tax Schedule).

> which will have no impact whatsoever on the non-domiciles concerned. Unless there is some issue related to European law, or human rights (which seem to be the normal culprits in these situations) I really cannot see why the parliamentary draftsman should have been troubled with the need to include them. And, frankly, if there is some such problem, then given the minuscule levels of relief they offer even to those not on the remittance basis, wouldn't it be simpler to just abolish the sections altogether? That would at least be simplification.[3]

Likewise s.3(1A)TCGA[4] disapplies the CGT annual exemption:

> Subsection (1) does not apply to an individual for a tax year if s.809B of ITA 2007 (claim for remittance basis to apply) applies to the individual for that year.

A DTA will occasionally restore the personal allowances and the CGT annual exemption, which are in general disapplied for remittance basis claimants.[5]

Individuals with income substantially above £100k are not concerned with the loss of IT personal allowances since these are withdrawn anyway; though they do suffer the loss of the CGT annual exemption.

The IT personal allowance and the CGT annual exemption are only lost in the year that a remittance basis claim is made. So an individual who has unremitted gains from earlier years, but who does not make a remittance basis claim in later years, may remit the exempt amount each year and set it against the CGT annual exemption.[6]

47.5.1 *Reporting small gains*

There is a relief for reporting small gains (which would in principle fall within the CGT annual exemption). Where the CGT annual exemption is disapplied, this relief is also disapplied. Section 3A TCGA provides:

> (1) Where in the case of an individual—
>
> (a) the amount of chargeable gains accruing to him in any year of assessment or, if that year is a split year as respects the individual, the UK part of that year does not exceed the

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3 Mike Truman, *Taxation* 21 Feb 2008 p.161.

4 Flagged (somewhat unnecessarily) in s.809G(3) ITA.

5 See 47.7.2 (Personal allowances under DTAs: remittance basis claimants).

6 Note that a loss election may also disapply the CGT annual exemption: see 54.11(Position if loss election is made).

exempt amount for that year, and

(b) the aggregate amount or value of the consideration for all chargeable disposals of assets made by him in that year or, as the case may be, that part of the year does not exceed four times the exempt amount for that year,

a statement to that effect is sufficient compliance with so much of any notice under section 8 of the Management Act as requires information for the purposes of establishing the amount in which he is chargeable to capital gains tax for that year. ...

(5A) Subsection (1) does not apply to an individual for a tax year if—

(a) section 809B of ITA 2007 (claim for remittance basis to apply), or

(b) section 16ZB below (certain chargeable gains charged on remittance basis),

applies to the individual for that year.

47.6 Persons entitled to IT personal allowances

There are ten categories of individuals who qualify for personal allowances under chapters 2 and 3 part 3 ITA. In short:

(1) UK residents

(2) Non-residents:

(a) Seven categories listed in s.56(3) ITA

(b) Those entitled under DTAs

(c) Visiting forces[7]

47.6.1 *Entitlement to personal allowances: UK residents*

Section 56(2) ITA 2007 sets out the first category of individuals who qualify for personal allowances, which is UK residents:

The individual meets the requirements of this section if the individual—

(a) is UK resident for the tax year, or

(b) meets the condition in subsection (3).

47.6.2 *Entitlement under s.56(3)*

Section 56(3) ITA 2007 sets out the next seven categories which apply to non-residents. The practical significance of this is limited, since often a claim for a personal allowance is effectively cancelled by non-resident

7 See App.5.2.4 (Personal allowances).

individual's IT relief.[8]

The most significant category is EEA nationals. These are presumably included because a relief for UK residents but not for EEA nationals would be incompatible with EU freedom of establishment.[9]

The remaining categories are a strange ragbag:

> An individual meets the condition in this subsection if, at any time in the tax year, the individual—
>
> (za) is a national of an EEA state,
>
> (a) is resident in the Isle of Man or the Channel Islands,[10]
>
> (b) has previously resided in the UK and is resident abroad for the sake of the health of—
>
> (i) the individual, or
>
> (ii) a member of the individual's family who is resident with the individual,
>
> (c) is a person who is or has been employed in the service of the Crown,
>
> (d) is employed in the service of any territory under Her Majesty's protection,
>
> (e) is employed in the service of a missionary society, or
>
> (f) is a person whose late spouse or late civil partner was employed in the service of the Crown.

47.6.3 *Commentary*

There is scope here for simplification: there is a very strong case for repeal of s.56(3)(a)-(f), ie the entire list apart from EEA nationals.

47.6.4 *Commonwealth citizens*

Before 2010/11 there was an additional category, namely, Commonwealth citizens. The tax law rewrite considered that this was contrary to the Human Rights Act.[11] Accordingly this category was deleted by the FA 2009. EN FA 2009 provides:

> 14. Previously, there was an entitlement for some individuals to claim purely by virtue of being a Commonwealth citizen but by meeting no other condition. Commonwealth citizens will no longer qualify for

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8 See 42.4 (Amount B (disregarded income and reliefs)).

9 See 60.4 (Freedom of establishment).

10 This category has been included since 1910: I would be grateful for any reader who could suggest the reason.

11 EN ITA para 135.

> personal allowances, married couple's allowance, blind person's allowance and relief for life assurance premiums by reference to their Commonwealth citizenship status alone. They may, of course, continue to qualify under the other conditions or through DTA provisions if appropriate.
> 15. This change will mainly affect citizens of the following countries: Bahamas; Cameroon; Cook Islands; Dominica; Maldives; Mozambique; Nauru; Niue; St Lucia; St Vincent & the Grenadines; Samoa; Tanzania; Tonga; and Vanuatu.

The objection was that granting personal allowances to an individual solely on the basis that they are a Commonwealth citizen would be discriminatory on the grounds of nationality.[12] The rewrite did not consider that there was the unlawful discrimination in providing allowances to EEA nationals, as the distinction between EEA nationals and the rest of the world is justified by the distinct legal relationship which the UK has with the EEA.[13]

This rule was just about the last remaining example of special treatment for Commonwealth citizens in UK tax legislation, so the issue does not have immediate tax implications in other areas but it does illustrate two interesting points: a significant restriction on the UK's ability to impose tax; and the (in)significance of the Commonwealth (at least in a Human Rights context); the tax law rewrite rejected the argument that the legal relationship which the UK has with the Commonwealth would justify the discrimination.

47.7 Personal allowances under DTAs

The last category of individuals entitled to personal allowances relates to DTAs.

47.7.1 *Non-residents*

The OECD model convention does not affect the rule that personal allowances are limited to UK residents (and other specific categories).[14]

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12 Art.14 ECHR (Prohibition of discrimination) in conjunction with Art.1 of 1st Protocol (Right to property).

13 Private correspondence.

14 OECD model convention art. 24(3) provides:
"This provision [non-discrimination] shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family

However most UK treaties are different. A Treasury consultation paper explains the position:

> Most tax treaties between the UK and other states extend entitlement to UK Personal Allowances to nationals of those states who are not entitled to claim a UK Personal Allowance under UK domestic statute. This is because of the interaction between the UK domestic statute and the UK's obligations under the non-discrimination articles in those tax treaties.
>
> Current UK statute provides that UK nationals are entitled to UK Personal Allowances wherever they are resident. The non-discrimination provisions found in most UK tax treaties extend the entitlement to UK Personal Allowances to nationals of the treaty partner state who are also resident there. Some of the UK's tax treaties also expressly provide that UK Personal Allowances will be granted to residents of the partner state regardless of nationality, or nationals of the partner state wherever they are resident....
>
> The UK's tax treaties do not all entitle overseas residents to a UK Personal Allowance. Some, such as that with the United States, do not contain a non-discrimination article of this sort or specifically exclude entitlement to Personal Allowances from the non-discrimination article. Also, whilst the UK's network of tax treaties is one of the most extensive in the world, it does not have a tax treaty with every country, for example there is currently no UK-Brazil tax treaty.[15]

For instance, art. 25(1) Austria/UK DTA provides:

> Subject to the provisions of paragraph (3) of this Article, individuals who are residents of Austria shall be entitled to the same personal allowances, reliefs and reductions for the purposes of UK tax as British subjects[16] not resident in the UK. ...

Non-resident British subjects qualify for personal allowances as they are nationals of an EEA state (the UK) so individuals who are treaty-resident in Austria will likewise do so.

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responsibilities which it grants to its own residents."

15 HM Treasury Consultation Paper, "Restricting non-residents' entitlement to the UK personal allowance" (July 2014) *https://www.gov.uk/government/consultations/restricting-non-residents-entitlement-to-the-uk-personal-allowance/restricting-non-residents-entitlement-to-the-uk-personal-allowance*

16 Defined in s.51 British Nationality Act 1981.

Sometimes there is a restriction. Article 25(3) Austria/UK DTA provides:

> Nothing in this Convention shall entitle an individual who is a resident of a Contracting State [Austria] and whose income from the other Contracting State [UK] consists solely of dividends, interest or royalties (or solely of any combination thereof) to the personal allowances, reliefs and reductions of the kind referred to in this Article for the purposes of taxation in that other Contracting State.

One could avoid the restriction by procuring income other than dividends, interest and royalties (maybe annual payments) but the amounts involved are small.

The RDR Manual provides:

> **10340 Non-resident individuals who may claim Personal Allowances under the provisions of Double Taxation Agreements** [March 2013]
> Non-resident individuals who satisfy one of the conditions below are entitled to UK Personal Allowances
> [1] an individual who is a national of Israel or Jamaica or
> [2] [EEA Nationals] or
> [3] an individual who is a national and also a resident of Argentina, Australia, Azerbaijan, Bangladesh, Belarus, Bolivia, Bosnia and Herzegovina*,Botswana, Canada, China, Côte d'Ivoire (Ivory Coast), Croatia*, Egypt, Gambia, India, Indonesia, Japan, Jordan, Kazakhstan, Korea, Lesotho, Malaysia, Montenegro*, Morocco, New Zealand, Nigeria, Oman, Pakistan, Papua New Guinea, Philippines, Russian Federation, Serbia*, South Africa, Sri Lanka, Sudan, Switzerland, Taiwan, Tajikistan, Thailand, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan, Uganda, Ukraine, Uzbekistan, Venezuela, Vietnam, Federal Republic of Yugoslavia*, Zimbabwe
> (*Note: Entitlement continues under the Double Taxation Treaty the UK had with the former Yugoslavia until such time as a new agreement takes effect.) or
> [4] an individual who is a resident of Austria, Barbados, Belgium, Fiji France, Germany, Greece, Ireland, Kenya, Luxembourg, Mauritius, Myanmar (Burma), Namibia, Netherlands, Portugal, Swaziland, Sweden, Switzerland, Zambia
> (Please note: If individual is a resident, but not a citizen of Austria, Belgium, France,* Germany*, Kenya, Luxembourg, Mauritius, Netherlands*, Portugal, Sweden, Switzerland or Zambia, they are not entitled to personal allowances if their income consists solely of

dividends, interest and royalties or any combination of them).

* France - FROM 6 April 2010 personal allowances are given to a Resident and a National of the country irrespective of their income
* Germany - FROM 6 April 2011 residents of the country are not entitled to personal allowances unless they are an EEA National.
* Netherlands - FROM 6 April 2011 personal allowances are given to a Resident of the country irrespective of their UK income.

The form to claim the relief is R43.

The practical significance of DTAs conferring personal allowances on non-residents is limited, since often a claim for the relief is effectively cancelled by non-resident individual's IT relief.[17] Also of course the personal allowance is only needed for UK source income which remains taxable in the UK under the treaty. The Treasury consultation paper mentioned above explains:

> Tax treaties allocate taxing rights between the state of source and the state of residence to avoid individuals and other persons facing double taxation. Depending on the nature of the income, double taxation is avoided either by conferring upon a state an exclusive right to tax or providing that both states can tax, but that the state of residence must relieve the tax levied in the state of source. Where an exclusive right to tax income is conferred upon one of the states, this is generally on the state of residence. Where the UK retains a taxing right over the income of non-residents under a tax treaty, such as income from UK property or certain employments exercised in the UK, non-residents entitled to a UK personal allowance may currently set it against these forms of income. It is therefore these non-residents who would be impacted by any restriction on non-residents' entitlement to the UK personal allowance.[18]

47.7.2 *Personal allowances under DTAs: Remittance basis claimants*

Remittance basis claimants (who would in principle qualify for personal allowances as they are by definition UK resident) lose their personal allowances (and CGT annual exemption) by making a remittance basis

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17 See 42.4 (Amount B (disregarded income and reliefs)).

18 HM Treasury Consultation Paper, "Restricting non-residents' entitlement to the UK personal allowance" (July 2014) *https://www.gov.uk/government/consultations/restricting-non-residents-entitlement-to-the-uk-personal-allowance/restricting-non-residents-entitlement-to-the-uk-personal-allowance*

claim.[19] This disallowance is overridden (so the right to personal allowances and CGT annual exemption is restored) by a DTA if applicable.[20] The treaties which confer personal allowances are those set out in the list above, with the exception of Myanmar and Greece.[21]

This treaty relief only affects remittance basis taxpayers who make a remittance basis claim, ie where:

(1) the individual is UK resident (so a remittance basis claim is made); and
(2) the individual is treaty-resident in the jurisdiction concerned (so that DT relief applies).

So this point will not be a common one, though it will arise from time to time.

47.8 The Future

Budget 2014 announced:

> **Personal allowances for non-residents** – To ensure the UK personal allowance remains well targeted, the Government intends to consult on whether and how the allowance could be restricted to UK residents and those living overseas who have strong economic connections in the UK, as is the case in many other countries, including most of the EU.

The issue has become more important because of the increase in personal allowance in recent years.

The consultation paper has now been published. It contains interesting comments on the impact of the personal allowance for non-residents.

> **6.1 Impact on individuals**
> HMRC estimate there to be at least 400,000 individuals claiming Personal Allowances in the UK who are non-resident for tax purposes. Based on the data available, if non-residents were not entitled to the UK Personal Allowance most of them would face increased UK tax

19 See 47.5 (Withdrawal of IT personal allowances & CGT annual exemption for remittance basis claimants).

20 Jane Kennedy (Financial Secretary to the Treasury) accepted this in the public Bill committee debate on the Finance Bill, Hansard 19 June 2008 col 818, accessible *http://www.publications.parliament.uk/pa/cm200708/cmpublic/finance/080619/am/80619s05.htm*.

21 The antique treaties of Myanmar and Greece only grant personal allowances to residents of Myanmar/Greece who are not UK-law UK resident; they do not help UK-law UK residents even if also residents of Myanmar/Greece.

liabilities. However most of these individuals would be able to claim relief overseas either in the form of a credit for tax paid in the UK or exemption from tax in their home state. Therefore most individuals would not generally pay more tax overall than they do now. However this will depend on the relative level of tax rates and allowances between the UK and their country of residence. Those living in low tax jurisdictions are likely to pay more tax overall than they do now if they were not able to claim the UK Personal Allowance than they do now...

6.2 High income individuals

Around 5,000 high earning non-residents already have their Personal Allowance tapered away because their UK income is greater than £100,000...

6.3 Middle income individuals

There are more than 110,000 migrant taxpayers with incomes over the level of the Personal Allowance and a significant proportion of this group are middle income non-residents. This includes, for example, professionals or managers seconded to the UK for a few months to work on specific projects. Individuals in this cohort who are not tax resident in the UK but pay UK tax on their earnings are likely to earn in excess of the Personal Allowance, so they have UK tax to pay on their earnings. Even without any policy change they are likely to claim double taxation relief in their country of residence to offset the UK taxation on their UK earnings. These individuals will not generally face a significant cash loss from the withdrawal of the UK Personal Allowance; however this will depend on the relative level of tax rates and allowances between the UK and their country of residence. Those living in low tax jurisdictions may face a cash loss...

6.4 Low income individuals

Around 250,000 migrants, many of whom are non-residents, receive UK income below the Personal Allowance. Although some will have higher incomes overseas, some of this group will have a very low overall income. This group includes a significant group who may not pay sufficient tax overseas to claim relief for any UK tax payable and might face a cash loss if their entitlement to a UK Personal Allowance is withdrawn.

6.5 Non-resident landlords and others with UK property income

There are around 175,000 non-UK resident taxpayers with rental income. Non-resident landlords will generally be taxed on their UK rental income in their country of residence as well as the UK. Although some may currently not need to claim double taxation relief as their UK income is below the Personal Allowance, many non resident landlords would be able to claim double taxation relief and so should not face an

overall cash loss without a UK Personal Allowance...

6.6 Pensioners

Pensioners who live overseas are a significant group of British national expatriates, estimated by DWP at around 1,200,000 individuals. Most UK national pensioners living overseas would not be affected by any restriction on non-residents entitlement to the Personal Allowance. This is because:

- some are still resident in the UK for tax purposes and so would not be affected by any change
- provisions of tax treaties generally mean that UK state pensions, personal pensions or private sector occupational pensions are only taxable in recipients' states of residence and not in the UK
- many non-resident UK national pensioners do not have any other income (i.e. employment or property) which is taxable in the UK and would not be affected by losing their Personal Allowance

However, under double tax treaties, UK sourced government service pensions (a wide category which includes, amongst others, some NHS staff and those employed by local authorities) are generally only taxed in the UK, regardless of recipients' residence status. This can also be the case with some other forms of income under specific treaties. The withdrawal of the UK personal allowance from non-residents in receipt of a UK government service pension would result in them paying more tax overall as there is no overseas tax liability against which the additional UK tax could be relieved.

The government is concerned that individuals, like those in receipt of government service pensions, who are not eligible for double taxation relief, would be disproportionately affected by the removal of the UK Personal Allowance.

The government does not intend to raise taxes on vulnerable groups or in situations where the UK is the principal taxing authority and an individual has no recourse to relief as a result of the UK having sole taxing rights under a tax treaty. If the government were to restrict non-residents' entitlement to the Personal Allowance, it would intend this to apply to types of income which are taxable both in the UK and overseas (such as that from immovable property) but to retain the Personal Allowance on income that is taxable exclusively in the UK.[22]

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22 HM Treasury Consultation Paper, "Restricting non-residents' entitlement to the UK personal allowance" (July 2014) *https://www.gov.uk/government/consultations/restricting-non-residents-entitlement-to-the-uk-personal-allowance/restricting-non-residents-entitlement-to-the-uk-personal-allowance*

CHAPTER FORTY EIGHT

NATIONAL INSURANCE CONTRIBUTIONS

48.1 NICs: Introduction

NICs should be regarded as a collection of seven more or less distinct taxes. Section 1(2) SSCBA classifies them semi-numerically:

> Contributions under this Part of this Act shall be of the following six classes—
>
> (a) Class 1, earnings-related, payable under section 6 below, being—
>
> (i) primary Class 1 contributions from employed earners; and
>
> (ii) secondary Class 1 contributions from employers and other persons paying earnings;
>
> (b) Class 1A, payable under section 10 below by persons liable to pay secondary Class 1 contributions and certain other persons;
>
> (bb) Class 1B, payable under section 10A below by persons who are accountable to the Inland Revenue in respect of income tax on general earnings in accordance with a PAYE settlement agreement;
>
> (c) Class 2, flat-rate, payable weekly under section 11 below by self-employed earners;
>
> (d) Class 3, payable under section 13 or 13A below by earners and others voluntarily with a view to providing entitlement to benefit, or making up entitlement; and
>
> (e) Class 4, payable under section 15 below in respect of the profits or gains of a trade, profession or vocation, or under section 18 below in respect of equivalent earnings.

Each class of NIC requires a book to itself, except for class 1 which requires many volumes. I focus on matters closest to the themes of this book. I do not consider the special rules for mariners, aircrew, diplomats and service personnel.

SSCBA does not apply in Northern Ireland[1] so it refers to "Great Britain". (Northern Ireland has its own equivalent legislation not discussed here.) SSCR applies throughout the UK, so it usually refers to the UK, or to "GB and Northern Ireland".

48.2 Meaning of "employed" and "self-employed"

Section 2(1) SSCBA provides:

> (1) In this Part of this Act and Parts II to V below—
> (a) "employed earner" means a person who is gainfully employed in Great Britain either under a contract of service, or in an office (including elective office)[2] with general earnings; and
> (b) "self-employed earner" means a person who is gainfully employed in Great Britain otherwise than in employed earner's employment (whether or not he is also employed in such employment).

The SSCBA, confusingly, (mis)defines the word "employment" to include trades and professions.[3] But in the definition the terms "employed" and "self-employed" are used in more or less their ordinary meanings. (To add to the confusion, the SSCER deems some persons actually self-employed to be employees for NIC purposes and vice versa.)

In this chapter I use the word "**employee**" to mean an "employed earner" and "**self-employed**" means a "self-employed earner".

48.3 Meaning of "secondary contributor"

Section 6(4) SSCBA provides:

> The primary and secondary Class 1 contributions referred to in subsection (1) above are payable as follows—
> (a) the primary contribution shall be the liability of the earner; and
> (b) the secondary contribution shall be the liability of the secondary contributor; …

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1 Section 177 SSCBA provides:
"(5) The following provisions extend to Northern Ireland—
section 16 and Schedule 2; section 116(2); and this section.
(6) Except as provided by this section, this Act does not extend to Northern Ireland."

2 The odd expression "elective office" is not defined and the words in brackets are otiose.

3 Section 122(1) SSCBA.

The identity of the secondary contributor is clearly crucial.

Section 7(1) SSCBA provides:

> For the purposes of this Act, the "secondary contributor" in relation to any payment of earnings to or for the benefit of an employed earner, is—
>
> (a) in the case of an earner employed under a contract of service, his employer;
>
> (b) in the case of an earner employed in an office with general earnings, either—
>
> (i) such person as may be prescribed in relation to that office; or
>
> (ii) if no person is prescribed, the government department, public authority or body of persons responsible for paying the general earnings of the office.

SSCER reg. 5(1) prevents avoidance by foreign employers seconding to the UK:

> For the purposes of section 4 of the Act[4] (Class 1 contributions), in relation to any payment of earnings to or for the benefit of an employed earner in any employment described in any paragraph in column (A) of Schedule 3 to these regulations, the person specified in the corresponding paragraph in column (B) of that Schedule shall be treated as the secondary Class 1 contributor in relation to that employed earner.
>
> ...

Column (A)	**Column (B)**
9. Employment by a foreign employer where— (a) in pursuance of that employment the personal service of the person employed is made available to a host employer; and (b) the personal service is rendered for the purposes of the business of that host employer; and (c) that personal service for the host employer begins on or after 6th April 1994.	9. The host employer to whom the personal service of the person employed is made available.

4 Section 4 Social Security Act 1975 is now s.7 SSCBA.

The identity of the employer is a question of contract/employment law.[5]

48.4 Territorial Limitation

Tax Bulletin 79 explains:

> For NIC purposes the world can be usefully divided into:
> **European Economic Area (EEA)**
> EC Treaty and EC Regulation [formerly 1408/71 and now 883/2004] applies to employees moving between EEA Member States to work. It modifies SSCBA 1992 and regulations.
> **RA/DCC Countries**[6]
> Bi-lateral Social Security agreements modify SSCBA 1992 and regulations.
> **Rest of The World** ("ROW")
> SSCBA 1992 and contributions regulations are unmodified.

Bilateral social security agreements are not considered in this book. I first consider what the NI Manual calls "ROW" [rest of the world] rules, and then the EU rules.

48.5 ROW: Employed in GB

Unless the individual is employed *in* GB, they are not an employed or self-employed earner, and so in principle no NIC liability arises.[7] I refer to this as the "**employed in GB rule**".

Tax Bulletin 79 explains:

> This requires that employment duties take place here. However, this is wide enough to allow for some temporary or incidental duties of the

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5 Tax Bulletin 49 provides:
"We would not seek to claim in isolation that there is a place of business [in the UK] where the overseas provider legally, and in exchange for a payment commensurate with the service, sub-contracts services to a UK business. And similarly we would also not normally attempt to claim in isolation that the unconnected UK business is the employer if it is genuinely not paying the mariners directly." (This has been flagged as no longer current, however the author is not currently aware of this passage being moved elsewhere.)
This is only relevant to mariners as others are caught by the SSCER.

6 These countries are: Barbados, Bermuda, Bosnia-Herzegovina, Canada, Croatia, Guernsey, Israel, Jamaica, Japan, Jersey, Macedonia, Mauritius, Montenegro, New Zealand (Social Security Benefits only), Philippines, Republic of Korea, Serbia, Turkey, USA.

7 See 48.2 (Meaning of "employed" and "self-employed").

employment to be performed outside the UK, if the UK is the place where the employment duties are usually performed.

48.5.1 *First year abroad*

Reg. 146 SSCR provides an extension to the employed in GB rule:

> (1) Where an earner is gainfully employed outside the UK, and that employment, if it had been in Great Britain or Northern Ireland, would have been employed earner's employment, that employment outside the UK shall be treated as employed earner's employment for the period for which under para (2)(a) contributions are payable in respect of the earnings paid to the earner in respect of that employment provided that—
>
> (a) the employer has a place of business in Great Britain or Northern Ireland (as the case may be);
>
> (b) the earner is ordinarily resident in Great Britain or Northern Ireland (as the case may be); and
>
> (c) immediately before the commencement of the employment the earner was resident in Great Britain or Northern Ireland (as the case may be).
>
> (2) Where, under para (1), the employment outside the UK is treated as an employed earner's employment, the following provisions shall apply in respect of the payment of contributions—
>
> (a) primary and secondary Class 1 contributions shall be payable in respect of any payment of earnings for the employment outside the UK during the period of 52 contribution weeks from the beginning of the contribution week in which that employment begins to the same extent as that to which such contributions would have been payable if the employment had been in Great Britain or Northern Ireland (as the case may be);
>
> (b) subject to regulations 148 and 148A, any earner by or in respect of whom contributions are or have been payable under sub-para (a) shall be entitled to pay Class 3 contributions in respect of any year during which the earner is outside the UK from and including that in which the employment outside the UK begins until that in which he next returns to Great Britain or Northern Ireland (as the case may be);
>
> (c) Class 1A contributions and Class 1B contributions shall be payable in respect of the period specified in sub-para (a).

Thus employment outside the UK is treated as employment in the UK (and so subject to NIC) for 52 weeks, provided the following conditions are

satisfied:

(1) The employer has a place of business in the UK.
(2) The employee is ordinarily resident in UK.
(3) The employee was UK resident immediately before the employment commenced.

NI Manual provides:

> **NIM33535 - special cases: international - people going to or coming from abroad: row: change of employment** [Oct 2013]
> **Change of employment overseas with the same employer**
> The 52 week period of continuing liability may cease when an employee changes employment. Whether or not an employee has entered into a new employment will be a question of fact. The contracts of employment will indicate if this were so.
> **Example**
> - Ralph was posted by the UK company to work in Australia for a period of 2 years as a General Manager of the Sydney office
> - After 6 months he applied for promotion as a Overseas Sales Executive with a separate department of the UK company
> - He was successful and immediately took up his new position in Malaysia
>
> The subsequent posting from Australia to Malaysia would be considered to arise in connection with the new employment with the UK Company. The 52 week period would cease.
> Had the UK employer simply posted him to Malaysia in connection with the original occupation/employment as a General Manager then the 52 week period would have continued in full.
> Whether or not this is actually right depends on the documentation relating to the contract of employment.

48.6 ROW: Residence requirements

Section 1(6) SSCBA provides:

> No person shall—
> (a) be liable to pay Class 1, Class 1A, Class 1B or Class 2 contributions unless he fulfils prescribed conditions as to residence or presence in Great Britain;
> (b) be entitled to pay Class 3 contributions unless he fulfils such conditions; or
> (c) be entitled to pay Class 1, Class 1A, Class 1B or Class 2 contributions other than those which he is liable to pay, except so far as he is permitted by regulations to pay them.

Reg. 145 SSCR provides five different sets of residence requirements. These apply in addition to the employed in GB rule.

48.6.1 *Primary Class 1 NIC*

Reg. 145(1)(a) SSCR provides that the requirement is:

> as respects liability of an employed earner to pay primary Class 1 contributions in respect of earnings for an employed earner's employment, that the employed earner is resident or present in Great Britain or Northern Ireland (or but for any temporary absence would be present in Great Britain or Northern Ireland) at the time of that employment or is then ordinarily resident in Great Britain or Northern Ireland (as the case may be).

There are four possible territorial connections, and if any one of them is satisfied Primary Class 1 NIC is in principle payable:

(1) Residence in UK.
(2) Presence in UK.
(3) Temporary absence from UK.
(4) Ordinary residence in UK.

Tax Bulletin 79 explains:

> The effect of Regulation 145 (1) SSCR 2001 is to provide for a kind of constructive presence for periods outside the UK which are merely a "temporary absence". This concept of temporary absence requires that:
>
> i. the person's absence be temporary,
> ii. that if he were not absent he would be present in the UK.
>
> This means that an employee who has employment based in the UK who goes abroad for a time on a short business trip or holiday abroad, and who departs from or returns to the UK, can continue to be within the UK scheme.
>
> An example of this would be the person who flies to a board meeting outside the UK and then returns to their UK based employment.

That seems obvious. The Bulletin continues:

> Taken together, Section 2(1)(a) SSCBA 1992 and Regulation 145 (1)(a) SSCR 2001 is enough to keep a person within Class 1 NIC if their employment is based here and their absence abroad is of a temporary or incidental nature. However, crucially, an employee who is not ordinarily resident in the UK and who normally works overseas cannot be said to be merely "temporarily absent" from employed earners employment in the UK if they are departing overseas for a time, to work for their

foreign employer. In such a situation, the person is not performing duties which is merely incidental to the employed earner's employment in the UK but is returning to an employment based outside the UK. In the absence of an express contractual provision as to the attribution of the earnings, the earnings must be apportioned between the employed earner employment in the UK and the overseas duties for the foreign employer.

48.6.2 *First year in UK exemption*

Reg. 145(2) SSCR provides an exception:

> Where a person is ordinarily neither resident nor employed in the UK and, in pursuance of employment which is mainly employment outside the UK by an employer whose place of business is outside the UK (whether or not he also has a place of business in the UK) that person is employed for a time in Great Britain or Northern Ireland (as the case may be) as an employed earner and, but for the provisions of this paragraph, the provisions of sub-para (a) of para (1) would apply, the conditions prescribed in that sub-paragraph and in sub-para (b) of that paragraph shall apply subject to the proviso that—
>
> (a) no primary or secondary Class 1 contribution shall be payable in respect of the earnings of the employed earner for such employment;
>
> (b) no Class 1A contribution shall be payable in respect of something which is made available to the employed earner or to a member of his family or household by reason of such employment; and
>
> (c) no Class 1B contribution shall be payable in respect of any PAYE settlement agreement in connection with such employment,[8]
>
> after the date of the earner's last entry into Great Britain or Northern Ireland (as the case may be) and before he has been resident in Great Britain or Northern Ireland (as the case may be) for a continuous period of 52 contribution weeks from the beginning of the contribution week following that in which that date falls.

Thus employment in the UK is not subject to NIC for 52 weeks provided

8 I have corrected a disastrous typographical error in the SSCR by inserting a paragraph break here. The last paragraph (beginning "after the date") governs paras (a), (b) and (c). This can be seen to be correct from context and by comparing the predecessor, reg.119(2) SSCR 1979.

the following conditions are satisfied:
(1) employee not ordinarily resident in UK;
(2) employee not ordinarily employed in UK;
(3) employment mainly outside the UK;
(4) employer has a place of business outside the UK.[9]
NI Manual provides:

> **NIM33515 - special cases: international - people going to or coming from abroad: row: exemption** [Oct 2013]
> **Regulation 145(2) SSCR 2001**
> This regulation provides exemption from the payment of primary and secondary Class 1 NICs for posted workers arriving in GB a continuous period of 52 contribution weeks provided the worker is
> - not ordinarily resident in GB ; and
> - not ordinarily employed in GB ; and
> - in pursuance of an employment that is mainly outside the UK ;
> - by an employer with a place of business outside the UK ; and
> - is employed for a time in GB as an employed earner
>
> The exemption lasts until the employee has been resident in GB for a continuous period of 52 weeks starting from the beginning of the contribution week following the week in which the worker arrives in GB to take up employment.
> A further 52 week period may commence where an employee returns to the overseas employment and then commences a new secondment in GB
> The exemption does not apply to:
> - EEA nationals as this would contravene the principle behind Regulation 883/04 see NIM33020
> - RA countries where a person is treated as being ordinarily resident in the UK if they fall within UK domestic legislation see NIM33400
> - To decide whether a person coming to the UK is ordinarily resident in the UK for NIC purposes, apply the tests suggested in NIM33505 and NIM33510.
>
> **NIM33520 - special cases: international - people going to or coming from abroad: row: exemption example** [Oct 2013]
> A doctor works for a hospital in Egypt as a surgeon and sees an advert in a medical journal for surgeon's position in Newcastle for a 2 year period. The position will enable him to obtain further advanced surgical

9 It might be inferred that the relief only applies if the employer's principal place of business is outside the UK, but the better view is that any place of business outside the UK is sufficient, and this is consistent with reg.146(2).

qualifications.

He applies and is successful. The Egyptian employer agrees to keep his employment position open until he returns. The doctor signs a contract of employment with the hospital in Newcastle for two years.

In this case the 52 week exemption tests are satisfied. He is not ordinarily resident or employed in GB. He is employed for a time in GB as an employed earner. A major indicator in this example is the continuing employment in Egypt and the employee being able to return after the period of employment in GB.

In order to satisfy the "in pursuance of employment" test the employment in GB must be related to the particular employment that the employee has outside of GB. The fact that the employee may be pursuing their own goals is not relevant. It is characteristic of much skilled work that the employer's interests in a person's improved skills will coincide with the employee's interest in advancing their career and marketability. Provided that the facts support that the employment in GB and obtaining of advanced qualifications (in this case advanced surgical qualifications) are required for the employment abroad then the test may apply

A different conclusion may have been reached if the employment and qualifications obtained in GB were diverse from the employment in Egypt.

48.6.3 *Student exemption*

Reg. 145(3) SSCR provides an exception for students and apprentices:

> Where a person to whom para (1)(a) would otherwise apply is not ordinarily resident in the UK and is not a person to whom the provisions of para (2) apply, the proviso in para (2) shall nevertheless apply if either—
>
> (a) during a vacation occurring in a course of full-time studies which that person is pursing [*sic*] outside the UK, that person is gainfully employed under a contract of service in Great Britain or Northern Ireland (as the case may be) in temporary employment of a nature similar or related to that course of studies; or
>
> (b) there exists between him and some other person outside the UK a relationship comparable with the relationship between an apprentice and his master in Great Britain or Northern Ireland (as the case may be) and that person is gainfully employed under a contract of service in Great Britain or Northern Ireland (as the case may be) in employment which began before he

attained the age of 25 and which is of a nature similar or related to the employment under the said relationship outside the UK.

48.6.4 *Secondary Class 1, Class 1A and 1B NICs*

Reg. 145(1)(b) SSCR provides that the requirement is:

> as respect[10] liability to pay secondary Class 1 contributions, Class 1A contributions or Class 1B contributions that the person who, but for any conditions as to residence or presence in Great Britain or Northern Ireland (as the case may be and including the having of a place of business in Great Britain or Northern Ireland),[11] would be the secondary contributor or the person liable for the payment of Class 1B contributions (in this Case referred to as "the employer") is resident or present in Great Britain or Northern Ireland when such contributions become payable or then has a place of business in Great Britain or Northern Ireland (as the case may be), so however that nothing in this paragraph shall prevent the employer paying the said contributions if he so wishes.

Thus there are three possible connecting factors and if any of them is satisfied, secondary Class 1 NIC is due:
(1) employer is resident in UK;
(2) employer is present in UK;
(3) employer has a place of business in UK.
The first year in UK and student exemptions may apply.

48.7 Primary and Secondary Class 1 NIC: HMRC examples

Tax Bulletin 79 provides:

> **Example 1 (Angus)**
> **Resident/Not Ordinarily Resident UK - Sent from ROW country to work in the UK - contractual employer in ROW country but seconded to the UK "host" employer.**

10 This is a slip for "*as respects*" … but nothing turns on that.

11 The long phrase beginning "but for" (and continuing to the close of brackets which follows) appears to be otiose. The paragraph means:
"as respects liability to pay secondary Class 1 contributions, Class 1A contributions or Class 1B contributions that the person who is the secondary contributor or the person liable for the payment of Class 1B contributions (in this Case referred to as 'the employer') is resident or present in Great Britain or Northern Ireland when such contributions become payable or then has a place of business in Great Britain or Northern Ireland …"

An Australian employer assigns A, who normally works in Australia to the UK for 2 years. Residence status is resident in the UK but not ordinarily resident in years 1 and 2.

A meets the criteria for a 52 weeks exemption from NIC because he is not ordinarily resident in the UK and he is not ordinarily employed in the UK and is working for his overseas employer and is in the UK in continuance of that employment. His Australian employer has no place of business in the UK.

Once the first 52 weeks period in Regulation 145(2) SSCR 2001 has expired, A will become liable for contributions in the UK. As his contractual employer has no place of business in the UK, the UK "host" employer to whom personal service is made available is the secondary contributor - liable for the employer part of the National Insurance. [Para 9 to Regulation 3, Social Security Categorisation of Earners Regulations 1978].

When he is in the UK, A is in employed earner's employment and meets the residence criteria in Regulation 145 (1) SSCR 2001 because he is present in the UK at the time of his employment.

A makes a short trip back to Australia in year 2 to brief the Australian company.

After 14 months in the UK, A returns to Australia for the month of June - 20 days holiday and 5 days working for the Australian company. He then returns to the UK to complete the rest of his assignment. A remains under contract to the Australian company and the costs of his employment in the UK is met by the Australian employer. There is no apportionment of salary specified in the contract. There can be apportionment of his salary for the days working outside the UK.

When A is in earners employment in the UK he is liable for NICs on his salary because he meets the criteria of residence and presence in Regulation 145 (1) SSCR 2001.

When in Australia, A is not in employed earners employment in the UK - his employment is one which is normally based outside the UK - so that the days working in Australia are not an incidental part of employed earners employment in the UK.

What if the employment had been funded by the UK company?

We would consider this a strong indicator that A was performing his duties in Australia for the purposes of the business of the UK "host" employer and his time in Australia was merely a "temporary absence" from employed earner's employment for the purposes of Regulation 145(1) SSCR 2001.

What if there is a letter of secondment - attaching A to his UK employer?

We consider that this would be a strong indicator that A's normal base is the UK and he can be considered to be merely "temporarily absent" for the purposes of Regulation 145(1) SSCR 2001 - the duties in Australia are incidental to the employment in the UK for which he is paid his salary.

What if A had travelled to China for 3 days to act on behalf of the UK company?

A's normal base is the UK and he can be considered to be merely "temporarily absent" for the purposes of Regulation 145(1) SSCR 2001 - the duties in China are incidental to the employment in the UK. No apportionment is required.

What if A had travelled to China for 3 days to act on behalf of the Australian company?

The duties are not further to the employment in the UK and cannot be regarded as merely a temporary absence. An apportionment is required.

What if A has been sent to the UK and become ordinarily resident here?

If A's normal base is the UK he will be in employed earner's employment in Great Britain. As he is ordinarily resident he meets the residence criteria in Regulation 145(1) SSCR 2001 - the duties in Australia are merely incidental to the employment in the employed earner's employment in the UK for which he is paid his salary. No apportionment is required.

Exactly how many days amounts to a "temporary absence"?

Whether an absence is a temporary absence is a question of fact and degree, which depends upon the nature of the circumstances. Examples of what we would consider to be temporary absence would include short business trips or holidays.

Method of Time Apportionment

In the absence of contractual provision, there is to be an apportionment between UK and non-UK workdays under Section 2 of the Apportionment Act 1870. Under the Apportionment Act, salary accrues on a daily basis. The earnings are to be multiplied by a fraction where the numerator is the number of days working overseas in the overseas employer's business and the denominator is the total number of days in employment – in a full year this will be 365 days.

Where the employee is monthly or weekly paid, the computation has to take account of the "pay period" basis for computing NIC.

Example 2 (Patel)

Mrs P is ordinarily resident in India and is sent to the UK by her employer to work in the UK at the offices of a UK company which is part of the group. She remains under contract to the Indian employer and the Indian employer bears the cost of the employment. Her salary is £100,000. Her employer recalls her to India to advise on a hostile take-over for a period of 5 days - From 1 June until 5 June. The substantial part of 2 of those days is spent flying to India and back.

The earnings are multiplied by a fraction where the numerator is the number of days working overseas in the overseas employer's business and the denominator is the total number of days in employment.

If Mrs P has an annual pay period, then the appropriate fraction can simply be applied to her annual salary.

Gross Pay £100,000×5/365

Amount attributable to overseas workdays less £1369.87

NIC is operated on the gross pay attributable to the UK £98,630.13

However, if Mrs P is monthly paid, the employer has to account for NIC each month as a payment is made, and is unable to "look back" over a year and know what percentage needs to be applied. So the apportionment has to be done in the monthly pay period.

In June, no NICs are due on the salary paid in respect of the work in India.

The earnings on which NICs are to be calculated are those for the month of June – after an apportionment to take account of the 5 days which were not in respect of the employed earners employment.
Monthly salary £8333.33×5/365×100,000 less £1369.87
Amount attributable to non-UK workdays £1369.87
NIC is operated on the monthly gross pay attributable to the UK **£6963.46**

Holidays

If Mrs P were to take a holiday in India, the holiday may need to be brought into the calculation of non-UK workdays in the apportionment – depending on the contractual provisions and whether the holiday is attributable to the UK or overseas employment.
In Example 2, if in June Mrs P took 10 days holiday in India – in the absence of contractual provisions setting out how holiday accrues, these would be added to the 5 days working in India:
Salary £8333.33×15/365×£100,000
amount attributable to non-UK workdays = £4109.59
Earnings in the Month on which NIC must be operated = £4223.74

What about part of a day worked in the UK and part overseas?

We operate the practice in SP 5/84 with regard to days spent working partly in the UK and partly outside the UK. That is to say, if a day is substantially worked overseas for the overseas business then it will count as a non-UK work day in the apportionment computation. Where an employee spends a whole day working in the UK but then leaves the country that evening on an overseas business trip, it would be difficult to say as a matter of contract that the employee's emoluments for that day were not attributable on a time apportionment basis to duties performed in the UK. It follows that the emoluments for a day spent working overseas before returning to the UK in the evening will be attributable to duties performed overseas.

Records

Employees are required to retain evidence such as travel documents and business diaries to demonstrate how they have calculated non-UK workdays for tax. Where records of "non-UK workdays" for tax have been kept, these may be used as the basis for identifying non-UK days for National Insurance.

48.8 ROW: Class 2 NIC

Reg. 145(1)(c) (d) SSCR provide that the requirements are:

(c) as respects entitlement of a self-employed earner to pay Class 2 contributions, that that earner is present in Great Britain or Northern Ireland (as the case may be) in the contribution week for which the contribution is to be paid;

(d) as respects liability of a self-employed earner to pay Class 2 contributions, that the self-employed earner is ordinarily resident in Great Britain or Northern Ireland (as the case may be), or, if he is not so ordinarily resident, that before the period in respect of which any such contributions are to be paid he has been resident in Great

> Britain [or Northern Ireland][12] (as the case may be) for a period of at least 26 out of the immediately preceding 52 contribution weeks under the Act, the Social Security Act 1975 or the National Insurance Act 1965 or under some or all of those Acts.

Thus there are two possible connecting factors and if either is present, Class 2 NIC is due:

(1) ordinary residence in UK;
(2) residence for 26 out of 52 contribution weeks.

48.9 ROW: Class 3 NIC

Reg. 145(1)(e) SSCR provides that the requirement is:

> as respects entitlement of a person to pay Class 3 contributions in respect of any year, either that—
>
> (i) that person is resident in Great Britain or Northern Ireland (as the case may be) throughout the year,
>
> (ii) that person has arrived in Great Britain or Northern Ireland (as the case may be) during that year and has been or is liable to pay Class 1 or Class 2 contributions in respect of an earlier period during that year,
>
> (iii) that person has arrived in Great Britain or Northern Ireland (as the case may be) during that year and was either ordinarily resident in Great Britain or Northern Ireland (as the case may be) throughout the whole of that year or became ordinarily resident during the course of it, or
>
> (iv) that person not being ordinarily resident in Great Britain or Northern Ireland (as the case may be), has arrived in that year or the previous year and has been continuously present in Great Britain or Northern Ireland (as the case may be) for 26 complete contribution weeks, entitlement where the arrival has been in the previous year arising in respect only of the next year.

48.10 Place of business in UK

Tax Bulletin 49 provides:

> **Place of business in UK**
> We would normally accept as a strong indication that there is a place of business in the UK if a company is registered under the Companies Act

12 These words are omitted (presumably accidentally) from the SSCR but the context requires them.

1985.[13] But whether there is a place of business in the UK is a question of fact based on the individual case. Case law has shown that a company establishes a place of business in the UK if it carries on part of its business here. Such business activity need not be either a substantial part of, or more than incidental to, its main objects (*South India Shipping Corporation v Export-Import Bank of Korea* [1985] 2 AER 219). However there must be a more or less permanent location, not necessarily owned or leased by the company but associated with the company, from which its business is conducted habitually or with some degree of regularity (*Re Oriel* [1985] 3 AER 216). In Canadian law the premises of a group company are not sufficient in themselves to be a place of business for another group member (*Imperial Oil v Oil Workers International* 69 WWR 702).

We would not seek to claim in isolation that there is a place of business where the overseas provider legally, and in exchange for a payment commensurate with the service, sub-contracts services to a UK business.[14]

48.11 Residence and ordinary residence

The NIC legislation does not define residence or ordinary residence. For residence, the NI Manual states:

> **29009 DL Conditions of domicile or residence** [December 2012]
> You should operate Residence, Domicile and Remittance Basis Manual guidance in deciding whether a person is domiciled or resident. Any difficulties on residence should be submitted to Marine NICs in Cardiff, see NIM29034.

For residence, the pre-SRT IT rules should strictly speaking be applied, but in practice I expect close regard will be had to the SRT (which is supposed to represent the former common law rules).

For ordinary residence, the NI Manual states:

> **33560 Special Cases: ROW – Meaning of "ordinarily resident" – Factors to consider** [October 2013]
> ... In considering whether a person is "ordinarily resident", you should:
> • take into account the following factors

13 [Author's Note] Regulations made under s.1043 Companies Act 2006 impose a registration duty on a foreign incorporated company which establishes a place of business in GB; Northern Ireland has equivalent legislation.

14 This has been flagged as no longer current, however the author is not currently aware of this passage being moved elsewhere.

- in order to build up an overall picture of the person's position.

Factor	Indication
1. Will the person be returning to Great Britain or Northern Ireland during the period of employment abroad?	**Yes** – indicates ordinary residence continues during the period(s) abroad, especially the more frequent or longer the return visits. **No** – indicates the person ceasing to be ordinarily resident.
2. What will be the purpose(s) of the return visit(s)?	Visit(s): to see family who have remained at the person's home in Great Britain or Northern Ireland; and/or as holidays spent at the home, indicate ordinary residence. If the visit(s) is in connection with the employment abroad, for instance, training, this is not such a strong indication of ordinary residence.
3. Will the person's family – spouse/partner and/or children – be going abroad as well?	**Yes** – indicates that the person is no longer ordinarily resident, especially if they do not maintain a home in Great Britain or Northern Ireland (see factor 4). **No** – indicates ordinary residence continuing during period(s) abroad.
4. Will the person retain a home in Great Britain or Northern Ireland during their period abroad?	**Yes** – indicates ordinary residence continuing during period(s) abroad. **No** – indicates that the person is less likely to remain ordinarily resident.
5. If the person retains a home, will it be available for their use when they return?	**Yes** – indicates ordinary residence continuing during period(s) abroad. **No** – because, for instance, it is let on a long lease, then it is less likely that the person will remain ordinarily resident.
6. Will the person be returning to Great Britain or Northern Ireland at the end of the period abroad?	**Yes** – indicates ordinary residence continuing during period(s) abroad. **No** – indicates that the person is no longer ordinarily resident, especially if they do not retain a home in Great Britain or Northern Ireland during their absence abroad (see factor 4 above).

7. How long has the person lived in Great Britain or Northern Ireland?	The longer the period, the stronger the indication that the person is ordinarily resident.

For guidance on the definition of "ordinarily resident" for tax purposes, see the Residence Manual.

The seven factors are unhelpful, first as no guidance is given how to deal with the practical problems when different factors point in different directions, and secondly because the reader who turns to HMRC 6 will find different guidance.

There are no statutory provisions on ordinary residence so case law is all we have. The leading case is *R v Barnet LBC ex p Shah.*[15] This is not a tax case but the expression "ordinary residence" is said to have a natural and ordinary meaning which is the same in tax and non-tax contexts.[16]

In *Shah* the House of Lords noted that ordinary residence was distinct from domicile and rejected a "real home" test (which was similar to a domicile test).

What is the test? A number of dicta were approved, saying (more or less) the same thing in different words:

> I think that [ordinary residence] connotes residence in a place with some degree of continuity and apart from accidental or temporary absences.[17]

> "Ordinarily resident" refers to a man's abode in a particular place or country which he has adopted voluntarily and for settled purposes as part of the regular order of his life for the time being, whether of short or long duration.[18]

The important requirement is the residence must have the degree of continuity, or in other words, it must be "for settled purposes." What does that mean?

> There must be a degree of settled purpose. The purpose may be one; or there may be several. It may be specific or general. All that the law requires is that there is a settled purpose. This is not to say that the

15 [1983] 2 AC 309. The case is noteworthy for the fact that oral argument over the two words "ordinarily resident" lasted 9 days.

16 *Shah* at p.340.

17 *Shah* at p.341 citing Viscount Sumner in *Lysaght v IRC* 13 TC 511 at p.528

18 *R v Barnet LBC ex p. Shah* [1983] 2 AC 309 at p.343. This passage has often been cited with approval.

> "propositus" intends to stay where he is indefinitely; indeed his purpose, while settled, may be for a limited period. Education, business or profession, employment, health, family, or merely love of the place spring to mind as common reasons for a choice of regular abode. And there may well be many others. All that is necessary is that the purpose of living where one does has a sufficient degree of continuity to be properly described as settled.[19]

48.11.1 *Accommodation*

Turberville at [9] notes that accommodation held long term is consistent with being non-ordinarily resident:

> We consider the retention of the house and flat in the UK as fairly neutral; he had retained these (or predecessor properties) throughout the time he was working abroad.

Accommodation is however a relevant factor in deciding whether a person is "settled".

48.11.2 *Minimum period before acquiring ordinary residence*

One would have thought that if a person settled in a country, they became ordinarily resident immediately. This was the view expressed in HMRC6.

In *Tuczka v HMRC*[20] however the Upper Tribunal suggested that there was a minimum time (though the minimum is not very long):

> 12. ...After referring also to the dicta in the tax cases, Lord Slynn concluded that it was "plain that as a matter of ordinary language a person is not habitually resident in any country unless he has taken up residence and lived there for a period." Lord Slynn continued (at 1942G-1943B):
>
> > "It seems to me impossible to accept the argument at one time advanced that a person who has never been here before who says on landing, "I intend to settle in the UK" and who is fully believed is automatically a person who is habitually resident here. Nor is it enough to say I am going to live at X or with Y. He must show residence in fact for a period which shows that the residence has become "habitual" and, as I see it, will or is likely to continue to be habitual...

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19 *Shah* at p.344.

20 [2011] UKUT 113 (TCC).

> The requisite period is not a fixed period. It may be longer where there are doubts. It may be short (as the House accepted in In *re S (A Minor) (Custody: Habitual Residence)* [1998] A.C. 750, my speech at p. 763A, and *In re F (A Minor) (Child Abduction)* [1992] 1 FLR 548, 555, where Butler-Sloss L.J. said: "A month can be ... an appreciable period of time")."
>
> 13. Even assuming for the purpose of argument that "habitually" and "ordinarily" mean the same thing, we do not regard *Nessa* as in any way departing from Lord Scarman's clear rejection of any requirement to establish an intention to reside permanently or for an indefinite period. All that *Nessa* established in that regard is that a person would not qualify as "habitually resident" immediately on arrival, save in a case where he resumed his previous habitual residence. Some period of time is therefore needed to establish "habitual residence". But the fact that this period need not be long can be seen not only from Lord Slynn's reference to the observation of Butler Sloss LJ quoted above but from the resolution of the *Nessa* case itself. The House of Lords upheld the decision of the Court of Appeal that the case be remitted for rehearing before a social security appeal tribunal to determine whether the claimant had established habitual residence by the date of the initial tribunal hearing (ie, 6 December 1994, and thus less than four months after her arrival in the UK) or "even earlier": see at 1943D.

This overlooks the fact that the question of ordinary residence is determined with an element of hindsight: see 3.10 (The relevant period of investigation). It is considered that there is no minimum period.

48.11.3 *Intention*

In *Shah*, Lord Scarman said:

> There are two, and no more than two, respects in which the mind of the "propositus" is important in determining ordinary residence. The residence must be voluntarily adopted. Enforced presence by reason of kidnapping or imprisonment, or a Robinson Crusoe existence on a desert island with no opportunity of escape, may be so overwhelming a factor as to negative the will to be where one is.

The "voluntary" requirement does not have much practical role to play, as it only concerns imprisoned, kidnapped or shipwrecked taxpayers.[21]

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21 "The residence must be voluntarily adopted. Enforced presence by reason of kidnapping or imprisonment, or a Robinson Crusoe existence on a desert island with no opportunity of escape, may be so overwhelming a factor as to negative the will to

The speech continues:

> And there must be a degree of settled purpose. The purpose may be one; or there may be several. It may be specific or general. All that the law requires is that there is a settled purpose. This is not to say that the "propositus" intends to stay where he is indefinitely; indeed his purpose, while settled, may be for a limited period. Education, business or profession, employment, health, family, or merely love of the place spring to mind as common reasons for a choice of regular abode. And there may well be many others. All that is necessary is that the purpose of living where one does has a sufficient degree of continuity to be properly described as settled. The legal advantage of adopting the natural and ordinary meaning, as accepted by the House of Lords in 1928 and recognised by Lord Denning M.R. in this case, is that it results in the proof of ordinary residence, which is ultimately a question of fact, depending more upon the evidence of matters susceptible of objective proof than upon evidence as to state of mind. Templeman L.J. emphasised in the Court of Appeal the need for a simple test for local education authorities to apply: and I agree with him. The ordinary and natural meaning of the words supplies one. For if there be proved a regular, habitual mode of life in a particular place, the continuity of which has persisted despite temporary absences, ordinary residence is established provided only it is adopted voluntarily and for a settled purpose.

In *Tuczka v HMRC* [2010] UKFTT 53 the tribunal said:

> The test requires objective examination of immediately past events, and not intention or expectation for the future ([1983] 2 AC 309 at 345).

It is considered that the concept of being "settled" necessarily requires an examination of intention or expectation for the future.

48.11.4 *Acquiring UK ordinary residence*

In *Tuczka v HMRC* [2011] UKUT 113 (TCC) the taxpayer came to the UK to work and intended to stay 33 months (2.5 years). There were other facts which suggested he was settled, in particular that his girlfriend came to join him.

It was argued that an intention to reside here for that period was too short

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be where one is." *Shah* at p.344.

to constitute a "settled purpose". The argument was rejected. Even a period of just over one year could be sufficient.[22]

48.11.5 *Losing UK ordinary residence*

In *Turberville v HMRC* [2010] UKFTT 69 the taxpayer left the UK in July 2001 to work abroad. The taxpayer remained ordinarily resident until July 2001 even though he had formed the intention to leave earlier, in February 2001:

> 8. In relation to 2001-02, while it was clear in February 2001 that he would go to Dallas in July 2001 we do not consider that this changes the quality of his residence between 6 April 2001 and 30 June 2001, which was a continuation of his residence during the previous four tax years. Although it was then known that such residence would cease about 1 July 2001 it was nevertheless part of his residence for settled purposes and the fact that the Appellant's state of mind was such that he would be leaving the UK at around that time does not, until his actual departure, alter the position.

In July 2001 the taxpayer ceased to be ordinarily resident.

In October 2001 the taxpayer unexpectedly lost his job, but remained non-ordinarily resident. The judgment at [8] continues:

> From the date of actual departure, we consider that in deciding whether there was then a distinct break one should look at the position as it was in July 2001 without the benefit of hindsight. The three-year employment contract coupled with his expenditure on furnishing the apartment rented by his employer point to a distinct break.

In the absence of purchase of accommodation, three years has traditionally been regarded as the period of residence which is sufficient to amount to settled.

48.11.6 *Habitual residence and ordinary residence compared*

Schuz explains the concept of "Habitual residence"

> Habitual residence has been chosen as the main connecting factor in many of the multinational conventions concluded under the auspices of the Hague Conference on Private International Law for nearly one

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22 At [17] citing relying on *Reed v Clark* quoted at [15]; but *Clark* was not considering ordinary residence of the taxpayer (which was not an issue).

> hundred years.[23] It is now also used in other international conventions and in the domestic legislation of a number of countries, including England and Canada. However, there was very little discussion as to the meaning of the concept until the explosion of litigation under the Hague Convention on the Civil Aspects of Child Abduction began in the 1980s. Under this Convention, the determination of habitual residence is often critical to the outcome of an application for the return of the child in international abduction cases.[24]

The term is not found in tax legislation.

If the concept was the same as "ordinary residence" then cases on habitual residence might be valuable for tax. In principle the terms habitual residence and ordinary residence could be regarded as synonymous. The natural meaning of the two expressions is the same (or at least, equally vague). However the case law has not been consistent. In some cases the expressions are regarded as the same. [25] Some cases suggest that habitual residence is "something more than" ordinary residence,[26] though that "something more" is elusive. It has been said that the concepts merely share a "common core of meaning".[27] In the context of the Hague Abduction Convention, at least, "habitual residence" has now been held to have an autonomous meaning (ie a meaning distinct from that in the domestic law of the parties to the Convention) and the Supreme Court refused to follow *Shah*.[28]

While it would be desirable that a person's habitual residence and ordinary residence should be in the same place for all purposes, the desire for conceptual simplicity cannot override the need to give effect to the purpose of the legislation in question.

In any case, the authorities on "habitual residence" do not provide a clear definition or explanation of the term, and the authorities on the Abduction

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23 It was first used in the Hague Convention on Guardianship in 1902, and is the main connecting factor in the Hague Convention on Jurisdiction and Foreign Judgments in Civil and Commercial Matters.

24 Schuz, "Policy Considerations in Determining the Habitual Residence of a Child and the Relevance of Context" (2001) 11 Journal of Transnational Law and Policy 101, *http://international-family-law.eu/wp-content/uploads/2012/12/Habitual-residence-of-a-child-by-Rhona-Schuz1.pdf*

25 *Mark v Mark* [2006] 1 AC 98 at [33].

26 *Cruse v Chittum* [1974] 2 All ER 940 at p.943.

27 *Nessa v Chief Adjudication Officer* [1999] 1WLR 1937 at p.1941.

28 *A v A* [2014] AC 1 at [54].

convention are best understood in the light of the policy considerations relevant to abduction.[29] In borderline cases, at least, the meaning of the term will vary according to the context.

48.11.7 *Residence and ordinary residence compared*

Tuczka significantly reduced the difference between residence (the common law, pre-SRT concept) and ordinary residence or (if one prefers) it shows that the difference is not as great as had generally been thought:

> [18] Nor is it correct to suggest that a finding that Dr Tuczka was ordinarily resident in the UK in the tax year 1998-99 erodes a fundamental distinction between the concepts of residence and ordinary residence. The distinction is not as wide or as basic as the present appellant seeks to suggest. Hence, in *Levene*, Viscount Cave LC stated at p507:
>
> > "The expression "ordinary residence" is found in the Income Tax Act of 1806 and occurs again and again in the later Income Tax Acts, where it is contrasted with the usual or occasional or temporary residence; and I think that it connotes residence in a place with some degree of continuity and apart from accidental or temporary absences. So understood, the expression differs little in meaning from the word "residence" as used in the Acts..."

Unless the courts step back from this, HMRC6 was more generous than the law on the subject.

48.12 The EU Regulation

The position within the EU is governed by Regulation 883/2004 of 29 April 2004 on the coordination of social security systems. EU regulations do not have short titles (which were introduced in the UK in 1845) so this is here called "Regulation 883/04".

This chapter considers the position from 1 May 2010. Before then the position was governed by regulation 1408/71. I do not discuss the transitional rules.

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29 Habitual residence is "a question of fact to be determined by the circumstances of each case": [2014] AC 1 at [36]; and see Schuz, "Policy Considerations in Determining the Habitual Residence of a Child and the Relevance of Context" (2001) 11 Journal of Transnational Law and Policy 101 *http://international-family-law.eu/wp-content/uploads/2012/12/Habitual-residence-of-a-child-by-Rhona-Schuz1.pdf*

HMRC have published guidance ("**NIC guidance**").[30]

The regulation covers social security benefits but this chapter only considers the NIC aspects. The NIC guidance provides:

> Where under the EU Regulations the UK's social security legislation applies, the employee and employer (or person treated as the employer) must pay UK Class 1 National Insurance contributions (and the employer pays Class 1A National Insurance on certain UK taxable benefits and Class 1B National Insurance where there is a PAYE Settlement Agreement.) All the earnings are treated as arising from activity in the UK.
>
> Where, under the EU rules, the social security legislation of another Member State applies then no UK National Insurance is due.

48.13 Persons covered by Regulation 883/04

Article 2 Regulation 883/04 provides:

> 1. This Regulation shall apply to
> [1] nationals of a Member State,
> [2] stateless persons and refugees residing in a Member State who are or have been subject to the legislation of one or more Member States,
> [3] as well as to the members of their families and to their survivors.[31]

NIC guidance provides:

> The new EU Regulations apply to nationals of the EU Member States. They also apply to stateless persons and refugees residing in a Member State, members of their families and survivors if those people have previously been subject to the legislation of a Member State.
>
> From 1 June 2012 883/2004 will apply to Norway, Iceland and Liechtenstein.
>
> The UK has also opted out of applying the new EU rules to third country nationals legally resident in a Member State and will continue to apply the old rules.

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30 *http://www.hmrc.gov.uk/nic/work/new-rules.htm*

31 In the UK, NICs (other than the voluntary Class 3 NIC) are only paid by employed or self-employed, so the reference to "members of their families and their survivors" is irrelevant for NIC, though it may be relevant for other purposes governed by the regulation.

48.13.1 *Persons within Regulation 1408/71*

The NIC guidance provides:

> In the UK, the old EU rules in 1408/71 are being kept for third country nationals legally resident in a Member State. This is because the UK has chosen to opt out of laws extending the new regulations to third country nationals.
> Example (Hank)
> H is a US national who has lived and worked in the UK for ten years and pays Class 1 National Insurance. The UK Border Agency has agreed he can live and work legally in the UK. His UK employer Big Bank posts H to the Frankfurt office for six months. Because he is a US national legally resident in the UK, the new rules do not apply to H. H continues to be subject to the old rules. Big Bank should apply to HMRC Residency for a Form E101 for H and he remains subject to UK National Insurance in Frankfurt. He is exempt from German contributions.

This has made the position much more complicated. The old rules are not discussed here but I hope to cover them in a future edition.

48.13.2 *Forms*

The NIC guidance provides:

> The EU Regulations provide for a system of forms so that employers and employees can demonstrate that they are entitled to operate the legislation of one Member State and be exempt contributions under the legislation of another. Under the old EU Regulations this was the E101 Form. Under the new EU Regulations the E101 will be replaced by Form A1.
> For employees coming to the UK from the other Member States, you should operate National Insurance contributions from the start of the employment unless you hold a valid E101 (or from 1 May 2010 Form A1 or an E101) showing that they are exempt National Insurance in the UK and subject to the legislation of another Member State.
> For employees going to work in another Member State, you should apply to HM Revenue & Customs (HMRC) NIC&EO to find out whether the employee should remain in UK National Insurance and you can be issued Form E101 (or Form A1 after 1 May 2010). As long as the UK's legislation continues to apply, you should continue to operate employer and employee National Insurance rather than the contributions of the other Member State.

48.14 EEA: Tie-breaker rules

Article 11.1 sets out the principle of a tie-breaker rule:

> 1. Persons to whom this Regulation applies shall be subject to the legislation of a single Member State only. Such legislation shall be determined in accordance with this Title.

48.14.1 *Place of employment rule*

Article 11.3 Regulation 883/04 provides a place of employment rule for employees and self-employed:

> 3. Subject to Articles 12 to 16:
>
> (a) a person pursuing an activity as an employed or self-employed person in a Member State shall be subject to the legislation of that Member State;

The key phrase "pursuing an activity" is defined in article 11.2:

> 2. For the purposes of this Title, persons receiving cash benefits because or as a consequence of their activity as an employed or self-employed person shall be considered to be pursuing the said activity. This shall not apply to invalidity, old-age or survivors' pensions or to pensions in respect of accidents at work or occupational diseases or to sickness benefits in cash covering treatment for an unlimited period.

Article 11.3 continues with some more specialist rules:

> (b) a civil servant shall be subject to the legislation of the Member State to which the administration employing him/her is subject;...
>
> (d) a person called up or recalled for service in the armed forces or for civilian service in a Member State shall be subject to the legislation of that Member State;
>
> (e) any other person to whom subparagraphs (a) to (d) do not apply shall be subject to the legislation of the Member State of residence,[32] without prejudice to other provisions of this Regulation guaranteeing him/her benefits under the legislation of one or more other Member States.

48.14.2 *Year abroad rule for employees*

Article 12 Regulation 883/04 provides a rough equivalent of the year

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32 Art.1(j) provides: "'residence' means the place where a person habitually resides."

abroad rule for employees:

> 1. A person who pursues an activity as an employed person in a Member State on behalf of an employer which normally carries out its activities there and who is posted by that employer to another Member State to perform work on that employer's behalf shall continue to be subject to the legislation of the first Member State, provided that the anticipated duration of such work does not exceed 24 months and that he/she is not sent to replace another person.
> 2. A person who normally pursues an activity as a self-employed person in a Member State who goes to pursue a similar activity in another Member State shall continue to be subject to the legislation of the first Member State, provided that the anticipated duration of such activity does not exceed 24 months.

48.14.3 *Two places of employment*

The place of employment rule cannot act as a tie-breaker if there are two places of employment. In this case Art.13 Regulation 883/04 provides:

> 1. A person who normally pursues an activity as an employed person in two or more Member States shall be subject to:
> (a) the legislation of the Member State of residence if he/she pursues a substantial part of his/her activity in that Member State or if he/she is employed by various undertakings or various employers whose registered office or place of business is in different Member States, or
> (b) the legislation of the Member State in which the registered office or place of business of the undertaking or employer employing him/her is situated, if he/she does not pursue a substantial part of his/her activities in the Member State of residence....

What is "substantial"? NIC guidance provides:

> When determining whether a substantial part of the activity of an employed person is pursued in a Member State HMRC will take into account:
> · the working time and/or
> · the remuneration
> If less than 25 per cent of the person's working time is carried out in the UK and/or less than 25 per cent of the person's remuneration is earned in the UK this will be an indicator that a substantial part of all the activities of the worker is not pursued in the UK. Other criteria may also

be taken into account. HMRC may look at the past but must also look at the position in the next 12 months. This will allow HMRC to take account of changing circumstances.

Regulation 883/04 continues with further tie-breakers:

> 3. A person who normally pursues an activity as an employed person and an activity as a self-employed person in different Member States shall be subject to the legislation of the Member State in which he/she pursues an activity as an employed person or, if he/she pursues such an activity in two or more Member States, to the legislation determined in accordance with paragraph 1.
> 4. A person who is employed as a civil servant by one Member State and who pursues an activity as an employed person and/or as a self-employed person in one or more other Member States shall be subject to the legislation of the Member State to which the administration employing him/her is subject.
> 5. Persons referred to in paragraphs 1 to 4 shall be treated, for the purposes of the legislation determined in accordance with these provisions, as though they were pursuing all their activities as employed or self-employed persons and were receiving all their income in the Member State concerned.

48.15 EEA: Self-employed rules

48.15.1 *Year abroad rule for self-employed*

Article 13.2 Regulation 883/04 provides a year abroad rule for the self-employed:

> 2. A person who normally pursues an activity as a self-employed person in two or more Member States shall be subject to:
> (a) the legislation of the Member State of residence if he/she pursues a substantial part of his/her activity in that Member State; or
> (b) the legislation of the Member State in which the centre of interest of his/her activities is situated, if he/she does not reside in one of the Member States in which he/she pursues a substantial part of his/her activity.

48.16 Special cases by agreement

Article 16.1 provides:

> 1. Two or more Member States, the competent authorities of these Member States or the bodies designated by these authorities may by

common agreement provide for exceptions to Articles 11 to 15 in the interest of certain persons or categories of persons.

48.17 Class 4 contributions

Section 15 SSCBA provides:

> (1) Class 4 contributions shall be payable for any tax year in respect of all profits which—
>
> (a) are immediately derived from the carrying on or exercise of one or more trades, professions or vocations,
>
> (b) are profits chargeable to income tax under Chapter 2 of Part 2 of the Income Tax (Trading and Other Income) Act 2005 for the year of assessment corresponding to that tax year and
>
> (c) are not profits of a trade, profession or vocation carried on wholly outside the UK.
>
> (2) Class 4 contributions in respect of profits shall be payable—
>
> (a) in the same manner as any income tax which is, or would be, chargeable in respect of those profits (whether or not income tax in fact falls to be paid), and
>
> (b) by the person on whom the income tax is (or would be) charged,
>
> in accordance with assessments made from time to time under the Income Tax Acts.
>
> (3A) Where income tax is (or would be) charged on a member of a limited liability partnership in respect of profits arising from the carrying on of a trade or profession by the limited liability partnership, Class 4 contributions shall be payable by him if they would be payable were the trade or profession carried on in partnership by the members. ...
>
> (5) For the purposes of this section the year of assessment which corresponds to a tax year is the year of assessment (within the meaning of the Tax Acts) which consists of the same period as that tax year.

A trade carried on wholly outside the UK is exempt from class 4 NIC. This is almost impossible for a sole trader, though it may be possible for a partnership.[33] But in such a case the self-employed earner would not be employed in the UK, and so would be exempt anyway.

What about unremitted trading profits of a remittance basis taxpayer? The word "chargeable" is ambiguous in that although all trading profits are strictly chargeable under part 2 ITTOIA, the context may show that unremitted profits of a remittance basis taxpayer, (un)taxed on the

33 See 15.3 (Trading income of UK resident).

remittance basis, do not count as "chargeable".[34] It is considered that that is the case here, so a remittance basis taxpayer pays class 4 NIC on taxable (remitted) profits only. That is consistent with the general scheme of the remittance basis.

48.18 Partnerships

Para 4 Sch 2 SSCBA provides:

> (1) Where a trade or profession is carried on by two or more persons jointly, the liability of any one of them in respect of Class 4 contributions shall arise in respect of his share of the profits of that trade or profession (so far as immediately derived by him from carrying it on); and for this purpose his share shall be aggregated with his share of the profits of any other trade, profession or vocation (so far as immediately derived by him from carrying it on or exercising it).
> (2) Where sub-paragraph (1) above applies, the Class 4 contributions for which a person is liable in respect of the profits of the trade or profession carried on jointly (aggregated, where appropriate, as mentioned in that sub-paragraph) shall be charged on him separately.

34 See 10.12 (Nature of charge on remitted RFI).

CHAPTER FORTY NINE

CAPITAL GAINS OF UK RESIDENTS

49.1 Territorial scope of CGT

49.1.1 *"Chargeable" gains*

Section 15(2) TCGA provides:

> Every gain shall, except as otherwise expressly provided, be a chargeable gain.

The expression "chargeable" gain is a label which brings in an uncountable number of rules, for the usual drafting technique to provide an exemption is to provide that gains of the specified nature are not chargeable. However, the term "chargeable" gain does not bring in a territorial limitation. Gains are in principle "chargeable" gains regardless of residence or domicile of the person to whom the gains accrue.

49.1.2 *CGT residence condition*

Section 2(1) TCGA provides:

> Subject to any exceptions provided by this Act, and without prejudice to sections 10 and 276, a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment if the residence condition is met.

"The residence condition" is defined in s.2(1A) TCGA:

> The residence condition is—
>
> (a) in the case of an individual, that the individual is resident in the UK for the year in question,
>
> (b) in the case of personal representatives of a deceased person, that the single and continuing body mentioned in section 62(3) is resident in the UK,
>
> (c) in the case of the trustees of a settlement, that the single person mentioned in section 69(1) is resident in the UK during any part

of the year in question, and

(d) in any other case, that the person is resident in the UK when the gain accrues.

Para (d) is rare, as companies are taken out of the scope of CGT by s.4 CTA 2009, but one example is a unit trust scheme.

In principle, therefore, a person who is not resident in the UK is not chargeable to CGT.

A non-resident person is in principle outside the scope of CGT regardless of domicile and regardless of the situs of the asset disposed of. (By contrast income tax is charged on UK source income, and IHT is charged on UK situate property, regardless of the residence or domicile of the individual.)

There are five exceptions to the general rule:

(1) Section 2(1) TCGA refers to two:
   (a) Non-resident trader with a UK branch or agency[1]
   (b) Exploration and exploitation assets on the continental shelf (not discussed in this book)

(2) Temporary non-residents[2]

(3) ATED-CGT[3]

(4) The forthcoming non-residents dwellinghouse charge[4]

It follows that an individual (wherever domiciled) can in principle avoid CGT if they dispose of an asset before they become UK resident or if they postpone the disposal until the tax year after they have lost that status. A simple form of CGT planning for an individual whose stay in the UK is a short-term one is not to dispose of assets giving rise to chargeable gains while UK resident.

49.2 CGT remittance basis

Section 12 TCGA provides:

> (1) This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if section 809B,

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1 See 49.8 (Non-resident trade with UK branch).

2 See 9.1 (Temporary non-residence). This is not technically an exception to the general rule, as the legislation does not impose CGT on gains accruing to a non-resident. It deems the gains to accrue later when the individual is resident. But it comes to the same thing.

3 See 75.29 (ATED-CGT).

4 See 74.1 (Forthcoming CGT charge on non-residents dwellinghouse).

> 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year...
> (2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the UK...
> (3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year or, where applicable, that part of the year.
> (4) In this section "foreign chargeable gains" means chargeable gains accruing from the disposal of an asset which is situated outside the UK.

The use of the word "individual" means that trustees and personal representatives do not qualify for the remittance basis.

The CGT remittance basis applies to foreign situate assets.[5] By contrast, the RFI remittance basis applies to foreign source income, which is a different concept.[6]

See too 11.30 (CGT disposal not for market value).

49.2.1 *Date gain accrues and date of disposal under remittance basis*

The gain is treated as accruing in the tax year of remittance. By implication the gain is to be treated as not accruing on the date of the actual disposal, when it actually accrues. This is relevant for:

(1) rate of CGT: the rate is the rate in the year of remittance, not the year of disposal.
(2) EIS reinvestment relief. The time limits for EIS relief depend on the time that the gain accrued (not the time that the disposal takes place).[7]

The time limits for rollover relief depend on the time of disposal.[8] The drafter of the former para 16(4) Schedule A1 TCGA clearly considered that the pre-2008 s.12(1) TCGA altered the time of disposal so that the asset is regarded as disposed of at the time of remittance (not at the time of the actual disposal).[9] But for the present entrepreneurs' relief, HMRC regard the date of disposal as the date of the actual disposal, not the date

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5 See 83.1 (Situs of assets for CGT).

6 In international tax law, gains are often said to have a source, which may be taken to be the state where the assets are situate. UK tax legislation does not use the word source in connection with gains.

7 Para 1 Sch 5B TCGA.

8 Section 152(3) TCGA

9 See the 6th edition of this work, para 29.4.

of remittance.[10]

49.3 Split years

49.3.1 *Gains accruing to individual in split year*

Section 2(1B) TCGA provides the usual split year rule:

> If the year is a split year as respects an individual, the individual is not chargeable to capital gains tax in respect of any chargeable gains accruing to the individual in the overseas part of that year.

Thus gains of the overseas part of a split year of an individual are in principle not subject to CGT.

Section 2(1C) TCGA provides two self-evident exceptions to the general rule:

> But subsection (1B)—
>
> (a) does not apply to chargeable gains in respect of which the individual would have been chargeable to capital gains tax under section 10, had the individual been not resident in the UK for the year, and
>
> (b) is without prejudice to section 10A [temporary non-residence].

49.3.2 *Remittance in split year*

Section 12(2A) TCGA provides:

> If that tax year is a split year as respects the individual, the chargeable gains are treated as accruing to the individual in the part of the year (the overseas part or the UK part) in which the foreign chargeable gains are so remitted.

Thus gains remitted in the overseas part of a split year are not taxed unless the temporary non-resident rules apply.

Section 12(1A) TCGA provides:

> But it [Section 12 TCGA] does not apply to foreign chargeable gains accruing to an individual in the overseas part of a split year as respects that individual, regardless of the part of the year (the overseas part or the UK part) in which the foreign chargeable gains are remitted.

Thus gains accruing during the overseas part of a split year are not charged even if remitted during the UK part of a subsequent split year. EN FB

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10 See 49.5.2 (Deadline for ER claim).

2014 provides:

> 1. This clause provides that foreign gains arising to a remittance basis user in the overseas part of a split year of residence and remitted in the UK part of the year are not charged to tax.
> 2. The clause inserts a new subsection (1A) into section 12 TCGA 1992 ensuring that foreign gains accruing in the overseas part of a split year of residence are not charged to tax regardless of when in the year they are remitted.
> 4. Schedule 45 of FA 2013 introduced a new Statutory Residence Test and contained rules (previously in extra-statutory concessions) to cater for a split year of residence for an individual coming to or leaving the UK. It provided that gains arising in the overseas part of the year were not charged. However, the consequential change in paragraph 95 of Schedule 45 to the rules for remittance basis users contained an inadvertent error, the effect of which is to wrongly charge their gains arising in the overseas part of the year and remitted in the UK part of the year. This measure corrects that error.

This provision is backdated to 2013/14.

49.3.3 *Gains accruing to trustees in split year*

Trustees are subject to CGT on gains in the whole of a year in which they become non-resident or in which they become UK resident (unless DT relief applies). There is no good reason for that rule[11] and it gives rise to an anomaly:

(1) If a UK trust becomes non-resident, gains of the entire year are in principle subject to CGT (DT relief might be available).
(2) If a UK trust transfers its assets to a non-resident trust, gains arising after the transfer are in principle not subject to CGT.

So a transfer could be better than a trust migration.

49.4 Interaction of remittance basis and taper and indexation reliefs

49.4.1 *Taper relief*

Para 56 sch 2 FA 2008 provides:

> (1) The amendments made by para 31(2) and (3) have effect where the intervening year is the tax year 2008-09 or any subsequent tax year.
> (2) The amendments made by paras 41 and 43 have effect where the

11 The position is different for IT: see 7.2 (Split year of trustees and PRs).

> eligible year is the tax year 2008-09 or any subsequent tax year.
> (3) The other amendments made by paras 23 to 55 have effect in relation to chargeable gains accruing or treated as accruing in the tax year 2008-09 or any subsequent tax year.

The important provision here is para 56(3).[12] This removes taper relief on gains on disposals before 2008/09 which are remitted after 2008/09. All computations of unremitted gains made before 2008 will need to be recomputed.

49.4.2 *Indexation relief*

Para 83 sch 2 FA 2008 provides:

> The amendments made by paragraphs 77 to 82 [which abolish the indexation allowance] have effect in computing gains on disposals made on or after 6 April 2008.

Assuming that this refers to the actual disposal, the effect is that indexation relief continues to apply to gains on pre-2008 disposals which are remitted after 6 April 2008. This is the HMRC view. The CG Manual provides:

> **CG25320 - Remittance basis: computing the foreign chargeable gain: indexation allowance and taper relief** [Apr 2010]
> When dealing with remittance basis cases the foreign chargeable gain should be computed as at the date of the disposal using all the normal computational rules.
> For disposals occurring after 5 April 1982 and before 6 April 1998 these rules will include an allowance for indexation up to the date of the disposal. No further allowance is due for indexation when the gain is remitted to the UK however long the interval is between the gain arising and the date of the remittance....

49.5 Interaction of remittance basis and entrepreneurs' relief

A full discussion of entrepreneurs' relief needs a book to itself.

The CGT liaison group (an HMRC led group involving the tax professional bodies) has issued a guidance note **("the entrepreneurs' relief note")**[13] which is discussed here. For other issues on this relief, see:

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12 Para 56 (1)(2) relate to specialist topics, s.56A, 279A and 279B TCGA.

13 *http://www.tax.org.uk/NR/rdonlyres/BC021C6A-EB7F-4E2E-BEFC-380ECB096FCF/0/120213ERTechnicalQuestionsandHMRCresponse.pdf*

53.32 (Entrepreneurs' relief: trading co held by non-resident company); 50.16 (Interaction of s.86, s.87 and entrepreneurs' relief).

49.5.1 *Application of remittance basis*

The entrepreneurs' relief note provides:

> **EXAMPLE D1 – Foreign chargeable gains qualifying for ER fall within s 12, TCGA 1992**
> 67 Section 169N(9) TCGA 1992 states that 'any gain or loss taken into account under subsection (1) is not to be taken account under this Act as a chargeable gain or an allowable loss.'
> 68 The Explanatory Notes published with the Finance Bill 2008 indicate that the purpose of s 169N(9) is merely to ensure that where there is one ER disposal, and gains and losses are aggregated to determine the qualifying net ER gain, this cannot be segregated as gains and losses separately for CGT purposes. There have, however, been concerns about the interpretation of s 169N(9) and how it interacts with other provisions within TCGA 1992.
> 69 As can be seen from the responses to the following queries, HMRC considers that foreign chargeable gains qualifying for ER fall within s 12 TCGA 1992 where such gains are realised by remittance basis users. The delay between the time the gains arises and when the remittance is made is no bar on the claiming of ER provided a valid ER claim is made within the specified time period (see Example D2).

49.5.2 *Deadline for ER claim*

The entrepreneurs' relief note provides:

> **EXAMPLE D2 – The deadline for making an ER claim**
> 70 The deadline for making an ER claim is linked to the tax year in which the qualifying business disposal is made, not to the tax year that the gain accrues to a taxpayer. Thus if a UK-resident foreign domiciliary wishes to make the claim for a qualifying business disposal of foreign property, it would seem that the following deadlines apply for disposals in the specified tax years, regardless of whether the chargeable gain has been remitted.
>
> | **Tax year** | **Claim deadline** |
> |---|---|
> | 2008/09 | 31 January 2011 |
> | 2009/10 | 31 January 2012 |
> | 2010/11 | 31 January 2013 |
> | 2011/12 | 31 January 2014 |
>
> 71 Does HMRC agree? How would it recommend that such a claim be

made if it does not impact on the tax liability as there has been no remittance of the disposal proceeds?

HMRC response to Example D2

72 ER is only available on the making of a claim and such claim must be made within the statutory time limit which is set by reference to the date of the qualifying disposal (see s 169M(3) TCGA 1992). It is for the taxpayer to consider whether to submit a protective claim for ER within this time period.

Further note

73 This means that where a remittance basis user makes a qualifying gain in a tax year he or she has until the first anniversary of 31 January following the end of the tax year to decide whether or not to make the ER claim. The date that the proceeds are remitted is irrelevant.

74 For example: AB is a remittance basis user. He makes a £10m gain on a qualifying disposal in 2011/12 of shares in a foreign company (total proceeds £15m). He has not made any previous ER claims and so has the entire £10m ER allowance available. He does not expect to remit the proceeds from the gain for at least three years (having sufficient clean capital to supplement his UK income). If he wants to be able to benefit from ER on any eventual remittance of the proceeds he has until 31 January 2014 to make the ER claim. The fact that he will not have remitted the proceeds at that date is irrelevant to the claim deadline.

75 Where an ER claim is required prior to the gains being remitted there will be no gain shown on the tax return. The claim should be made by way of a note to the tax return, with the ER computation included.

49.5.3 *Increase in entrepreneurs' relief limit*

There is a lifetime limit on the relief which has gradually been increased:

Date of disposal from	**Limit**
6 April 2008	£1 million.
6 April 2010	£2 million
23 June 2010	£5 million
6 April 2011	£10 million

The entrepreneurs' relief note provides:

EXAMPLE D3 – The raised ER limit

76 It is understood that HMRC's settled view is that the ER limit to apply in respect of remittance basis gains is that which is in force when the gains arise.

77 For example, assuming there have been no other qualifying ER gains, where the disposal date for a qualifying ER gain of £5m (paid into a

separate offshore bank account with interest being paid into a separate account) is 19 August 2008 and the proceeds are remitted on 25 October 2010, it is understood that HMRC believes that the £1m lifetime limit in force in 2008/09 applies, such that ER can only be claimed on £1m of the disposal. It would seem to follow from this that HMRC's view must be that the 4/9ths deduction applies to the gain rather than the special 10% tax rate. For a higher rate taxpayer this would mean that even the gain benefiting from ER will be subject to tax at 28% (meaning an effective 15.6% tax rate on the £1m gain benefiting from ER relief) with the £4m excess being taxed at 28%.

78 Can HMRC confirm that the above summarises its thoughts on the issue?

HMRC response to Example D3

79 HMRC agree with the analysis. The ER limit to apply with respect to remittance basis gains is that which is in force when the qualifying disposal is made, not when any proceeds are remitted.

49.5.4 *Entrepreneurs' relief: mixed fund rules*

The entrepreneurs' relief note provides:

EXAMPLE D4 – The ER provisions prior to 23 June 2010 and the mixed fund rules

80 The ER legislation at s 169N(4) TCGA 1992 states:

> The amount arrived at under subsections (1) to (3) is to be treated for the purposes of this Act as a chargeable gain accruing at the time of the disposal to the individual or trustees by whom the claim is made.

81 Does HMRC agree that this means that for the purposes of the mixed fund rules (s 809Q ITA 2007) the amount that will go into the foreign chargeable gains category is the amount of the gain after ER (ie after the 4/9ths reduction)?

HMRC response to Example D4

82 The amount to be included in a mixed fund under s 809Q(4) ITA 2007 is the gain as restricted by s 169N.

EXAMPLE D5 – How does ER relief work for remittance basis users given it is now a tax rate?

83 It is clear that without the 4/9ths discount provisions, which reduced the gain itself, the mixed fund rules work somewhat differently. It is unclear whether, in situations where the gain is in excess of the unused ER lifetime allowance, this means that:

- ER can be applied such that 10% tax is paid on the amount on which ER can be claimed (either the £10m lifetime limit or that

limit less the aggregate of prior ER claims made) with future remittances being taxed at the full rates.

- Or, that a blended rate has to be used.

84 As an example: the capital gain on a disposal of shares by a UK-resident foreign domiciliary is, say, £13m. The individual has not made a prior ER claim and the first £10m is remitted over a number of years. Can you apply ER to this first £10m or do you have to use a blended rate because the actual gain exceeds £10m?

HMRC response to Example D5

85 Wherever there is a qualifying disposal and a chargeable gain that attracts the tax rate of 10% and there is a balance of that gain that is taxable at either 18% or 28% (and indeed where the individual may have other gains that do not qualify for ER), then the question arises of how these elements are identified for the purposes of s 12 TCGA 1992.

86 HMRC considers that the mixed fund rules in ITA 2007 may be used to identify and quantify the remittance of the foreign chargeable gain. In the absence of a statutory rule for determining whether or not the gains brought into charge under s 12 are liable at the 10% rate, the onus is on the individual to nominate the 10% rate to apply to the maximum extent (by reference to the computational rules in ss (4)–(4B) of s 169N) in priority to other rates and the individual can do so as part of the normal self assessment process.

Further note

87 We have confirmed with HMRC that the above response means that in the example given the taxpayer would be able to claim on his or her self assessment return that the first £10m remitted is taxed at the special 10% rate.

88 For example: the disposal occurred in 2011/12 and pattern of remittance was as follows:

5m in 2011/12;
5m in 2012/13; and
3m in 2013/14.

Provided an ER claim is made the taxpayer can claim that the remittances in 2011/12 and 2012/13 are taxed at the 10% ER rate.

49.6 Liquidation of offshore company

Suppose:

(1) F (a remittance basis taxpayer) owns non-UK situate shares in a company, and

(2) the company is put into liquidation and F receives a distribution from the liquidator of the company.

F is treated as if F had disposed of the shares in consideration of the distribution: s.122 TCGA. The gain is taxable if the liquidator transfers to the shareholder money in the UK. The same applies if the liquidator transfers assets (land or chattels) enjoyed *in specie* here. It should normally be possible to avoid this.

49.7 UK resident trust

A UK resident trust is in principle subject to CGT even if:
(1) the settlor is a remittance basis taxpayer; and
(2) the trust assets are not situated in the UK.
The remittance basis does not apply as that only applies to "individuals"; trustees are not individuals.

One might avoid this problem for the future by exporting the trust (appointing non-resident trustees) but there may in principle be a migration charge.[14]

One solution may be to transfer assets from the trust to UK resident foreign domiciled beneficiaries absolutely. Although this involves a disposal by the trustees, it may be possible to claim CGT hold-over relief. The relief applies on a disposal to a foreign domiciled beneficiary, even though that beneficiary may later be able to dispose of the asset without a CGT charge.

49.8 Non-resident trade with UK branch

Section 10 TCGA provides:

> (1)[A] Subject to any exceptions provided by this Act, a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment if
> [i] the residence condition is not met (see section 2(1A)) but
> [ii] the person is carrying on a trade in the UK through a branch or agency,
> [B] and shall be so chargeable on chargeable gains accruing on the disposal—
> (a) of assets situated in the UK and used in or for the purposes of the trade at or before the time when the capital gain accrued, or
> (b) of assets situated in the UK and used or held for the purposes of the branch or agency at or before that time, or assets acquired for use by or for the purposes of the branch or agency.

14 See 8.5 (Liability of trustees for exit charge).

(2) Subsection (1) above does not apply unless the disposal is made at a time when the person is carrying on the trade in the UK through a branch or agency.

...

Section 10(5) TCGA extends the rule to professions:

This section shall apply as if references in subsections (1) and (2) above to a trade included references to a profession or vocation, but subsection (1) shall not apply in respect of chargeable gains accruing on the disposal of assets only used in or for the purposes of the profession or vocation before 14th March 1989 or only used or held for the purposes of the branch or agency before that date.

Section 10B TCGA provides a similar rule for companies:

(1) Subject to any exceptions provided by this Act, the chargeable profits for the purposes of corporation tax of a company not resident in the UK but carrying on a trade[15] in the UK through a permanent establishment there include chargeable gains accruing to the company on the disposal of—

(a) assets situated in the UK and used in or for the purposes of the trade at or before the time the gain accrued, or

(b) assets situated in the UK and used or held for the purposes of the permanent establishment at or before the time the gain accrued or acquired for use by or for the purposes of the permanent establishment.

(2) Subsection (1) does not apply unless the disposal is made at a time when the company is carrying on a trade in the UK through a permanent establishment there. ...

49.9 DT relief for chargeable gains

Article 13(5) OECD Model provides:

Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

Subject to the four exceptions (discussed below) taxing rights are given to the residence state and not the source state.

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15 For completeness, s.10B(4) TCGA defines "trade" to include an office, but in practice this will not often be significant.

49.9.1 *Gain subject to income tax*

The OECD Commentary provides:

> 3. ... The Article does not specify to what kind of tax it applies. It is understood that the Article must apply to all kinds of taxes levied by a Contracting State on capital gains. The wording of Article 2 is large enough to achieve this aim and to include also special taxes on capital gains.

See 35.24 (DT relief on offshore income gain).

49.9.2 *Gains*

The OECD Commentary provides:

> 11. The Article does not distinguish as to the origin of the capital gain. Therefore all capital gains, those accruing over a long term, parallel to a steady improvement in economic conditions, as well as those accruing in a very short period (speculative gains) are covered. Also capital gains which are due to depreciation of the national currency are covered. It is, of course, left to each State to decide whether or not such gains should be taxed.
>
> 12. The Article does not specify how to compute a capital gain, this being left to the domestic law applicable. As a rule, capital gains are calculated by deducting the cost from the selling price. To arrive at cost all expenses incidental to the purchase and all expenditure for improvements are added to the purchase price. In some cases the cost after deduction of the depreciation allowances already given is taken into account. Some tax laws prescribe another base instead of cost, e.g. the value previously reported by the alienator of the asset for capital tax purposes.
>
> 13. Special problems may arise when the basis for the taxation of capital gains is not uniform in the two Contracting States. The capital gain from the alienation of an asset computed in one State according to the rules mentioned in paragraph 12 above, may not necessarily coincide with the capital gain computed in the other State under the accounting rules used there. This may occur when one State has the right to tax capital gains because it is the State of situs while the other State has the right to tax because the enterprise is a resident of that other State.
>
> 14. The following example may illustrate this problem: an enterprise of State A bought immovable property situated in State B. The enterprise may have entered depreciation allowances in the books kept in State A. If such immovable property is sold at a price which is above cost, a

capital gain may be realised and, in addition, the depreciation allowances granted earlier may be recovered. State B, in which the immovable property is situated and where no books are kept, does not have to take into account, when taxing the income from the immovable property, the depreciation allowances booked in State A. Neither can State B substitute the value of the immovable property shown in the books kept in State A for the cost at the time of the alienation. State B cannot, therefore, tax the depreciation allowances realised in addition to the capital gain as mentioned in paragraph 12 above.

15. On the other hand, State A of which the alienator is a resident, cannot be obliged in all cases to exempt such book profits fully from its taxes under paragraph 1 of the Article and Article 23 A (there will be hardly any problems for States applying the tax credit method). To the extent that such book profits are due to the realisation of the depreciation allowances previously claimed in State A and which had reduced the income or profits taxable in such State A, that State cannot be prevented from taxing such book profits. The situation corresponds to that dealt with in paragraph 44 of the Commentary on Article 23 A.

16. Further problems may arise in connection with profits due to changes of the rate of exchange between the currencies of State A and State B. After the devaluation of the currency of State A, enterprises of such State A may, or may have to, increase the book value of the assets situated outside the territory of State A. Apart from any devaluation of the currency of a State, the usual fluctuations of the rate of exchange may give rise to so-called currency gains or losses. Take for example an enterprise of State A having bought and sold immovable property situated in State B. If the cost and the selling price, both expressed in the currency of State B, are equal, there will be no capital gain in State B. When the value of the currency of State B has risen between the purchase and the sale of the asset in relation to the currency of State A, in the currency of that State a profit will accrue to such enterprise. If the value of the currency of State B has fallen in the meantime, the alienator will sustain a loss which will not be recognised in State B. Such currency gains or losses may also arise in connection with claims and debts contracted in a foreign currency. If the balance sheet of a permanent establishment situated in State B of an enterprise of State A shows claims and debts expressed in the currency of State B, the books of the permanent establishment do not show any gain or loss when repayments are made. Changes of the rate of exchange may be reflected, however, in the accounts of the head office. If the value of the currency of State B has risen (fallen) between the time the claim has originated and its repayment, the enterprise, as a whole, will realise a gain (sustain

a loss). This is true also with respect to debts if between the time they have originated and their repayment, the currency of State B has fallen (risen) in value.

17. The provisions of the Article do not settle all questions regarding the taxation of such currency gains. Such gains are in most cases not connected with an alienation of the asset; they may often not even be determined in the State on which the right to tax capital gains is conferred by the Article. Accordingly, the question, as a rule, is not whether the State in which a permanent establishment is situated has a right to tax, but whether the State of which the taxpayer is a resident must, if applying the exemption method, refrain from taxing such currency gains which, in many cases, cannot be shown but in the books kept in the head office. The answer to that latter question depends not only on the Article but also on Article 7 and on Article 23 A. If in a given case differing opinions of two States should result in an actual double taxation, the case should be settled under the mutual agreement procedure provided for by Article 25.

18. Moreover the question arises which Article should apply when there is paid for property sold an annuity during the lifetime of the alienator and not a fixed price. Are such annuity payments, as far as they exceed costs, to be dealt with as a gain from the alienation of the property or as "income not dealt with" according to Article 21? Both opinions may be supported by arguments of equivalent weight, and it seems difficult to give one rule on the matter. In addition such problems are rare in practice, so it therefore seems unnecessary to establish a rule for insertion in the Convention. It may be left to Contracting States who may be involved in such a question to adopt a solution in the mutual agreement procedure provided for by Article 25.

19. The Article is not intended to apply to prizes in a lottery or to premiums and prizes attaching to bonds or debentures.

31. If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price and the par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated profits and not as a capital gain. The Article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in Article 10: such taxation is permitted because such difference is covered by the definition of the term "dividends" contained in paragraph 3 of Article 10 and interpreted in paragraph 28 of the Commentary relating thereto. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value

at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with Article 11 (cf. also paragraphs 20 and 21 of the Commentary on Article 11).

32. There is a need to distinguish the capital gain that may be derived from the alienation of shares acquired upon the exercise of a stock-option granted to an employee or member of a board of directors from the benefit derived from the stock-option that is covered by Articles 15 or 16. The principles on which that distinction is based are discussed in paragraphs 12.2 to 12.5 of the Commentary on Article 15 and paragraph 3.1 of the Commentary on Article 16.

49.9.3 *"Alienation"*

The Supreme Court of Appeal of South Africa has held that "alienation" includes a deemed disposal:

> [24] Article 13 is widely cast. It includes within its ambit capital gains derived from the alienation of all property. It is reasonable to suppose that the parties to the DTA were aware of the provisions of the Eighth Schedule and must have intended Art 13 to apply to capital gains of the kind provided in the Schedule. It is of significance that no distinction is drawn in Art 13(4) between capital gains that arise from actual or deemed alienations of property. There is moreover no reason in principle why the parties to the DTA would have intended that Art 13 should apply only to taxes on actual capital gains resulting from actual alienations of property.
>
> [25] Having regard to the factors mentioned, I am of the view that the term 'alienation' as it is used in the DTA is not restricted to actual alienation. It is a neutral term having a broader meaning, comprehending both actual and deemed disposals of assets giving rise to taxable capital gains.[16]

The same point should apply in the UK.

The OECD Commentary provides:

> 5. The Article does not give a detailed definition of capital gains. This is not necessary for the reasons mentioned above. The words "alienation of property" are used to cover in particular capital gains resulting from

16 *Commissioner for the South African Revenue Service v Tradehold* [2012] ZASCA 61, 14 ITELR 967.

the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.

6. Most States taxing capital gains do so when an alienation of capital assets takes place. Some of them, however, tax only so-called realised capital gains. Under certain circumstances, though there is an alienation no realised capital gain is recognised for tax purposes (e.g. when the alienation proceeds are used for acquiring new assets). Whether or not there is a realisation has to be determined according to the applicable domestic tax law. No particular problems arise when the State which has the right to tax does not exercise it at the time the alienation takes place.

7. As a rule, appreciation in value not associated with the alienation of a capital asset is not taxed, since, as long as the owner still holds the asset in question, the capital gain exists only on paper. There are, however, tax laws under which capital appreciation and revaluation of business assets are taxed even if there is no alienation.

8. Special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated. This may be the case if the value of a capital asset has increased in such a manner that the owner proceeds to the revaluation of this asset in his books. Such revaluation of assets in the books may also occur in the case of a depreciation of the national currency. A number of States levy special taxes on such book profits, amounts put into reserve, an increase in the paid-up capital and other revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset. These taxes on capital appreciation (increment taxes) are covered by the Convention according to Article 2.

9. Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the Article or to lay down special rules. The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment, the prior right to tax belongs to the State where such property is situated. Special attention must be drawn, however, to the cases dealt with in paragraphs 13 to 17 below.

10. In some States the transfer of an asset from a permanent establishment situated in the territory of such State to a permanent establishment or the head office of the same enterprise situated in

another State is assimilated to an alienation of property. The Article does not prevent these States from taxing profits or gains deemed to arise in connection with such a transfer, provided, however, that such taxation is in accordance with Article 7.

49.9.4 *Losses accruing to person who qualifies for DT relief on gains*

The International Manual provides:

> **INTM153150 - Description of double taxation agreements: Capital gains** [March 2011]
> ...Business International, Tax Treaty Team would like to see any case where an individual claims relief for capital losses in circumstances where a corresponding gain would be exempt from United Kingdom tax under the terms of a double taxation agreement. In the case of companies such losses are not allowable by virtue of TCGA92/S8(2).

It is easy to think of cases where losses would be allowable but gains exempt; however in practice it will not often matter.

49.10 DT relief: Exceptions

The OECD Commentary provides:

> 4. It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom.

The exceptions are fairly narrow.

49.10.1 *Immovable property*

Article 13(1) OECD model provides:

> Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6[17] and situated in the other Contracting State may be taxed in that other State.

49.10.2 *Business property of a PE*

Article 13(2) OECD model provides:

> Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such

17 See 16.6.1 ("Immovable property").

gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

The OECD Commentary provides:

4. The right to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such gain is a capital gain or a business profit. Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question.

49.10.3 *Ships and aircraft*

For completeness: Article 13(3) OECD model provides:

Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

49.10.4 *Land-rich company*

For completeness: Article 13(4) OECD model provides:

Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

This clause is not usually found in UK treaties.

CHAPTER FIFTY

GAINS OF NON-RESIDENT SETTLOR-INTERESTED TRUSTS: S.86

50.1 CGT on non-resident trusts: Introduction

A trust is in principle treated as a taxable unit.[1] If the trustees are UK resident, they are subject to CGT, even if the beneficiaries have no connection with the UK. Non-resident trustees are in principle not subject to CGT, even if beneficiaries are resident in the UK.[2] This rule presents an obvious means of CGT avoidance. HMRC's first answer to this is the anti-avoidance rules in ss.86, 87 TCGA.

In outline:

(1) A settlor is subject to CGT on gains accruing to a non-resident trust if:
   (a) The settlor is UK resident and UK domiciled.
   (b) The settlor has an "interest" in the settlement. (This is widely and artificially defined.)

   I refer to this as the **"s.86 charge"** and I refer to the gains treated as accruing to the settlor under this section as **"s.86 gains"**.

(2) A beneficiary is subject to CGT if:
   (a) The beneficiary is UK resident.
   (b) The beneficiary receives a capital payment from the trust.
   (c) The trust realises gains.

   I refer to this as the **"s.87 charge"** or the **"s.87 capital payments basis"** and I refer to the gains treated as accruing to a beneficiary under this section as **"s.87 gains"** . This topic is discussed in the next chapter.

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1 See 5.3 (Trustees treated as single and distinct person).

2 See 49.1 (Territorial scope of CGT).

The s.86 charge is the subject of this chapter. The charge was extended in 1991 and 1998 with transitional relief for:
(1) trusts made before 19 March 1991 **("pre-1991 trusts")**
(2) trusts made before 17th March 1998 **("pre-1998 trusts")**
I refer to trusts which qualify for these reliefs as **"pre-1991 protected trusts"** and **"pre-1998 protected trusts"**.

Sloppy and repetitive drafting adds to the difficulties.

50.1.1 *Cross references*

The following matters are considered elsewhere:
51.5.2 (Section 86 gains deducted from s.2(2) amount)
54.6 (Loss accruing to non-resident trustees)
54.8 (Personal losses of settlor and s.86 gains)
51.33 (CGT planning aspects of non-resident trusts)
59.10 (DT reliefs: s.86 TCGA)
81.3 (Two or more settlors of settlor-interested trust: CGT).

50.2 Fundamental s.86 conditions

Section 86(1) TCGA sets out eight sets of conditions for s.86 to apply. I refer to these as "**the fundamental s.86 conditions**". In their statutory order they are:
(1) Qualifying settlement
(2) Trustee residence condition
(3) Settlor residence and domicile condition
(4) Settlor-interested condition
(5)-(8) Death/divorce of settlor or certain beneficiares
It is convenient to consider the settlor-interested condition before the others.

50.3 Minor definitions

It is helpful first of all to clear out of the way some (relatively) minor and unsurprising definitions. They are repeated up to five times, in identical words: the repetition is because on each occasion the definitions are expressed to be for the purposes of the paragraph and not for the purposes of the schedule or the Act. I set out the para 9 version and give the references for the others.

50.3.1 *"Settlement" and "settlor"*

"Settlement" is not expressly defined so the standard IT/CGT definition

applies. Contrast the IT settlor-interested trust rules, and the s.87 rules, where the settlement-arrangement definition applies. It would be bold to plan on the assumption that this will not change.

For "settlor" see 80.3.5 (CGT s.86 definition of settlor).

50.3.2 *"Control" and "participator"*

Para 9(9) Sch 5 TCGA provides a slightly cut down form of the ultra-wide sense of control:[3]

> [a] For the purposes of sub-paragraph (7) above the question whether a company is controlled by a person or persons shall be construed in accordance with sections 450 and 451 of CTA 2010;
> [b] but in deciding that question for those purposes no rights or powers of (or attributed to) an associate or associates of a person shall be attributed to him under section 451(4) to (6) of CTA 2010 if he is not a participator in the company.

Paras 2(8), 2A(8) and 8(8) Sch 5 TCGA and s 96(10) TCGA each repeat this definition.

Participator is relevant to this definition of control. Para 9(11) sch 5 TCGA provides the standard definition:

> In this paragraph ... "participator" has the meaning given by section 454 of CTA 2010.

Paras 2(10), 2A(10), 8(9) sch 5 TCGA and s.96(10) TCGA each repeat this definition verbatim.

ESC D40 provides:

> [The concession outlines the context in which the definition is used, and continues:]
> In applying the provisions of Sch 5 paras 2A(10), 8, 9(11) and s 96 a beneficiary of the trust, by concession, is not regarded as a participator in the company solely because of his status as beneficiary.[4]

It may be in the interest of a taxpayer to rely on the law rather than this concession. A concession cannot be used to increase the tax burden.

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3 For discussion of the ultra-wide sense of control, see 85.2.2 (Meaning(s) of "control").

4 In March 2013 HMRC consulted informally on a proposals either to withdraw ESC D40 or to introduce legislation with like effect.

50.3.3 *"Associated company"*

Para 9(10) Sch 5 TCGA provides a slightly cut down form of the usual wide definition:

> For the purposes of sub-paragraph (7) above the question whether one company is associated with another shall be construed in accordance with section 449 of CTA 2010; but where in deciding that question for those purposes it falls to be decided whether a company is controlled by a person or persons, no rights or powers of (or attributed to) an associate or associates of a person shall be attributed to him under section 451(4) to (6) of CTA 2010 if he is not a participator in the company.

Paras 2(9) and 2A(9) Sch 5 TCGA repeat the definition.

50.3.4 *"Child" and "grandchild"*

Para 9(11) sch 5 TCGA provides:

> In this paragraph—
> "child" includes a step-child;
> "grandchild" means a child of a child;

This is repeated verbatim in para 2A(10) Sch 5 TCGA.

50.3.5 *"Relevant property" and "relevant income"*

Para 2(2) Sch 5 TCGA provides:

> (a) relevant property is property originating from the settlor,
> (b) relevant income is income originating from the settlor.

This is repeated (more or less) verbatim in para 9(10D) Sch 5 TCGA.

50.4 Settlor-interested condition

This s.86 condition is in s.86(1)(d):

> at any time during the year the settlor has an interest in the settlement;

If a settlement becomes (or ceases to be) settlor-interested during a tax year, s.86 TCGA applies for the whole tax year, This is unlike the IT rules (where if a settlor is excluded s.624 ITTOIA ceases to apply from the date of the exclusion).[5] There is reason for the distinction, because the s.86 charge is on gains less losses for the entire year, and splitting the year

5 See 27.3.6 (Settlement ceasing to be settlor-interested).

would involve some trouble. The rule does however mean that CGT planning by excluding the settlor must be carried out some time in advance.

50.4.1 "*Settlor-interested*"

The term "settlor-interested" in a s.86 context[6] is a label for a complex set of rules.

Para 2 Sch 5 TCGA provides:

> (1) For the purposes of section 86(1)(d) a settlor has an interest in a settlement if—
>
> (a) any relevant property[7] which is or may at any time be comprised in the settlement is, or will or may become, applicable for the benefit of or payable to a defined person in any circumstances whatever,
>
> (b) any relevant income which arises or may arise under the settlement is, or will or may become, applicable for the benefit of or payable to a defined person in any circumstances whatever, or
>
> (c) any defined person enjoys a benefit directly or indirectly from any relevant property which is comprised in the settlement or any relevant income arising under the settlement;
>
> but this sub-paragraph is subject to sub-paragraphs (4) to (6) and paragraph 2A below.

The key term is "defined person". Para 2(3) Sch 5 TCGA provides:

> For the purposes of sub-paragraph (1) above each of the following is a defined person—
>
> (a) the settlor,
>
> (b) the settlor's spouse or civil partner;
>
> (c) any child of the settlor or of the settlor's spouse or civil partner;
>
> (d) the spouse or civil partner of any such child;
>
> (da) any grandchild of the settlor or of the settlor's spouse or civil partner;
>
> (db) the spouse or civil partner of any such grandchild;
>
> (e) a company controlled by a person or persons falling within paragraphs (a) to (db) above;

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6 The same term is used in an IT context with a different meaning: see 27.3.1 (The concepts of "settlor-interested").

7 See 50.3.5 ("Relevant property" and "relevant income").

(f) a company associated with a company falling within paragraph (e) above.

The history has been one of gradual expansion, with the reference to children added in 1991 and paras (da) and (db) - dealing with grandchildren - added in 1998. Thus the definition of settlor-interested is wider than the IT equivalent in s.624, eg the settlor is chargeable on gains accruing to a trust from which their children or grandchildren could benefit even though there is no actual benefit to the settlor.

Para 2(4) Sch 5 TCGA provide exceptions copied from the precedent of the IT settlor-interested trust rules; they have no significant application in practice.

The IT settlor-interested rules have a provision that references to spouses do not include separated or potential future spouses. Unfortunately, the CGT settlor-interested rules do not have that rule. The omission raises a number of difficulties.

50.4.2 *Civil partner and same-sex spouses as beneficiaries*

The Civil Partnership Act took effect on 5 December 2005. Before then, civil partners of the settlor were not expressly excluded in trust drafting, so a trust which merely excluded spouses might become settlor-interested from 2005! HMRC will tactfully overlook that:

> For settlements made before 5 December 2005, the settlor may not have been considered to have retained an interest in the settlement for Income Tax purposes, as both the settlor and his spouse were specifically excluded from benefit under the particular terms of the settlement deed. Although such an 'exclusion clause' would not have included a 'civil partner', HMRC will not regard the settlor as retaining an interest unless and until a beneficiary becomes the civil partner of the settlor.[8]
>
> With regards to the provisions of Section 86 TCGA 1992, whereby the gains of a non-resident trust or dual resident trust are chargeable on the settlor. If such provisions did not apply in relation to a settlement made prior to 5 December 2005, and the deed was drafted in such an obvious way as to exclude spouses or future spouses without particular definition of those terms, that exclusion might reasonably be regarded in the context as covering civil partners and those treated as such under CPA who stand in the same position as spouses under the law from 5 December 2005. In such circumstances it will not be HMRC's intention

8 For IT, this rule is statutory; see ? (Meaning of "spouse/civil partner").

> to apply those provisions to a settlement only as a result of the coming into effect of the CPA. For settlements made on or after 5 December 2005, it is expected that the drafting of the settlement deed excludes the full list of 'defined persons' (Schedule 5, Para 2(3) TCGA 1992), including 'civil partners', from benefiting in any circumstances under the settlement, if it is intended for the settlement not to be caught by the provisions.[9]

This is just a concession and it may be in the interest of beneficiaries to argue that a pre-2005 settlement under which a future civil partner may benefit should be treated as settlor-interested for CGT purposes.

A similar problem arises with same-sex spouses, for trusts made before the Marriage (Same Sex Couples) Act 2013 came into force. A pre-Act exclusion clause which excludes "spouses" will not exclude a same-sex spouse: see para 1 sch 4 Marriage (Same Sex Couples) Act 2013. But I expect HMRC will operate a similar concession.

50.4.3 *Potential defined persons*

ICAEW Guidance note on non-resident settlements (TAX 20/92) 14 December 1992 provides:

> 24 ... TCGA 1992 Sch 5 specifies the test as to whether the settlor has an interest. Each of sub-paragraphs 2(1)(a) and(b) uses the words "may…in any circumstances whatever". Interpreted literally, it appears virtually impossible to define a trust where the settlor does not have an interest, because any beneficiary may become a relative of the settlor as a result of subsequent marriages (or indeed subsequent births if necessary to imagine all conceivable possibilities). ...
>
> *Revenue response:* If the terms of a settlement are so framed that a clearly defined person can benefit, eg the class of beneficiaries includes "any spouse of the settlor" or "spouses of the settlor's children", or such persons could be added to the class of beneficiaries, then the settlor will be treated as having an "interest" in the trust. However, where there is no prima facie possibility of a defined person benefiting, the Revenue will not treat the settlor as having an "interest", unless the terms of the settlement and the circumstances of the case indicate an intention to benefit a person who is likely to become a defined person in the future, eg a settlement in favour of the fiancé of the settlor or of the settlor's child.

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9 "HMRC Residency: Non-resident trusts" *http://www.hmrc.gov.uk/cnr/nr_trusts.htm*.

50.4.4 *Separated spouse*

ICAEW Guidance note on non-resident settlements (TAX 20/92) 14 December 1992 provides:

> 25 Also on the question of whether a settlor has an interest in a trust, it would be helpful if the statement of practice could confirm that a separated spouse would not be regarded as the settlor's spouse for this purpose.
> *Revenue response:* A separated spouse would be regarded as a spouse for the purposes of these provisions unless, in accordance with existing practice (see para 13(a) Appendix B of the Resident trusts consultative document 19 March 1991)[10] on other provisions having a bearing on "settlor interest" trusts, the separation is permanent.

50.5 Pre-1998 protected trusts

Para 2A(1) TCGA provides:

> In determining for the purposes of section 86(1)(d) whether the settlor has an interest at any time during any year of assessment in a settlement created before 17th March 1998, paragraphs (da) and (db) of paragraph 2(3) above, and the reference to those paragraphs in paragraph 2(3)(e), shall be disregarded ...

In short, the relief is that a protected pre-1998 trust (one where the trigger conditions do not apply) is allowed to benefit the settlor's grandchildren without becoming "settlor-interested".

Para 2A continues:

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10 The reference is to the former SP A30 which provided:
"The settlement legislation [now s.624 ITTOIA] includes provisions which may be applied to any settlement where the spouse or any possible future spouse of a settlor may be able to benefit from the income or capital of the settlement in any circumstances whatsoever. In relation to the concept of "possible future spouse" the Board of Inland Revenue have considered the scope of the decision reached in the case of *IRC v Tennant* (24 TC 215) and they take the view that that decision applies -
(a) where, although a settlor is not at the material time a party to a subsisting marriage, the terms of the settlement are such that a benefit may be conferred on substantially any person who may become the wife or husband of the settlor in future, or
(b) where, whether or not the settlor is married, the terms of the settlement are such as to indicate a specific intention that a future wife or husband of the settlor may be enabled to benefit."

> ... unless—
>
> (a) that year is a year in which one of the four conditions set out in the following provisions of this paragraph becomes fulfilled as regards the settlement; or
>
> (b) one of those conditions became fulfilled as regards that settlement in any previous year of assessment ending on or after 5th April 1998.

I refer to these conditions as **"s.86 trigger conditions"**. Technically their effect is that the trust becomes settlor-interested, but the real consequence is that s.86 begins to apply.

50.5.1 *First s.86 trigger condition: Provision of property*

Para 2A(2) Sch 5 TCGA provides:

> The first condition is (subject to sub-paragraph (3) below) that on or after 17th March 1998 property or income is provided directly or indirectly for the purposes of the settlement—
>
> (a) otherwise than under a transaction entered into at arm's length, and
>
> (b) otherwise than in pursuance of a liability incurred by any person before that date.

This is discussed in the chapter "who is the settlor": see 80.3.5 (CGT s.86 definition of settlor).

Para 2A(3) Sch 5 TCGA provides:

> For the purposes of the first condition, where the settlement's expenses relating to administration and taxation for a year of assessment exceed its income for the year, property or income provided towards meeting those expenses shall be ignored if the value of the property or income so provided does not exceed the difference between the amount of those expenses and the amount of the settlement's income for the year.

SP 5/92 provides:

> 26 The following items are not regarded as "expenses relating to administration" within the terms of the proviso to TCGA 1992 Sch 5 para 9(3)—
>
> – loan interest (other than interest on a loan taken out to meet expenses of administration within the terms of the proviso);
>
> – the costs of acquiring, enhancing or disposing of an asset;
>
> – expenses incurred in connection with a particular trust asset to the extent that such expenditure can be set against income arising from

that asset. For the purpose of the proviso to para 9(3), the measure of the gross income from such a source is net of expenses.

27 The term "expenses relating to… taxation" in TCGA 1992 Sch 5 para 9(3) is regarded as encompassing UK or foreign taxes to which the trustees are liable, along with any interest and penalties due on that tax. It could also include certain costs incurred by the trustees under the terms of the trust in obtaining information regarding the beneficiaries' tax liabilities. One example might be where the trustees, in order to ensure they were acting in a beneficiary's best interests, had to ascertain the tax implications for the beneficiary in adopting a particular course of action.

28 It is only the settlement's expenses relating to administration or taxation which are within the terms of the proviso to TCGA 1992 Sch 5 para 9(3). Expenses of, for example, a company wholly owned by the trustees fall outside its scope....

30 Normally the specific date on which the liability to an expense relating to administration or taxation was incurred determines the year into which it falls for the purpose of applying the proviso to TCGA 1992 Sch 5 para 9(3). Where, however, the expense is incurred for a period rather than on a specific date, the basis of allocating expenses adopted by the trustees in preparing trust accounts or returns is, generally, regarded as acceptable provided that this basis is consistently adopted and is in accordance with conventional trust accounting practice.

31 Additions to meet the difference between expenses relating to administration and taxation and any income arising to the trust do not have to be made by 5 April in the relevant year of assessment. There must, however, be a clear connection between the amount added and the computed shortfall. Additions should, therefore, be made as soon as the relevant figures are available.

32 Income, for the purposes of the proviso to TCGA 1992 Sch 5 para 9(3), is the total income which arises to the trustees in the relevant year, rather than the income which is (or would be if the trust were resident in the UK) subject to UK tax. Usually, items of income will need to be allocated to the year in which they arise for the purposes of the proviso, but, in practice, income arising from a trade carried on by the trustees may be apportioned on a time basis, provided that this basis is consistently followed.

50.5.2 *Second s.86 trigger condition: Emigrating trust*

Para 2A(4) Sch 5 TCGA provides:

The second condition is that—

(a) the trustees cease on or after 17 March 1998 to be resident in the UK, or
(b) the trustees, while continuing to be resident in the UK, become on or after 17th March 1998 trustees who fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK.

If the emigration is to an EU member state, this rule would breach EU law: see 8.9 (EU restriction on exit taxes).

50.5.3 *Third s.86 trigger condition: Variation of trust*

Para 2A(5) Sch 5 TCGA provides:

> The third condition is that on or after 17th March 1998 the terms of the settlement are varied so that any person falling within sub-paragraph (7) below becomes for the first time a person who will or might benefit from the settlement.

SP 5/92 provides:

> 36 This provision is concerned with situations where the terms of the settlement are varied by the beneficiaries or a court to admit new beneficiaries within the class of persons defined at TCGA 1992 Sch 5 para 9(7) without thereby bringing the settlement to an end and creating a new one. For example, where the terms of the trust include a power to appoint anyone within a specified range to be a beneficiary, exercise of that power after 19 March 1991 will not be regarded as a variation of the settlement...

50.5.4 *Fourth s.86 trigger condition: Unexpected beneficiary*

Para 2A(6) Sch 5 TCGA provides:

(6) The fourth condition is that—
  (a) on or after 17th March 1998 a person falling within sub-paragraph (7) below enjoys a benefit from the settlement for the first time, and
  (b) the person concerned is not one who (looking only at the terms of the settlement immediately before 17th March 1998) would be capable of enjoying a benefit from the settlement on or after that date.
(7) Each of the following persons falls within this sub-paragraph—
  (a) any grandchild of the settlor or of the settlor's spouse or civil partner;
  (b) the spouse of or civil partner any such grandchild;

(c) a company controlled by a person or persons falling within paragraph (a) or (b) above;
(d) a company controlled by any such person or persons together with any person or persons (not so falling) each of whom is for the purposes of paragraph 2(1) above a defined person in relation to the settlement;
(e) a company associated with a company falling within paragraph (c) or (d) above.

SP 5/92 provides:

> 37 For the purposes of clarification, this condition deals with "ultra vires" payments, ie cases where one of the persons defined at TCGA 1992 Sch 5 para 9(7) receives a benefit from the trust for the first time and that person is not a beneficiary under the terms of the trust deed. It may also apply where such a person benefits from a transaction with the settlement carried out, for example, under the trustees' investment powers.

This trigger condition may apply in the case of an ultra vires payment (ie a payment in breach of trust), but only if the payment is in fact a benefit.[11] A transaction under the trustees investment powers is not in principle a benefit, unless perhaps the transaction is a breach of trust, in which case it is not really "under the trustees investment powers".

50.6 Qualifying settlement

Section 86(1) provides:

> This section applies where the following conditions are fulfilled as regards a settlement in a particular year of assessment—
> (a) the settlement is a qualifying settlement in the year;

"Qualifying" settlement is a label for a set of transitional rules.

50.6.1 *Post-1991 trust*

This is straightforward. Para 9(1) Sch 5 TCGA provides:

> A settlement created on or after 19th March 1991 is a qualifying settlement for the purposes of section 86 and this Schedule in—
> (a) the year of assessment in which it is created, and
> (b) subsequent years of assessment.

---

11 See 30.4.15 ("Benefit" provided in breach of trust).

50.7 Pre-1991 protected trusts

Para 9 continues with a complex grandfathering relief for what statute calls "protected settlements"; although it is generally better to adopt statutory terminology, I refer to these as **"pre-1991 protected trusts"**. That terminology avoids confusion with pre-1998 protected trusts.

Para 9 (1A) Sch 5 TCGA provides:

> Subject to sub-paragraph (1B) below, a settlement created before 19th March 1991 is a qualifying settlement for the purposes of section 86 and this Schedule in—
>
> (a) the year 1999–00, and
>
> (b) subsequent years of assessment.

The relief is in para 1B. Para 9(1B) sch 5 TCGA provides:

> Where a settlement created before 19th March 1991 is a protected settlement immediately after the beginning of 6th April 1999, that settlement shall be treated as a qualifying settlement for the purposes of section 86 and this Schedule in a year of assessment mentioned in sub-paragraph (1A)(a) or (b) above only if—
>
> (a) any of the five conditions set out in subsections (3) to (6A) below becomes fulfilled as regards the settlement in that year; or
>
> (b) any of those five conditions became so fulfilled in any previous year of assessment ending after 19th March 1991.

I refer to these conditions as **"s.86 trigger conditions"**. Technically their effect is that the trust becomes a qualifying settlement, but the real consequence is that s.86 begins to apply. The drafting technique is different from that used for pre-1998 settlements but the end result is essentially the same.

The relief for pre-1991 trusts was important in its day, and HMRC issued extensive guidance. The guidance has ceased to be directly important (because there are now few if any pre-1991 protected trusts left) but it is still relevant where similar wording is used elsewhere.

50.7.1 "*Protected settlements*"

Para 9 sch 5 TCGA provides:

> (10A) Subject to sub-paragraph (10B) below, a settlement is a protected settlement at any time in a year of assessment if at that time the

beneficiaries[12] of that settlement are confined to persons falling within some or all of the following descriptions, that is to say—

(a) children of a settlor or of a spouse or civil partner of a settlor who are under the age of eighteen at that time or who were under that age at the end of the immediately preceding year of assessment;

(b) unborn children of a settlor, of a spouse or civil partner of a settlor, or of a future spouse or civil partner of a settlor;

(c) future spouses or civil partners of any children or future children of a settlor, a spouse or civil partner of a settlor or any future spouse or civil partner of a settlor;

(d) a future spouse or civil partner of a settlor;

(e) persons outside the defined categories.

(10B) For the purposes of sub-paragraph (10A) above a person is outside the defined categories at any time if, and only if, there is no settlor by reference to whom he is at that time a defined person in relation to the settlement for the purposes of paragraph 2(1) above.

The point is that a pre-1991 protected trust may have minor children of the settlor as beneficiaries, but if it is to remain protected, it must exclude them before they become 18.

The trigger conditions are set out at length in para 9, but the first two are the same as the s.86 trigger conditions which apply to pre-1998 protected trusts; they need not be separately set out here.[13]

50.7.2 *Third and fourth conditions*

The third and fourth conditions are based on the s.86 trigger conditions which apply to pre-1998 protected trusts with corresponding amendments

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12 Para 9(10C) defines beneficiary: "For the purposes of sub-paragraph (10A) above a person is a beneficiary of a settlement if—

(a) there are any circumstances whatever in which relevant property which is or may become comprised in the settlement is or will or may become applicable for his benefit or payable to him;

(b) there are any circumstances whatever in which relevant income which arises or may arise under the settlement is or will or may become applicable for his benefit or payable to him;

(c) he enjoys a benefit directly or indirectly from any relevant property comprised in the settlement or any relevant income arising under the settlement."

13 Para 9(3) = para 2A(2); see 50.5.1 (First s.86 trigger condition: provision of property). Para 9(4) = para 2A(4); see 50.5.2 (Second s.86 trigger condition: emigrating trust).

in the wording. Para 9 Sch 5 TCGA provides:

> (5) The third condition is that on or after 19th March 1991 the terms of the settlement are varied so that any person falling within sub-paragraph (7) below becomes for the first time a person who will or might benefit from the settlement.
> (6) The fourth condition is that—
> (a) on or after 19th March 1991 a person falling within sub-paragraph (7) below enjoys a benefit from the settlement for the first time, and
> (b) the person concerned is not one who (looking only at the terms of the settlement immediately before 19th March 1991) would be capable of enjoying a benefit from the settlement on or after that date.

Para 9(7) Sch 5 TCGA provides:

> Each of the following persons falls within this sub-paragraph—
> (a) a settlor;
> (b) the spouse or civil partner of a settlor;
> (c) any child of a settlor or of a settlor's spouse or civil partner;
> (d) the spouse or civil partner of any such child;
> (da) any grandchild of a settlor or of a settlor's spouse or civil partner;
> (db) the spouse or civil partner of any such grandchild;
> (e) a company controlled by a person or persons falling within paragraphs (a) to (db) above;
> (f) a company associated with a company falling within paragraph (e) above.

See 50.5.3 (Third s.86 trigger condition: variation of trust); 50.5.4 (Fourth s.86 trigger condition: unexpected beneficiary).

50.7.3 *Fifth s.86 trigger condition: Ceasing to be protected*

Para 9(6A) Sch 5 TCGA provides:

> The fifth condition is that the settlement ceases to be a protected settlement at any time on or after 6th April 1999.

50.7.4 *Commentary: let's abolish relief for pre-1991 protected trusts*

These rules have been in place since 1991. Children then living (or indeed born in the following few years) have now reached 18. It is possible to envisage circumstances in which pre-1991 protected trusts could still exist

but I suspect that there are no pre-1991 protected trusts now in existence. It is suggested in the interests of simplification that the transitional relief for pre-1991 protected trusts should now be withdrawn.

50.8 Trustee residence condition

This s.86 condition is in s.86(1)(b) TCGA:

> the trustees of the settlement fulfil the condition as to residence specified in subsection (2) below;

This takes us to s.86(2) TCGA which provides:

> (2) The condition as to residence is that—
> (a) there is no time in the year when the trustees are resident in the UK, or
> (b) there is such a time but, whenever the trustees are resident in the UK during the year, they fall to be regarded for the purposes of any double taxation relief arrangements[14] as resident in a territory outside the UK.

Condition (a) is that the trustees are non-resident; condition (b) is that the trustees are UK-law UK resident but treaty-resident in a foreign state with a capital gains article (under the tie-breaker).[15]

50.9 Settlor residence and domicile condition

This s.86 condition is in s.86(1)(c):

> a person who is a settlor in relation to the settlement ("the settlor"):
> [i] is domiciled in the UK at some time in the year and
> [ii] is resident in the UK for the year;

Section 86 does not apply to a foreign domiciled settlor, whether or not they claim the remittance basis. At first sight this seems a surprising inconsistency with the general scheme of taxation of foreign domiciliaries, introduced in 2008. It was however a deliberate decision.[16] No reason was given for it so it is tempting to speculate. Probably it reflects an understanding, which most readers would accept, that it is not appropriate to apply the rules to settlors and trustees from outside the UK because: (1) the definition of "settlor-interested" for s.86 purposes is too wide, and

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14 For the meaning of this term, see 9A.3.3 ("DTR arrangements" – CGT).

15 For treaty aspects, see 59.10 (DT reliefs: s.86 TCGA).

16 The draft clauses which would have amended s.86 were withdrawn.

(2) the trigger conditions are too harsh and too complicated,

One must bear in mind that foreign settlors and trustees may not have had the same opportunities to consider UK legislation when making or administering their settlements.

That is actually quite a good reason, though one should not assume that rules of tax law, even important rules, are necessarily enacted with good reasons in mind. Perhaps it was just a concession thrown without much rationalisation, to placate the lobby opposing the 2008 reforms, that is, the true explanation may be located in tax politics rather than tax policy.

Although no claim is needed, the matter should be disclosed on a tax return, if one is completed: see 50.17.1 (Non-domiciled settlor).

50.10 Section 86 trust gains condition

This condition is in s.86(1)(e):

> by virtue of disposals of any of the settled property originating from the settlor, there is an amount on which the trustees would be chargeable to tax for the year under section 2(2) if the assumption as to residence specified in subsection (3) below were made.

I refer to this as the "**s.86 trust gains condition**".

50.10.1 *Assumption as to residence*

The assumption as to residence is set out in s.86(3) TCGA but in order to follow it one must read it with s.86(2):

> (2) The condition as to residence is that—
>
> (a) there is no time in the year when the trustees are resident in the UK, or
>
> (b) there is such a time but, whenever the trustees are resident in the UK during the year, they fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK
>
> (3) [a] Where subsection (2)(a) above applies, the assumption as to residence is that the trustees are resident in the UK throughout the year; and
>
> [b] where subsection (2)(b) above applies, the assumption as to residence is that the double taxation relief arrangements do not apply.

In para [b] the assumption is not in fact an assumption "as to residence": the assumption is a disapplication of treaty relief, but the meaning is clear.

50.10.2 *Ascertaining the s.86 trust gains*

The condition in s.86(1)(e) is that there is an amount, which I call "**the s.86 trust gains**". The quantum of the s.86 trust gains matters because the amount of the charge depends on that.

All the usual CGT reliefs are in principle applicable in computing the s.86 trust gains. For instance, hold-over relief is available on a transfer to a UK resident beneficiary, if the usual conditions are satisfied.[17]

Para 1(1) Sch 5 TCGA provides:

> In construing section 86(1)(e) as regards a particular year of assessment, the effect of section 3 shall be ignored.

This disapplies the trustee annual exemption (which is fair because the settlor has their own annual exemption).

50.11 Year of death of settlor

This s.86 condition is in s.86(1)(f):

> paragraph 3, 4 or 5 of schedule 5 does not prevent this section applying.

This sets out three conditions which are best considered separately.

Para 3 Sch 5 TCGA provides:

> Section 86 does not apply if the settlor dies in the year.

What is the reason for this rule? Presumably it was thought unfair to tax the settlor's estate on post-death gains, and too much trouble to split the year into disposals before/after the death.

50.12 Death or divorce of certain beneficiaries

The last two s.86 conditions are set out in paras 4 and 5 Sch 5 TCGA:

> 4(1)This paragraph applies where for the purposes of section 86(1)(d) the settlor has no interest in the settlement at any time in the year except for one of the following reasons, namely, that—
>
> (a) property is, or will or may become, applicable for the benefit of or payable to one of the persons falling within para 2(3)(b) to (db) above,
>
> (b) income is, or will or may become, applicable for the benefit of or payable to one of those persons, or
>
> (c) one of those persons enjoys a benefit from property or income.
>
> (2) This paragraph also applies where sub-para (1) above is fulfilled by virtue of

17 See the HMRC helpsheet quoted at 51.5.1 (Ascertaining the s.2(2) amount).

2 or all of paras (a) to (c) being satisfied by reference to the same person.
(3) Where this paragraph applies, section 86 does not apply if the person concerned dies in the year.
(4) In a case where—
(a) this paragraph applies, and
(b) the person concerned falls within para 2(3)(b), (d) or (db) above,
section 86 does not apply if during the year the person concerned ceases to be married to, or a civil partner of, the settlor, child or grandchild concerned (as the case may be).
5 (1) This paragraph applies where for the purposes of section 86(1)(d) the settlor has no interest in the settlement at any time in the year except for the reason that there are 2 or more persons, each of whom—
(a) falls within para 2(3)(b) to (db) above, and
(b) stands to gain for the reason stated in sub-para (2) below.
(2) The reason is that—
(a) property is, or will or may become, applicable for his benefit or payable to him,
(b) income is, or will or may become, applicable for his benefit or payable to him,
(c) he enjoys a benefit from property or income, or
(d) 2 or all of paras (a) to (c) above apply in his case.
(3) Where this paragraph applies, section 86 does not apply if each of the persons concerned dies in the year.

I cannot see the point of this, though it does offer a kind of symmetry with para 3. I doubt if it ever has or ever will apply.

50.13 Attribution of s.86 gains to settlor

Assuming all eight fundamental s.86 conditions are satisfied, we proceed to s.86(4) TCGA which provides:

Where this section applies—
(a) chargeable gains of an amount equal to that referred to in subsection (1)(e) above shall be treated as accruing to the settlor in the year or if, as respects the settlor, the year is a split year, in the UK part of that year, ...

50.14 Interaction of s.86 and s.13 TCGA

Suppose a settlor-interested trust within s.86 TCGA owns a non-resident company within s.13 TCGA, and a gain accrues to the company. The gain is treated as accruing to the trustees. In the absence of express provision, this gain would not fall within s.86 because the s.86 trust gains condition would not be satisfied: the gain does not accrue "by virtue of disposals of

any of the settled property".[18] The company property is not settled property. Para 1(3) Sch 5 TCGA deals with this:

> In a case where—
>
> (a) the trustees are participators in a company in respect of property which originates from the settlor, and
>
> (b) under section 13 gains or losses would be treated as accruing to the trustees in a particular year of assessment by virtue of so much of their interest as participators as arises from that property if the assumption as to residence specified in section 86(3) were made,
>
> the gains or losses shall be taken into account in construing section 86(1)(e) as regards that year as if they had accrued by virtue of disposals of settled property originating from the settlor.

50.15 Corporate settlor

It is considered that s.86 TCGA does not apply to a company even if it does create a settlor-interested settlement and is the settlor. The context suggests that only individuals are intended to be caught. It appears that HMRC may not accept this view.[19] The issue rarely arises in practice. Where a company with one or few shareholders is a settlor, HMRC may instead look to see if the shareholders are settlors.[20]

50.16 Interaction of s.86, s.87 and entrepreneurs' relief

This section considers whether entrepreneurs' relief[21] is available on a disposal by a non-resident trust, within s.86, assuming all the relevant

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18 See 50.10 (Section 86 trust gains condition).

19 The CG Manual provides:

> "**35020. Trusts for employees** [February 2006]
>
> There is nothing in Section 77 [TCGA] itself to prevent it being applied to a company. In particular, where a company has set up a settlement for its employees, the deed may provide that if all the trusts fail, the property may revert to the company. The most common cases are share option schemes and unapproved pension schemes."

Section 77 TCGA was repealed in 2008, the issue for s.86 is similar. For a further discussion, see Kessler & Marre, *Taxation of Charities and Nonprofit Organisations*, (9th ed, 2013-14) para 20.2.2 (Loan by company) (online version *http://www.taxationofcharities.co.uk*).

20 See 80.35 (Trust made by company: are shareholders settlors?).

21 See 49.5 (Entrepreneurs' relief).

conditions are satisfied (so that a disposal by a UK resident trust would qualify for the relief).

Section 169N TCGA provides (so far as relevant):

> (1) Where a claim is made in respect of a qualifying business disposal—
> (a) the relevant gains (see subsection (5))[22] are to be aggregated, and
> (b) any relevant losses (see subsection (6)) are to be aggregated and deducted from the aggregate arrived at under paragraph (a).
> (2) The resulting amount is to be treated for the purposes of this Act as a chargeable gain accruing at the time of the disposal to the individual or trustees by whom the claim is made.
> (3) The rate of capital gains tax in respect of that gain is 10%, but this is subject to subsections (4) to (4B)...[23]
> (9) Any gain or loss taken into account under subsection (1) is not to be taken into account under this Act as a chargeable gain or an allowable loss.

The technical question is whether the gains which are treated as accruing to the settlor are the same gains as the gains accruing to the trustees. It is considered that one should apply a purposive construction so that the relief is available.[24] If that were wrong, UK law would not be EU law compliant, which would give a further defence if the trustees were resident in a MS.

However if it is possible to make the trust UK resident in the year of the disposal, that would be better, as the issue would not arise.

On the other hand, entrepreneurs' relief is probably not available if the trust is within s.87, as the s.87 gain accruing to a beneficiary is not the same gain.[25]

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22 Section 169N(5) TCGA provides: "In subsection (1)(a) "relevant gains" means—
(a) if the qualifying business disposal is of (or of interests in) shares in or securities of a company (or both), the gains accruing on the disposal (computed in accordance with the provisions of this Act fixing the amount of chargeable gains), and
(b) otherwise, the gains accruing on the disposal of any relevant business assets comprised in the qualifying business disposal (so computed)."

23 Subsections (4) to (4B) impose a £10m cap which need not be considered here.

24 A similar issue arises for DTAs; see 59.10.1 (Trustees within s.86 treaty-resident outside UK).

25 See 59.12.1 (Trustees within s.87 treaty-resident outside UK).

50.17 Tax return: Disclosure of s.86 gains or non-domiciled status

50.17.1 *Non-domiciled settlor*

This section considers the position where gains accrue to a settlor-interested trust, but s.86 does not apply because the settlor is not UK domiciled.

If the settlor claims the remittance basis, and submits a tax return, they will have completed the relevant boxes in SA109 and no further return or disclosure is necessary.[26]

If the settlor does not claim the remittance basis, but does submit a tax return, then:

(1) It is necessary to tick box 23 in form SA109 (2013/14). The caption by this box states: *If you are domiciled outside the UK and it is relevant to your Income Tax or Capital Gains Tax liability, put 'X' in the box.* (There are further relevant boxes if this is the first domicile claim.)

(2) It is not necessary to tick box 8 in the form SA100 (2013/14). The caption by this box reads: *Residence, remittance basis etc. Were you, for all or part of the year to 5 April 2014, one or more of the following – not resident, not ordinarily resident or not domiciled in the UK and claiming the remittance basis; or dual resident in the UK and another country?*

If the settlor does not submit a tax return (because HMRC have not sent a notice to submit the return, and there are no income/gains requiring a return) then no claim or notification is needed.

50.17.2 *UK domiciled settlor*

Helpsheet 299 (Non-resident trusts and Capital Gains Tax) 2014 provides:

> If you are liable to tax when gains arise to the non-resident trustees of your trust and/or to relevant overseas private companies in which they invest, the trustees' net chargeable gains are attributed to you. You should include them in the overall figure in box 33 on your Capital gains summary pages. You should include details of these gains in your computations accompanying these pages.

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26 See 10.7.1 (How to make a remittance basis claim).

CHAPTER FIFTY ONE

CAPITAL PAYMENTS FROM NON-RESIDENT TRUSTS: S.87

51.1 The s.87 regime: Introduction and terminology

This chapter considers the CGT charge on beneficiaries who receive capital payments from non-resident trusts, under s.87 TCGA. I call this **"the s.87 regime**". The charge is supplemented by a further charge in s.89 TCGA but I use the expression "s.87 regime" loosely to refer to both charges.

There are *four* versions of the s.87 regime:

(1) **"The standard s.87 regime"**, discussed in this chapter.

(2) **"The Sch4C s.87 regime"**, which applies where there has been a Sch4B-transfer.[1]

(3,4) Modified versions of (1) and (2) which apply for offshore income gains.[2]

The result is so intricate that no written description could ever do justice to the complexities.

The rules were introduced in 1981, extended in 1998, and extended again and rewritten in 2008.

In the following discussion:

"The pre-2008 s.87" means s.87 as it was before the 2008 amendments.

"The HMRC s.87 guidance note" means the 54 page guidance note, first published May 2009, 2nd version October 2009, entitled "FA 2008 changes to the CGT charge on beneficiaries of non-resident settlements".[3]

51.1.1 *Cross references*

The following matters are considered elsewhere:

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1 See 52.14 (Schedule 4C).

2 See 35.13 (OIG s.87 charge) and 52.27 (OIG sch 4C).

3 *http://www.hmrc.gov.uk/cnr/beneficiaries-non-resident.pdf*

50.16 (Interaction of s.86, s.87 and entrepreneurs' relief)
54.6 (Loss accruing to non-resident trustees)
54.7 (Disallowance of personal losses against s.87 gains)
59.12 (DT reliefs: s.87 TCGA)

For s.87 gains accruing to charity, see Kessler & Marre, *Taxation of Charities and Nonprofit Organisations*.[4]

51.2 "Settlement" and "trustee"

51.2.1 *"Settlement"*

Section 97(7) TCGA provides:

> In sections 86A to 96 and Schedule 4C and in this section—
> "settlement" has the meaning given by section 620 of ITTOIA 2005, and
> "settled property" and references (however expressed) to property comprised in a settlement shall be construed accordingly.

"Settlement" here means settlement-arrangement.[5]

The estate of a deceased person is not a settlement-arrangement.[6]

In practice one is normally concerned with trusts in the classic sense. That is just as well, as the problems raised by other types of settlement (which I call **"non-trust settlement-arrangements"**) such as a foundation, have not been fully thought through.

51.2.2 *"Trustee" of non-trust settlement-arrangement*

A problem arises for an entity which is a settlement-arrangement (and so a settlement for s.87 purposes) but which (not being a classic settlement) has no trustees in the normal (trust law) sense of the word. For s.87 purposes one needs to identify trustees because:

(1) one needs to ascertain trustee residence;[7]
(2) one needs to identify s.2(2) amounts (trust gains), which are the amounts on which "the trustees of the settlement" would be chargeable to tax under s.2(2) if they were resident in the UK.

Accordingly s.97(7A) TCGA provides:

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4 (9th ed., 2013), Chap. 32 (Payments to charity from non-resident trusts) online version *http://www.taxationofcharities.co.uk*.

5 See 80.2.3 (Settlement-arrangement definition of settlement).

6 See 78.6.1 (Is an estate a "settlement" within s.87 TCGA?).

7 See 51.3 (Non-resident settlement condition).

> [a] In this section, sections 86A to 96 and Schedule 4C "trustee", in relation to a settlement in relation to which there would be no trustees apart from this subsection, means any person in whom the settled property or its management is for the time being vested ... [8]

When this extended sense applies, I use the word "trustees" (using scare quotation marks).

An example is a Liechtenstein stiftung (foundation). The "trustees" are (a) the foundation itself (a body corporate in which the "settled property" is vested) or (b) the members of the board of management (in whom its management is vested).

What about a civil law usufruct? There is no need for the s.87 rules: under ordinary principles the gain can come into charge on a disposal by the usufructuary or by the encumbered owner but since a usufruct is in principle a settlement-arrangement, what reason can one find that s.87 does not apply? The answer is that there is nothing which one can identify as "settled property". There are two items of property, one belonging to the usufructuary and the other belonging to the bare owner. So it is considered that there are no "trustees" and a usufruct is not within the scope of s.87.

51.2.3 *2006 transitional rules?*

Section 97(7A) was introduced by para 15 Sch 12 FA 2006. Para 15(3) provides:

> This paragraph shall come into force on 6th April 2006 (in relation to settlements whenever created).

This raises the interesting possibility that s.87 did not apply to a foundation[9] before 2006 as a foundation has no "trustees" in the normal (trust law) sense. But it is suggested that the context shows that the word "trustee" should be construed widely enough to include a foundation (bear in mind that the word "settlement" is given the wide and artificial meaning

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8 There is a similar definition for IHT. Section 45 IHTA provides:
"In this Act "trustee", in relation to a settlement in relation to which there would be no trustees apart from this section, means any person in whom the settled property or its management is for the time being vested."

9 Or any other settlement-arrangement which was not a classic settlement and so had no trustees in the strict sense.

of settlement-arrangement). Section 97(7A) is only for the avoidance of doubt and the law before 2006 was the same as now.

51.3 Non-resident settlement condition

Section 87(1) TCGA sets out the fundamental condition for the application of s.87:

> This section applies to a settlement for a tax year ("the relevant tax year") if there is no time in that year when the trustees are resident in the United Kingdom.

Statute often refers to a settlement "to which s.87 applies"; from 1998/99 this means (in short) a non-resident settlement. In full, it means:

(1) a non-resident settlement; or
(2) a dual resident settlement (more accurately, UK-law UK resident, but treaty non-resident under the tie-breaker).[10]

51.3.1 *Residence of "trustee" of non-trust settlement-arrangement*

Section 97(7A) TCGA provides:

> [a] ... "trustee", in relation to a settlement in relation to which there would be no trustees apart from this subsection, means any person in whom the settled property or its management is for the time being vested
> [b] (and a person who is treated as a trustee of the settlement by virtue of this subsection shall be treated as a trustee of the settlement for the purposes of section 69).

The effect of s.97(7A)[b] is that the s.69 trustee test of residence applies.

In the case of a foundation, the "trustees" are (a) the foundation itself or (b) the members of the board of management. The residence of (a) and (b) will normally be the same so there is no need to consider the analysis if they were resident in different places but one would presumably look to the foundation itself, as that is the person (a body corporate) to which gains accrue on a disposal of foundation property.

51.4 The s.87 charge

Section 87(2) TCGA provides:

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10 See 51.17 (Dual resident trust: s.88 TCGA).

[a] Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement
[b] who has received a capital payment from the trustees in the relevant tax year or any earlier tax year
[c] if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the s.2(2) amount for the relevant tax year or any earlier tax year.

The key terms here are "capital payment" "s.2(2) amount" and "matching". I refer to gains treated as accruing as "**s.87 gains**". The term "deemed gains" is sometimes used, but I think my term is clearer.

A s.87 gain accrues in the year that a capital payment is matched with a s.2(2) amount. That may be later than the year that the capital payment is made.

Section 87 is not strictly a charging section, it feeds into s.2 TCGA which imposes the charge. It is nevertheless convenient to use the expression "s.87 charge" as a shorthand.

51.4.1 *Split year*

Section 87(7) TCGA provides:

> If the relevant tax year is a split year as respects a beneficiary of the settlement—
>
> (a) the amount on which the beneficiary is chargeable to capital gains tax by virtue of this section for that year (in respect of the settlement) is a portion of the amount on which the beneficiary would have been so chargeable if the relevant tax year had not been a split year, and
>
> (b) the portion is the portion attributable to the UK part of the relevant tax year calculated on a time apportionment basis.

This is a curious rule. One would have expected benefits received in the UK part of the year to be taxable and benefits received in the overseas part to be tax free.

51.5 Section 2(2) amount

Section 87(4) TCGA provides:

> The s.2(2) amount for a settlement for a tax year for which this section applies to the settlement is—
>
> (a) the amount upon which the trustees of the settlement would be chargeable to tax under s.2(2) for that year if they were resident

> in the UK in that year ...[11]

The term "s.2(2) amount" has more or less the same meaning as the term "trust gains" in the pre-2008 s.87. The old terminology was clearer, and EN FB 2008 itself uses the term "trust gains". It is usually better to adopt statutory terminology, rather than using a different term with the same meaning as a statutory defined term, and I do so here but somewhat reluctantly. The term "s.2(2) amount" is so opaque that I sometimes clarify it by using the phrase *"s.2(2) amounts (trust gains)."*

Some practitioners use the term "stockpiled gains" or describe a trust as having a pool of s.2(2) amounts.

There is a s.2(2) amount *for a tax year* ie each s.2(2) amount must be linked to a specific tax year. The expression "s.2(2) amounts" (in the plural) is used to refer to the case where there are s.2(2) amounts for more than one tax year.

Section 87(5) TCGA provides:

> The s.2(2) amount for a settlement for a tax year for which this section does not apply to the settlement is nil.

This makes sense, of course, since if s.87 does not apply the trustees must be UK resident and within the scope of CGT.

The HMRC s.87 guidance note provides:

> 10. Section 87(5) provides that the section 2(2) amount for a year in which section 87 does not apply is nil. In particular this is needed to deal with transfer between settlements. The transferee settlement may have a section 2(2) amount for a year in which the trustees were resident in the UK. Section 87(5) ensures no account is taken of that amount. But it can still be treated as having a section 2(2) amount for that year from the transferor settlement. See paragraph 68 below.

51.5.1 *Ascertaining the s.2(2) amount*

All the usual CGT reliefs are in principle available for computing the s.2(2) amount. For instance, hold-over relief is available on a transfer to a UK resident beneficiary, if the usual conditions are satisfied. HMRC accept this. Helpsheet 295 (Relief for gifts and similar transactions 2013/2014) provides:

> There is no need for the transferor to be resident in the UK. Therefore

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11 For s.87(4)(b) see 51.5.2 (Section 86 gains deducted from s.2(2) amount)

> the relief is available for trustees of nonresident settlements where the chargeable gain would, or might otherwise be, charged on UK residents.[12]

HMRC say:

> The trustees compute gains as if they were resident in the UK. Any exemptions and reliefs due to resident trustees are included in this computation. But no annual exempt amount is available...[13]

And again:

> 9. ... section 2(2) amount. This is defined in section 87(4). It is the amount on which the trustees would be liable to Capital Gains Tax if they had been resident and ordinarily resident in the UK during the year. As in the original section 87 this is the amount of the gains after deducting losses and without giving any annual exempt amount.[14]

The last sentence is wrong, as s.3 TCGA (extended to trustees by sch 1 TCGA) provides that trustees "shall not be chargeable to CGT" on the exempt amount. So "the amount upon which the trustees would be chargeable to tax under s.2(2) for that year if they were resident" is reduced by the exempt amount. The Courts might disapply the plain words if the result were absurd, but it is not absurd. There may be an element of double relief as beneficiaries may have their own annual exemption. This rule is nevertheless sensible because it saves trustees from having to keep track of small gains (or it avoids non-compliance so far as one could not reasonably expect trustees to actually do so.). Of course, there is not much tax at stake here. Perhaps the author has confused the position for s.86, where the trustee annual exemption is disapplied: see 50.10 (Section 86 trust gains condition).

51.5.2 *Section 86 gains deducted from s.2(2) amount*

In the absence of relief, a gain accruing to a trust may be:
(1) a s.86 gain taxed on the settlor and
(2) a s.2(2) amount (trust gain)
Section 87(4)(b) TCGA provides relief for s.87 and so prevents double

---

12 ie the gain might be charged if the UK resident transferee disposed of the asset.

13 "HMRC Residency: Non-resident trusts" published online at *http://www.hmrc.gov.uk/cnr/nr_trusts.htm* on 1 April 2008.

14 HMRC s.87 guidance note, para 9.

taxation. It is necessary to read the whole of s.87(4) in order to follow the sense:

> (4) The section 2(2) amount for a settlement for a tax year for which this section applies to the settlement is—
>
> (a) the amount upon which the trustees of the settlement would be chargeable to tax under section 2(2) for that year if they were resident in the UK in that year, or
>
> (b) if section 86 applies to the settlement for that year, the amount mentioned in paragraph (a) minus the total amount of chargeable gains treated under that section as accruing in that year.

In short, s.86 in principle has priority over s.87.

51.5.3 *Foundation or other non-trust settlement-arrangement: s.2(2) amount*

A foundation is in principle a settlement-arrangement and so a settlement for s.87 purposes. What is the s.2(2) amount, ie the amount on which the "trustees" of the settlement would be chargeable under s.2(2) if they were UK resident? If the "trustees" are the members of the board of the foundation, the amount is nil as no gains accrue to them. Assuming (which is a better analysis) the "trustees" are the foundation itself, the position would be that the foundation would be subject to CT and so at first sight, the amount chargeable under s.2(2) would be nil! The answer is that s.97(7A)[b][15] applies s.69 TCGA, which deems the "trustees" to be a separate person which is not a company; though one could reach the same result by construction even without reference to that provision.[16]

51.6 Capital payment

51.6.1 *Definition of capital payment*

"Capital payment" is defined in s.97(1) TCGA:

> In sections 86A to 96 and Schedule 4C and this section "capital payment" —
>
> (a) means
>
> [i] any payment which is not chargeable to income tax on the recipient
>
> [ii] or, in the case of a recipient who is not resident in the UK,

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15 See 51.3.1 (Residence of "trustee" of non-trust settlement-arrangement).

16 *de Rothschild v Lawrenson* 67 TC 300.

any payment received otherwise than as income...[17]

For the interaction with s.731, see 30.12 (Is a benefit within s.731 a capital payment?).

51.6.2 *"Payment"*

Section 97(2) TCGA provides:

> In subsection (1) above references to a payment include references to
> [a] the transfer of an asset and
> [b] the conferring of any other benefit, and to
> [c] any occasion on which settled property becomes property to which s.60 applies.

The issues overlap with s.731 ITA so the following matters are discussed elsewhere:
30.4 (Benefit).
30.7 (Valuation of benefits).

51.6.3 *Termination of settlement*

The termination of a settlement constitutes a capital payment, so any s.2(2) amounts at that time will be attributed to the beneficiaries who become entitled to the trust property: s.97(2)[c] TCGA.

This rule should not, in practice, affect well drafted settlements, whose life may extend for a century or more. If action is taken in time it will generally be possible to extend the life of poorly drafted settlements by appropriate exercise of trustees' powers. Trustees should if appropriate diarise the date when the settlement may come to an end so as to take action beforehand.

51.6.4 *Arm's length transaction*

Section 97(1) TCGA provides:

> In sections 86A to 96 and Schedule 4C and this section "capital payment"—
> (b) does not include a payment under a transaction entered into at arm's length if it is received on or after 19th March 1991.

It is considered that a transaction at arm's length could not be a capital

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17 As to when a payment is received as income, see 25.8 (Payment from discretionary trust: income or capital receipt?).

payment at all, and this provision was inserted only for the avoidance of doubt; even if (contrary to that view) the transaction were a capital payment, the amount of the capital payment would normally be nil.

The issue is not theoretical, as a transaction between connected persons is (in short) treated as not at arm's length.[18]

It would be simpler if s.97(1)(b) were repealed, as unnecessary, but it does no harm.

51.6.5 *Payment in form of income (un)taxed on remittence basis*

What is the position if a trust makes an income distribution[19] to a remittance basis taxpayer, which is not remitted? It is considered that this is not a capital payment. The payment is "chargeable to income tax" even if no tax is paid because of the remittance basis.[20] If that were wrong:

(1) There would be double taxation, a s.87 gain and an IT charge, if the payment were remitted.
(2) The payment would be matched to s.2(2) amounts which would reduce tax on subsequent capital payments with odd results and some scope for tax planning.

Similarly a benefit which is within s.731, or within s.731 subject to the s.731 remittance basis, is not a capital payment.[21]

The same applies if a settlor-interested discretionary trust within s.624 makes a distribution out of its income to the settlor: that is not a capital

---

18 Section 18 TCGA.

19 For what is an income distribution, see 25.8 (Payment from discretionary trust: income or capital receipt?).

20 Before 2005, the former s.65 ICTA drew a distinction between a "charge" and a "computation;" unremitted income was described as "chargeable" even though ignored in the computation of the charge. This is still the case: ITTOIA imposes a charge on all RFI and the remittance basis only affects the amount on which the charge is made. See 10.12 (Nature of charge on remitted RFI).

It was assumed by the drafter of s.37 TCGA (consideration chargeable to tax on income) that unremitted foreign income is "charged" to income tax. Otherwise there would be a charge to CGT on unremitted income of an asset to which the RFI remittance basis applies but the CGT remittance basis does not apply. An example would be income accruing to a foreign domiciliary from an asset which was UK situate for CGT purposes, but a foreign income source for income tax purposes.

It is true that the word "chargeable" takes its meaning from the context, and in some contexts unremitted income is not regarded as chargeable to IT. But the context shows that is not the case here.

21 See 30.12 (Is a benefit within s.731 a capital payment?).

payment. In this case there does seem at first sight to be a problem, as there is no income tax charge on receipt of the payment.[22] However the sum is treated for all purposes of income tax to be the income of the settlor and that deeming should be applied in order to determine whether the payment is chargeable to income tax for the purposes of the definition of capital payment.

The same applies if the settlor is within the s.624 remittance basis.

The same applies if a person abroad makes a distribution out of its income to a transferor within s.720, or a transferor within the s.720 remittance basis: that is not a capital payment. (This issue arises in the exceptional case of a trust within s.720 and not within s.624, and in the more common case of a payment from a company held by a trust.)

51.6.6 *Payment derived from old unremitted income taxable on remittance*

Suppose:

(1) A remittance basis taxpayer ("S") receives foreign income ("the old income") which is not remitted to the UK and so not taxed.
(2) S transfers the old income to a non-resident trust.
(3) The trustees invest and realise gains ("trust gains") in a subsequent tax year. For simplicity, assume that no income accrues to the trustees, or any income which arises to them is segregated and paid out to the settlor.
(4) The trustees make a distribution to the settlor which is received in the UK and which is derived from the old income.[23]

It is considered that the distribution is not a capital payment as it is chargeable to income tax. Otherwise there would be double taxation on the distribution, an income tax charge and a s.87 charge.

51.6.7 *Payment derived from old unremitted gains taxable on remittance*

Suppose:

(1) A remittance basis taxpayer ("S") receives foreign gains ("the old gains") which are not remitted to the UK and so not taxed.
(2) S transfers the old gains to a non-resident trust.
(3) The trustees invest and realise gains ("trust gains") in a subsequent tax year.

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22 See 27.7.3 (Relief for settlor-beneficiary).

23 On the mixed fund rules which apply in this case, see 13.8 (Unremitted income transferred to trust).

(4) The trustees make a distribution to the settlor which is received in the UK and which is derived from the old gains.[24]

At first sight there is a double charge, CGT on the old gains on the remittance basis, and a s.87 charge. That can hardly be right.

The RDR Manual gives this example:

> **31180. Foreign chargeable gains accruing on disposal made otherwise than for full consideration [**June 2010**]**
> Example 2 (Ahmeda)
> A transfers his property in Dubai to a trust receiving no consideration in return. The deemed gain computed using the market value of the property at date of transfer is £400,000.
> The trustees subsequently sell the property for £550,000.
> The trustees then make a capital payment of £300,000 to a UK close company in which A's spouse is a participator.

The HMRC analysis is as follows:

> [1] £300,000 of A's foreign chargeable gain [the £400k deemed gain] has been remitted to the UK. This is because the property is treated as deriving from his gain (Section 809T ITA 2007) and the proceeds from the sale of the property therefore also derive from the gain.

This overlooks the mixed fund rules. Putting aside the interaction with s.87, for a moment, I would say that £150,000 of A's foreign chargeable gain has been remitted to the UK. The £550,000 proceeds of sale received by the trustees is a mixed fund, consisting of

A's deemed gain £400,000
The trustees' gain £150,000

The payment out of the mixed fund is treated as coming from the trustees gain (assume it accrues in a later year).

The HMRC analysis continues:

> [2] The company is a relevant person (Section 809M(2)(f) ITA 2007)

This is correct.

> [3] and property (that is, money) which derives from A's gain has therefore been received in the UK by or for the benefit of a relevant person (Section 809L ITA 2007).

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24 On the mixed fund rules which apply in this case, see 13.8 (Unremitted income transferred to trust).

The example did not in fact specify that the money was received in the UK, only that it was received by a UK company (which is not the same); but let us assume that is factually correct.

> [4] The gain which accrues to the trust on the actual sale of the property will be subject to normal rules.

But what are the normal rules? Possibly HMRC assume that there is a s.87 charge on the £300,000 leading to double taxation but tactfully refrain from saying so. The effective rate of CGT on a capital payment could be:

CGT on the old gain	28%
CGT on capital payment[25]	44.8%
	72.8%

It is suggested that one should construe the legislation to avoid a double charge; the question is how best to reach that conclusion. Possibilities include:

(1) The old gains exclude the deeming under s.87; or
(2) The reference to income tax in the definition of capital payment could be read purposively as extending to CGT so the payment is not a capital payment.[26]
(3) Section 809P(10) ITA
(4) Section 32 TMA

These solutions would be consistent with the position where old income is settled.[27]

An alternative would be to say that to the extent that the s.87 charge applies, the capital payment is not to be regarded as derived from the old chargeable gains.

Another possibility is to say that the value of the benefit is reduced to reflect the fact that remittance gives rise to a charge on the old gains.

The position is simpler where the payment is made to the settlor, and not to a third party (as in the HMRC example). But even then, none of these solutions are straightforward. Legislation enacted in the slapdash manner of the FA 2008 is bound to leave rough edges, and the courts should seek

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25 Including the interest surcharge.

26 Contrast the ToA rules where a reference to income tax was construed to include corporation tax in order to avoid double taxation: see the 2011/12 edition of this work para 31.2.1 (Transferor's credit); that point does not now arise.

27 See 51.6.6 (Payment derived from old unremitted income taxable on remittance).

to find a construction which avoids double taxation and produces a workable result.

51.7 Receipt from the trustees

The s.87 charge applies where a beneficiary has received a capital payment from the trustees. There are two requirements here: a *receipt by a beneficiary,* and a receipt *from the trustees.*

On the general meaning of "receipt by a beneficiary" see 30.5 (Who is the recipient of a benefit?).

Section 97(5) TCGA expands on these concepts:

> For the purposes of sections 86A to 90 and Schedule 4C a capital payment shall be regarded as received by a beneficiary from the trustees of a settlement if—
>
> (a) he receives it from them directly or indirectly, or
>
> (b) it is directly or indirectly applied by them in payment of any debt of his or is otherwise paid or applied for his benefit, or
>
> (c) it is received by a third person at the beneficiary's direction.

This does not extend the meaning of capital payment. It assumes that there is a capital payment (as defined) and addresses the question(s) of who is the recipient and whether the receipt is from the trustees.[28]

The explanation for s.97(5) is to be found in *Potts' Executors v IRC* 32 TC 211. This concerned (what is now) s.641 ITTOIA which (then) applied to:

> Any capital sum paid directly or indirectly ... to the settlor.

In *Potts*, at the request of the settlor, a company connected with a settlement paid tax liabilities of the settlor.[29] The settlor did not actually receive the funds. The House of Lords (in the era of literal interpretation) held that this was not a payment to the settlor directly or indirectly, so (what is now) s.641 ITTOIA did not apply.

Lord Simonds said:

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28 This is clear from the wording, but if authority is needed, see *Burton v HMRC* [2009] SFTD 682 at [43]: "Section 97(5)(b) does not ... require that the benefit be received by the beneficiary but rather extends the circumstances in which a capital payment is treated 'as received' from the trustees."

29 The trust also made other payments, such as payments to charities at the request of the settlor.

> It is sufficient to say that [the word 'indirectly'] cannot so enlarge the meaning of the words 'paid to the settlor' as to include payment to some other person than the settlor for his own use and benefit. I do not feel called upon to determine positively what transactions it might be apt to cover. It may be that it is not apt to cover any that are not already covered by the normal meaning of the words 'paid to the settlor'.

Lords Normand and Oaksey said:

> ...it was obviously necessary to provide for the case when persons accountable to the settlor are interposed between the payer and the settlor for the purpose of disguising the transaction. That is a satisfactory explanation of the use of the words "directly or indirectly".
> I think the words "paid directly or indirectly to the settlor" should be held to mean paid into the settlor's hands or into the hands of someone accountable to him.

Lord MacDermott said:

> [The payments] made to Mr. Potts' agents or in some circuitous way designed to put the money under his control eventually. Had they been, the word "indirectly" might have had a part to play, for in that case the issue would be whether, as a matter of fact, payment had been made one way or another to the settlor. In short, as it appears to me, the words "directly or indirectly" bear only on the mechanics of payment in fact.

It seems to me that there are three distinct views here:

(1)The word "indirectly" adds nothing or nothing much (Lord Simonds).
(2) The word "indirectly" applies to payments to X via someone accountable to X (Lords Normand and Oaksey).
(3) The word "indirectly" applies to payments "in some circuitous way designed to put the money under his control eventually" (Lord MacDermott).

The second of these views was adopted in *Piratin v IRC* 54 TC 730. Here a payment was made from A to B on terms which obliged B to pay an equivalent sum to C. This was held not to amount to an indirect payment to C, because B was not "accountable" for the sum received. The Judge considered the comments of Lords Simonds, Normand and Oaksey set out above and continued:

> One thus finds both Lord Normand and Lord Oaksey expressing the opinion in the *Potts* case that a sum cannot be said to be "paid indirectly" to the settlor within the section, unless it is paid into the

hands of someone accountable to him.

"Accountable" was understood strictly (I would have thought, excessively so):

> It is common ground that the word "accountable" in an English law sense is not apt to describe the position of a person who is under a mere contractual obligation, such as that owed by [B] to the two settlors. [Counsel for the Revenue] suggested that Lord Normand may have intended to use the word according to a broader meaning attributed to it by Scottish lawyers, but I can see no sufficient justification for that inference. I think that Lord Normand referred to strict accountability in English law, and Goff J. took the same view in *IRC v Wachtel* 46 TC 543 at page 555F....

He rejected the view that the word "indirectly" adds nothing but also rejected Lord MacDermott's wide approach:

> The phrase "or indirectly" in the context of s 451(1) undeniably gives rise to problems of interpretation. If, however, a broader meaning is attributed to it than that attributed to it by Lord Normand and Lord Oaksey, so that it is capable of including payments to persons who are not accountable to the settlor, it is difficult to see where the line should be drawn.

In 1981 Parliament reversed these decisions by adding a new subsection to (what was then) s.451 ICTA 1970:

> (9) For the purposes of this section there shall be treated as a capital sum paid to the settlor by the trustees of the settlement any sum which—
>
> (a) is paid by them to a third party at the settlor's direction or by virtue of the assignment by him of his right to receive it; or
>
> (b) is otherwise paid or applied by them for the benefit of the settlor...

The 1981 Act also introduced s.87 regime including the provision which is now s.97(5) TCGA:[30]

> ... a capital payment shall be regarded as received by a beneficiary from the trustees of a settlement if—
>
> (a) he receives it from them directly or indirectly, or
>
> (b) [i] it is directly or indirectly applied by them in payment of any debt of his or

30 Then s.83(5) FA 1981.

[ii] is otherwise paid or applied for his benefit, or

(c) it is received by a third person at the beneficiary's direction.

The wording of (b) and (c) has its equivalents in s.451(9). In practice these paragraphs are not so important. However, the *Potts* and *Piratin* cases set out above are relevant to discussion of the meaning of "directly or indirectly" in paragraph (a), which is important, and to which I can now turn.

51.7.1 *Indirect receipt from trustees*

Section 97(5) TCGA provides:

> ... a capital payment shall be regarded as received by a beneficiary from the trustees of a settlement if—
>
> (a) he receives it from them directly or indirectly...

This raises two problems. Firstly, the meaning of "indirectly". There are two possible views:

(1) The word "indirectly" applies to payments to X via someone accountable to X (following the approach of Lords Normand and Oaksey in *Potts*). I refer to this as **"the narrow view"**.

(2) The word "indirectly" applies to payments "in some circuitous way designed to put the money under his control eventually" (following the approach of Lord MacDermott in *Potts*). I refer to this as **"the wide view".**

There are two difficulties with the wide view. The first is raised in *Piratin*:

> If, however, a broader meaning is attributed to [indirectly] than that attributed to it by Lord Normand and Lord Oaksey, so that it is capable of including payments to persons who are not accountable to the settlor, it is difficult to see where the line should be drawn.

Secondly, if it is possible for one person to receive a payment directly, and another to receive the same payment indirectly, there is the problem of double taxation, as each may be taxed on the payment. The double taxation problem arises if there is held to be an indirect payment to B in two cases:

Case (1):

(a) Trust 1 makes a payment to A; and

(b) A makes a payment to B.

Case (2):

(a) Trust 1 makes a payment to trust 2; and
(b) Trust 2 makes a payment to B.

In case (1) there is in principle double taxation in the form of tax on both A and B.[31] In case (2) there is in principle double taxation on B.[32] There is no double taxation in some cases[33] but one cannot say that the question of whether there is an indirect payment depends on whether there is double taxation.[34]

These considerations support the narrow view. The wider view was however adopted in *Herman v HMRC*.[35] This was an arrangement of case (2) above. The Special Commissioner held that B had received funds directly from trust 2[36] *and* indirectly from trust 1.

An unsatisfactory aspect of this decision is that no attempt was made to explain where to draw the line, ie where a capital payment is or is not received indirectly from trustees; thus leaving taxpayers (and indeed HMRC) none the wiser in other cases. Certainly, there is a line to be drawn somewhere:

> 21 The right approach, I think, is to make an enquiry, using whatever signposts appropriate to the circumstances are available, and to determine whether the receipts of [B] can properly be linked to the disposition from [trust 1] as their indirect source.

"Properly linked" to trust 1 as their "indirect source" is, I think, intended as a paraphrase of the statutory words "received indirectly from" trust 1; but it does not take matters any further as it is even less clear than the statutory words.

> An obvious *signpost* will be the existence of a plan, if there is one. In the present circumstances the appointment by the trustees of [trust 1] was in pursuance of a scheme ...; it will be relevant to the enquiry to

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31 Assuming the payments to A and to B can be matched to a s.2(2) amounts (trust gains). It is assumed in these examples that A and B are both beneficiaries. For the position if A or B are not, see 51.12.1 (Receipt by beneficiary and non-beneficiary).

32 Assuming the payment can be matched to a s.2(2) amounts in trust 1 and trust 2.

33 Eg in case (1) if A is non-resident; or in case (2) if trust 1 has no trust gains.

34 If the temporary non-resident rules are in point, ie if in case (1) A is temporarily non resident, it may not be determined for some years whether there is double taxation.

35 [2007] STC (SCD) 571. The issue in *Herman* will be relitigated in *Bowring v HMRC* [2013] UKFTT 366 (TC). HMRC have won the first round, but consideration should wait until the case has become final.

36 [2007] STC (SCD) 571 at [17].

> determine whether the plan as a whole envisaged that [B] should receive the amounts that they did. If the relevant receipt resulted by accident or on account of circumstances not envisaged by the scheme, then the linkage *may* not be there.

This is too tentative. Unless one takes the narrow view, which *Herman* rejected, a plan of the kind found in *Herman* is not the signpost but the end of the matter; conversely if the receipt resulted by accident (assuming trusts have accidents) then the linkage cannot be there.

> The second signpost is to analyse the trust law and determine whether [trust 2] "served as a vehicle to receive and continue the act of bounty effected by" the trustees[37] of [trust 1] (see the words of Lord Walker in para 41 of *West v Trennery*)...

This is misconceived, for *all* transferee trusts "serve as a vehicle to receive and continue the act of bounty" effected by the settlor of the transferor trust.[38]

While the taxpayer in *Herman* had the better argument on a strict construction, a purposive construction to knock down the tax avoidance scheme, or one might say, legal realism, won the day. There is no point in looking to the decision to find the test of when a payment from trust 2 should also be regarded as an indirect payment from trust 1. The guidance is not there. We are therefore thrown back to first principles. On that basis it is considered that the concept of indirect receipt should be limited to cases where there is an arrangement (as in *Herman*) under which payments are (more or less) inevitably to be made from trust 1 to trust 2, and from trust 2 to the beneficiary. The scheme of s.90 TCGA (and the double taxation consequences from any other view) show that this is the case. This view has support in *Burton v HMRC*:

> This is not a 'conduit' case like *Herman v HMRC* where the assets went in and the money came out in a very short time.[39]

In "conduit" cases the double tax problem can be resolved by saying that if there is an indirect payment to B, one ignore the direct payment to A. There cannot be both.

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37 "Trustees" is presumably a slip for settlor, for the trustees do not confer any bounty.

38 Lord Walker said this in the passage to which the judge refers: *West v Trennary* 76 TC 713, HL, at [41].

39 *Burton v HMRC* [2009] SFTD 682 at [14].

51.8 Capital payment from close company

Section 96 TCGA contains two rules:
(1) Capital payment received from a close company **("the s.96(1) rule").**
(2) Capital payment made to a close company **("the s.96(2) rule")**.
These labels are not ideal, but it is difficult to think of better. I consider the s.96(1) rule in this section and the s.96(2) rule in the next.

Section 96(1) TCGA provides:

> Where a capital payment is received from a qualifying company which is controlled by the trustees of a settlement at the time it is received, for the purposes of sections 87 to 90 and Schedule 4C it shall be treated as received from the trustees.

See too 78.8 (Capital payment from company held by Estate).

51.8.1 *When is a distribution from a company a capital payment?*

SP 5/92 para 18 provides:

> In general, transactions between trustees and companies which they, directly or indirectly, wholly own, or between such companies, are … not treated as capital payments within TCGA 1992 s 97.

The paragraph sets out a commonsense definition of "wholly owned" and concludes with a qualification:

> This approach may not, however, be taken where, on the facts of a particular case, it appears that the transaction has been entered into solely or mainly for the purposes of obtaining a UK tax advantage.

SP 5/92 provides:

> 40 The payment must, however, be a capital payment within TCGA 1992 s 97(1)—ie it must not be chargeable to income tax on the recipient nor be made under a transaction entered into at arm's length. Intragroup payments which are not capital payments, for example
> [1] a capital distribution on winding up which represents merely a repayment of capital on shares, or
> [2] a distribution chargeable to corporation tax,
> do not fall within the ambit of TCGA 1992 s 96.

See 20.6 (Distribution to non-shareholder) for a discussion as to whether a payment from a company held by a trust to a beneficiary is a capital or income payment.

51.8.2 *"Qualifying company"*

Section 96(6) TCGA provides:

> For the purposes of subsection (1) above a qualifying company is
> [a] a close company[40] or
> [b] a company which would be a close company if it were resident in the UK.

For a note on this terminology, see 85.22.1 (Non-resident close company).

51.8.3 *"Controlled by the trustees"*

Section 96 TCGA provides:

> (7) For the purposes of subsection (1) above a company is controlled by the trustees of a settlement if it is controlled
> [a] by the trustees alone or
> [b] by the trustees together with a person who (or persons each of whom) falls within subsection (8) below.
> (8) A person falls within this subsection if—
> (a) he is a settlor in relation to the settlement, or
> (b) he is connected with a person falling within paragraph (a) above.

"Control" is defined in s.96(10) TCGA. This provides a slightly cut down form of the ultra-wide sense of control. The same definition is found in the context of s.86, for a discussion see 50.3.2 ("Control" and "participator").

In the following discussion it is important to distinguish between:

(1) Control in the s.96(10) sense (which I call **"control in the defined sense"**).
(2) Control in the natural sense of the word.

51.8.4 *Consequence of capital payment from company*

The s.96(1) rule is needed because s.87 only applies if a beneficiary receives a capital payment *from the trustees*. A capital payment from a *company* which was not (directly or indirectly) from the trustees would not be caught.

It might perhaps have been argued that receipt from a company is not

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40 In practice it would be rare for s.96(1) to apply to a (UK resident) close company, as a payment from a (UK resident) close company is not likely to be a capital payment.

receipt (directly or indirectly) from the trustees even in a case where the trustees control the company in the natural sense of control, though the argument seems implausible.

The s.96(1) rule is needed in a case where the trustees "control" a company (in the defined sense) but they do not control the company in the natural sense of control. For instance, if a company is held in equal shares by three separate trusts with the same settlor. No one trust has control in the natural sense of control, and it could be argued (in the absence of s.96(1)) that a capital payment from the company is not received from the trustees of any of the trusts.

Where a capital payment is received from a company "controlled" (in the defined sense) by several persons, there is no apportionment provision (unlike the s.96(2) rule for a capital payment *to* a company). It is suggested that s.96(1) is a deeming provision which deems the payment to be received from the trustees, but the amount of the capital payment is not affected by the deeming. The amount of the capital payment is not the amount received from the company but the amount actually attributable to the trust. If each trust holds a third of the company, and they act together to procure the payment, each makes a third of the capital payment. But if one trust has control (in the natural sense), and is in a position to procure the capital payment, the capital payment is from that trust alone, and not from any other trust with some other interest in the company.

51.9 Capital payment to non-resident close company

Section 96(2) TCGA provides:

> Where
> [1][a] a capital payment is received from the trustees of a settlement
> [b] (or treated as so received by virtue of subsection (1) above)[41] and
> [2] it is received by a non-resident qualifying company,
> the rules in subsections (3) to (6) below shall apply for the purposes of sections 87 to 90 and Schedule 4C.

I refer to this as **"the s.96(2) rule"**.

51.9.1 *"Non-resident qualifying company"*

Section 96(9) TCGA provides:

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41 See 51.8 (Capital payment from close company).

> For the purposes of subsection (2) above a non-resident qualifying company is a company which is not resident in the UK and would be a close company if it were so resident.

For a note on this terminology, see 85.22.1 (Non-resident close company).

51.9.2 *Consequence of capital payment to company*

The rules depend on whether:

(1) the company is controlled by one person alone.
(2) the company is controlled by 2 or more persons (taking each one separately).
(3) the company is controlled by 2 or more persons (taking them together).

Section 96 TCGA provides:

> (3) If the company is controlled by one person alone at the time the payment is received, and that person is then resident in the UK, it shall be treated as a capital payment received by that person.
> (4) If the company is controlled by 2 or more persons (taking each one separately) at the time the payment is received, then—
> (a) if one of them is then resident in the UK, it shall be treated as a capital payment received by that person;
> (b) if 2 or more of them are then resident in the UK ("the residents") it shall be treated as being as many equal capital payments as there are residents and each of them shall be treated as receiving one of the payments.
> (5) If the company is controlled by 2 or more persons (taking them together) at the time the payment is received-
> (a) it shall be treated as being as many capital payments as there are participators in the company at the time it is received, and
> (b) each such participator (whatever his residence) shall be treated as receiving one of the payments, quantified on the basis of a just and reasonable apportionment,
> but where (by virtue of the preceding provisions of this subsection and apart from this provision) a participator would be treated as receiving less than one-twentieth of the payment actually received by the company, he shall not be treated as receiving anything by virtue of this subsection.

51.9.3 *Interaction with temporary non-residence rules*

Section 96 TCGA provides:

(9A) For the purposes of this section an individual shall be deemed to have been resident in the United Kingdom at any time in any year of assessment for which he or she was not so resident if—
(a) section 10A applies to him or her, and
(b) the year falls within the temporary period of non-residence..
(9B) If—
(a) it appears after the end of any year of assessment that any individual is to be treated by virtue of subsection (9A) above as having been resident in the United Kingdom at any time in that year, and
(b) as a consequence, any adjustments fall to be made to the amounts of tax taken to have been chargeable by virtue of this section on any person,
nothing in any enactment limiting the time for the making of any claim or assessment shall prevent the making of those adjustments (whether by means of an assessment, an amendment of an assessment, a repayment of tax or otherwise).

51.9.4 *Disregard of capital payments to companies*

These are odd rules, to say the least. As often happens, the anomalies may favour the taxpayer. Section 87C TCGA was brought in to counteract this. It provides:

(1) For the purposes of sections 87 and 87A as they apply in relation to a settlement, no account is to be taken of a capital payment (or a part of a capital payment) within subsection (2).
(2) A capital payment is within this subsection if (and to the extent that) it is received (or treated as received) in a tax year from the trustees of the settlement by a company that—
(a) is not resident in the UK in that year, and
(b) would be a close company if it were resident in the UK,
(and is not treated under any of subsections (3) to (5) of section 96 as received by another person).

51.10 Matching

51.10.1 *Why does matching matter?*

The matching of capital payments with s.2(2) amounts is important for many reasons:
(1) *Time of charge:* The s.87 gains accrue in the year that a capital payment is matched with a s.2(2) amount.
(2) *Amount of charge:* The amount of the s.87 gain is the amount of the

capital payment or the amount matched, if less.

(3) *Which beneficiaries come into charge:* if
   (a) more than one beneficiary receives capital payments, and
   (b) there are not enough s.2(2) amounts to match all the capital payments

   the question which capital payment is matched with a s.2(2) amount makes all the difference as to which beneficiary receives s.87 gains.

(4) *Which capital payments come into charge:* if
   (a) one beneficiary receives more than one capital payment, some in and some outside the UK; and
   (b) there are not enough s.2(2) amounts to match all the capital payments

   the question which capital payment is matched with a s.2(2) amount matters for the remittance basis. If a UK benefit is matched, there is a charge; if a non-UK benefit is matched, the s.87 remittance basis offers a defence to the charge.

(5) *The interest surcharge,* which depends on the time gap between a capital payment and the s.2(2) amount with which it is matched.

(6) *2008 transitional relief*, which applies where post-2008 capital payments are matched to pre-2008 s.2(2) amounts.

Matching is carried out on a LIFO (last in first out) basis. EN FB 2008 provides a summary:

> 452. Where the s.2(2) amount is equal to or greater than the capital payments then all the capital payments are matched:
> [1] any surplus s.2(2) amount is carried back to the year preceding the current tax year and any unmatched capital payments of that earlier year are matched to the surplus s.2(2) amount;
> [2] any surplus s.2(2) amount is carried back to the preceding year and matched with unmatched capital payments of that year, and so on, until the s.2(2) amount has been reduced to nil or there are no unmatched capital payments left in any earlier year; and
> [3] any surplus s.2(2) amount left after matching to previous years is available to match against future capital payments.
>
> 453. Where the amount of capital payments for the latest relevant tax year is greater than the s.2(2) amount for that year, then the surplus capital payments are carried back in the same way as surplus s.2(2) amounts, matching the surplus capital payments against the unmatched trust gains of each earlier year, starting with the latest year first and only moving back to an earlier year where there are no unmatched trust gains left in the later year. Any capital payments that remain unmatched are

> carried forward from the current tax year to be matched against the s.2(2) amounts of future years. ...
> 455. Note that:
> [1] the matching rules are modified by new subs.(4) of s.762 ICTA in relation to offshore income gains; and
> [2] capital payments are matched to trust gains within a given tax year on a pro rata basis, not on a daily basis.

The HMRC s.87 guidance note provides:

> 14. A key element of the FA 2008 changes is the introduction of rules for matching capital payments to section 2(2) amounts from 6 April 2008. The basic rules are set out in section 87A TCGA in a series of steps. Capital payments are matched against section 2(2) amounts in the following order:
> 15. First against section 2(2) amounts of the same year.
> 16. Second against unmatched section 2(2) amounts of earlier years taking the most recent year first.
> 17. Third against section 2(2) amounts of later years. In this case priority is given first to any capital payments received in that year and then to any capital payments brought forward. If capital payments are brought forward from more than one year the capital payment received in the latest year is matched first.

The rules changed from a FIFO to a LIFO basis in 2008. HMRC did not state why they made this change. I surmise that it was done to minimise the benefit of 2008 transitional relief, which applies if post-2008 capital payments are matched with pre-2008 s.2(2) amounts. The old rule would have maximised the benefit of the relief, so that trusts with substantial s.2(2) amounts may have been free of CGT for a substantial period of time. Had the reason been given, there might have been some debate about whether the benefit justified the change, but as it was, there was none. But there it is.

51.10.2 *The statute*

Section 87A TCGA provides:

> (1) This section supplements s.87.
> (2) The following steps are to be taken for the purposes of matching capital payments with s.2(2) amounts.
> *Step 1*
> Find the s.2(2) amount for the relevant tax year.

Step 2
Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

Armed with these figures we proceed to the matching rule:

Step 3
The s.2(2) amount for the relevant tax year is matched with—

(a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount for the relevant tax year, each capital payment so received, and

(b) otherwise, the relevant proportion of each of those capital payments.

"The relevant proportion" is the s.2(2) amount for the relevant tax year divided by the total amount of capital payments received in the relevant tax year.

I refer to a case within (a) as a "**surplus s.2(2) amount**" and a case within (b) as a "**surplus capital payment**".

The next step is a recomputation of the s.2(2) amount and of the amount of capital payments

Step 4
[1] If para (a) of Step 3 applies—

That is, if there is a surplus s.2(2) amount—

(a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and

(b) reduce the amount of those capital payments to nil.

I refer to the s.2(2) amount after this reduction as "**the unmatched s.2(2) amount**".

[2] If para (b) of that Step applies—

That is the case of a surplus capital payment—

(a) reduce the s.2(2) amount for the relevant tax year to nil, and

(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

I refer to the amount of the capital payments after this deduction as "**the unmatched capital payments**".

Then one starts again at the beginning, but with modifications:

Step 5

[1] Start again at Step 1 (unless subs.(3) applies).

[2] If the s.2(2) amount for the relevant tax year (as reduced under Step 4) is not nil, read references to capital payments received in the relevant tax year as references to capital payments received in the latest tax year which—

(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

I again refer to a case within step 5[2] (where there is an unmatched s.2(2) amount) as a "**surplus s.2(2) amount**".

Amended as step 5[2] directs, Steps 1-4 become:

Step 1

Find the s.2(2) amount for the relevant tax year [ie the unmatched s.2(2) amount].

Step 2

Find the total amount of capital payments received by the beneficiaries from the trustees ~~in the relevant tax year~~ *in the latest tax year which—*

(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

Step 3

The s.2(2) amount for the relevant tax year is matched with—

(a) if the total amount of capital payments received ~~in the relevant tax year~~ *in the latest tax year which—*

(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

does not exceed the [unmatched] s.2(2) amount for the relevant tax year, each capital payment so received, and

(b) otherwise, the relevant proportion of each of those capital payments.

"The relevant proportion" is the [remaining] s.2(2) amount for the relevant tax year divided by the total amount of capital payments received ~~in the relevant tax year~~ *in the latest tax year which—*

(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

Step 4

If para (a) of Step 3 applies—

(a) reduce the [unmatched] s.2(2) amount for the relevant tax year by the

total amount of capital payments referred to there, and

(b) reduce the amount of those capital payments to nil.

If para (b) of that Step applies—

(a) reduce the [unmatched] s.2(2) amount for the relevant tax year to nil, and

(b) reduce the [unmatched] amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

Eventually the unmatched s.2(2) amount is reduced to nil (ie all the s.2(2) amount is matched). Then step 5[2] ceases to apply. The journey then takes us to step 5[3]:

Step 5

[3] If the s.2(2) amount for the relevant tax year (as so reduced) is nil, read references to the s.2(2) amount for the relevant tax year as the s.2(2) amount for the latest tax year—

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

I refer to a case within step 5[3] as a "**surplus capital payment**". This is a case where:

(1) there is no unmatched s.2(2) amount for the relevant year;

(2) there is a s.2(2) amount for an earlier year.

Amended as step 5[3] directs, steps 1-4 become:

Step 1

Find the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year —*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

Step 2

Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

Step 3

The s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil

is matched with—

(a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount ~~for the relevant tax year~~, *for the latest tax year—*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

each capital payment so received, and

(b) otherwise, the relevant proportion of each of those capital payments.

"The relevant proportion" is the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

divided by the total amount of capital payments received in the relevant tax year.

Step 4

If para (a) of Step 3 applies—

(a) reduce the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

by the total amount of capital payments referred to there, and

(b) reduce the amount of those capital payments to nil.

If para (b) of that Step applies—

(a) reduce the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) for which the s.2(2) amount is not nil.

to nil, and

(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

51.10.3 *When to stop*

Section 87A(3) TCGA (incorporated at step 5[1]) states when one can stop repeating these steps:

> This subsection applies if—
>
> (a) all of the capital payments received by beneficiaries from the trustees in the relevant tax year or any earlier tax year have been reduced to nil, or
>
> (b) the s.2(2) amounts for the relevant tax year and all earlier tax years have been reduced to nil.

That is, one stops when there are no unmatched capital payments or s.2(2) amounts.

Section 87A(4) TCGA provides:

> The effect of any reduction under Step 4 of subsection (2) is to be taken into account in any subsequent application of this section.

That seems self-evident.

51.10.4 *HMRC example: Surplus s.2(2) amount*

EN FB 2008 provide two examples. *Text in italics represents HMRC comments:*

> ***56. Section 87A: Example 1: section 2(2) amount is greater than the total amount of capital payments for latest tax year:***
> The facts assumed in the example are as follows:
> *2008-09: no surplus trust gains or surplus capital payments*

Year	***Capital payment***	***s.2(2) amount***
2009-10:	*£100k*	*nil*
2010-11:	*£200k*	*nil*
2011-12:	*£500k*	*nil*
2012-13:	*£500k*	*£2m*

I set out the text of the relevant steps in the analysis.

> *Step 1*
> Find the s.2(2) amount for the relevant tax year.
> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

The relevant tax year is 2012/13 and we can take the figures from the table.

We move on to step 3. There is (in my terminology) a surplus s.2(2) amount, because "the total amount of capital payments received in the relevant tax year" (£500k) does not exceed "the s.2(2) amount for the relevant year" (£2m). Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (a) ... each capital payment so received,

Thus step 3 states that £2m (the s.2(2) amount for 2012/13) is matched with the £500k capital payment. There are two difficulties with this. First, the charge in s.87(2) requires us to ask whether the *capital payment* is matched with the s.2(2) amount, and step 3 tells us that the *s.2(2) amount* is matched with the capital payment. The answer is that matching is by implication a reflexive operation, ie if A is matched with B, then B is matched with A.

Secondly, applying step 3 literally, the capital payment (£500k) is matched with the *entire* s.2(2) amount (£2m). This does not matter because s.87(3) TCGA restricts the charge to the amount of the capital

payment. In order to follow s.87(3) one needs to read it together with s.87(2):

> (2) Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement who has received a capital payment from the trustees in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under s.87A as it applies for the relevant tax year) with the s.2(2) amount for the relevant tax year or any earlier tax year.
> (3) The amount of chargeable gains treated as accruing is equal to—
> (a) the amount of the capital payment, or
> (b) if only part of the capital payment is matched, the amount of that part.

But the HMRC analysis is as follows:

> *Match as follows:*
> *a. 2012-13 capital payments £500,000 match to £500,000 gains.*

The HMRC analysis (wisely) does not try to refer to the statutory steps which authorise this conclusion. (Indeed, there is no reason to think that the author of the HMRC example read the legislation.) But the end result is the same.

We move on to step 4. Ours is a surplus capital payment case, so step 4 provides:

> *Step 4*
> If para (a) of Step 3 applies—
> (a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and
> (b) reduce the amount of those capital payments to nil.

So our revised table becomes:

Year	***Capital payment***	***s.2(2) amount***
2009-10:	*£100k*	*nil*
2010-11:	*£200k*	*nil*
2011-12:	*£500k*	*nil*
2012-13:	*£0 ~~£500k~~*	*£1.5 ~~£2m~~*

The HMRC analysis is as follows:

> *[1] 2012-13 capital payments reduced to nil.*
> *[2] Unmatched 2012-13 trust gains reduced to £1.5 million.*
> *[3] Refer unmatched trust gains to preceding year.*

Point [1] is correct. Points [2] and [3] are a fair paraphrase.

Our journey takes us to step 5:

> *Step 5*
> [1] Start again at Step 1 (unless subsection (3) applies).
> [2] If the s.2(2) amount for the relevant tax year (as reduced under Step 4) is not nil, read references to capital payments received in the relevant tax year as references to capital payments received in the latest tax year which—
> (a) is before the last tax year for which Steps 1 to 4 have been undertaken, and
> (b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

There is still a surplus s.2(2) amount (the s.2(2) amount for the relevant tax year is not nil, it is now £1.5m).

We revert to step 2 which now reads:

> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees ~~in the relevant tax year~~ *in the latest tax year which—*
> *(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and*
> *(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries*

The "latest tax year" is now 2011-12 and we can take the figures from the revised table.

We move on to step 3. This is a surplus s.2(2) amount case, because "the total amount of capital payments received in the latest tax year" (£500k) does not exceed "the s.2(2) amount for the relevant year" (£1.5m). Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (a) ... each capital payment so received,

Thus step 3 states that £1.5m (the unmatched s.2(2) amount) is matched with the £500k capital payment. But the HMRC analysis is as follows:

> *b. 2011-12 unmatched capital payments £500,000 match to £500,000 gains.*

As noted, this is a loose paraphrase of step 3, but it does not matter.

We move on to step 4. Ours is a step 3(a) case, so step 4 provides:

> *Step 4*
> If para (a) of Step 3 applies—
> (a) reduce the s.2(2) amount for the relevant tax year by the total amount of capital payments referred to there, and
> (b) reduce the amount of those capital payments to nil.

So:
(a): reduce the s.2(2) amount for the relevant year thus: £1.5m – £500k = £1m.
(b): reduce the capital payment for the latest year [2011-12] to nil.
The HMRC analysis is as follows:

> *2011-12 capital payments reduced to nil.*
> *Unmatched 2012-13 trust gains reduced to £1 million.*
> *Refer unmatched trust gains to preceding year.*

The process repeats once again, but "the latest tax year" now becomes 2009-10. It is not necessary to set out the steps. The reader will by now have the idea. The HMRC analysis (or paraphrase) is as follows:

> *2010-11 unmatched capital payments £200,000 match to £200,000 gains.*
> *2010-11 capital payments reduced to nil.*
> *Unmatched 2012-13 trust gains reduced to £800,000.*
> *Refer unmatched trust gains to preceding year.*

The process repeats once again, but "the latest tax year" now becomes 2009-10. It is not necessary to set out the steps. The HMRC analysis (or paraphrase) is as follows:

> *d. 2009-10 unmatched capital payments £100,000 match to £100,000 gains.*
> *2010-11 capital payments reduced to nil.*
> *Unmatched 2012-13 trust gains reduced to £700,000.*
> *Refer unmatched trust gains to preceding year.*

At this point s.87A(3) TCGA applies because "all of the capital payments received by beneficiaries from the trustees in the relevant tax year or any earlier tax year have been reduced to nil". Accordingly the steps come to an end. The HMRC analysis is:

> *e. No unmatched capital payments in 2008-09 or earlier years.*

Lastly, the HMRC analysis provides:

> *Carry forward unmatched trust gains of 2012-13 of £700,000 to be matched against capital payments of 2013-14 and subsequent years.*

This is a reference to step 1 as amended by step 5[3] but the point does not actually arise under the facts of the HMRC example.

It is noteworthy that in order to deal with the facts of the HMRC example (which is a simplication of the facts of a typical case in real life because there is only one s.2(2) amount) one has to carry out 15 steps.

The HMRC s.87 guidance note provides:

> **Example 3: New section 87A - Section 2(2) amounts greater than capital payments in latest year**
>
> At the start of 2008-09 there are no unmatched capital payments or section 2(2) amounts.

Year	Capital payments	S.2(2) amount
2008-09	£10,000	Nil
2009-10	£15,000	Nil
2010-11	£2,000	£24,000

> When the years 2008-09 and 2009-10 are considered immediately after the end of those years no chargeable gains accrue.
>
> In 2010-11 the capital payment of £2,000 is matched against the section 2(2) amount. A chargeable gain of £2,000 accrues in the year 2010-11.
>
> The capital payments for 2010-11 are reduced to nil. The section 2(2) amount is reduced to £22,000 (£24,000 - £2,000).
>
> The £22,000 section 2(2) amount for 2010-11 is matched against the capital payments of £15,000 in 2009-10. A chargeable gain of £15,000 accrues in the year 2010-11.
>
> The section 2(2) amount for 2010-11 is reduced to £7,000 (£24,000 - £2,000 - £15,000)
>
> The capital payments for 2009-10 are reduced to nil.
>
> The £7,000 section 2(2) amount for 2010-11 is matched against the capital payments of £10,000 for 2008-09. A chargeable gain of £7,000 accrues in the year 2010-11.
>
> The section 2(2) amount for 2010-11 is reduced to nil (£24,000 - £2,000 - £15,000 - £7,000). The capital payments for 2008-09 are reduced to £3,000 (£10,000 - £7,000). These capital payments will be set against future section 2(2) amounts.
>
> The chargeable gains for 2010-11 total £24,000 (£2,000 + £15,000 + £7,000).

51.10.5 *HMRC example: Surplus capital payment*

HMRC's second example is as follows

> ***57. Section 87A: Example 2: capital payments are greater than section 2(2) amount for latest tax year: The facts assumed in the example are as follows:***
>
> *2008-09: no surplus trust gains or surplus capital payments*
>
> | ***Year*** | ***Capital payment*** | ***s.2(2) amount*** |
> |---|---|---|
> | *2009-10:* | *nil* | *£100k* |
> | *2010-11:* | *nil* | *£200k* |
> | *2011-12:* | *nil* | *£500k* |
> | *2012-13:* | *£2m* | *£500k* |

I set out the text of the relevant steps in the analysis.

> *Step 1*
> Find the s.2(2) amount for the relevant tax year.
> *Step 2*
> Find the total amount of capital payments received by the beneficiaries from the trustees in the relevant tax year.

The relevant tax year is 2012/13 and we can take the figures from the table.

We move on to step 3. There is (in my terminology) a surplus capital payment because "the total amount of capital payments received in the relevant tax year" (£2m) does exceed "the s.2(2) amount for the relevant year" (£500k). Accordingly:

> *Step 3*
> The s.2(2) amount for the relevant tax year is matched with—
> (b) ... the relevant proportion of each of those capital payments.

The relevant proportion" is the s.2(2) amount for the relevant tax year (£500k) divided by the total amount of capital payments received in the relevant tax year (£2m) = 0.25.

Thus step 3 states that £500k (the s.2(2) amount) is matched with one quarter of the capital payment = £500k. As noted, the charge in s.87(2) requires us to ask whether the *capital payment* is matched with the s.2(2) amount, and step 3 tells us that the *s.2(2) amount* is matched with the capital payment. The solution is that matching is a reflexive operation, ie if A is matched with B, then B is matched with A.

The HMRC analysis is as follows:

Match as follows:
a. 2012-13 capital payments £500,000 match to £500,000 gains.

We move on to step 4. Ours is a surplus capital payment case, so step 4 provides:

Step 4
[2] If para (b) of that Step [step 3] applies—
(a) reduce the s.2(2) amount for the relevant tax year to nil, and
(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

So our revised table becomes:

Year	**Capital payment**	**s.2(2) amount**
2009-10:	nil	£100k
2010-11:	nil	£200k
2011-12:	nil	£500k
2012-13:	£1.5 ~~£2m~~	£0 ~~£500k~~

The HMRC analysis is as follows:

Unmatched 2012-13 capital payments reduced to £1.5 million.
Refer unmatched capital payments to preceding year.

Our journey takes us to step 5.

Step 5
[1] Start again at Step 1 (unless subs.(3) applies)....
[3] If the s.2(2) amount for the relevant tax year (as so reduced) is nil, read references to the s.2(2) amount for the relevant tax year as the s.2(2) amount for the latest tax year—
(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and
(b) for which the s.2(2) amount is not nil.

This is a surplus capital payment case, (the s.2(2) amount for 2012–13 is now nil).

We revert to step 3 which now reads:

Step 3
The s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year—*
(a) which is before the last tax year for which Steps 1 to 4 have been undertaken, and
(b) for which the s.2(2) amount is not nil
is matched with—

(a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount ~~for the relevant tax year~~, *for the latest tax year—*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken,

(b) for which the s.2(2) amount is not nil.

each capital payment so received, and

(b) otherwise, the relevant proportion of each of those capital payments.

"The relevant proportion" is the s.2(2) amount ~~for the relevant tax year~~ *for the latest tax year*

(a) which is before the last tax year for which Steps 1 to 4 have been undertaken,

(b) for which the s.2(2) amount is not nil

divided by the total amount of capital payments received in the relevant tax year.

The "latest tax year" is now 2011-12. This is a surplus capital payment case because "the total amount of capital payments received in the relevant tax year" (now £1.5m) does exceed "the s.2(2) amount for the latest year" (£500k). Accordingly:

Step 3

The s.2(2) amount for the latest tax year is matched with—

(b) ... the relevant proportion of each of those capital payments.

The relevant proportion is one third.

The process repeats again and again. It is not necessary to set out the steps. The reader will by now have the idea. The HMRC analysis (or paraphrase) is as follows:

2012-13 trust gains reduced to nil.
b. 2011-12: match 2012-13 capital payments £1.5 million to £500,000 gains.
2011-12 trust gains reduced to nil.
Unmatched 2012-13 capital payments reduced to £1 million.
Refer unmatched capital payments to preceding year.
c. 2010-11: match 2012-13 capital payments £200,000 to £200,000 gains.
2010-11 trust gains reduced to nil.
Unmatched 2012-13 capital payments reduced to £800,000.
Refer unmatched capital payments to preceding year.
d. 2009-10: match 2012-13 capital payments £100,000 to £100,000 gains. 2010-11 trust gains reduced to nil.
Unmatched 2012-13 capital payments reduced to £700.000.
Refer unmatched capital payments to preceding year.
e. No unmatched trust gains in 2008-09 or earlier years.
Carry forward unmatched capital payments of 2012- 13 of £700,000 to

be matched against trust gains of 2013-14 and subsequent years.

It is noteworthy that in order to deal with the facts of the HMRC example (which is a simplication of the facts of a typical case in real life for there is only one capital payment in five years) one has to carry out 15 steps.

51.10.6 *Year of death of beneficiary*

If a beneficiary dies in a tax year, all gains accruing to the trustees in that year are s.2(2) amounts, which can be matched to capital payments made to the beneficiary, even post-death gains. However gains of a subsequent tax year cannot be matched. Section 87 does not say so expressly but the beneficiary could not be subject to CGT on s.87 gains, as the charge is limited to UK residents (s.2 TCGA) and a deceased person is not resident in the UK. That has to be the rule: otherwise it could happen that an estate of a beneficiary who received capital payments could not be completely administered, as there might be a possibility of gains accruing at any time in the future.

Contrast the rule for s.86 which does not apply to gains accruing to the trustees in the year that the settlor dies, even pre-death gains.[42] Perhaps the reason for the s.87 rule is that it works (slightly) more fairly when two beneficiaries receive capital payments in a tax year and one of them dies during that year.

51.10.7 *Commentary: Step-based drafting*

The pre-2008 s.87 provided:

> *(4) Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as chargeable gains accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments in any earlier year.*
> *(5) The attribution of chargeable gains to beneficiaries under subsection (4) above shall be made in proportion to, but shall not exceed, the amounts of the capital payments received by them.*
> *(6) A capital payment shall be left out of account for the purposes of subsections (4) and (5) above to the extent that chargeable gains have by reason of the payment been treated as accruing to the recipient in an earlier year.*

---

42 See 50.11 (Year of death of settlor).

No reader who labouriously works through the almost endless iterative steps of s.87A will consider the new style of wording is an improvement on the old. I first speculated whether the legislation was drafted by someone who trained to write computer programs rather than legislation. The correct explanation seems to be that "step-based drafting" was an innovation of the tax law rewrite project in the search for new and clearer methods of drafting; the drafter of the FA 2008 sought to adopt the same technique, but in more clumsy hands the technique delivered obscurity rather than clarity.

This does not necessarily mean that step-based drafting is a bad technique, but it certainly demonstrates how it can be used to bad effect. Finance Bills are generally drafted in a hurry (the FA 2008 was a mad panic) and clarity was a victim of the process.

The fundamental problem however is not the drafting, but the need to match capital payments with trust gains for a year.

51.11 Planning by matching

Matching is a rough and ready rule and trustees need to plan carefully to avoid unfairness.

51.11.1 *Planning to obtain remittance basis*

Suppose:

(1) Years 1–10: A beneficiary ("B") occupies a UK house held by a trust. This is a capital payment.

(2) Year 11: The house is sold for £1m gain and a s.2(2) amount arises.

In principle the s.2(2) amount in year 11 is matched with the capital payments in years 1–10. The s.87 gain is taxed on an arising basis of the benefit received in the UK. If B is UK resident in year 11, this is an expensive matter. Suppose:

(3) Year 11: The trustees make a capital payment of £1m to B outside the UK.

The s.2(2) amount is matched with the £1m capital payment and the s.87 gain is taxed on the remittance basis.

51.11.2 *Planning to avoid interest surcharge*

Since the surcharge matches on a LIFO basis, the charge can be avoided by realising gains in the year that any capital payment is made, so as to frank any capital payment with current year gains. If gains are not actually

realised, the rules in schedule 4B TCGA make it fairly easy to realise deemed gains which may do just as well.[43]

51.12 Capital payment received by non-beneficiary

Chargeable gains are treated as accruing in the relevant tax year to *a beneficiary of the settlement* who has received a capital payment from the trustees.

At first sight, the charge only applies to beneficiaries so if a capital payment is received by a non-beneficiary there is no charge. However, s.97(8) TCGA provides:

> In a case where—
>
> (a) at any time on or after 19th March 1991 a capital payment is received from the trustees of a settlement or is treated as so received by virtue of section 96(1),
>
> (b) it is received by a person, or treated as received by a person by virtue of section 96(2) to (5),
>
> (c) at the time it is received or treated as received, the person is not (apart from this subsection) a beneficiary of the settlement, and
>
> (d) subsection (9) or (10) below does not prevent this subsection applying,
>
> for the purposes of sections 86A to 90 and Schedule 4C the person shall be treated as a beneficiary of the settlement as regards events occurring at or after that time.

The drafting is clumsy: the s.87 charge applies to a "beneficiary" who receives a capital payment, but any person who receives a capital payment is treated as a beneficiary: it would have been easier to say that the charge applies to a "person" who receives a capital payment and drop the (now only nominal) requirement that recipient has to be a beneficiary! But it comes down to the same thing.

The reader may wonder how a capital payment could be received by a non-beneficiary. In general, trustees may only confer benefits on beneficiaries. However, there are cases where it could happen:

(1) A capital payment to a non-resident close company, which is treated as received by the persons who control it;[44] those persons might not be beneficiaries.

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43 See 52.1 (Borrowing by non-resident trust: Sch 4B TCGA).

44 See 51.9 (Capital payment to non-resident close company).

(2) An exercise of the power of advancement for the benefit of B (a beneficiary) may take the form of a payment to a third person, X (not a beneficiary). This is not a capital payment received by B[45] but it is a capital payment received by X.
(3) Beneficiaries may authorise trustees to make a payment to a non-beneficiary.

On the other hand if B (a beneficiary) *directs* trustees to make a payment to a third person, X, the benefit is treated as received by B (not X).[46] If the payment is made in breach of trust, there is no capital payment (or the value of the benefit is nil).[47]

It is possible that a person may be a beneficiary at the time of a capital payment but not when the s.87 gain accrues (if the trust gain is matched in a later year and the person has then ceased to be a beneficiary). Section 97(8) TCGA does not apply in such a case, because the condition in s.97(8)(a) does not apply. It is considered that s.87(2) can and should be construed so as to apply in this case; otherwise there would be a strange anomaly in the legislation. That is, when it states that s.87 gains accrue to "a beneficiary of the settlement who has received a capital payment" it is sufficient that the recipient is a beneficiary at the time they receive the capital payment, it is not required that the recipient is also a beneficiary at the time that the s.87 gains accrue.

51.12.1 *Receipt by beneficiary and non-beneficiary*

There are two exceptions to the rule in s.97(8). One concerns transfers between trusts and is discussed elsewhere.[48]

The other is s.97(9) TCGA which provides:

> Subsection (8) above shall not apply where a payment mentioned in para
> (a) is made in circumstances where it is treated (otherwise than by subsection (8) above) as received by a beneficiary.

I do not understand the purpose of this. It concerns a case where:
(1) s.97(8) would otherwise apply, that is, in short:
(a) a capital payment is received from the trustees of a settlement (or is treated as so received)

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45 See 30.4.12 (Moral, sentimental and other benefits difficult to quantify).
46 See 51.7 (Receipt from the trustees).
47 See 30.4.15 ("Benefit" provided in breach of trust).
48 See 51.18.1 (No s.87 charge on transfer between trusts).

(b) it is received by a person, (or treated as received by a person),
(c) at the time it is received (or treated as received) the person is not a beneficiary of the settlement

but

(2) the capital payment is treated as received by a beneficiary.

The exception seems to be considering a case where a capital payment is received by two persons, one a beneficiary and the other a non-beneficiary. Suppose an arrangement where X receives property directly and Y later receives it indirectly.

(1) Assume one of X or Y is a beneficiary but not both. Perhaps in this case the non-beneficiary is not charged, because the capital payment is "treated as received by a beneficiary". However, this is a case where the payment is *actually* received by the beneficiary (directly or indirectly), not a case where it is *treated* as received; but perhaps the words "treated as" here include an actual receipt.
(2) Assume neither X nor Y are a beneficiary. In that case, X is treated as a beneficiary, but not Y. But this scenario is very far fetched.

Perhaps the subsection has no application.

51.13 Interest surcharge

Section 91(1) TCGA provides:

> This section applies if—
> (a) chargeable gains are treated under s.87 or 89(2) as accruing to a beneficiary by virtue of the matching (under s.87A) of all or part of a capital payment with the s.2(2) amount for a tax year ("the relevant tax year"),
> (b) the beneficiary is charged to tax by virtue of that matching, and
> (c) the capital payment was made more than one year after the end of the relevant tax year.

It is not enough that chargeable gains to accrue to a beneficiary, and that the beneficiary is charged to tax; this must be "by virtue of the matching". But since gains never accrue unless there is matching, and the beneficiary is never charged unless there is matching, the words appear to be otiose. Section 91 goes on to deal with part matching:

> (1A) Where part of a capital payment is matched, references in subsections (2) and (3) to the capital payment are to the part matched.

We then turn to the tax increase:

(2) [a] The tax payable by the beneficiary in respect of the payment shall be increased by the amount found under subsection (3) below,
[b] except that it shall not be increased beyond the amount of the payment;
[c] and an assessment may charge tax accordingly.

Para 2[b] stops the Treasury increasing the rate of tax beyond 100%. One would hope it is not necessary.

Para 2[c] is otiose.

Section 91 goes on to specify the amount of the increase:

(3) The amount is one equal to the interest that would be yielded if an amount equal to the tax which would be payable by the beneficiary in respect of the payment (apart from this section) carried interest for the chargeable period at the rate of 10 per cent per annum.

Thus we have a notional 10% interest – the rate bears no relation to actual interest rates – for a period called a chargeable period.

(4) The chargeable period is the period which—
(a) begins with the later of the 2 days specified in subsection (5) below, and
(b) ends with 30th November in the year of assessment following that in which the capital payment is made.
(5) The 2 days are—
(a) 1st December in the tax year immediately after the relevant tax year, and
(b) 1st December falling 6 years before 1st December in the year of assessment following that in which the capital payment is made.

I call this the "**interest surcharge.**" It is not in fact interest but the wording is designed to give the some of the appearance of interest.

As the chargeable period cannot exceed 6 years and the maximum surcharge is 60% of the tax. As the top CGT rate is 28% the maximum rate of tax on a capital payment is therefore 44.8%. Where the full surcharge applies, there is not a very great difference between IT and CGT rates.

For completeness, the Treasury may alter the rules;[49] but they have never

49 Section 91 TCGA provides:
"(6) The Treasury may by order substitute for the percentage specified in subsection (3) above (whether as originally enacted or as amended at any time under this

done so.

What is the position if the s.87 remittance basis applies? Section 12(2) TCGA (applied by s.87B TCGA, discussed below) provides:

> Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign [s.87] chargeable gains are remitted to the UK.

One might argue that there is no interest surcharge, because the gains are not charged to tax by virtue of matching; they are charged by virtue of the remittance. But the better view is the surcharge applies (by reference to the year of capital payment, not by reference to the year of remittance). HMRC agree: see 51.15.1 (HMRC examples).

There is a small planning point here for remittance basis taxpayers. One could avoid the interest surcharge if the trustees make capital payments in the year that s.2(2) amounts (trust gains) accrue, with a view to remittance in later years; whereas if the capital payment is made in the later year, followed by prompt remittance, there is an interest surcharge.

The HMRC s.87 guidance note provides:

Example 13: New section 91 - tax increase under section 91 TCGA
As at [the start of] 2008-09 there are no unmatched capital payments or section 2(2) amounts.

Year	**Capital payments**	**S.2(2) amount**
2008-09	£ 3,000	£17,000
2009-10	£ 5,000	£ 6,000
2010-11	£37,000	£16,000
Total	£45,000	£39,000

In summary the capital payments for each year are matched against the section 2(2) amounts for each year as shown below:

	Capital payment	**s.2(2) amount**	**s.87 gain**	**Unmatched s2(2) amount**	**Unmatched capital payment**
2008-09	3,000	17,000	3,000	14,000	
2009-10	5,000	6,000	5,000	1,000	
2010-11	37,000	16,000	16,000	nil	21,000

---

subsection) such other percentage as they think fit.

(7) An order under subsection (6) above may provide that an alteration of the percentage is to have effect for periods beginning on or after a day specified in the order in relation to interest running for chargeable periods beginning before that day (as well as interest running for chargeable periods beginning on or after that day)."

In 2010-11 it is necessary to match the unmatched capital payments for that year against the unmatched section 2(2) amounts of earlier years. On a last in-first out basis £1000 is matched against the unmatched amount section 2(2) for 2009-10 and £14,000 against the unmatched section 2(2) amount for 2008-09.
Total gains of £31,000 arise as a result of the capital payment in 2010-11 matched as follows:
2010-11 £16,000
2009-10 £1,000
2008-09 £14,000
At the time of writing the annual exempt amount and rate of Capital Gains Tax are not known for 2010-11. This example assumes they are £10,200 and 18% respectively.
The tax due for 2010-11 is £3744 ([£31,000 - £10,200] @ 18%).
Section 91 TCGA will apply to increase the tax due on the gain £14,000. The taxpayer's annual exempt amount can be set against that part of the gain. The tax due on £14,000 – £10,200 is £3800 @ 18% = £684. This amount of tax is increased by 20% ie £136 making the total tax payable £3880 (£3,744 + £136).

In the terminology of s.91, so far as the s.87 gain is matched to the £14k s.2(2) amount for 2008/09:
The relevant tax year is 2008/09
The chargeable period begins 1 December 2009.
The chargeable period ends 30 November 2011.
Hence the rate of the interest surcharge is 20%.
There is no interest surcharge so far as the s.87 gain is matched to the s.2(2) amount for 2009/10 as the condition in s.91(1)(c) is not met. In short, the interest surcharge rule does not apply if only one year has passed since the s.2(2) amount (trust gain).

51.13.1 *Interest surcharge: Commentary*

What is the reason for the interest surcharge? It is to counter the perceived advantage that UK trusts pay CGT on an arising basis, but non-resident trusts (outside s.86) pay CGT on a capital payments basis, which is more favourable. But it works very oddly and unfairly, particularly after the extension of s.87 to foreign domiciled settlors and beneficiaries in 2008. For instance, consider a trust set up some years ago by an Australian for Australian beneficiaries; one beneficiary comes to the UK and receives a capital payment here. Why should there be a surcharge?

The surcharge is not likely to bring in sufficient tax to justify the complications and unfairness that arises. The case for repeal of the rule is very strong.

51.14 Non-resident beneficiary

It does not matter that s.87 gains accrue to a beneficiary who is non-resident (unless the temporary non-residence rules apply) since the gains are not subject to CGT. The HMRC s.87 guidance note provides:

> 7. Whether there is a charge to Capital Gains Tax depends on the general rule in section 2 TCGA. This imposes a charge to Capital Gains Tax on UK resident and ordinarily resident persons. So if the gain accrues to a person who is not UK resident or not ordinarily resident there is no charge to Capital Gains Tax but section 87 still applies to match the gain.

But the time which matters is when the gains accrue, so the matching rules need to be considered and pose something of a trap.

Suppose:

(1) Year 1: A capital payment is made to a beneficiary ("B") when B is non-resident. There are no s.2(2) amounts so that the capital payment is not matched.

(2) Year 2: A s.2(2) amount accrues when B is UK resident.

The capital payment is matched in year 2, so the s.87 gain is chargeable (subject to the s.87 remittance basis).

51.14.1 *Planning for beneficiary coming to UK*

This problem arises if a beneficiary has an unmatched capital payment before coming to the UK. In this situation the trustees should trigger gains in year 1. The capital payment will then be matched in year 1, and will not come into charge in year 2.

51.14.2 *Capital payment to non-resident: Commentary*

It is suggested that (subject to the temporary non-residence rules) a capital payment accruing to a non-resident should not come into charge. The present charge only affects those who fail to take the necessary planning, and in many of those cases it is likely that it will be overlooked or ignored by non-compliant taxpayers.

51.15 Section 87 remittance basis

Section 87B TCGA provides a relief which I call the "**s.87 remittance basis**". Section 87B(1) provides:

> This section applies if—
> (a) chargeable gains are treated under s.87 as accruing to an individual in a tax year, and
> (b) s.809B, 809D or 809E (remittance basis) applies to the individual for that year.

In short, the relief applies to remittance basis taxpayers. Section 87B(2) provides the relief:

> The chargeable gains are foreign chargeable gains within the meaning of s.12 (non-UK domiciled beneficiaries to whom remittance basis applies).

The effect of s.87B(2) is to incorporate the ITA remittance basis. Section 87B continues:

> (3) For the purposes of Chapter A1 of part 14 of ITA 2007 (remittance basis) treat relevant property or benefits[50] as deriving from the chargeable gains.

A rule of this kind is needed because s.87 gains (being fictional) could not be remitted.

As to where benefits are received, see 30.37 (Where is a benefit received?).

Since one treats a capital payment as derived from the s.87 gain, one should treat anything derived from the capital payment as derived (indirectly) from the s.87 gain. That is just a matter of following through

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50 Section 87B(4) defines "relevant property or benefits":

> "For the purposes of subsection (3) property or a benefit is "relevant" if the capital payment by reason of which the chargeable gains are treated as accruing consists of—
> (a) the payment or transfer of the property or its becoming property to which s.60 applies, or
> (b) the conferring of the benefit."

The drafting of s.87B(4) is somewhat clumsy because a capital payment will always fall within (a) or (b) so every capital payment gives rise to relevant property or benefits. But it does not matter.

the logic of the deeming.[51]

A capital payment still reduces the s.2(2) amount even though the payment is (un)taxed under the s.87 remittance basis. This is sensible because other beneficiaries (and the trustees) could not know what the position was.

It does not matter whether the s.2(2) amounts (trust gains) accrue on disposals of UK or foreign assets. All that matters is whether the capital payment is remitted to the UK. HMRC agree. FAQ Residence & Domicile – NR trusts provides:

> **Does it make any difference if the assets in the non-resident trust or underlying non-resident company owned by the trust are UK situated?**
> There is no difference in the Capital Gains Tax treatment of UK situated vs foreign situated assets when these are owned by a non-resident trust or underlying non-resident company.

The HMRC s.87 guidance note provides:

> 43. The remittance basis applies to the section 87 gain not the gain that created the section 2(2) amount. For example, trustees dispose of an asset held outside the UK creating a section 2(2) amount. In the same year they make a capital payment outside the UK to a non-domiciled beneficiary. The capital payment is matched against the section 2(2) amount. A section 87 gain accrues to the beneficiary who has claimed the remittance basis for that year. The trustees apply the proceeds of the disposal in buying investments in the UK. This remittance of the gain which created the section 2(2) amount is not treated as a remittance of the section 87 gain by the beneficiary.

A capital payment may be remitted to the UK in a year before the s.87 gains accrue, due to the quirky matching rules. Suppose:

(1) Year 1: a beneficiary receives a benefit; there are no s.2(2) amounts so the benefit is not matched and no s.87 gain accrues.
(2) Year 2: the beneficiary remits the benefit to the UK. There is still no s.87 gain.
(3) Year 3: s.2(2) amounts accrue to the trustees and a s.87 gain accrues to the beneficiary.

The s.87 gain is deemed to be remitted in the year it arises (year 3) and not

51 See App 2.1 (Construction of deeming provisions).

before.[52]

51.15.1 *HMRC examples*

The HMRC s.87 guidance note provides:

> **Example 8 – New section 87B - remittance of capital payment: payment**
> A is a UK resident and domiciled beneficiary of a non-UK resident settlement. B is a UK resident but non-UK domiciled beneficiary of the same settlement. The settlement owns shares in X Inc. X Inc is an American company registered on the New York Stock Exchange.[53]
> In 2008-09 the trustees sell shares in X Inc for $120,000 when the spot rate is £1 = $1.50. The acquisition cost of the shares was $20,000 when spot was also £1 = $1.50. This creates a section 2(2) amount of £66,666 for 2008-09, ie $100,000 @ 1.50.
> In 2010-11 the trustees make capital payments of $40,000 into the US bank accounts of each beneficiary. The spot rate of the US dollar at the date of the payment is £1 = $1.75. Chargeable gains of £22,857 accrue to each beneficiary under section 87 in 2010-11 in respect of these capital payments. $40,000 @ $1.75 = £22,857.
> At the time of writing the annual exempt amount and rate of Capital Gains Tax are not known for 2010-11 and 2012-13. This example assumes the rate of Capital Gains Tax is 18% for both years and the annual exempt amount was £10,000 in 2010-11 and £11,000 in 2012-13.
> Beneficiary A has other gains in 2010-11. The overall position is as follows.
> - Section 87 gains £22,857
> - Other personal gains £40,000
> - Other personal losses £20,000
> - Annual exempt amount £10,000
>
> The amount on which Capital Gains Tax is chargeable is £32,857. The personal losses can be set only against the other personal gains but the annual exempt amount is allocated first to the section 87 gain leaving £12,857 of that part of the gain chargeable at 18%. The tax due on £12,857 is £2,314 (£12,857 @ 18%). This is increased by £462 (£2,314 @ 20%) because there is a delay of over one year in making the capital payment.
> Beneficiary B claims the remittance basis for 2010-11 and leaves the $40,000 in the US bank account. B also has other gains in 2010-11. These gains and losses arise on the disposal of assets situated in the UK. The overall position is as follows.
> - Section 87 gains £22,857
> - Other personal gains on UK assets £40,000
> - Other personal losses on UK assets £20,000

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52 See 11.33 (Remittance before income or gains arise).

53 This sentence is irrelevant, as the situs of the trust asset does not matter for s.87 purposes.

B does not have an annual exempt amount in 2010-11 because they have claimed the remittance basis. B is not liable to Capital Gains Tax on the section 87 gain of £22,857 because of section 87B. B is liable to CGT at 18% on the full amount of the other net personal gains £20,000.

Because B has claimed the remittance basis they also have to decide whether or not to make an election under section 16ZA TCGA. The effect of that election is allow losses on the disposal of assets situated outside the UK to be set-off against gains, either foreign chargeable gains or gains on the disposal of assets situated in the UK. Unless the election is made the foreign losses will be lost. An effect of the election is that the annual exempt amount cannot be set foreign chargeable gains remitted to the UK, section 16ZB(4). B makes a valid election within the time limit, 31 January 2017.

In 2012-13 B remits $30,000 of the $40,000 from the US bank to their UK bank where it is converted to sterling at a rate of £1 = $2.00 ie £15,000. B is not a remittance basis user in 2012-13. The rate of Capital Gains Tax is 18%. The annual exempt amount is £11,000. The remittance is a disposal of foreign currency in the US bank account giving a loss of £2,142 [$30,000 @ $2.00 = £15,000 – $30,000 @ 1.75 = £17,142].

B is liable to Capital Gains Tax in 2012-13 on the following elements.

The section 87 gain is a foreign chargeable gain. Section 12(2) and (3) TCGA provides this chargeable gain is treated as accruing in 2012-13 equal to the full amount of the gains remitted in 2012-13. B has remitted 75% of the £22,857 chargeable gain (30,000/40,000×£22,857) = £17,142. Section 2(4) TCGA prevents the personal losses, £2,142, being set against this gain. Because of the election under s16ZA neither can the annual exempt amount be set against this part of the gain. Tax is due at 18% on £17,142 = £3,085. This tax is subject to the increase in section 91 TCGA. This is calculated by reference to the year the gain was matched ie 2010-11 not the year the gain was remitted. The rate charged, 20%, will be the same that applied to beneficiary A. The total tax charged on this part of the gain is £3,085 + £617 = £3,702.

If B had not made the election under s16ZA the annual exempt amount could be set against the remitted gains reducing the amount liable to the increase under s91. But they would lose the benefit of losses on any assets situated the UK.

Additionally for 2012-13 B has other personal gains on UK assets of £18,000. Because of the election under s16ZA the personal losses £2,142 can be set against these gains as can the annual exempt amount £11,000. With a tax rate of 18% the total tax charged on the net gains of £4,858 is £971. The total Capital Gains Tax payable for 2012-13 is £4,673 (£3,702 + £971).

The next example concerns capital payments which take the form of benefits (use of accommodation) rather than transfer of cash. Omitting irrelevant detail, the example is as follows:[54]

54 The example in full, including its irrelevant detail, is as follows:

"C is a UK resident but non-UK domiciled beneficiary of a non-UK resident settlement. C claims the remittance basis. The settlement owns 100% of the issued

Example 9 - New section 87B - Remittance of capital payment: benefit
C is a UK resident but non-UK domiciled beneficiary of a non-UK resident settlement. C claims the remittance basis. The settlement has s.2(2) amounts.
The trustees (or underlying companies) allow C to use rent-free:
(1) a property outside the UK and
(2) a property in the UK.

The HMRC analysis is as follows:

The use of both properties by C gives rise to a capital payment equal to the value of the benefit. These capital payments are matched against the section 2(2) amount and a section 87 chargeable gain accrues to C. Section 87B(2) TCGA provides this is a foreign chargeable gain.
The use of the UK property meets condition A in section 809L. Because section 87B(3) TCGA provides the benefits derive from the chargeable gains the use of that property also meets condition B in section 809L(3)(b) ITA 2007. C is treated as remitting the capital payment created [by] the use of the Devon property to the UK and C is liable to CGT on that payment.
The use of the property outside the UK is not treated as a remittance to the UK and C is not liable to CGT on that payment.

51.16 Migrant settlements

51.16.1 *UK resident trust becomes non-resident*

Section 89(1) TCGA provides:

Where a period of one or more years of assessment for which s.87 applies to a settlement ("a non-resident period") succeeds a period of one or more years of assessment for each of which s.87 does not apply to the settlement ("a resident period"), a capital payment received by a beneficiary in the resident period shall be disregarded for the purposes of sections 87 and 87A if it was not made in anticipation of a disposal made by the trustees in the non-resident period.

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share capital of a Gibraltarian holding company which in turn owns 100% of the issued share capital of a Gibraltarian company. That company owns a property in Spain. Both companies are non-UK resident.
The company sells the property in Spain creating a section 2(2) amount of £120,000 through section 13 TCGA. The company invests some of the proceeds in the purchase of a smaller property in Spain. C is allowed to use the property rent-free. C is also allowed rent-free use of a cottage in Devon owned by the settlement."

51.16.2 *Non-resident trust becomes UK resident*

Section 89 TCGA provides:

> (1A) Subsection (2) applies to a settlement if—
>
> (a) a non-resident period is succeeded by a resident period, and
>
> (b) in relation to the last tax year in the non-resident period ("the last non-resident tax year"), s.87A(3) applied by virtue of para (a) of that provision (exhaustion of capital payments).[55]
>
> (2) Chargeable gains are treated as accruing in a tax year (in the resident period) to a beneficiary of the settlement who receives a capital payment from the trustees in that year if all or part of the capital payment is matched (under s.87A as it applies for that year) with the s.2(2) amount for the last non-resident tax year or any earlier tax year.
>
> (3) Section 87(3) and (4) and ss.87A to 87C apply for the purposes of subsection (2) as if the relevant tax year were the tax year mentioned in subsection (2).
>
> (4) Section 87B (remittance basis) applies in relation to chargeable gains treated under subsection (2) as accruing as it applies in relation to chargeable gains treated under s.87 as accruing.

51.17 Dual resident trust: s.88 TCGA

In the context of s.88 TCGA, **"dual resident"** is used as a shorthand to describe a trust which is:

(1) UK-law UK resident; and

(2) treaty-resident in a foreign state with a DTA which has an article conferring CGT relief (under the tie-breaker).

This is a slightly artificial use for the term "dual resident", which would naturally be used with a slightly wider meaning[56] but it is difficult to think of a better term and no difficulty arises as long as one bears that meaning in mind.

A dual resident trust would not be within s.87.[57] This gap is filled by s.88 TCGA:

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55 See 51.10.3 (When to stop).

56 On the terminology see 57.4 (Types of residence).

57 See 51.3 (Non-resident settlement condition). For trusts which are UK-law UK resident but which are treaty-resident outside the UK, see 59.12 (DT reliefs: s.87 TCGA).

88 Gains of dual resident settlements

(1) Section 87 also applies to a settlement for any year of assessment beginning on or after 6th April 1991 if—

(a) the trustees are resident in the UK during any part of the year, and

(b) at any time of such residence they fall to be regarded for the purposes of any double taxation relief arrangements[58] as resident in a territory outside the UK.

51.17.1 *Revised definition of s.2(2) amount*

The usual definition of s.2(2) amount (trust gains) would not work for a dual resident trust, so s.88(2) TCGA amends it:

> The section 2(2) amount for a tax year for which section 87 applies by virtue of this section is what it would be if the amount mentioned in section 87(4)(a) were the assumed chargeable amount.

Amended as s.88(2) directs, s.87(4) provides:

> The section 2(2) amount for a settlement for a tax year for which this section applies to the settlement is—
>
> (a) ~~the amount upon which the trustees of the settlement would be chargeable to tax under section 2(2) for that year if they were resident and ordinarily resident in the United Kingdom in that year~~ the assumed chargeable amount, or
>
> (b) if section 86 applies to the settlement for that year, the amount mentioned in paragraph (a) minus the total amount of chargeable gains treated under that section as accruing in that year.

The term "assumed chargeable amount" is defined in s.88(3):

> For the purposes of subsection (2) above the assumed chargeable amount in respect of a year of assessment is the lesser of the following 2 amounts—
>
> (a) the amount on which the trustees would be chargeable to tax for the year under section 2(2) on the assumption that the double taxation relief arrangements did not apply;
>
> (b) the amount on which, by virtue of disposals of protected assets, the trustees would be chargeable to tax for the year under section 2(2) on the assumption that those arrangements did not apply.

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58 For the meaning of this term, see 9A.3.3 ("DTR arrangements": CGT).

51.17.2 *Protected assets*

Section 88 TCGA provides:

> (4) For the purposes of subsection (3)(b) above assets are protected assets if—
>
> (a) they are of a description specified in the double taxation relief arrangements, and
>
> (b) were the trustees to dispose of them at any relevant time, the trustees would fall to be regarded for the purposes of the arrangements as not liable in the UK to tax on gains accruing to them on the disposal.
>
> (5) For the purposes of subsection (4) above—
>
> (a) the assumption specified in subsection (3)(b) above shall be ignored;
>
> (b) a relevant time is any time, in the year of assessment concerned, when the trustees fall to be regarded for the purposes of the arrangements as resident in a territory outside the UK;
>
> (c) if different assets are identified by reference to different relevant times, all of them are protected assets.

Most trust assets are "protected assets;" the most common exception would be UK land.[59]

51.17.3 *Planning: avoid dual resident trusts*

It is best to avoid dual resident (ie, UK law resident, treaty non-resident) trusts because they involve tax in the UK (so far as the treaty does not provide relief), tax in the treaty jurisdiction, and tax liabilities under s.87. In practice such trusts only arise by accident.

51.18 Transfer between trusts

51.18.1 *No s.87 charge on transfer between trusts*

Suppose a trust (trust 1) transfers funds to another trust (trust 2). Section 87(2) TCGA does not apply, because:
(1) the transfer is not a capital payment, or
(2) the trustees of trust 2 are not regarded as a beneficiary of trust 1.
It does not much matter which is correct (or both) as no-one has ever suggested the contrary. But for completeness, the drafter of s.97(8)(10)

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59 See 49.9 (DT relief for chargeable gains).

TCGA may have considered the second point to be the correct one, as they took special care to preserve it. Section 97(8) TCGA provides that a non-beneficiary is treated as a beneficiary. It provides (in short):

> (8) In a case where—
>
> (a) ... a capital payment is received from the trustees of a settlement...
>
> (b) it is received by a person ...
>
> (c) at the time it is received ... the person is not ... a beneficiary of the settlement...
>
> for the purposes of sections 86A to 90 ... the person shall be treated as a beneficiary of the settlement as regards events occurring at or after that time.

This might apply s.87 to an inter-trust transfer, but it is excluded by s.97(10):

> Subsection (8) above shall not apply so as to treat—
>
> (a) the trustees of the settlement referred to in that subsection, or
>
> (b) the trustees of any other settlement,
>
> as beneficiaries of the settlement referred to in that subsection.

51.18.2 *Section 90 TCGA*

Section 90(1) TCGA provides:

> This section applies if the trustees of a settlement ("the transferor settlement") transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement").

In short, s.90 applies on a transfer between trusts.

The section only applies on a transfer of trust capital: if trustees of a discretionary trust distribute trust income to another trust, it is suggested that s.90 does not apply, because the income is not "settled property".

Section 90 TCGA provides:

> (3) Treat the s.2(2) amount for the transferee settlement for any tax year (not later than the year of transfer)[60] as increased by—
>
> (a) the s.2(2) amount for the transferor settlement for that year (as reduced under s.87A as it applies in relation to that settlement for the year of transfer and all earlier tax years), or

60 Section 90(2) TCGA gives this term a commonsense definition: "In this section 'the year of transfer' means the tax year in which the transfer occurs."

(b) if part only of the settled property is transferred, the relevant proportion of the amount mentioned in para (a).

(4) "The relevant proportion" is—

(a) the market value of the property transferred, divided by

(b) the market value of the property comprised in the transferor settlement immediately before the transfer.

Section 90(5) TCGA provides corresponding relief for the transferor settlement:

> Treat the s.2(2) amount for the transferor settlement for any tax year as reduced by the amount by which the s.2(2) amount for the transferee settlement for that year is increased under subs.(3).
>
> ...
>
> (7) The increase under subs.(3) has effect for the year of transfer and subsequent tax years.
>
> (8) The reduction under subs.(5) has effect for tax years after the year of transfer.

It is interesting to compare the technique of s.81 IHTA (deeming transferred property to remain in the original trust).[61] While that is not without its problems, it is a more effective anti-avoidance rule. The reason may be that s.90 is not (or not just) an anti-avoidance provision. It is intended to facilitate inter-trust transfers. Such transfers may be desirable for family reasons or to avoid unfairness which otherwise follows from the operation of s.87. Suppose trustees hold a trust fund worth £2m with s.2(2) amounts of £1m and they wish to make a capital payment of £1m to beneficiary B1. If they do so then a subsequent distribution to beneficiary B2 would be tax free. That would not be fair as between B1 and B2. A transfer of one half of the trust fund to a separate trust, followed by a capital payment to B1, in principle solves this unfairness: B1 pays tax on one half of the s.2(2) amounts and B2 in due course will in principle pay tax on the other half, when that fund is transferred to B2.

Section 90(6) TCGA deals with a transfer to a UK resident settlement:

> If neither s.87 nor s.89(2) would otherwise apply to the transferee settlement for the year of transfer—
>
> (a) s.89(2) to (4) apply to the settlement for that year (and subsequent tax years), and

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61 See 64.8 (The same settlement fiction: section 81).

(b) for this purpose, references there to the last non-resident tax year are to be read as the year of transfer.

Amended as s.90(6) directs, s.89(2) to (4) provides:

(2) Chargeable gains are treated as accruing in a tax year (in the resident period) to a beneficiary of the settlement who receives a capital payment from the trustees in that year if all or part of the capital payment is matched (under section 87A as it applies for that year) with the section 2(2) amount for the ~~last non-resident tax year~~ *year of transfer* or any earlier tax year.
(3) Section 87(3) and (4) and sections 87A to 87C apply for the purposes of subsection (2) as if the relevant tax year were the tax year mentioned in subsection (2).
(4) Section 87B (remittance basis) applies in relation to chargeable gains treated under subsection (2) as accruing as it applies in relation to chargeable gains treated under section 87 as accruing.

Section 90(9) TCGA deals with trust debts:

When calculating the market value of property for the purposes of this section or s.90A in a case where the property is subject to a debt, reduce the market value by the amount of the debt.

A transfer between trusts triggers the deadline for a rebasing election.[62]

51.18.3 *Transfer for consideration*

Section 90A TCGA provides:

(1) Section 90 does not apply to a transfer of settled property made for consideration in money or money's worth if the amount (or value) of that consideration is equal to or exceeds the market value of the property transferred.
(2) The following provisions apply if—
(a) s.90 applies to a transfer of settled property made for consideration in money or money's worth, and
(b) the amount (or value) of that consideration is less than the market value of the property transferred.
(3) If the transfer is of all of the settled property, for the purposes of s.90 treat the transfer as being of part only of the settled property.
(4) Deduct the amount (or value) of the consideration from the amount of the market value referred to in s.90(4)(a).

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62 See 51.27 (Rebasing: the election).

Section 90 does not apply to a loan from trust 1 to trust 2 on commercial terms. It does not apply to an interest free loan repayable on demand, because the promise to repay is full consideration. For the same reason it does not apply to repayment of a loan.

51.18.4 *Interaction with schedule 4B*

Section 90(10) TCGA provides:

> This section does not apply to—
> (a) a transfer to which Schedule 4B applies, or
> (b) any s.2(2) amount that is in a Schedule 4C pool (see para 1 of Schedule 4C).

See 52.14 (Schedule 4C: the key condition).

51.18.5 *HMRC examples*

The HMRC s.87 guidance note provides:

Example 14 – New section 90 – All settled property transferred between settlements for nil consideration

All the settled property of the transferor settlement is transferred to the transferee settlement for nil consideration in 2008-09. No capital payments have been made out of the transferor settlement. The transferor settlement had the following gains made by the trustees:

2005-06	Trustees' gains (section 2(2) amount)	£20,000
2008-09	Section 2(2) amount on transfer of all settled property	£75,000

The transferee settlement acquires these unmatched section 2(2) amounts. They are added to any unmatched section 2(2) amounts it already has for the years 2005-06 and 2008-09. This applies whatever the residence status of the transferee settlement.

The unmatched section 2(2) amounts in the transferor settlement are now reduced to Nil.

Example 15 – New section 90 – Part of settled property transferred between settlements for nil consideration

The transferor settlement's assets consist of shares with a market value of £400,000 and cash of £100,000. The shares are transferred to the transferee settlement for nil consideration in 2008-09. The cash remains in the transferor settlement.

No capital payments have been made out of the transferor settlement. The transferor settlement has the following gains made by the trustees:

2005-06	Trustees' gains (section 2(2) amount)	£20,000
2008-09	Section 2(2) amount on transfer of shares	£75,000

It is only the 'relevant proportion' of these unmatched section 2(2) amounts that is transferred to the transferee settlement. The relevant proportion is 4/5 (£400,000 / [£400,000 + £100,000]).

Transferee settlement

The transferee settlement acquires the following unmatched section 2(2) amounts:

2005-06 £16,000 (£20,000 × 4/5)
2008-09 £60,000 (£75,000 × 4/5)
They are added to any unmatched section 2(2) amounts it already has and can be matched with capital payments made from the transferee settlement in 2008-09 or a later year. This applies whatever the residence status of the transferee settlement.
Transferor settlement
The unmatched section 2(2) amounts of the transferor settlement are reduced by the section 2(2) amounts that have been treated as transferred to the transferee settlement. The unmatched section 2(2) amounts become:
2005-06 £4,000 (£20,000 - £16,000)
2008-09 £15,000 (£75,000 - £60,000)
This reduction has effect for matching in the year after the year of transfer (2009-10) and subsequent years.

Example 16 – New section 90A – All settled property transferred between settlements for consideration of market value
All the settled property of the transferor settlement is transferred to the transferee settlement in 2008-09. The transferee settlement pays market value to the transferor settlement for these assets.
No capital payments have been made out of the transferor settlement. The transferor settlement has the following gains made by the trustees:

2005-06	Trustees' gains (section 2(2) amount)	£20,000
2008-09	Section 2(2) amount on transfer of all settled property	£75,000

These unmatched section 2(2) amounts remain in the transferor settlement and can be matched with future capital payments from that settlement. None of the unmatched section 2(2) amounts are transferred to the transferee settlement.

Example 17 – New section 90A – All settled property transferred between settlements for consideration less than market value
The transferor settlement's assets consist of shares with a market value of £400,000 and cash of £100,000. All these assets are transferred to the transferee settlement in 2008-09. The transferee settlement pays £300,000 to the transferor settlement for these assets.
No capital payments have been made out of the transferor settlement. The transferor settlement has the following gains made by the trustees:

2005-06	Trustees' gains (section 2(2) amount)	£20,000
2008-09	Section 2(2) amount on transfer of all settled property	£75,000

The transfer is treated as if it was a transfer of part only of the settled property. This is to bring in the 'relevant proportion' rules in section 90(3) and (4) TCGA in deciding how much of the unmatched section 2(2) amounts are transferred to the transferee settlement. In calculating the 'relevant proportion' you deduct the amount paid by the transferee settlement from the 'market value of the property transferred'. The relevant proportion is 2/5 ([£400,000 + £100,000 - £300,000] / [£400,000 + £100,000]).
Transferee settlement
The transferee settlement acquires the following unmatched section 2(2) amounts:
2005-06 £8,000 (£20,000 × 2/5)
2008-09 £30,000 (£75,000 × 2/5)
They are added to any unmatched section 2(2) amounts it already has and can be matched with capital payments made from the transferee settlement in 2008-09 or a later year.

This applies whatever the residence status of the transferee settlement.

Transferor settlement

The unmatched section 2(2) amounts of the transferor settlement are reduced by the section 2(2) amounts that have been treated as transferred to the transferee settlement. The unmatched section 2(2) amounts become:

2005-06 £12,000 (£20,000 - £8,000)
2008-09 £45,000 (£75,000 - £30,000)

This reduction has effect for matching in the year after the year of transfer (2009-10) and subsequent years.

Example 18 – New section 90A – Part of settled property transferred between settlements for consideration less than market value

The transferor settlement's assets consist of shares with a market value of £400,000 and cash of £100,000. The shares are transferred to the transferee settlement in 2008-09. The cash remains in the transferor settlement. The transferee settlement pays £300,000 to the transferor settlement for the shares. No capital payments have been made out of the transferor settlement. The transferor settlement has the following gains made by the trustees:

2005-06	Trustees' gains (section 2(2) amount)	£20,000
2008-09	Section 2(2) amount on transfer of shares	£75,000

This transfer of part of the settled property brings in the 'relevant proportion' rules in section 90(3) and (4) TCGA in deciding how much of the unmatched section 2(2) amounts are transferred to the transferee settlement. In calculating the 'relevant proportion' you deduct the amount paid by the transferee settlement from the 'market value of the property transferred'. The relevant proportion is 1/5 ([£400,000 - £300,000] / [£400,000 + £100,000]).

Transferee settlement

The transferee settlement acquires the following unmatched section 2(2) amounts:

2005-06 £4,000 (£20,000 × 1/5)
2008-09 £15,000 (£75,000 × 1/5)

They are added to any unmatched section 2(2) amounts it already has and can be matched with capital payments made from the transferee settlement in 2008-09 or a later year.

This applies whatever the residence status of the transferee settlement.

Transferor settlement

The unmatched section 2(2) amounts of the transferor settlement are reduced by the section 2(2) amounts that have been treated as transferred to the transferee settlement. The unmatched section 2(2) amounts become:

2005-06 £16,000 (£20,000 - £4,000)
2008-09 £60,000 (£75,000 - £15,000)

This reduction has effect for matching in the year after the year of transfer (2009-10) and subsequent years.

Example 19 – New section 90(7) – Unmatched section 2(2) amounts transferred on a transfer between settlements do not affect matching in earlier years in transferee settlement

All the settled property of the transferor settlement is transferred to the transferee settlement for nil consideration in 2008-09. No capital payments have been made out of the transferor settlement. The transferor settlement has the following gains made by the

trustees:

2005-06	Trustees' gains (section 2(2) amount)	£20,000
2008-09	Section 2(2) amount on transfer of all settled property	£75,000

The transferee settlement acquires these unmatched section 2(2) amounts. They are added to any unmatched section 2(2) amounts it already has. This applies whatever the residence status of the transferee settlement.

The unmatched section 2(2) amounts in the transferor settlement are now reduced to Nil.

In its own right the transferee settlement had:

2001-02	Trustees' gains (section 2(2) amount)	£10,000
2004-05	Capital payments	£30,000
2006-07	Trustees' gains (section 2(2) amount)	£50,000

This has resulted in chargeable gains treated as accruing to the beneficiary of:

2004-05 £10,000

(Also possible increase in tax charged under section 91)

2006-07 £20,000

There is no reworking of this matching when section 2(2) amounts are transferred from the transferor settlement. So the 2005-06 section 2(2) amount transferred in is not matched with any of the 2004-05 capital payments. The transferee settlement has unmatched section 2(2) amounts to carry forward of:

2005-06 £20,000

From transferor settlement

2006-07 £30,000

In its own right

2008-09 £75,000

From transferor settlement

Example 20 – New section 90(3) – Capital payments out of transferor settlement in year of transfer matched with section 2(2) amounts of transferor settlement for that and earlier years before calculating section 2(2) amounts transferred

The transferor settlement's assets consist of shares with a market value of £400,000 and cash of £100,000. The shares are transferred to the transferee settlement for nil consideration in 2008-09. The cash remains in the transferor settlement.

The transferor settlement has the following gains made by the trustees:

2005-06	Trustees' gains (section 2(2) amount)	£20,000
2008-09	Section 2(2) amount on transfer of shares	£75,000

The first capital payment made out of the transferor settlement is made in 2008-09. It does not matter whether the capital payment is made before or after the transfer of the shares between settlements. The capital payment is £50,000 to a beneficiary. That £50,000 capital payment is matched with £50,000 of the 2008-09 section 2(2) amount and a chargeable gain of £50,000 is treated as accruing to the beneficiary under section 87 for 2008-09. The remaining unmatched section 2(2) amount for 2008-09 is reduced to £25,000 (£75,000 - £50,000).

It is only the 'relevant proportion' of the remaining unmatched section 2(2) amounts that is transferred to the transferee settlement. The relevant proportion is 4/5 (£400,000 / [£400,000 + £100,000]).

Transferee settlement

The transferee settlement acquires the following unmatched section 2(2) amounts:

2005-06 £16,000 (£20,000 × 4/5)
2008-09 £20,000 (£25,000 × 4/5)
They are added to any unmatched section 2(2) amounts it already has and can be matched with capital payments made from the transferee settlement in 2008-09 or a later year. This applies whatever the residence status of the transferee settlement.
Transferor settlement
The unmatched section 2(2) amounts of the transferor settlement are reduced by the section 2(2) amounts that have been treated as transferred to the transferee settlement. The unmatched section 2(2) amounts become:
2005-06 £4,000 (£20,000 - £16,000)
2008-09 £5,000 (£25,000 - £20,000)
This reduction has effect for matching in the year after the year of transfer (2009-10) and subsequent years.

51.19 1981 transitional relief

Para 116 Sch 7 FA 2008 provides:

> For the purposes of sections 87 and 87A of TCGA 1992, no account is to be taken of—
> (a) any capital payment received before 10 March 1981, or
> (b) any capital payment received on or after that date but before 6 April 1984, so far as it represents a chargeable gain which accrued to the trustees before 6 April 1981.

All capital payments before 10 March 1981 are disregarded.

Capital payments before 6 April 1984 are disregarded if they represent a chargeable gain which accrued to the trustees before 6 April 1981. How does one decide whether a capital payment represents a pre-1981 gain? Fortunately this problem will not often arise now.

51.20 1998 transitional relief

Para 118 Sch 7 FA 2008 provides:

> (1) This paragraph applies if—
> (a) s.87 of TCGA 1992 applies to a settlement for the tax year 2008-09 or any subsequent tax year ("the tax year"),
> (b) the settlement was made before 17 March 1998,
> (c) none of the settlors fulfilled the residence requirements when the settlement was made, and
> (d) none of the settlors fulfils the residence requirements in the tax year.
> (2) For the purposes of that section as it applies to the settlement for the tax year, no account is to be taken of—
> (a) any gains or losses accruing to the trustees of the settlement

before 17 March 1998, or

(b) any capital payments received before that date.

(3) A settlor "fulfils the residence requirements" when the settlor is—

(a) resident or ordinarily resident in the UK, and

(b) domiciled in any part of the UK.

I refer to this as "**1998 transitional relief**". In principle, (inter alia) for foreign domiciled settlor settlements, one disregards gains and capital payments before 17 March 1998. But if in any year there is a UK resident and domiciled settlor, even only one of several, the relief is lost in that year. Thus, a "tainting" principle applies. A small, even nominal contribution from a UK resident and domiciled settlor will forfeit the transitional relief for all years that that settlor is UK resident and domiciled.

One can envisage a case where it is better that this relief does not apply, in which case it would be possible to arrange to forfeit the relief, but this will not be common.

51.21 Ascertaining s.2(2) amounts as at end 2007/8

The concept of s.2(2) amount was introduced in the FA 2008 with effect from 2008/9, but it is necessary to compute the s.2(2) amount for earlier years in order to know what s.2(2) amount is carried forward to 2008/09 and subsequently.

Para 120 Sch 7 FA 2008 provides:

> (1) This paragraph applies to a settlement if s.87 or s.89(2) of TCGA 1992 applied to it for the tax year 2007–08 or any earlier tax year.
>
> (2) The following steps are to be taken for the purposes of calculating the s.2(2) amount for the settlement for the tax year 2007-08 and earlier tax years.
>
> *Step 1*
>
> Calculate (in accordance with s.87 and, where appropriate, s.88) the s.2(2) amount for the settlement for the tax year 2007-08 and earlier tax years.
>
> For this purpose, references in s.87(4) and (5) of TCGA 1992 (as substituted) to s.87 of that Act applying to a settlement for a tax year are to be read as references to s.87 of that Act (as it had effect before that substitution) applying to a settlement for a tax year.
>
> *Step 2*
>
> Find the total amount of chargeable gains treated under s.87 or 89(2) as accruing to beneficiaries of the settlement in the tax year 2007-08 or any

earlier tax year ("the total deemed gains").

I prefer the label "pre-2008 gains".

Step 3
Find the earliest tax year for which the s.2(2) amount is not nil.
If the s.2(2) amount for that year is less than or equal to the total deemed gains, reduce that s.2(2) amount to nil.
Otherwise, reduce that s.2(2) amount by the amount of the total deemed gains.
Step 4
Reduce the total deemed gains by the amount by which the s.2(2) amount was reduced under Step 3.
Step 5
If the total deemed gains is not nil, start again at Step 3.
For this purpose, read references to the earliest tax year for which the s.2(2) amount is not nil as references to the earliest tax year—

(a) which is after the last tax year for which Steps 3 and 4 have been undertaken, and
(b) for which the s.2(2) amount is not nil.

EN FB 2008 provides an example:

60. Example: determining the s.2(2) amount for years preceding 2008-09:
The s.2(2) amounts of a settlement were:
2004-05: £100,000
2005-06: £50,000
2006-07: £200,000
2007-08: £200,000
Total deemed gains were £450,000.

a. Subtract the s.2(2) (£100,000) amount for the earliest year from the total deemed gains. Section 2(2) amount for 2004-05 reduces to nil. Total deemed gains reduced to £350,000.
b. Subtract the s.2(2) (£50,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2005-06 reduces to nil. Total deemed gains reduced to £300,000.
c. Subtract the s.2(2) (£200,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2006-07 reduces to nil. Total deemed gains reduced to £100,000.
d. Subtract the s.2(2) (£200,000) amount for the next earliest year from the total deemed gains carried forward. Section 2(2) amount for 2007-08 reduces to £100,000. Total deemed gains reduced to nil.

The s.2(2) amount for the settlement for 2007-08 is therefore £100,000.

In short, pre-2008 s.87 gains are deducted from pre-2008 s.2(2) amounts on a FIFO basis (first in first out). It is expressed in just about the most obscure way possible.[63]

The HMRC s.87 guidance note provides:

> **Identifying unmatched section 2(2) amount for years before 2008-09: paragraph 120 of Schedule 7**
>
> 30. Although the new matching rules in section 87A take effect from 2008-09 they will apply to match capital payments received in 2008-09 and later against unmatched section 2(2) amounts of 2007-08 and earlier. This means it is necessary to calculate what those section 2(2) amounts are. Paragraph 120 of Schedule 7 explains how to do this in a series of steps. Capital payments matched with these section 2(2) amounts may be subject to the increased tax charge under section 91 TCGA.
>
> 31. First you calculate what the section 2(2) amount would be for each earlier year using the definition in the new section 87(4) but applying the Capital Gains Tax rules for the earlier year. So you give taper relief and indexation allowance as appropriate. These section 2(2) amounts include gains made by the trustees which have been matched with capital payments.
>
> 32. Second you identify the total chargeable gains that have accrued to beneficiaries under section 87 in the years up to and including 2007-08. This includes chargeable gains that have not been charged to tax – for example because of the non-UK residence or domicile status of the beneficiary. This figure is called the "total deemed capital gains".
>
> 33. Third you allocate the total deemed capital gains to years in which there is a section 2(2) amount taking the earliest year first. You reduce the section 2(2) amount by the amount of the total deemed gains. If the total deemed gains are greater than the section 2(2) amount the section 2(2) for the year is reduced to nil. A corresponding reduction is made in the total deemed gains. When all the total deemed gains have been allocated you are left with the unmatched section 2(2) amounts for 2007-08 and earlier years. See example 5.
>
> **Example 5: Identifying unmatched section 2(2) amounts for years before 2008-09: paragraph 120 of Schedule 7**
>
> The section 2(2) amounts for a settlement are:-
>
> | | |
> |---|---|
> | 2005-06 | £50,000 |
> | 2006-07 | £75,000 |
> | 2007-08 | £60,000 |

63 For discussion of the drafting technique, see 51.10.7 (Commentary: Step-based drafting).

Up to and including 2007-08 capital payments of £90,000 have been received by beneficiaries and the total deemed gains are £90,000. None of the capital payments were received in the period 12 March to 5 April 2008. See example 12 for an example of payments received in this period by a non-UK domiciled beneficiary.

The total deemed gains are allocated against the section 2(2) amounts using the FIFO rules in paragraph 120 of Schedule 7 that apply to matching for 2007-08 and earlier years. They are allocated as follows:

	Original s2(2) amount	Total deemed gains	Deemed s2(2) amount
2005-06	£50,000	£50,000	Nil
2006-07	£75,000	£40,000	£35,000
2007-08	£60,000	Nil	£60,000

Suppose capital payments of £70,000 were received by beneficiaries in 2009-10 and there is no section 2(2) amount for that year or 2008-09. The £70,000 capital payments are matched under the LIFO rules in the new section 87A TCGA that apply for matching in 2008-09 and later years. £60,000 of those payments are matched against the section 2(2) amount for 2007-08 and £10,000 of those payments are matched against the section 2(2) amount for 2006-07. The total deemed gains are £70,000 (£60,000 + £10,000) treated as accruing in 2009-10. This leaves unmatched a deemed section 2(2) amount for 2006-07 of £25,000 (£35,000 - £10,000) available to match against capital payments made in 2010-11 or later years.

Assuming all the beneficiaries were resident in the UK in 2009-10 their liability to Capital Gains Tax on the section 87 gains accruing to them will depend on their domicile in 2009-10. If any of the beneficiaries are non-UK domiciled individuals paragraph 124(2)(b) of Schedule 7 will prevent them being charged to Capital Gains Tax. This applies whether or not they have claimed to use the remittance basis for 2009-10. If any of the beneficiaries are UK domiciled they will be charged to Capital Gains Tax on the section 87 gains. Any tax due on these gains will be increased by section 91 TCGA.

Assume the entire capital payment is received by a UK resident and domiciled beneficiary who has no other capital gains and losses in 2009-10. At the time of writing the annual exempt amount and rate of Capital Gains Tax are not known for 2009-10. This example assumes they are the same as for 2008-09 at £9,600 and 18% respectively. The annual exempt amount is set first against the gain accruing from the 2006-07 capital payment. Ie £10,000 – £9,800 = £200. The tax due on the gain accruing from the 2006-07 capital payment is £36 (£200 @ 18%). This tax is increased by £10 (£36 @ 30% = £10). The tax due on the gain accruing from the 2007-08 amount is £10,800 (£60,000 @ 18%). This tax is increased by £2,160 (£10,800 @ 20%). The total Capital Gains

Tax payable for 2009-10 is £13006 (£36 + £10 + £10,800 + £2,160).

Para 120(3) provides for Schedule 4B cases, though the drafter does not try very hard:

> If, before 6 April 2008, the trustees of the settlement made a transfer of value to which Schedule 4B to TCGA 1992 applied, sub-para (2) has effect subject to such modifications as are just and reasonable on account of Schedule 4C to that Act having applied in relation to the settlement.

51.21.1 *Pre-2008 OIG amounts*

Para 99 Sch 7 FA 2008 applies the same rule to OIG amounts:

> Paragraphs 120 and 121 apply in relation to offshore income gains as if—
>
> (a) references to section 2(2) amounts were to OIG amounts,
>
> (b) references to chargeable gains were to offshore income gains, and
>
> (c) Step 1 of paragraph 120(2) provided that OIG amounts are to be calculated in accordance with—
>
> (i) section 762(2) of ICTA (the reference in the second sentence of that Step to section 87(4) of TCGA 1992 being read as a reference to section 762(2) of ICTA), or
>
> (ii) section 87(5) of TCGA 1992 as applied by section 762(3) of ICTA.

Section 762 ICTA is now repealed. The OFTR should have updated the references but (somewhat negligently) failed to do so. It is considered that the slip can be corrected by construction, ie references to the new provisions should be implied.

51.22 Pre-2008 capital payments

In order to follow the present legislation, one needs to have in mind the original terms of s.87(6) TCGA and in order to follow that, one needs to read all of the pre-2008 s.87(4)-(6) TCGA:

> *(4) Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as chargeable gains accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments in any earlier year.*
>
> *(5) The attribution of chargeable gains to beneficiaries under subsection*

(4) above shall be made in proportion to, but shall not exceed, the amounts of the capital payments received by them.
(6) A capital payment shall be left out of account for the purposes of subsections (4) and (5) above to the extent that chargeable gains have by reason of the payment been treated as accruing to the recipient in an earlier year.

Para 122 Sch 7 FA 2008 provides:

(1) If all of a capital payment would (in the tax year 2008-09) have been left out of account by virtue of s.87(6) of TCGA 1992 as originally enacted, the amount of that capital payment is reduced to nil.
(2) If part of a capital payment would (in the tax year 2008-09) have been left out of account by virtue of s.87(6) of TCGA 1992 as originally enacted, the amount of that capital payment is reduced by the amount of that part.
(3) If—

(a) chargeable gains were treated under s.87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 as accruing in the tax year 2007-08 or any earlier tax year to a beneficiary,
(b) more than one capital payment that the beneficiary had received was taken into account for the purposes of determining the amount of chargeable gains treated as accruing to the beneficiary, and
(c) the amount of those chargeable gains was less than the total amount of capital payments taken into account,

for the purposes of this paragraph treat s.87(6) of TCGA 1992 as originally enacted as having effect in relation to earlier capital payments before later ones.

The point of this (I think) is to prevent double counting of a capital payment: it is set against s.2(2) amounts under para 120 and not a second time.
The HMRC s.87 guidance note provides:

34. In the same way that it is necessary to deal with unmatched section 2(2) amounts for a year before 2008-09 it is also necessary to deal with unmatched capital payments received before 2008-09. You have to identify the year in which an unmatched capital payment was received. This is dealt with in paragraph 122 of Schedule 7.
35. First you apply the rule in the original section 87(6) to determine if all or any of a capital payment would be left out of account. A payment would be left out of account to the extent that chargeable gains accrued to a beneficiary as a result of making the payment. In other words if the payment is matched against gains made by the trustees. See example 6.

36. If more than one capital payment is matched against the trustees' gains for a year and the total of the payments is greater than the chargeable gain that accrues the rule in paragraph 122(3) applies. You identify the year the unmatched payment was received by matching the payments received in the earliest years first. See example 7.

Example 6: Identifying unmatched capital payments received before 2008-09: paragraph 122(1) & (2) of Schedule 7

2005-06	Capital payments received	Beneficiary A	£15,000
		Beneficiary B	£12,000
	Trustees' gains (section 2(2) amount)		£37,000
2007-08	Capital payments received	Beneficiary A	£8,000
		Beneficiary B	£9,000

In 2005-06 the capital payments £15,000 and £12,000 are matched against £37,000 trustees' gains and chargeable gains of £15,000 and £12,000 accrue to A and B. In 2008-09 and later years paragraph 122(1) of schedule 7 applies and the capital payments are reduced to nil. The unmatched trustees' gains of £10,000 are carried forward under the old section 87(2) to later years.

In 2007-08 £10,000 trustees' gains are matched against the £17,000 capital payments received. Gains of £4,705 (£10,000 × 8,000/17,000) accrue to A and gains of £5,295 (£10,000 × 9,000/17,000) accrue to B. Their respective unmatched capital payments are reduced to £3,295 (£8,000 - £4,705) and £3,705 (£9,000 - £5,295). Paragraph 122(2) of Schedule 7 ensures only those unmatched parts of the capital payments are carried forward for use in 2008-09 or later years.

The HMRC s.87 guidance note provides:

36. If more than one capital payment is matched against the trustees' gains for a year and the total of the payments is greater than the chargeable gain that accrues the rule in paragraph 122(3) applies. You identify the year the unmatched payment was received by matching the payments received in the earliest years first. See example 7.

The HMRC s.87 guidance note provides:

Example 7: Identifying unmatched capital payments received before 2008-09: Paragraph 122(3) of Schedule 7

2005-06	Capital payments received	Beneficiary A	£16,000
		Beneficiary B	£14,000
	Trustees' gains (section 2(2) amount)		£5,000
2007-08	Capital payments received	Beneficiary A	£10,000
		Beneficiary B	£8,000
	Trustees' gains (section 2(2) amount)		£13,000
2008-09	Section 2(2) amount		£20,000

In 2005-06 gains of £2,667 (£5,000 × 16,000/30,000) would accrue to beneficiary A and the unmatched capital payment would be reduced to £13,333 (£16,000 - £2,667). Gains of £2,333 (£5,000 × 14,000/30,000) would accrue to beneficiary B and the unmatched capital payment would be reduced to £11,667

(£14,000 - £2,333).

In 2007-08 A receives a further capital payment of £10,000 giving them total unmatched capital payments of £23,333. B receives a further capital payment of £8,000 giving them total unmatched capital payments of £19,667. Gains of £7,054 (£13,000 × 23,333/43,000) accrue to A. Gains of £5946 (£13,000 × 19,657/43,000) accrue to B. A's unmatched capital payments to carry forward to 2008-09 are £16,279 (£23,333 - £7,054). B's unmatched capital payments are £13,721 (£19,667 - £5,946).

In 2008-09 the conditions for paragraph 122(3) of Schedule 7 are satisfied:

(a) Chargeable gains have accrued to both beneficiaries in 2007-08.

(b) Capital payments from 2005-06 and 2007-08 have been used for the purposes of determining those gains.

(c) The amount of the chargeable gains £13,000 is less than the total of the capital payments £43,000.

Paragraph 122(3) matches the £13,000 gains first against the capital payments received in 2005-06. In 2005-06 A's unmatched capital payments were £13,333. The 2007-08 gains of £7,054 are matched first against those payments reducing the unmatched capital payments to £6,279. B's unmatched capital payments were £11,667. The 2007-08 gains of £5,496 are matched first against those payments reducing the unmatched capital payments to £5,721. The total unmatched capital payments to carry forward to 2008-09 are then:

- To A £16,279 consisting of £6,279 from 2005-06 and £10,000 from 2007-08
- To B £13,721 consisting of £5,721 from 2005-06 and £8,000 from 2007-08

The ordinary rules of section 87A then apply for the purpose of matching the £20,000 2008-09 section 2(2) amount with the earlier years' capital payments. Gains of £10,000 accrue to A and gains of £8,000 accrue to B as a result of matching the section 2(2) amount against the capital payments received in 2007-08. That leaves £2,000 of the section 2(2) amount to match with capital payments from 2005-06. A gain of £1,046 (£2,000 × 6279/12,000) accrues to A and a gain of £954 (£2,000 × 5721/12,000) accrues to B as a result of matching that £2,000 of the section 2(2) amount. The total gains attributed under section 87 for 2008-09 are:

- To A £11,046 (£10,000 + £1,046)
- To B £8,954 (£8,000 + £954)

The total unmatched capital payments to carry forward to 2009-10 are then:

- To A £5,233 (£6,279 - £1,046) all from 2005-06
- To B £4,767 (£5,721 - £954) all from 2005-06.

Para 122 then imposes the same rules for OIGs:

(4) References in this paragraph to s.87(6) of TCGA 1992 include that provision as it would (but for the amendments made by this Schedule) have applied by virtue of s.762(3) of ICTA (offshore income gains).

(5) References in this paragraph to chargeable gains include offshore income gains.

Section 762 ICTA is now repealed. The OFTR should have updated the reference but (somewhat negligently) failed to do so. It is considered that the slip can be corrected by construction, ie references to the new provisions should be implied.

51.23 Pre-2008 capital payment matched after 2008; Pre-2008 s.2(2) amounts matched after 2008

Para 124 Sch 7 FA 2008 provides:

> (1) This paragraph applies if—
>
> (a) chargeable gains are treated under s.87 or 89(2) of TCGA 1992 as accruing to an individual in the tax year 2008-09 or any subsequent tax year, and
>
> (b) the individual is not domiciled in the UK in that year.
>
> (2) The individual is not charged to capital gains tax on the chargeable gains if and to the extent that they are treated as accruing by reason of—
>
> (a) a capital payment received (or treated as received) by the individual before 6 April 2008, or
>
> (b) the matching of any capital payment with the s.2(2) amount for the tax year 2007-08 or any earlier tax year.

Para (2)(a) provides relief for pre-2008 capital payments to foreign domiciliaries which are matched to post-2008 s.2(2) amounts. Para (2)(b) provides relief for post 2008 capital payments which are matched with pre-2008 s.2(2) amounts.

EN FB 2008 summarises the matter this way:

> 440. The overall effect of these new rules is that: ...
>
> [1] there will be no charge to tax in respect of capital payments made to non-UK domiciled beneficiaries who:
>
> [a] receive capital payments before 6 April 2008 that are matched to trust gains accruing on or after 6 April 2008; or
>
> [b] receive capital payments on or after 6 April 2008 that are matched to trust gains accruing before 6 April 2008.
>
> This will be so irrespective of whether the non-UK domiciled beneficiary is a remittance basis user;

The HMRC s.87 guidance note provides:

> **Example 10: Capital payments received by non-UK domiciled beneficiary before 6 April 2008 matched with section 2(2) amount for 2008-09 or later: paragraph 124 of Schedule 7**

2005-06	Capital payments received	£10,000
2008-09	Capital payments received	£16,000
	Section 2(2) amount	£24,000

The capital payments are received by a beneficiary who is UK resident but non-UK domiciled in 2008-09. A chargeable gain of £24,000 accrues to the beneficiary in 2008-09. On the LIFO basis the capital payments received are matched £16,000 2008-09 and £8,000 2005-06. The beneficiary is liable to Capital Gains Tax on the £16,000 only. The beneficiary is not liable on the £8,000 because the section 2(2) amount realised in 2008-09 is matched to a capital payment received in 2005-06 by a person who is not domiciled in the UK. This applies whether or not the beneficiary is a remittance basis user.

The Capital Gains Tax due on the £16,000 will depend on whether the beneficiary is a remittance basis user and on whether the trustees had made an election under paragraph 126 of Schedule 7. If the trustees have made the election the gain will be restricted to the amount that relates to the growth in the value of the asset since 5 April 2008. If the beneficiary is a remittance basis user the gain will not be charged until it is remitted.

In any circumstances the settlement's section 2(2) amount for 2008-09 is reduced to nil. There are unmatched capital payments from 2005-06 of £2,000 (£10,000 - £8,000) to carry forward.

If the beneficiary was non-UK domiciled in 2005-06 but became UK domiciled sometime before the capital payment was received the condition in paragraph 124(1)(b) is not satisfied. The beneficiary is liable to Capital Gains Tax on the entire gain of £24,000. It is irrelevant whether the domicile status changed before or after 6 April 2008.

Example 11: Gain accruing in respect of section 2(2) amount for a year before 2008-09 when beneficiary non-UK domiciled: paragraph 124 of Schedule 7

2005-06	Capital payments received	Nil
	Section 2(2) amount	£ 7,000
2006-07	Capital payments received	Nil
	Section 2(2) amount	£ 5,000
2008-09	Capital payment received	£30,000
	Section 2(2) amount	£16,000

The capital payment in 2008-09 was received by a UK resident but non-UK domiciled beneficiary. A chargeable gain of £28,000 accrues in 2008-09. Using the last-in first-out basis of matching the capital payment £30,000 is matched against the section 2(2) amounts as follows.

2008-09	£16,000
2006-07	£ 5,000
2005-06	£ 7,000
	£28,000

The beneficiary is liable to Capital Gains Tax only on the £16,000 matched with the section 2(2) amount for the year 2008-09. The beneficiary is not liable to Capital Gains Tax on the section 87 gains that accrue as a result of matching the capital payment against section 2(2) amounts for 2006-07 and 2005-06. This is because the beneficiary was not domiciled in the UK in 2008-09 when the capital

payment was received and the section 2(2) amounts are for years before 2008-09.

The Capital Gains Tax due on the £16,000 will depend on whether the beneficiary is a remittance basis user and on whether the trustees had made an election under paragraph 126 of Schedule 7. If the trustees have made the election the gain will be restricted to the amount that relates to the growth in the value of the asset since 5 April 2008. If the beneficiary is a remittance basis user the gain will not be charged until it is remitted.

In any circumstances the settlement's section 2(2) amounts for 2008-09, 2006-07 and 2005-06 are reduced to nil. The unmatched capital payments for 2008-09 are reduced to £2,000 (£30,000 - £28,000).

Suppose the beneficiary was non-UK domiciled in 2005-06 and 2006-07 but became UK domiciled in 2007-08 or 2008-09. They would be liable to Capital Gains Tax on the whole chargeable gain £28,000. The fact that they were non-UK domiciled in the years before 2008-09 when the section 2(2) amounts were realised is not relevant. The test in paragraph 124(1)(b) of Schedule 7 is the domicile status for the year in which the gain accrues as a result of matching those amounts with a capital payment.

51.23.1 *Pre-2008 capital payments and pre-2008 OIG amounts*

Para 100 Sch 7 FA 2008 provides the same rules for OIG amounts:

(1) This paragraph applies if—
- (a) by virtue of section 87 or 89(2) of, or Schedule 4C to, TCGA 1992 as applied by regulation 20 of the Offshore Funds (Tax) Regulations 2009 (S.I. 2009/3001), income is treated under such regulations (regulation 17 of those Regulations[)] as arising to an individual in the tax year 2008–09 or any subsequent tax year, and
- (b) the individual is not domiciled in the UK in that year.

(2) The individual is not charged to income tax on the income if and to the extent that it is treated as arising by reason of—
- (a) a capital payment received (or treated as received) by the individual before 6 April 2008, or
- (b) the matching of any capital payment with the OIG amount for the tax year 2007–08 or any earlier tax year.

51.23.2 *Capital payments between 12 March and 5 April 2008*

Para 125 Sch 7 FA 2008 provides a special rule for these capital payments:

(1) This paragraph applies in relation to a settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year") if—
- (a) an individual who was resident or ordinarily resident, but not

domiciled, in the UK in the tax year 2007-08 received a capital payment from the trustees of the settlement on or after 12 March 2008 but before 6 April 2008, and

(b) the individual is resident or ordinarily resident, but not domiciled, in the UK in the relevant tax year.

(2) For the purposes of sections 87 to 89 of TCGA 1992 as they apply in relation to the settlement for the relevant tax year, no account is to be taken of the capital payment.

One might refer to capital payments made between 12 March and 5 April 2008 as post-budget 2008 capital payments. There is no matching for post-budget 2008 capital payments, so such payments do not reduce s.2(2) amounts.

January 2009 Qs & As provides some background explanation:

Q4: Paragraph 125(2) appears to disregard payments between 12 March and 5 April altogether, which is different to the treatment proposed in the Budget documentation published on 12 March.

A: The original intention set out in the Budget documentation of 12 March and legislation was to allow the matching of capital payments between 12 March 2008 and 5 April 2008 with any gains relating to the period up to 5 April 2008 arising to the trustees after 5 April 2008. However, this proposal was dropped because it would have introduced additional and unnecessary complexity to the legislation.

This rule is not extended to offshore income gains. It is not clear if that was deliberate or an oversight.

The HMRC s.87 guidance note provides:

Non-UK domiciled beneficiaries: capital payments received 12 March to 5 April 2008: paragraph 125 of Schedule 7

50. Paragraph 125 of Schedule 7 is an anti-avoidance measure. Its purpose was to discourage trustees making large capital payments to non-UK domiciled beneficiaries immediately before the beginning of 2008-09. These would then be matched against section 2(2) amounts for 2008-09 or later and, unless they had become UK domiciled, the beneficiaries would not be liable to Capital Gains Tax on any gains accruing to them.

51. The paragraph provides that any capital payment received by a UK resident or ordinary resident beneficiary is ignored if it was received on or after 12 March and before 6 April 2008 by a non-UK domiciled beneficiary. The payment is ignored only if the chargeable gain accrues in 2008-09 or later and the beneficiary is still non-domiciled when the gain accrues. See example 12.

Example 12: Non-UK domiciled beneficiary: capital payment received 12 March to 5 April 2008: paragraph 125 of Schedule 7

Year	**Capital payments**	**S.2(2) amount**
2007-08	£200,000	£ 50,000
2010-11	Nil	£ 80,000

The 2007-08 capital payment was made on 4 April 2008 to a UK resident but non-UK domiciled beneficiary.

A chargeable gain of £50,000 accrues to the beneficiary in 2007-08 but they are not liable to Capital Gains Tax on this gain. The settlement's section 2(2) amount for 2007-08 is reduced to nil. The unmatched capital payment for 2007-08 is reduced to £150,000.

If the beneficiary is non-UK domiciled in 2010-11 the unmatched capital payment £150,000 for 2007-08 is not matched against the section 2(2) amount £80,000 for 2010-11 and no section 87 gain accrues for that year. This is because the capital payment was received in the period 12 March 2008 to 5 April 2008 inclusive by a beneficiary who was not domiciled in the UK when they received the payment. The settlement's unmatched section 2(2) amount for 2010-11 remains at £80,000.

The capital payment will remain unmatched against section 2(2) amounts for future years provided the beneficiary remains non-domiciled. If the taxpayer has become UK domiciled by the time a section 2(2) amount is realised in a future year the payment can be matched against that amount and a section 87 gain will accrue to the beneficiary in that year.

In the example suppose a section 2(2) amount of £20,000 is realised in 2011-12. There are no capital payments in that year. The beneficiary is still non-UK domiciled. The unmatched capital payment £150,000 from 2007-08 is not matched against this section 2(2) amount.

The beneficiary becomes UK domiciled in 2012-13 and stays UK domiciled in later years.

In 2014-15 a section 2(2) amount of £80,000 is realised. No capital payments are made in that year. Paragraph 125 of Schedule 7 does not apply to year 2014-15 because the taxpayer is UK domiciled in that year. The rules in section 87A match the section 2(2) amount for 2014-15 with the unmatched capital payment £150,000 2007-08. A chargeable gain of £80000 accrues to the beneficiary in 2014-15. At the time of writing the annual exempt amount and rate of Capital Gains Tax are not known for 2014-15. This example assumes they are £15,000 and 18% respectively. Assuming that the annual exempt amount is £15,000 and the rate of Capital Gains Tax 18% the beneficiary will be liable to £11,700 Capital Gains Tax on this gain.

The section 2(2) amount for 2014-15 is reduced to nil and the unmatched capital payment for 2007-08 is reduced to £70,000 (£150,000 - £80,000). This capital payment will be matched against section 2(2) amounts realised in later years. Applying the matching rules in section 87A TCGA to a section 2(2) amount for 2014-15 does not result in a capital payment received in 2007-08 being matched against section 2(2) amounts for years 2010-11 and 2011-12. The section 2(2) amounts for those years will be matched against capital payments received in years after 2014-15. The remaining unmatched capital payments for 2007-08 £70,000 will be matched against section 2(2) amounts for years after 2014-15.

51.24 Pre-2008 inter-trust transfer

Para 120(4) Sch 7 FA 2008 disapplies the rules in para 120 where there was an inter-trust transfer before 2008/09[64] and para 121 Sch 7 FA 2008 sets out its own set of rules:

> (1) If s.90 of TCGA 1992 (as originally enacted) applied to a transfer of settled property made before 6 April 2008, this paragraph applies in relation to the transferor settlement and the transferee settlement.
> (2) In this paragraph "the year of transfer" means the tax year in which the transfer occurred.
> (3) The following steps are to be taken for the purpose of calculating the s.2(2) amount for the transferor and transferee settlements for the tax year 2007-08 and earlier tax years.
> *Step 1*
> Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount (at the end of the year of transfer) for the transferor settlement for the year of transfer and earlier tax years.
> For this purpose, read references there to the tax year 2007-08 as references to the year of transfer.
> *Step 2*
> Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount (before the year of transfer) for the transferee settlement for the tax year before the year of transfer and earlier tax years.
> For this purpose, read references there to the tax year 2007-08 as references to the tax year before the year of transfer.
> *Step 3*
> Calculate the s.2(2) amount for the transferee settlement for the year of transfer.
> *Step 4*
> Treat the s.2(2) amount for the transferee settlement for the year of transfer or any earlier tax year (as calculated under Step 2 or 3) as increased by—
> (a) the s.2(2) amount for the transferor settlement for that year (as calculated under Step 1), or
> (b) if part only of the settled property was transferred, the relevant proportion of the amount mentioned in para (a).
> "The relevant proportion" here has the same meaning as in s.90(4) of TCGA 1992 (as substituted by this Schedule).
> *Step 5*
> Treat the s.2(2) amount for the transferor settlement for any tax year as reduced by the amount by which the s.2(2) amount for the transferee settlement for that year is increased under Step 4.

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64 Para 120(4) provides:

> This paragraph does not apply if s.90 of TCGA 1992 applied to a transfer of settled property by or to the trustees of the settlement that was made before 6 April 2008 (see para 121).

Step 6

Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount for the transferor settlement for the tax year 2007-08 and earlier tax years.

For this purpose—

(a) treat the s.2(2) amount for the year of transfer or any earlier tax year as the amount calculated by taking Steps 1 and 5 above, and

(b) reduce the total deemed gains by the amount of the total deemed gains calculated by taking Step 1 above.

Step 7

Take the steps in para 120(2) for the purpose of calculating the s.2(2) amount for the transferee settlement for the tax year 2007-08 and earlier tax years.

For this purpose—

(a) treat the s.2(2) amount for the year of transfer or any earlier tax year as the amount calculated by taking Steps 2 to 4 above, and

(b) reduce the total deemed gains by the amount of the total deemed gains calculated by taking Step 2 above.

The drafter felt something should be done about multiple transfers, and Sch 4B, but did not know what:

(4) This paragraph applies with any necessary modifications in relation to a settlement as respects which more than one relevant transfer was made.

(5) In sub-para (4) "relevant transfer" means a transfer—

(a) made before 6 April 2008, and

(b) to which s.90 of TCGA 1992 applied.

(6) If, before 6 April 2008, the trustees of the transferor or transferee settlement made a transfer of value to which Schedule 4B to TCGA 1992 applied, this paragraph has effect subject to such modifications as are just and reasonable on account of Schedule 4C to that Act having applied in relation to the settlement.

Para 99 Sch 7 FA 2008[65] applies the same rules for OIG amounts.

51.25 Pre-2008 trust immigration

In order to follow the present legislation, one needs to have in mind the original terms of s.89(2) TCGA, and in order to follow that it needs to be read with s.89(1):

(1) Where a period of one or more years of assessment for which section 87 applies to a settlement ("a non-resident period") succeeds a period of one or more years of assessment for each of which section 87 does not apply to the settlement ("a resident period"), a capital payment received by a beneficiary in the resident period shall be disregarded for the purposes of section 87 if it was not made in anticipation of a disposal

65 Set out at 51.21.1 (Pre-2008 OIG amounts).

made by the trustees in the non-resident period.
(2) Where
(a) a non-resident period is succeeded by a resident period, and
(b) the trust gains for the last year of the non-resident period are not (or not wholly) treated as chargeable gains accruing in that year to beneficiaries,
then, subject to subsection (3) below, those trust gains (or the outstanding part of them) shall be treated as chargeable gains accruing in the first year of the resident period to beneficiaries of the settlement who receive capital payments from the trustees in that year; and so on for the second and subsequent years until the amount treated as accruing to beneficiaries is equal to the amount of the trust gains for the last year of the non-resident period.

Para 123 Sch 7 FA 2008 provides:

> Section 89(2) of TCGA 1992 as substituted applies to a settlement for the tax year 2008-09 (and subsequent tax years) if s.89(2) of that Act as originally enacted would (but for the amendments made by this Schedule) have applied to the settlement for the tax year 2008-09.

51.26 Rebasing: Introduction

Paragraph 126 Sch 7 FA 2008 provides a relief which I call "**rebasing**". The HMRC s.87 guidance note provides:

> 80. The election is commonly known as a "rebasing" election ... But it is not rebasing as that term applies to section 35 TCGA and assets held at 31 March 1982. There is no across the board revaluation of the assets in the trust fund as at 6 April 2008.

51.27 Rebasing: The election

51.27.1 *Need for rebasing election*

Para 126 Sch 7 FA 2008 provides:

> (1) The following provisions apply to a settlement if—
> (a) s.87 applies to the settlement for the tax year 2008-09, and
> (b) the trustees of the settlement have made an election under this subparagraph. ...
> (5) An election under sub-para (1) is irrevocable.

EN FB 2008 provides:

> 63. The provisions of para [126] are subject to an election rather than

being mandatory because:

[1] depending on the assets comprised in the settlement as at 6 April 2008 it may not be advantageous for the paragraph to apply; and

[2] the trustees will be required to provide additional information to HMRC about trust assets. Trustees of non-resident settlements have been assured in a letter from the Acting Chairman of HMRC, Dave Hartnett, dated 12 February 2008 that in applying the provisions set out in this Schedule, HMRC will not require any additional disclosure.

As far as [1] is concerned, it can never be disadvantageous for para 126 to apply (the election cannot in any circumstances increase the tax liability). The HMRC s.87 guidance note provides:

> 79. The election ... cannot increase the tax payable by a beneficiary. Whether it improves the position of the beneficiary depends on the history of the assets disposed of.

Subject to point [2] (confidentiality) an election should be made in every case where it might be useful, which is generally the case where there are or might be UK resident foreign domiciled beneficiaries. I understand however that an election in relation to a trust unknown to HMRC will generally lead to enquiries.

51.27.2 *Requirements for valid rebasing election*

The HMRC s.87 guidance note provides:

> 82. The election can be made only if the settlement was non-UK resident throughout 2008-09.

This follows from para 126(1)(a). The guidance note continues:

> Paragraph 126(1) requires that the election be made by the trustees of the settlement. It must be made by all the trustees or by a majority of them if they are permitted to act through a majority. It cannot be made by a beneficiary. If the beneficiary's Self Assessment tax return is taken up for enquiry an election may require additional disclosure to HMRC about assets held by the trustees in order to agree the valuation.

Para 126(6) sch 7 FA 2008 provides:

> An election under that sub-paragraph must be made in the way and form specified by the Commissioners for HMRC.

The HMRC s.87 guidance note provides:

> 89. ... HMRC have provided a form RBE1 to satisfy this requirement and all elections must be made on that form. The form asks for the name of the settlement and the date it was created. The date is used to distinguish between settlements with similar names in particular those created by settlors with a prevalent surname. The form also asks the trustees to identify if and when a trigger event has occurred. The RBE1 can be downloaded from the HMRC website[66]....
> 90. Some trustees may have made the election by writing to CAR Residency before the form was available. That election remains valid and there is no need to make a further election on the form.

51.27.3 *Time limit for election*

Para 126(2) sch 7 FA 2008 provides:

> An election under sub-para (1) may only be made on or before the first 31 January to occur after the end of the first tax year (beginning with the tax year 2008-09) in which an event within either of the following paragraphs occurs—
>
> (a) a capital payment is received (or treated as received) by a beneficiary of the settlement,[67] and the beneficiary is resident in the UK in the tax year in which it is received, and
>
> (b) the trustees transfer all or part of the settled property to the trustees of another settlement, and s.90 of TCGA 1992 applies in relation to the transfer.

The time limit is crucial. The HMRC s.87 guidance note provides:

> 83. The relief is given only to individuals, paragraph 126(7), but the time limit is triggered if a capital payment is received by any UK resident beneficiary.

"Capital payment" is not defined in sch 7. The term is of course defined in s.97 TCGA but only "for the purposes of s.86A to 97 (and sch 4C)".

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66 Accessible *http://www.hmrc.gov.uk/cnr/rbe1.pdf*.

67 Para 126 expands on this in Sch 4C cases:

> "(3) For a tax year as respects which the settlement has a Schedule 4C pool, the reference in sub-para (2)(a) above to a capital payment received (or treated as received) by a beneficiary of the settlement is to be read as a capital payment received (or treated as received) by a beneficiary of a relevant settlement from the trustees of a relevant settlement.
>
> (4) Para 8A of that Schedule (relevant settlements) applies for the purposes of sub-para (3) above."

Strictly that definition does not apply for the purposes of sch 7. It is considered however that the context shows that the usual definition is intended to be incorporated, notwithstanding the absent-minded omission of a provision to that effect. If that is right, a benefit within s.731 is not a capital payment so does not trigger the deadline for an election. It is well arguable that a benefit within the scope of OIG s.87 (which is chargeable to income tax) is not a "capital payment" for the purposes of para 126,[68] but it would be best not to rely on that point and to make the election in good time.

The HMRC s.87 guidance note provides:

> 87. An election may be made before a triggering event happens.

This is important as it is convenient and (in offshore fund cases, may be necessary) to make the election before there is any capital payment. The HMRC s.87 guidance note continues:

> There is no requirement that the beneficiary receiving the payment was a beneficiary of the settlement as at 6 April 2008. The recipient may become a beneficiary at some later time. The time limit in paragraph 126(2) of Schedule 7 runs from the time the trustees first make a capital payment to a UK resident beneficiary. If the trustees make such a payment and do not make the election they may be out of time for making the election if they make a payment to a UK-resident but non-domiciled beneficiary at a later time. The election can be made even if there are no non-UK domiciled beneficiaries when the payment is made.
>
> 88. Any election made late will be considered in accordance with the guidance in paragraph 13801 onwards in HMRC's Capital Gains Tax Manual [*recte* Capital Gains Manual].

51.28 Rebasing: The relief

Assuming an election has been made, we can move on to consider the relief. Para 126 Sch 7 FA 2008 provides:

> (7) Sub-para (8) applies if—
>
> (a) by virtue of the matching of a capital payment with the s.2(2) amount for the settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year"), chargeable gains are treated under s.87 or 89(2) of, or para 8 Schedule 4C to,

68 See 35.13.3 ("Capital payment").

TCGA 1992 as accruing to an individual in a tax year, and

(b) the individual is resident, but not domiciled, in the UK in that year.

(8) The individual is not charged to capital gains tax on so much of the chargeable gains as exceeds the relevant proportion of those gains.

EN FB 2008 provides:

64. It should be noted that para [126] does not affect the computation of the s.2(2) amount under s.87 for a year. It simply provides a mechanism for identifying an amount of the chargeable gain treated as accruing to a non-UK domiciled beneficiary that is not chargeable to tax because an element of the underlying s.2(2) amounts are attributable to the period before 6 April 2008, when non-UK domiciled beneficiaries were not chargeable to tax in respect of chargeable gains attributed to them under s.87.

65. Para [126] applies to all non-UK domiciled beneficiaries of a settlement, the trustees of which have made a valid election. The non-UK domiciled beneficiary does not need to be a remittance basis user. Only once the provisions of para [126] have been applied is it necessary to see whether the amount of tax that is left in charge is chargeable on the arising basis, in the year in which the gains are treated as having accrued to the beneficiary, or on the remittance basis where one of s.809B, [809D or 809E] applies.

66. ... Although there is only one s.87 pool for each tax year, where an election has been made under para [126](1) trustees will need to keep track of the separate elements of gains attributed to the period before and after 6 April 2008 within the pool.

67. There are no special rules to deal with assets where the market value as at 6 April 2008 was either higher or lower than both the cost of acquisition of the asset and the disposal proceeds....

81. The election has no effect on the matching of capital payments to section 2(2) amounts or the reduction of capital payments and section 2(2) amounts. It has no effect on gains accruing to UK domiciled beneficiaries.

51.28.1 *"Relevant proportion"*

Para 126(9) Sch 7 FA 2008 provides:

The relevant proportion is A ÷ B where—

A is what would be the s.2(2) amount for the settlement for the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the trustees (or the company concerned) and immediately

re-acquired by them (or it) at the market value at that time, and
B is the s.2(2) amount for the settlement for the relevant tax year.

In short, rebasing relief applies to relevant assets; A = gains after rebasing and B = the historical gain.

51.28.2 *"Relevant asset"*

Para 126(10) Sch 7 FA 2008 provides:

For the purposes of sub-para (9) an asset is a "relevant asset" if—
(a) by reason of the asset, a chargeable gain or allowable loss accrues to the trustees in the relevant tax year, and
(b) the asset has been comprised in the settlement from the beginning of 6 April 2008 until the time of the event giving rise to the chargeable gain or allowable loss.

The HMRC s.87 guidance note provides:

79. ... It is not possible to make the election only in respect of assets which have increased in value since 6 April 2008...
97. You consider only the assets whose disposal gave rise to the section 2(2) amount. Any assets held at 6 April 2008 which are not disposed of are not included in the comparison. This means that assets held at 6 April 2008 need be valued only when they are disposed of.

Para 126(11) extends rebasing relief to assets held by companies held by trusts:

For those purposes, an asset is also a "relevant asset" if—
(a) by reason of the asset, chargeable gains are treated under s.13 of TCGA 1992 as accruing to the trustees in the relevant tax year,
(b) the company to whom the chargeable gains actually accrue has owned the asset from the beginning of 6 April 2008 until the time of the event giving rise to those chargeable gains, and
(c) had the company disposed of the asset at any time in the relevant period,[69] part[70] of the chargeable gains (if any) accruing on the disposal would have been treated under s.13 of TCGA 1992 as accruing to the trustees.

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69 Para 126(12) provides: "In sub-para (11)(c) "the relevant period" means the period beginning at the beginning of 6 April 2008 and ending immediately before the event giving rise to the chargeable gains."

70 The context shows that this must mean: *all or* part...

A company's asset is not a relevant asset if a loss accrues on the disposal. But a trust asset can be a relevant asset even if a loss accrues on the disposal. It follows that one can envisage cases where the fraction A/B is greater than 1 (because an asset which gives rise to a loss on an actual disposal may be such that a gain would arise if the asset had been disposed of on 6/4/2008). However it does not matter if this is so. The relief is that:

> The individual is not charged to capital gains tax on so much of the chargeable gains as exceeds the relevant proportion of those gains.

So if the relevant proportion is greater than 1, no relief applies but the tax charge is not increased.

51.29 Rebasing - HMRC examples

EN FB 2008 provides some examples. Example 1 is relatively straightforward.

> 68. *Example 1: basic mechanism of para [126(8)(9)]*:
> The trustees of a settlement make an election under para [126](1).
> In 2009-10 the trustees dispose of a property for £10 million. The chargeable gain accruing to the trustees is £8 million.
> The chargeable gain that would have accrued to the trustees if the gain had been computed using the market value of the property as at 6 April 2008 as the cost of acquisition is £1 million.
> The trustees make a capital payment to beneficiaries X and Y of £4 million each. X and Y are both resident in the UK but X is also domiciled in the UK whereas Y is not.
> There are no unmatched capital payments or trust gains relating to earlier years.

The HMRC analysis is as follows:

> a. Match the capital payments to the s.2(2) amount for the year. Capital payments total £8 million and match to the s.2(2) amount of £8 million. Chargeable gains of £4 million are treated as accruing to X and Y for 2009-10.
> X is chargeable to CGT in 2009-10 under s.87 on the gains of £4 million.
> Y is non-UK domiciled so para [126](1) applies to determine how much of the chargeable gains of £4 million is chargeable to tax.
> b. The s.2(2) amount for 2009-10 is £8 million ("B" in para [126(9)].
> c. The s.2(2) amount that would have applied if the trustees had sold the property and reacquired it immediately before 6 April 2008 is £1 million

("A" in para [126(9)].
d. A/B is 1/8.
e. Apply A/B to the chargeable gains of £4 million accruing to Y: the amount of the gains that is chargeable to tax under para [126(8)] is £4 million/8, i.e. Y is chargeable to capital gains tax on £500,000.
If Y is a remittance basis user there will be no charge to tax until Y remits gain to the UK.
There are no surplus capital payments or trust gains for 2009-10.

Example 2 is more challenging.

69. *Example 2: matching capital payments across years and s.13 gains*
The trustees of a settlement make an election under para [126](1)]. The beneficiaries of the settlement are X, who is UK domiciled, and Y, who is not. Both X and Y are resident in the UK.
There are no unmatched trust gains or capital payments relating to earlier years.
In 2010-11 the trustees dispose of two assets:
a. the chargeable gains are £8 million: the pre 6 April 2008 gains are £7 million and the post 5 April 2008 gains are £1 million;
b. the overall loss is £5 million: the pre 6 April 2008 gain is £1 million and the post 5 April 2008 loss is £6 million.
A capital payment of £5 million is made to beneficiary Y.
In 2011-12 the trustees dispose of an asset. The chargeable gain is £5 million: the pre 6 April 2008 gain is £4 million and the post 5 April 2008 gain is £1 million.
Capital payments are made to beneficiaries X and Y of £2 million each.
In 2012-13 an underlying company within s.13 wholly owned by the trustees disposes of an asset.[71] The loss on the asset is £2 million.[72] But substituting the market value as at 6 April 2008 creates a post 5 April gain of £1 million. The trustees also dispose of an asset. The chargeable gain is £3 million: the pre 6 April 2008 gain is £2 million and the post 5 April 2008 gain is £1 million.
Capital payments are made to beneficiaries X and Y of £2 million each.

The EN sets out a table to summarise these facts which for ease of reference I set out here slightly expanded. It is easier to follow the

71 The example confusingly adds that the disposal is for £5m. But that is irrelevant, as what matters for tax is the gain or loss on the disposal, not the amount of the sale proceeds.

72 [Author's Footnote] This loss is not allowable; careful planning might have avoided that result.

example with the fuller spreadsheet which is accessible *http://www.kessler.co.uk/tfd-archive* (not set out here because it requires an A4 sheet).

	Pre 6/4/08 gain/loss	**Post 5/4/08 gain/loss**	**"A"**	**s.2(2) amount "B"**	**A/B**	**Cap p't to X**	**Cap p't to Y**
2010-11	£8m	(£5m)	£0	£3m	0	-	£5m
2011-12	£4m	£1m	£1m	£5m	1/5	£2m	£2m
2012-13	£2m	£2m	£2m(?)	£3m	2/3(?)	£2m	£2m

The HMRC analysis is as follows:

2010-11

The s.2(2) amount is £3 million. Match capital payment of £5 million against trust gains of £3 million: chargeable gains of £3 million treated as accruing to Y. But Y is not UK domiciled so para [126] applies.

Only £3 million×(A÷B) of the matched capital payment is chargeable to tax. However, the s.2(2) amount based on the market value of the assets as at 6 April 2008 is £0. Therefore A÷B is zero and none of the chargeable gains treated as accruing to Y is chargeable to tax.

2010-11: £2 million unmatched capital payments to Y.

2011-12

The s.2(2) amount is £5 million. Match capital payments of £4 million in the year against trust gains of £5 million; chargeable gains of £2 million treated as accruing to each of X and Y.

There are £1 million trust gains of 2011-12 unmatched. Step 5 of s.87A(2) applies.

Match 2011-12 £1 million trust gains to unmatched capital payments of £2 million to Y of 2010-11.

Chargeable gains of £1 million treated as accruing to Y. Unmatched capital payment to Y of 2010-11 reduced to £1 million.

X is chargeable to tax on £2 million in respect of 2012-13.

Y has chargeable gains of £3 million in respect of 2012-13. But Y is not UK domiciled so para [126] applies.

Under para [126(8)(9)]£3 million×(A÷B) of the matched capital payment is chargeable to tax.

A÷B is 1/5 so £600,000 of the chargeable gains treated as accruing to Y in 2011-12 are taxable.

£1 million unmatched capital payments to Y originating from 2010-11 to carry forward.

2012-13

The s.2(2) amount is £3 million. The disposal of the asset by the underlying company does not form part of the s.2(2) amount because only s.13 gains are brought into s.87. However, by applying the market values to the assets as at 6 April 2008 there is a gain attributable to the disposal of the asset by the company.

Match the capital payments of £4 million to the s.2(2) amount. Chargeable gains are treated as accruing to X and Y of £1.5 million each under part (b) of Step 3

of s.87A(2).
X is chargeable to tax on £1.5 million in respect of 2012-13.
Y has chargeable gains of £1.5 million in respect of 2012-13. But Y is not UK domiciled so para [126] applies.
Under para [126(8)(9)], £1.5 million×(A÷B) of the matched capital payment is chargeable to tax. A÷B is 2/3 so £1 million of the chargeable gains treated as accruing to Y in 2012-13 are taxable. While the kink in the value of the company's asset has increased the proportion of gains on which Y is chargeable to tax, Y is still better off than if no election had been made.

This assumes that the company's asset is a "relevant asset". However it is not a relevant asset, as it is not the case that "by reason of the asset, chargeable gains are treated under s.13 TCGA as accruing to the trustees in the relevant tax year." The correct figure for A/B is 1/3 and not 2/3 and the taxable gain after rebasing relief is £0.5m and not £1m.

There are £1.5m unmatched capital payments to Y to carry forward - £1m from 2010-11 and £0.5m from 2012-13.
There are £0.5m unmatched capital payments to X to carry forward all originating from 2012-13.

70. *Example 3: keeping track of pre 6 April and post 5 April gains and losses.*
The trustees of a settlement make an election under para [126](1). The beneficiaries of the settlement are X, who is UK domiciled, and Y, who is not. Both X and Y are resident in the UK. There are no unmatched trust gains or capital payments relating to earlier years.
In 2010-11 the trustees dispose of an asset. The chargeable gain is £8 million: the pre 6 April gain is £7 million and the post 5 April 2008 gain is £1 million. A capital payment of £2 million is made to each of beneficiaries X and Y.
In 2011-12 the trustees make a further capital payment to X and Y of £2 million each.

The example may be easier to follow if the facts are set out in a table:

	Pre 6/4/08 gain/loss	**Post 5/4/08 gain/loss**	**"A"**	**s.2(2) amount "B"**	**A/B**	**Cap p't to X**	**Cap p't to Y**
2010-11	£7m	£1m	£1m	£8m	1/8	£2m	£2m
2011-12	0	0	n/r	£5m	n/r	£2m	£2m

The HMRC analysis is as follows:

2010-11
The s.2(2) amount is £8 million.
Match capital payments of £4 million in the year against trust gains of £8 million: chargeable gains of £2 million treated as accruing to each of X and Y.
X is chargeable to tax on £2 million in respect of 2010-11.
Y has chargeable gains of £2 million in respect of 2010-11. But Y is not UK domiciled so para [126] applies.
Under para [126(8)(9)] £2 million×(A÷B) of the matched capital payment is

chargeable to tax.
A÷B is 1/8 so £250,000 of the chargeable gains treated as accruing to Y in 2010-11 are taxable.
The reduced s.2(2) amount for 2010-11 for the purposes of matching with future capital payments is £4m.
2011-12
There is no s.2(2) amount for the year. Apply s.87A matching rules to earlier year.
Match capital payments of £4 million in 2011-12 to s.2(2) amount (as reduced) for 2010-11 of £4m:
chargeable gains of £2 million treated as accruing to each of X and Y.
X is chargeable to tax on £2m in respect of 2011-12.
Y has chargeable gains of £2 million in respect of 2011-12. But Y is not UK domiciled so para [126] applies.
Under para [126(7)(8)] £2 million×(A÷B) of the matched capital payment is chargeable to tax.
A÷B is 0.5/4 so £250,000 of the chargeable gains treated as accruing to Y in 2011-12 are taxable.
The table below shows how the s.2(2) amount for the year and the underlying gains (or losses) relating to the period before and after 6 April 2008 are matched.

2010-11 matching of capital payments	**Pre 6 April gain/loss**	**Post 5 April gain/loss**	**Total trust gains (section 2(2) amount)**
2010-2011	£7m	£1m	£8m
Less matched to capital payment in 2010-11	£3.5m	£500,000	£4m
Unmatched in 2010-11	£3.5m	£500,000	£4m
Less matched to capital payments in 2011-12	£3.5m	£500,000	£4m
Unmatched in 2011-12	£0	£0	£0

The HMRC s.87 guidance note provides:

Example 22: Rebasing: basic operation: paragraph 126 of Schedule 7
Settlement X is a non-UK resident settlement created in September 2000. The trust fund consists of a number of quoted investments. Some of these have been held since September 2000. Others have been acquired since 6 April 2008. The settlement has two UK resident beneficiaries. A is domiciled in the UK. B is not domiciled in the UK.
As at 6 April 2008 there are no unmatched capital payments and section 2(2) amounts.
2008-09
In 2008-09 a section 2(2) amount of £180,000 accrues to the trustees and capital payments of £50,000 are made to A and B. The capital payments are matched to the section 2(2) amount as shown below.

	2008-09	**Matched**	c/f
Section 2(2) amount	£180,000	£100,000	£80,000
Capital payments A	£50,000	£50,000	nil

Capital payments B	£50,000	£50,000	nil

A chargeable gain of £50,000 accrues to each beneficiary. Beneficiary A is liable to Capital Gains Tax on the full amount of £50,000. The trustees make a valid election under paragraph 126(1) of Schedule 7 before 31 January 2010. The effect of the election is to reduce the gains chargeable on beneficiary B in accordance with paragraph 126(8) of Schedule 7.

You calculate the section 2(2) amount that the trustees would have made if the gain were calculated by reference to the 6 April 2008 value of assets held at that date and included in the disposal.

	Held 6/4/08	**Acquired after 6/4/08**	**Total**
Disposal Proceeds	£180,000	£170,000	£350,000
Acquisition cost	– £10,000	– £160,000	– £170,000
Gain	£170,000	£10,000	£180,000

Disposal Proceeds	£180,000
6/4/08 value	– £165,000
Gain	£15,000

Relevant proportion of s87 gain £50,000 =

$$£50{,}000 \times \frac{15{,}000 + 10{,}000}{180{,}000} = £6944$$

Beneficiary B is liable to Capital Gains Tax on £6944 of the £50,000 capital payment. If beneficiary B is a remittance basis user the gain will be taxed only when the gain is remitted to the UK.

2009-10

The trustees dispose of assets creating a £20,000 section 2(2) amount. They make capital payments of £15,000 to each beneficiary. £10,000 of each capital payment is matched to the 2009-10 section 2(2) amount. Section 87 gains of £10,000 accrue to each beneficiary in respect of the 2009-10 section 2(2) amount. The £5,000 balance of each capital payment is matched to the £80,000 2008-09 section 2(2) amount. Section 87 gains of £5,000 accrue to each beneficiary in respect of the 2008-09 section 2(2) amount giving total chargeable gains of £15,000 for 2009-10 for each beneficiary. The capital payments for that year are reduced to nil. The section 2(2) amount for 2008-09 is reduced to £70,000.

	Amount/payment	**Matched**	**Year**	**c/f**
2009-10 s.2(2) amount	£20,000	£20,000	2009-10	Nil
Capital payments A	£15,000	£10,000	2009-10	Nil
		£5,000	2008-09	
Capital payments B	£15,000	£10,000	2009-10	Nil
		£5,000	2008-09	
2008-09 s.2(2) amount	£80,000	£10,000	2009-10	£70,000

Beneficiary A will be liable to Capital Gains Tax on the full £15,000 section 87 gain. Beneficiary B's liability will be reduced in accordance with paragraph 126(8) of Schedule 7. This has to be calculated separately for the £10,000 payment matched to the 2009-10 amount and the £5,000 payment matched to the

2008-09 amount.
For 2009-10 the figures are:

	Held 6/4/08	**Acquired after 6/4/08**	**Total**
Disposal proceeds	£70,000	£100,000	£170,000
Acquisition cost	– £65,000	– £85,000	– £150,000
Gain	£5,000	£15,000	£20,000

Disposal proceeds	£70,000
6/4/08 value	£80,000
Loss	(£5,000)

The section 2(2) amount calculated using 6 April 2008 values is £10,000 ie £15,000 – £5,000. The relevant proportion of the £10,000 section 87 gain is:
£10,000 × 10,000 / 20,000 = £5,000
The Capital Gains Tax liability on the £5,000 section 87 gain relating to the 2008-09 section 2(2) amount is limited to:
£5,000 × 25,000 / 180,000 = £694
B's total liability to Capital Gains Tax in 2009-10 is on gains of £5,694 (£5,000 + £694). If beneficiary B is a remittance basis user the gain will be taxed only when the gain is remitted to the UK.

Example 23: Rebasing: relevant proportion is 0: para 126 of Schedule 7
The facts are the same as that in example 22 year 2009-10 except for the 6 April 2008 value of the assets sold. This is £120,000.
The calculation is now:

	Held 6/4/08	**Acquired after 6/4/08**	**Total**
Gain	**£5,000**	**£15,000**	**£20,000**

Disposal proceeds	£70,000
6/4/08 value	– £120,000
Loss	£50,000

The section 2(2) amount calculated using 6 April 2008 values is £15,000 - £50,000. This is restricted to 0 as a section 2(2) amount cannot be negative. Beneficiary B is not liable to Capital Gains Tax on any of the £10,000 2009-10 gain ie £10,000 × 0 = 0. B remains liable to Capital Gains Tax on the section 87 gain matched to the 2008-09 section 2(2) amount. As in example 22 this is £694. B's capital payments for 2009-10 are still reduced to nil.

51.30 Rebasing: Minor rules

51.30.1 *Asset derived from another asset*

Para 126(13) Sch 7 FA 2008 extends the relief where one asset is derived from another asset; this will not be very common. It must be read with s.43 TCGA in order to follow the sense:

> If and so far as, in a case where assets have been merged or divided or

have changed their nature or rights or interests in or over assets have been created or extinguished, the value of an asset is derived from any other asset in the same ownership, an appropriate proportion of the sums allowable as a deduction in the computation of a gain in respect of the other asset under paragraphs (a) and (b) of section 38(1) shall, both for the purpose of the computation of a gain accruing on the disposal of the first-mentioned asset and, if the other asset remains in existence, on a disposal of that other asset, be attributed to the first-mentioned asset.

If a case where s.43 applies, one turns to para 126(13):

If—

(a) by reason of an asset which would not otherwise be a relevant asset ("the new asset"), chargeable gains or allowable losses accrue, or are treated under s.13 as accruing, to the trustees in the relevant tax year,

(b) the value of the new asset derives wholly or in part from another asset ("the original asset"), and

(c) s.43 of TCGA 1992 applies in relation to the calculation of the chargeable gains or allowable losses,

the new asset (or part of that asset) is a "relevant asset" if the condition in sub-para (10)(b) or the conditions in sub-para (11)(b) and (c) would be met were the references there to the asset to be read as references to the new asset or the original asset.

51.30.2 *Inter-group transfer*

Para 126(14)(15) Sch 7 FA 2008 extends rebasing relief where there is an inter-group transfer:

(14) If—

(a) on or after 6 April 2008, a company ("company A") disposes of an asset to another company ("company B"), and

(b) s.171 of TCGA (transfers within groups) (as applied by s.14(2) of that Act) applies in relation to the disposal,

for the purposes of sub-para (11) (and this sub-paragraph) treat company B as having owned the asset throughout the period when company A owned it.

(15) If an asset is a relevant asset by virtue of sub-para (14), for the purposes of sub-para (9)—

(a) treat the chargeable gains as having accrued to the company which owned the asset at the beginning of 6 April 2008, and

(b) treat the proportion of those chargeable gains attributable under s.13 of TCGA 1992 to the trustees as being the

proportion of the chargeable gains actually accruing that are so attributable.

Para 126(16) to (18) deals with the situation where an asset is held by a company, and the trustees have held different interests in the company at different times:

(16) If—
(a) an asset would otherwise be a "relevant asset" within sub-para (11), and
(b) the proportion of chargeable gains treated under s.13 of TCGA 1992 as accruing to the trustees by reason of the asset ("the relevant proportion") is greater than the minimum proportion,
for the purposes of sub-para (9) treat the appropriate proportion of the asset as a relevant asset and the rest of the asset as if it were not a relevant asset.
(17) "The minimum proportion" is the smallest proportion of chargeable gains (if any) that would have been attributable to the trustees on a disposal of the asset at any time in the relevant period (as defined by sub-para (12)).
(18) "The appropriate proportion" is the minimum proportion divided by the relevant proportion.

This does not work. Suppose for example a trust held 50% of the shares in a non resident company, T Ltd before 2008, and later acquired all the shares. T Ltd realises a gain of £100 on an asset (the company's asset) held before 2008. The gain is deemed to accrue to the trust under s.13. The terms of subpara 16 are met:

(a) the company's asset would otherwise be a "relevant asset" within sub-para (11), and
(b) the proportion of chargeable gains treated under s.13 of TCGA 1992 as accruing to the trustees by reason of the asset ("the relevant proportion" - 100%) is greater than the minimum proportion (which under the definition in 126(17) is 50%.

So subpara 16 directs:

for the purposes of sub-para (9) treat the appropriate proportion of the asset as a relevant asset and the rest of the asset as if it were not a relevant asset.

We need to ascertain the appropriate proportion. That is one half divided

by the relevant proportion. So we need to know the relevant proportion. That is:

> A÷B where—
> A is what would be the s.2(2) amount for the settlement for the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the trustees (or the company concerned) and immediately re-acquired by them (or it) at the market value at that time, and
> B is the s.2(2) amount for the settlement for the relevant tax year.

B is £100. In order to work out A we need to know what is the relevant asset, but we do not know what is a relevant asset until we have applied subpara 16. Presumably we are to ignore the subpara 16 reduction, in which case the company asset is the relevant asset. Assume that the company asset was worth £50 on 6 April 2008, so the relevant proportion is one half. Then the appropriate proportion is one half divided by one half, = one. I suspect that the drafter has confused "divided" with "multiplied". What a shambles! Fortunately the problem may not often arise.

51.31 Rebasing: OIG amounts

Paragraph 101 Sch 7 FA 2008 provides equivalent rebasing relief for OIGs:

> (1) This paragraph applies if—
> (a) the trustees of a settlement have made an election under paragraph 126(1) (re-basing election),
> (b) income is treated under regulation 17 of the Offshore Funds (Tax) Regulations 2009 (S.I. 2009/3001) as arising to an individual in the tax year 2008–09 or any subsequent tax year ("the relevant tax year") by reason of the matching, under section 87A of TCGA 1992 as applied by regulation 20 of those Regulations, of an OIG amount with a capital payment received by the individual from the trustees, and
> (c) the individual is resident or ordinarily resident, but not domiciled, in the UK in the relevant tax year.
> (2) The individual is not charged to income tax on so much of the income as exceeds the relevant proportion of that income.
> (3) Sub-paragraphs (9) to (18) of paragraph 126 (meaning of "the relevant proportion") apply for the purposes of sub-paragraph (2) above as if—
> (a) references to section 2(2) amounts were to OIG amounts,

(b) references to chargeable gains were to offshore income gains,
(c) references to allowable losses were omitted, and
(d) references to anything accruing were to it arising (and similar references were read accordingly).

Amended as para 101(3) requires, para 126(9) to (13) provide:

(9) The relevant proportion is A÷B where—

A is what would be the ~~section 2(2) amount~~ OIG amount for the settlement for the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the trustees (or the company concerned) and immediately re-acquired by them (or it) at the market value at that time, and

B is the ~~section 2(2) amount~~ OIG amount for the settlement for the relevant tax year.

(10) For the purposes of sub-paragraph (9) an asset is a "relevant asset" if—

(a) by reason of the asset, ~~a chargeable gain or allowable loss accrues~~ an offshore income gain arises to the trustees in the relevant tax year, and
(b) the asset has been comprised in the settlement from the beginning of 6 April 2008 until the time of the event giving rise to the chargeable gain or allowable loss.

(11) For those purposes, an asset is also a "relevant asset" if—

(a) by reason of the asset, ~~chargeable gains~~ offshore income gains are treated under section 13 of TCGA 1992 as ~~accruing~~ arising to the trustees in the relevant tax year,
(b) the company to whom the ~~chargeable gains~~ offshore income gains actually accrue has owned the asset from the beginning of 6 April 2008 until the time of the event giving rise to those ~~chargeable gains~~ offshore income gains, and
(c) had the company disposed of the asset at any time in the relevant period, part of the ~~chargeable gains~~ offshore income gains (if any) accruing on the disposal would have been treated under section 13 of TCGA 1992 as ~~accruing~~ arising to the trustees.

(12) In sub-paragraph (11)(c) "the relevant period" means the period beginning at the beginning of 6 April 2008 and ending immediately before the event giving rise to the ~~chargeable gains~~ offshore income gains.

(It is not necessary to set out the rest of para 126, as amended).

51.32 Rebasing: transfers between trusts

Para 127(1) Schedule 7 FA 2008 provides:

> This paragraph applies if—
>
> (a) in the tax year 2008-09 or any subsequent tax year, the trustees of a settlement ("the transferor settlement") transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement"),
>
> (b) s.90 of TCGA 1992 applies in relation to the transfer,
>
> (c) the trustees of the transferor settlement have made an election under para 126(1),
>
> (d) by virtue of the matching of a capital payment with the s.2(2) amount for the transferee settlement for the tax year 2008-09 or any subsequent tax year ("the relevant tax year"), chargeable gains are treated under s.87 or 89(2) of, or para 8 of Schedule 4C to, TCGA 1992 as accruing to an individual in a tax year, and
>
> (e) the individual is resident, but not domiciled, in the UK in that year.

51.32.1 *Transferee trust makes rebasing election*

Para 127(2) Sch 7 FA 2008 provides:

> If the trustees of the transferee settlement have made an election under para 126(1), para 126(7) to (9) have effect in relation to the transferee settlement for that year as if the reference in para 126(9) to relevant assets included relevant assets within the meaning of this paragraph.

51.32.2 *Transferee trust does not make rebasing election*

Para 127 Sch 7 FA 2008 provides:

> (3) If the trustees of the transferee settlement have not made an election under para 126(1), the individual is not charged to capital gains tax on so much of the chargeable gains mentioned in sub-para (1)(d) above as exceeds the relevant proportion of those gains.
>
> (4) The relevant proportion is A ÷ B where—
>
> A is what would be the s.2(2) amount for the transferee settlement for the relevant tax year, if immediately before 6 April 2008 every relevant asset had been sold by the company concerned and immediately re-acquired by it at the market value at that time, and
>
> B is the s.2(2) amount for the transferee settlement for the relevant tax year.

(5) For the purposes of this paragraph an asset is a "relevant asset" if—

(a) by reason of the asset, chargeable gains are treated under s.13 of TCGA 1992 as accruing to the trustees of the transferee settlement in the relevant tax year,

(b) the company to whom the chargeable gains actually accrue has owned the asset from the beginning of 6 April 2008 until the time of the event giving rise to those chargeable gains,

(c) had the company disposed of the asset at any time in the relevant period, part of the chargeable gains (if any) accruing on the disposal would have been treated under s.13 of TCGA 1992 as accruing to—

(i) the trustees of the transferor settlement (if the disposal had been made before the transfer), or

(ii) the trustees of the transferee settlement (if it had not).

(6) In sub-para (5)(c) "the relevant period" means the period beginning at the beginning of 6 April 2008 and ending immediately before the event giving rise to the chargeable gains.

(7) Sub-paras (13) to (18) of para 126 apply for the purposes of this paragraph (with such modifications as are necessary) as they apply for the purposes of that paragraph.

January 2009 Qs & As provides:

Q7 In applying the allocation rules to transfers between settlements, the transferor trust gains carried across will be treated as having accrued to the transferee trust in the year in which they in fact accrued to the transferor trust. Those gains that have been matched with capital payments out of transferor trust in the year of transfer or previous years will be left out of account. Gains carried across will be allocated to a capital payment from the transferee trust on a 'last in first out' (LIFO) basis. Gains on such assets will be governed by whether or not the transferor trust has made a rebasing election under paragraph 126 sch 7 FA 2008.

If the transferor settlement has made a rebasing election by the time of the transfer of the transferee settlement, then pre and post April 2008 gains which are deemed to have accrued on the actual disposal of an asset go across *pro rata*.

If the transferor settlement has not made a rebasing election by the 31 January following the year of the transfer, then even if no capital payment has yet been made, the right to rebase is lost in relation to the transferred assets and any assets retained in the transferor trust.

However, it should be noted that any transfers between settlements made prior to 6 April 2008 will not trigger a time limit on rebasing and

any assets moving over to the transferee settlement as a result of a transfer made prior to 6 April 2008 will not be affected by any subsequent election for rebasing made by the transferor trust. If the asset appointed over to the transferee settlement before 6 April 2008 includes shares in a company within s.13 TCGA 1992, then the transferee settlement may wish to elect for rebasing in its own right. An election made by the transferee settlement may cover gains made by such a company – see para 127 Sch 7 FA 2008. Transferee settlements which receive property on or after 6 April 2008 cannot elect for rebasing in relation to the transferred assets – the decision is solely that of the transferor settlement.

The HMRC s.87 guidance note provides:

Rebasing and transfers between settlements

110. A rebasing election made by the transferor settlement can cover gains made by that settlement after 5 April 2008 even if they are not brought into charge until they are matched with capital payments made by the transferee settlement. Transferee settlements receiving property on or after 6 April 2008 cannot elect for rebasing in relation to the transferred assets – the decision is solely that of the transferor settlement. See example 26.

111. An election made by the transferee settlement can cover gains made by that settlement after 5 April 2008 including those on assets received, prior to 6 April 2008, from another settlement.

Example 26 – Paragraph 126 of Schedule 7 – Effect of 'rebasing election' made by transferor settlement on gains made by transferor settlement treated as accruing when matched with capital payments made by transferee settlement

All the settled property of the transferor settlement is transferred to the transferee settlement for nil consideration in 2009-10. No capital payments have been made out of the transferor settlement. The transferor settlement had no gains made by the trustees prior to the transfer.

Gains arise on the transfer of £100,000. These are on the disposal of an asset which had been held by the trustees since 2001. The post 5 April 2008 element of the gain is £15,000 based on the difference between the value at 6 April 2008 and the value at the time it is transferred.

The transferee settlement has no unmatched section 2(2) amounts of its own. Its only unmatched section 2(2) amount is the £100,000 for 2009-10 it is treated as receiving on the transfer.

In 2010-11 the transferee settlement makes a capital payment of £300,000 to a UK resident but non-UK domiciled beneficiary. Under section 87 £100,000 of the capital payment is matched with the section 2(2) amount and a £100,000 chargeable gain is treated as accruing to the beneficiary.

If a valid election under paragraph 126 Schedule 7 has been made by the trustees of the transferor settlement then only the post 5 April 2008 element of the gain (£15,000) is chargeable to tax on the beneficiary. And that is subject to the

remittance basis if the beneficiary is a remittance basis user.

If no valid election has been made by the trustees of the transferor settlement then the full £100,000 is chargeable to tax on the beneficiary. Again this is subject to the remittance basis if the beneficiary is a remittance basis user.

An election made by the trustees of the transferee settlement has no effect on this gain.

Rebasing and transfers between settlements owning non-UK resident companies: paragraph 127 of Schedule 7

The transfer of settled property between settlements does not result in a disposal of the assets held in the underlying non-UK resident company. Where the transfer takes place after 5 April 2008 a disposal may subsequently be made by the underlying company of assets it acquired prior to 6 April 2008. In such a case the rules in paragraph 126 do not apply to any gains made by the underlying company as it has not been part of the transferee settlement structure since 5 April 2008 – paragraph 126(11)(c)

There are special rules in paragraph 127 to give 'rebasing election' relief in such cases.

113. For any relief to be available the trustees of the transferor settlement must have made a 'rebasing election'. How any relief is calculated depends on whether, or not, the trustees of the transferee settlement have also made a 'rebasing election'.

114. If the trustees of the transferee settlement have made a rebasing election then the assets disposed of by the underlying company are treated in the same way as any assets the transferee settlement has owned from before 6 April 2008 – paragraph 127(2).

115. If the trustees of the transferee settlement have not made a rebasing election then you have to calculate a fraction 'A/B' called the 'relevant proportion' where (A) is defined as the section 2(2) amount for the transferee settlement for the year a gain is treated as accruing to the non-UK domiciled beneficiary on the assumption the underlying company had sold and immediately re-acquired all its relevant assets at market value immediately before 6 April 2008, divided by (B) is defined as the actual section 2(2) amount for the transferee settlement for the relevant tax year

116. The non-UK domiciled beneficiary is not charged to tax on so much of the gains treated as accruing to him that exceeds the 'relevant proportion' of those gains – paragraph 127(3) & (4). See example 27.

Example 27 – Paragraph 127 of Schedule 7 – Effect of 'rebasing election' made by transferor settlement on gains made by underlying non-UK resident close company after company has been transferred to another settlement

All the settled property of the transferor settlement is transferred to the transferee settlement for nil consideration in 2009-10. No capital payments have been made out of the transferor settlement. The transferor settlement had no gains made by the trustees prior to the transfer.

The transferor settlement's only assets at the time of transfer are shares in a wholly owned non-UK resident company which it has owned since 2001. A gain arises on the transfer of £100,000. The post 5 April 2008 element of the gain is

£15,000 based on the difference between the value at 6 April 2008 and the value at the time it is transferred.

The underlying non-UK resident company continues to own an asset which it acquired in 2002. That asset is sold in 2011-12 and produces an overall gain of £150,000. The post 5 April 2008 element of the gain is £20,000 based on the difference between the value at 6 April 2008 and the value at the time of its disposal.

The transferee settlement has no unmatched section 2(2) amounts of its own. Its only unmatched section 2(2) amount is the £100,000 for 2009-10 it is treated as receiving on the transfer.

In 2011-12 the transferee settlement makes a capital payment of £250,000 to a UK resident but non-UK domiciled beneficiary. Under section 87 £150,000 of the capital payment is matched with the £150,000 gain made by the underlying non-UK resident company in 2011-12. A £150,000 chargeable gain is treated as accruing to the beneficiary in 2011-12.

Under section 87 a further £100,000 of the capital payment is matched with the section 2(2) amount for 2009-10 and a £100,000 chargeable gain is treated as accruing to the beneficiary in 2011-12.

If no valid election has been made by the trustees of the transferor settlement then the full amount of the gains (£150,000 and £100,000 respectively) are chargeable to tax on the beneficiary in 2011-12. This is subject to the remittance basis if the beneficiary is a remittance basis user. The tax due on the gain relating to the 2009-10 section 2(2) amount will be increased by section 91.

If a valid election under paragraph 126 of Schedule 7 has been made by the trustees of both settlements only the post 5 April 2008 element of both of the gains (£20,000 for the 2011-12 section 2(2) amount and £15,000 for the 2009-10 section 2(2) amount) are chargeable to tax on the beneficiary in 2011-12. This is subject to the remittance basis if the beneficiary is a remittance basis user. The time limit for making the election is 31 January 2011 for the transferor settlement and 31 January 2013 for the trustees of the transferee settlement. The tax due on the gain relating to the 2009-10 section 2(2) amount will be increased by section 91.

If a valid election has been made by the trustees of the transferor settlement but not the trustees of the transferee settlement the formula in paragraph 127(4) applies to determine the relevant proportion of the gain on which the beneficiary is taxed. Suppose the facts are the same as the example but there is further section 2(2) amount for 2011-12 when the trustees dispose of an asset they have held since before 6 April 2008. The gain on this asset is £80,000. £80,000 of the capital payment made in 2011-12 is matched against this section 2(2) amount. The total amount matched against the 2011-12 section 2(2) amount is £230,000 leaving only £20,000 to be matched against the 2009-10 section 2(2) amount.

A in the formula in paragraph 127(4) is the transferee settlement's section 2(2) amount for 2011-12 if all the relevant assets had been sold and reacquired at their value immediately before 6 April 2008. These are the assets in the underlying company. This part of the section 2(2) amount is £20,000 to which you have to add the £80,000.

B in paragraph 127(4) is the full section 2(2) amount of the transferee settlement

for 2011-12 of £230,000 (£150,000 + £80,000).
The UK resident but non-UK domiciled beneficiary is charged on £230,000 × £100,000/£230,000 = £100,000 of the gains matched to the 2011-12 section 2(2) amount. The gain on the payments matched against the section 2(2) amount on the transfer in 2009-10 is covered by the paragraph 126 election made the trustees of the transferor settlement. The amount of that gain charged to Capital Gains Tax on the UK resident but non-UK domiciled beneficiary is limited to £3000 (£20,000 × 15,000/100,000). The total gains chargeable in 2011-12 are £103,000. This is subject to the remittance basis if the beneficiary is a remittance basis user. The tax due on the gain relating to the 2009-10 section 2(2) amount will be increased by section 91.

51.32.3 *Transfer between trusts: OIG amounts*

Para 102 Sch 7 FA 2008 provides equivalent rules for OIG amounts:

(1) This paragraph applies if—
- (a) in the tax year 2008–09 or any subsequent tax year, the trustees of a settlement ("the transferor settlement") transfer all or part of the settled property to the trustees of another settlement ("the transferee settlement"),
- (b) section 90 of TCGA 1992 applies in relation to the transfer,
- (c) the trustees of the transferor settlement have made an election under paragraph 126(1),
- (d) by virtue of the matching (under section 87A of TCGA 1992 as applied by regulation 20 of the Offshore Funds (Tax) Regulations 2009 (S.I. 2009/3001)) of a capital payment with an OIG amount of the transferee settlement, income is treated under such regulations (regulation 17 of those Regulations [)] as arising to an individual in a tax year ("the relevant tax year"), and
- (e) the individual is resident or ordinarily resident, but not domiciled, in the UK in the relevant tax year.

(2) If paragraph 101 applies in relation to the transferee settlement, paragraph 126(9) as applied by paragraph 101(3) has effect as if the reference there to relevant assets included relevant assets within the meaning of paragraph 127(4) (as modified by sub-paragraph (4)(b) below).
(3) If paragraph 101 does not apply in relation to the transferee settlement, the individual is not charged to income tax on so much of the income mentioned in sub-paragraph (1)(d) above as exceeds the relevant proportion of that income.
(4) Sub-paragraphs (4) to (7) of paragraph 127 (meaning of "the relevant proportion") apply for the purposes of sub-paragraph (3) above

as if—

(a) references section 2(2) amounts were to OIG amounts,

(b) references to chargeable gains were to offshore income gains, and

(c) references to anything accruing were to it arising.

51.33 CGT planning aspects of non-resident trusts

When are non-resident trusts advantageous for CGT?

One situation is to maximise use of losses: losses of remittance basis taxpayers are generally unallowable, but losses of non-resident trusts can be set against s.2(2) amounts (trust gains). However no-one *plans* to realise losses so that is not generally a planning point.

51.33.1 *Where capital payment basis better than arising basis*

Non-resident trusts are in principle better than ownership of UK situate property by UK resident foreign domiciled individuals directly (or through a non-resident company), whether or not the individuals claim the remittance basis.

That is, suppose a trust holds:

(1) UK situate property; or

(2) a company within s.13 TCGA which holds UK situate property.

If the trust property is held by the settlor directly, gains on the UK situate property are chargeable on an arising basis; if the same property is held on a trust, the gains are taxable on a capital payments basis.

For foreign domiciled individuals who do not claim the remittance basis, similar points apply regardless of the situs of the trust property. That is, where an individual does not wish to pay the remittance basis charge, it may be worthwhile setting up a non-resident trust to ensure that gains are taxed on a s.87 capital payment basis and not on the arising basis.

51.33.2 *Where capital payment basis better than remittance basis*

Non-resident trusts may be better than absolute ownership of foreign situate property by remittance basis taxpayers as they may avoid the application of the mixed fund rule.

Example 1 (trust better than absolute ownership)

Suppose a foreign situate asset is acquired for £1m, sold for £2m, giving a gain of £1m. If the asset is held by a remittance basis taxpayer (T) who remits £1m, there is a CGT charge on £1m as the remitted sum is all gain. By contrast, suppose:

(1) the asset is held in a non-resident trust.
(2) the trust makes a capital payment of £1m to T offshore.
(3) in the following year, the trust makes a capital payment of £1m to T onshore.

The offshore payment has reduced the s.2(2) amount to nil, so the second payment is free of CGT.

However to take advantage of this requires careful timing of gains and payments that is often not practical. Often, the remittance basis will be better than the capital payments basis.

Example 2 (trust worse than absolute ownership)
Suppose 3 foreign situate assets are each acquired for £1m, sold for £2m, giving a gain of £1m each. If the assets are held by a remittance basis taxpayer (T) who remits the £2m proceeds of one of the assets, there is a CGT charge on £1m only. (Assume the proceeds are not paid into a singe account, ie are not mixed.)

By contrast, suppose:
(1) the assets are held in a non-resident trust.
(2) the trust makes a capital payment of £2m in the UK.

There is then a CGT charge on £2m.
The solution may be to have three separate trusts, one for each asset.

51.33.3 *Where non-resident trusts not desirable*

Non-resident trusts are not desirable where the settlor is non-UK resident, since trust gains are s.2(2) amounts and gains accruing to the settlor are in principle CGT free.

51.33.4 *Should trustees hold assets through an underlying company?*

Trustees may hold trust assets directly or through a wholly owned non-resident company (here called **"an underlying company"**). Which is better?

For CGT an underlying company has no CGT advantage and some disadvantages as there may be a double CGT charge:
(1) Gains accruing to the company may be attributed to the trustees under s.13[73] and so constitute s.2(2) amounts.
(2) In addition, there may be a further charge on extraction of the assets from the company:

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73 See 53.1 (Gains of non-resident companies). But the motive defence may apply.

(a) a chargeable gain the offshore trustees dispose of the company's shares and so further s.2(2) amounts; or
(b) income tax on a distribution by way of dividend.

There is normally no relief for that double charge.[74]

Losses of the underlying company are restricted and easily lost altogether. If the property is a residence, CGT private residence relief is lost by use of a company.[75]

So an underlying company should not be used unless there is some good reason (which might be IT or IHT or some other reason.)[76] If the trustees need limited liability, a limited partnership (which is transparent for CGT) is an alternative which avoids the CGT problems.

51.34 Four basic strategies for the s.87 regime

In outline the position is as follows:

51.34.1 *Indefinite deferral*

Beneficiaries are only liable to the s.87 charge if they receive a capital payment. But there may be no need for a capital payment to be made. Instead, the capital of the trust fund may be retained. The beneficiaries of the settlement would enjoy a trust fund unreduced by the burden of CGT. In this way the charge may be postponed until further tax planning becomes possible – or indefinitely.

51.34.2 *Non-resident beneficiary*

Section 2(2) amounts are treated as chargeable gains accruing to a beneficiary who receives capital payments. But a beneficiary who is not resident in the UK is not subject to CGT on those gains. Such a beneficiary may therefore receive capital payments from the trust tax free, just as they can realise capital gains of their own without incurring any tax charge. The temporary non-residence rules need to be considered, see 9.1 (Temporary non-residence).

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74 There are some reliefs: see 53.23 (Company distribution relief). However these only help the person who pays tax under s.13, so would only be relevant to a settlor-interested trust within s.86.

75 See 53.31 (Private residence relief).

76 See too 32.31 (Transfer from non-resident trust to underlying company).

51.34.3 *Mixed UK and foreign beneficiaries: Simple capital payments*

Section 2(2) amounts which have been matched with a capital payment to a beneficiary in an earlier tax year cease to be available for the purpose of the s.87 charge in the following year. This principle applies whether or not the beneficiary was subject to the s.87 charge. Suppose that s.2(2) amounts are matched with capital payments to a non-resident beneficiary and the capital payments equal the total s.2(2) amounts. Those s.2(2) amounts are sometimes said to have been "washed". In subsequent tax years these are not taken into account and a capital payment may be made to a UK beneficiary without incurring any tax charge under s.87. Careful timing is essential. The payment to the exempt beneficiary must be made in one tax year and the payment to a UK beneficiary must be postponed until the following tax year. Section 2(2) amounts accruing in a subsequent tax year may be taxed on the UK beneficiary.

51.34.4 *Mixed UK and foreign beneficiaries: Capital payment/resettlement*

If one or more of the beneficiaries of the settlement are not UK resident, the trustees might consider advancing trust capital to those beneficiaries absolutely. The beneficiaries might then independently resettle the property and may gain additional inheritance tax advantages. The CGT position would be substantially improved for the other beneficiaries by washing s.2(2) amounts equal to the advancement. But successfully implementing arrangements of this kind is easier said than done. See 80.36 (Planning to create trust with foreign domiciled settlor).

51.35 GAAR guidance

The GAAR guidance provides two s.87 examples.

51.35.1 ***Carefully timed capital payments***

The first example is straightforward timing planning, which no practitioner would have thought was within the GAAR:

D20 Offshore trust and washing out gains - example 1
This example illustrates that where the legislation sets precise boundaries the GAAR will not be in point where taxpayers satisfy the statutory conditions.
D20.2 The arrangements
D20.2.1 A trust resident outside the UK was set up by a now deceased foreign

domiciled settlor.[77] The trust is worth £4m, has a pool of trust gains of £2.5m and no accumulated income or offshore income gains. There are no Sch 4C gains.

D20.2.2 There are four beneficiaries, two of whom are resident and domiciled in the UK and two of whom live permanently outside the UK. The trustees have made no capital distributions in recent years and it has been decided to end the trust. The trustees have three options and the taxpayer's analysis on each is as follows:

- **Option 1** - End the trust in Year 1 paying £1m to each beneficiary. The UK resident beneficiaries will each pay UK tax on one quarter of the trust gains i.e. £625,000, at the appropriate rate, since the gains are allocated pro rata to the beneficiaries. The non-resident beneficiaries will pay no UK tax although half the trust gains are allocated to them.
- **Option 2** - Pay the UK resident beneficiaries £2m in Year 1 and the non-resident beneficiaries £2m in Year 2. The UK resident beneficiaries will each pay UK tax on £1m of gains since all the gains are allocated to them on a LIFO basis. The non-UK resident beneficiaries pay no UK tax and no gains are allocated to them.
- **Option 3** - Pay the non-UK resident beneficiaries £2m in Year 1 and the UK resident beneficiaries £2m in Year 2. The non-UK resident beneficiaries pay no UK tax but the pool of trust gains that can be allocated to payments in the following year is reduced to £500,000. £2m of gains have been "washed out". The UK resident beneficiaries each pay capital gains tax on £250,000.

D20.2.3 The trustees therefore choose option 3 resulting in the least amount of tax for the beneficiaries. The UK resident beneficiaries receive their payment later but with less tax payable.

D20.4 The taxpayer's tax analysis

D20.4.1 The taxpayer's analysis is as set out above. The taxpayer contends that LIFO should be applied.

D20.5 What is the GAAR analysis under [s.207(2) FA 2013]?

D20.6 *Are the substantive results of the arrangements consistent with any principles on which the relevant tax provisions are based (whether expressed or implied) and the policy objectives of those provisions?*

The trustees are entitled to organise distributions in a way that minimises tax for the beneficiaries within the range of normal tax planning.

In relation to option 3 the substantive results of the transactions are consistent with the principles on which the relevant provisions are based. The trustees have three different ways of achieving the same result viz to end the trust and

77 The example kills off the settlor in order to avoid complications of s.86, and, perhaps, to establish the genuineness or long term nature of the trust.

distribute property equally to the beneficiaries. They are not compelled to choose the one that raises the most tax or the "middle" option. Provided the payments to the non-resident beneficiaries in Year 1 are genuinely intended to benefit them (and the cash will not simply be passed back to the UK residents later) HMRC would not seek to invoke the GAAR.[78] It is clear that the policy of the capital gains tax legislation in relation to capital payments to beneficiaries is to operate a LIFO policy and in some cases this will result in greater tax on UK residents and in some cases less.

D20.6.1 *Do the means of achieving the substantive tax results involve one or more contrived or abnormal steps?*

Delaying payment to UK resident beneficiaries by a year might be regarded as an abnormal step but as this is the specific effect of the legislation it is not regarded as abnormal in the context of achieving the substantive tax results.

D20.6.2 *Are the arrangements intended to exploit any shortcomings in the relevant tax provisions?*

The anomalies that may arise under the LIFO rules are not seen as shortcomings in themselves but just a necessary result of having a system that allocates gains to capital payments in a certain order.

D20.6.3 *Do the tax arrangements accord with established practice and has HMRC indicated its acceptance of that practice?*

The arrangements accord with established practice and HMRC has indicated acceptance of the practice.[79]

D20.7 Conclusion

D20.7.1 This is not regarded as an abusive tax arrangement and HMRC would not seek to invoke the GAAR.[80]

51.35.2 *Self-cancelling capital payment*

The second GAAR example is an artificial scheme which would also fail on traditional *Furniss v Dawson* grounds of circular arrangement/inserted step:

D21 Offshore trusts and washing out gains - Example 2

This example illustrates that the inclusion of abnormal steps may cause the arrangement to become abusive in its own context.

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78 An arrangement under which the benefits will be passed from the non-resident beneficiaries to the UK resident beneficiaries is caught without invoking the GAAR: see 51.7.1 (Indirect receipt from trustees).

79 The author is not aware of any publication where HMRC have formally accepted the practice. But it does not matter.

80 HMRC GAAR Guidance Part D (Examples) (April 2013) accessible *http://www.hmrc.gov.uk/avoidance/gaar-partd-examples.pdf*

D21.2 The arrangements

Mrs X is non-UK resident and domiciled. Her son Y is UK resident but foreign domiciled and occupies a house owned by a non-UK resident company that is held within a trust. The trustees own no other assets. The property is worth £10m. Gains that have accrued[81] post April 2008 are £4m (£2m on property and £2m on company).[82] The property has not increased in value since April 2013.[83] The trustees do not want to pay the annual tax on enveloped dwellings and decide to end the trust by liquidating the company. The intention of the trustees and family is that the son should own the property. There is no accumulated income or offshore income gains.

The trustees are advised on two options and the taxpayer's analysis on each is as follows:

- Option 1 - Trustees pay [more correctly, transfer] the property to the son. He receives a capital payment of £10m in the UK to which gains of £4m are attributed. He will pay tax on all the trust gains at 28%. The remittance basis does not apply. There is also a small inheritance tax exit charge.
- Option 2 - The settlor adds £4m cash to the trust in year 1. In the same year the trust liquidates the company and holds the property direct thus realising the £4m gain. It then pays the £4m cash back to the settlor in the same year.

Year 2 - the property is distributed to the son with a small amount of inheritance tax. The £4m cash payment made in Year 1 washes out the trust gains and so on the distribution of the property to the son there is no capital gains tax.

The trustees therefore choose option 2.

There are other options. For instance, if the trustees transferred the shares in the company to the son, there would be no IHT exit charge. The son might then liquidate the company. But that complication does not spoil the point of the example.

D21.4 The taxpayer's tax analysis

D21.4.1 The taxpayer's analysis is as set out above. The taxpayer contends that LIFO should be applied.

D21.5 What is the GAAR analysis under [s207(2) FA 2013]?

D21.5.1 *Are the substantive results of the arrangements consistent with any principles on which the relevant tax provisions are based (whether expressed or implied) and the policy objectives of those provisions?*

The trustees are entitled to organise distributions in a way that minimizes tax for

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81 I think the reference is to unrealised gains.

82 In fact the £2m gain accruing to the company is likely to qualify for the s.13 motive defence. But this does not spoil the point of the example.

83 The example states this fact in order to avoid the complication of ATED-CGT.

the beneficiaries within the range of normal tax planning.[84]

However, option 2 is not consistent with the principles on which the relevant tax provisions are based. LIFO was intended to operate on distributions of capital to beneficiaries by matching gains in a certain order. In this case the settlor has added the cash to the trust as part of a pre-arranged scheme to wash out the gains that she knows will be realised and on the basis that she will receive the cash back again. HMRC would seek to invoke the GAAR. The legislation was not intended to allow settlors to add cash to trusts on a short term basis only to receive it back again shortly thereafter and simply as an exercise to wash out gains.

D21.5.2 *Do the means of achieving the substantive tax results involve one or more contrived or abnormal steps?*

The addition of cash followed by the payment out is an abnormal step that is contrived.

D21.5.3 *Are the arrangements intended to exploit any shortcomings in the relevant tax provisions?*

This does intend to exploit a shortcoming in the legislation in a manner where the transactions are intended to have no economic consequences. The settlor has made the gift in the full expectation of receiving the monies back shortly and therefore not losing out.

The position would be different if the settlor had made the gift of cash and the trustees later independently decided in the exercise of their discretion to pay that cash out to other beneficiaries rather than as part of a pre-arranged circular scheme to pass the cash back to the settlor. Then the same issues would not arise.

D21.5.4 *Do the tax arrangements accord with established practice and has HMRC indicated its acceptance of that practice?*

HMRC has never accepted such practice.

D21.6 Conclusion

D21.6.1 HMRC would seek to apply the GAAR to such arrangements.

D21.7 Proposed counteraction

D21.7.1 The likely counteraction would be that the addition to the trust and payment of cash to the settlor would be ignored and the son will pay tax as under option 1.[85]

This seems right. The unfairness should be noted of imposing ATED on a company set up in accordance with standard professional practice,

84 This is a slightly loose paraphrase of the statutory rules, but I think unobjectionable in the context of the example.

85 HMRC GAAR Guidance Part D (Examples) (April 2013) accessible *http://www.hmrc.gov.uk/avoidance/gaar-partd-examples.pdf*

without any CGT relief for beneficiaries on winding up that company; but that unfairness is one of the *principles on which the relevant tax provisions are based (whether expressed or implied)*.

51.36 Record keeping

The HMRC s.87 guidance note provides:

> 133. Before 6 April 2008 trustees of non-UK resident settlements that have no UK domiciled beneficiaries, or beneficiaries who may become UK domiciled, will not have had to consider the possible UK Capital Gains Tax liabilities of the beneficiaries. From 6 April 2008 they will have to consider the possibility that a charge under section 87 or Schedule 4C TCGA may accrue to UK resident but non-UK domiciled beneficiaries.
> 134. In relation to pre 6 April 2008 transactions HMRC recognise that in such cases trustees
> - May not have kept sufficient records to calculate precisely the post 5 April 2008 Capital Gains Tax liabilities that may accrue on UK resident but non-UK domiciled beneficiaries, or
> - May not want to incur the expense of searching through old records to obtain all the necessary information to calculate precise Capital Gains Tax liabilities.
>
> 135. In such cases HMRC will consider any reasonable solution suggested to them. Usually proposed solutions will have to be considered on a case by case basis.

The guidance note concludes:

> One solution that HMRC will accept generally is that all assets held by trustees or underlying companies at midnight on 5 April 2008 are treated as having a zero acquisition cost. Provided the trustees make a valid election under paragraph 126 of Schedule 7 there will be no disadvantage to the beneficiaries. This is because the chargeable gain is restricted to the growth in the value of asset since 6 April 2008.

If a rebasing election is made, historic gain does not often matter, but there are situations in which it does.

51.37 Tax return: Disclosure of s.87 gains

S.87 gains are returned in Box 34 in the Capital Gains Summary pages (form SA108) 2013/14. The note beside this box reads:

> Attributed gains where personal losses cannot be set off.

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TAXATION OF NON-RESIDENTS AND FOREIGN DOMICILIARIES 2014-15

VOLUME FOUR

by

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CHAPTER FIFTY TWO

BORROWING BY NON-RESIDENT TRUST: SCH 4B

52.1 Borrowing by non-resident trust: introduction

This chapter considers schedules 4B and 4C TCGA, which are designed to counter a set of tax avoidance schemes informally known as flip-flop schemes.

52.1.1 *Cross references*

Trustees borrowing can raise so many other issues it is impossible to set out a full list, but see in particular:

Loan to trust and s.624: see 27.3.3 (Beneficial loan or guarantee).

Repayment of loan & s.633: see 27.11 (Settlor receives capital sum).

Transfer of assets: see 29.11 (Transferor receives a capital sum).

Loan to trust and definition of relevant person for remittances: see 11.6 (Relevant persons: trusts).

Loans to trust and pre-owned assets: see 76.8 (POA intangible property charge).

For IHT issues which arise when trustees borrow, see 65.11 (Deduction for trust debt).

For 2008 transitional rules relating to sch 4B and 4C, see 51.21 (Ascertaining s.2(2) amounts as at end 2007/8); 51.24 (Pre-2008 inter-trust transfer).

52.2 Outline of flip-flop schemes

In order to understand the law it is helpful to review these schemes. They were designed avoid ss.86, 77 and 87 TCGA and I refer to them as **"s.86, 77, and 87 schemes"**.

The s.86 scheme was as follows. Suppose a non-resident settlor-interested trust wished to dispose of an asset. The gain on the disposal

would in principle be taxed on the settlor under s.86 TCGA. The following steps could be taken:

(1) The trustees borrow money up to the value of the asset.
(2) They transfer the borrowed money to a second trust ("trust 2").
(3) The trustees exclude the settlor and designated persons from the first trust ("trust 1") so that s.86 ceases to apply to it.[1]
(4) In the following tax year, the trustees of trust 1 may sell the asset and realise a gain to which s.86 does not apply. They may then repay the loan.

This scheme was in principle successful[2] (though in practice it was often combined with a payment to the settlor from trust 2, which turned out to be taxable under s.87).

The s.77 scheme was designed to avoid s.77 TCGA. It involved (more or less) the same steps as the s.86 scheme. In this case however the legislation was (slightly) differently worded, and the scheme was eventually held to be unsuccessful in *West v Trennary* 76 TC 713, where the result (appropriately) flip-flopped through taxpayer success before the Commissioners, failure in the High Court, success in the Court of Appeal, to eventual failure in the House of Lords. Section 77 is now repealed, so this is now of historic interest only, but the background explains one or two features which survive in the present legislation.

The s.87 TCGA schemes came in two versions. The first version was as follows. Suppose a non-resident trust ("trust 1") without any s.2(2) amount (trust gains) wished:

(1) to dispose of an asset on which trust gains would accrue, and
(2) to make a capital payment to UK beneficiaries.

The beneficiaries would in principle be chargeable under s.87. The following steps could be taken:

(1) The trustees of trust 1 borrow money up to the value of the asset.
(2) They transfer the borrowed money to a second settlement ("trust 2").
(3) The trustees of trust 2 made a capital payment to the beneficiary.
(4) In the following tax year, the trustees of trust 1 sell the asset and realise a gain. The capital payment from trust 2 is not matched with the gain in trust 1.
(5) The trustees may then repay the loan.

---

1 See 50.4 (Settlor-interested condition).

2 *Burton v HMRC* [2009] SFTD 682. It is striking that the transactions took place in 2000 but the appeal was not heard until a decade later.

A second (and more common) version of the s.87 scheme could be used for a trust which did have trust gains. Suppose the trust wished to make a capital payment to UK beneficiaries. The beneficiaries would in principle be chargeable under s.87. The following steps could be taken:

(1) The trustees of trust 1 borrow money.
(2) They transfer the borrowed money to trust 2.
(3) The trustees of trust 2 make a capital payment to the beneficiary. The capital payment from trust 2 is not matched with the trust gains of trust 2. Section 90 TCGA would have stopped this scheme (it carried the trust gain across to trust 2 where the gain would be matched to the capital payment from trust 2). However this section was absentmindedly disapplied by Sch 4B TCGA in 2000, which lead to a flurry of tax planning until the mistake was finally corrected in 2003.[3]
(4) In due course, the trustees of trust 1 may repay the loan.

The s.87 schemes were held to be unsuccessful in *Herman v HMRC*.[4]

It is striking that most of these expensive and widely marketed schemes failed, contrary (I think) to the general expectation of the profession. The reader may think that the taxpayer had the better argument, in *Trennary* and in *Herman*. What lessons should be learned from that debacle? I leave readers to ponder over that.

The key features of the schemes were trustee borrowing and a transfer of trust property in year 1, followed by a disposal in a subsequent year. Schedule 4B produces a deemed disposal in year 1, which counteracts the s.86 (and s.77) schemes and the first version of the s.87 scheme. Schedule 4C contains a modified version of the s.87 regime, which allows gains of trust 1 to be matched with capital payments from trust 2; this counteracts the second version of the s.87 scheme.

The provisions were introduced in 2000 and revised in 2003 and 2008.

52.2.1 *What about income tax flip-flop schemes?*

Since schedule 4B only applies for CGT purposes, the reader may wonder if similar schemes could work for IT. Suppose a non-resident settlor-interested discretionary trust ("trust 1") wished to receive income (for instance by surrendering a life policy or receiving dividends) which would

---

3 See 51.18.4 (Interaction with schedule 4B).

4 See 51.7.1 (Indirect receipt from trustees).

fall within s.624 or s.720. Could the following steps be taken:
(1) The trustees borrow money up to the anticipated income.
(2) They transfer the borrowed money to a second trust ("trust 2").
(3) The trustees use their powers to exclude the settlor (etc) from trust 1 so that trust ceases to be settlor-interested.
(4) In the following tax year, the trustees of trust 1 receive the income and repay the borrowing.

The answer is that income tax capital payment provisions, s.633 ITTOIA and s.727 ITA, fill that gap but there may be occasions where planning of that kind is practical.

Similarly, since sch 4C only applies for CGT and OIG purposes, the reader may wonder if planning of this kind would work for s.731; the answer is no, as transfers between trusts do not isolate relevant income; see 30.33 (Transfer between trusts). In this respect s.731 operates rather like schedule 4C.

52.3 The key conditions

Para 1 Sch 4B TCGA provides:

> (1) This Schedule applies where trustees of a settlement—
> (a) make a transfer of value (see paragraph 2) in a year of assessment in which the settlement is within section 86 or 87 (see paragraph 3), and
> (b) in accordance with this Schedule the transfer of value is treated as linked with trustee borrowing (see paragraphs 4 to 9).

Thus the three key conditions, or sets of conditions, are:
(1) A transfer of value (in my terminology, **"a Sch4B-transfer"**)
(2) Trustee borrowing
(3) The Sch4B-transfer is "linked" with trustee borrowing

When these conditions are all satisfied, there is what I call **"a Sch4B-disposal"**.[5]

52.4 Sch4B-transfer

The statutory term "transfer of value" is unfortunate. Firstly the term is usually used with its IHT meaning. Secondly, the term is artificially defined to include loans and other transactions which do not constitute a transfer of value in any normal sense of the term. Although it is normally

5 See 52.12 (Sch4B-disposal).

better to adopt statutory terminology, in this case I think it is clearer to use the term **"Sch4B-transfer"**.

The fact that there is a Sch4B-transfer does not necessarily mean that there is a Sch4B-disposal: the transfer is only the first of the three conditions that must be met for a Sch4B-disposal.

There are three types of Sch4B-transfer. Para 2(1) Sch 4B TCGA provides:

> For the purposes of this Schedule trustees of a settlement make a transfer of value if they—
>
> (a) lend money or any other asset to any person,
>
> (b) transfer[6] an asset[7] to any person and receive either no consideration or a consideration whose amount or value is less than the market value of the asset transferred, or
>
> (c) issue a security of any description to any person and receive either no consideration or a consideration whose amount or value is less than the value of the security.

Trustees do not make a Sch4B-transfer if an underlying company held by them lends, transfers, or issues a security. Trustees do not make a Sch4B-transfer if they repay a loan.

I comment on the 3 types of Sch4B-transfer in their order of importance, rather than in the order set out in the statute.

52.4.1 *Sch4B-transfer type (b): Actual transfer of asset*

This is the most important type of sch 4B-transfer.

RI 259 provides:

> **B1 Paragraph 2(1)(b)—cash distributions which are income**
> Where trustees of a discretionary trust make a distribution which is income of the recipient for UK tax purposes, this is not a "transfer of value" within para 2, which is concerned with capital transactions.

The CG Manual provides:

> **35125. Transfer of value** [February 2006]
> References to transfers of value include everything that is or is treated as a disposal under TCGA 1992, and also include transfers or loans of money, and loans of other assets. Note that this includes disposals of

---

6 See 52.25.2 ("Transfer").

7 See 52.25.1 (Assets").

assets such as government stock or a dwelling house occupied as a beneficiary's principal private residence, even though there would be no chargeable gain on the disposal. It also includes the occasion of a beneficiary becoming absolutely entitled as against the trustee but in this context see CG35128.

Some part disposals involve the creation of a new asset. In this situation any reference in the legislation to the transfer of an asset refers to the (part) disposal of the old asset.

CG35124(b) above makes it clear that a sale of an asset, whether to an unconnected person or a beneficiary, is not a transfer of value provided it is for full consideration.

52.4.2 *Sch4B-transfer type (a): Loan of money or other asset*

35124. Transfer of value [February 2006]

Under TCGA 1992, SCH 4B, para 2(1) trustees make a transfer of value if they

(a) lend money or any other asset, regardless of whether a commercial rate of interest or hire is charged...

The flip-flop schemes[8] used in practice involved a transfer of an asset, not a loan. But there could be a s.87 scheme under which:

(1) trust 1 lent to trust 2, and
(2) trust 2 lent to a beneficiary (or acquired property used rent free by the beneficiary).

So the legislation needed to deal with loans as well as transfers of assets.

RI 259 provides:

B2 Paragraph 2(1)(a)—beneficiary exercising rights under [TOLATA][9] 1996 s 12

In certain circumstances a beneficiary's occupation of property, instead of being the consequence of the volition of the trustees, may result from personal rights under Trusts of Land and Appointment of Trustees Act 1996 s 12. Our view is that if the rights of the beneficiary arise as a consequence of the wording of the deed or will, then the occupation does not give rise to a transfer of value. It may be otherwise where the rights have arisen as a consequence of the exercise by the trustees of a power of appointment or advancement.

---

8 See 52.2 (Outline of flip-flop schemes).

9 The original refers erroneously to the "Trustee etc Act".

But it is considered that a beneficiary's occupation of property is not a loan of an asset, so the application of TOLATA is not relevant.

RI 259 provides:

> **B7 What happens when trustees put money into a conventional current or deposit account at a bank or building society?**
> Although in general law this is regarded as a loan from the customer to the bank, in the context of this legislation we do not consider that this comes within the meaning of "lend" for the purposes of para 2(1)(a). The currency in which the deposit is made is immaterial.

This is purposive, bordering on wishful, thinking; but since it usually suits the taxpayer, it will not usually be challenged.

52.4.3 *Sch4B-transfer type (c): Issuing a security*

It is normally companies rather than trustees who issue securities so this is of somewhat theoretical interest. RI 259 provides:

> **B3 Paragraph 2(1)(c)— "issue a security"**
> We have been asked what the expression "issue a security" covers. It caters for those exceptional circumstances where trustees issue to a beneficiary or to the trustees of another trust a document acknowledging liability. Schedule 4B para 13(2) provides that references to the transfer of an asset include everything that is or is treated as a disposal of an asset. The issue of a security is not in itself the disposal or part disposal of an asset. Therefore para 2(1)(b) does not apply to it, and it was necessary to have a specific provision to cover this possibility.

I find the idea that any flip-flop scheme could be carried out by issuing a security somewhat implausible. Assuming it was necessary, a neater solution would have been to define transfer to include the creation of an asset (as for the ToA provisions); but it does not do much harm.

52.4.4 *Amount of value transferred*

Para 2 Sch 4B TCGA provides:

> (3) In the case of a loan, the amount of value transferred is taken to be the market value of the asset.
> (4) In the case of a transfer, the amount of value transferred is taken to be—
>
> (a) if any part of the value of the asset is attributable to trustee borrowing, the market value of the asset;

(b) if no part of the value of the asset is attributable to trustee borrowing, the market value of the asset reduced by the amount or value of any consideration received for it...

(5) In the case of the issue of a security, the amount of value transferred shall be taken to be the value of the security reduced by the amount or value of any consideration received by the trustees for it.

(6) References in this paragraph to the value of an asset are to its value immediately before the material time, unless the asset does not exist before that time in which case its value immediately after that time shall be taken.

52.5 Settlement "within section 86 or 87"

Para 3 Sch 4B TCGA provides (more or less) commonsense definitions.

52.5.1 *Within s.86*

Para 3 Sch 4B TCGA provides:

(1) This paragraph explains what is meant in this Schedule by a settlement being "within section 86 or 87" in a year of assessment.

(3) A settlement is "within section 86" in a year of assessment if, assuming—

(a) that there were chargeable gains accruing to the trustees by virtue of disposals of any of the settled property originating from the settlor, and

(b) that the other elements of[10] the condition in subsection (1)(e) of that section were met,

chargeable gains would, under that section, be treated as accruing to the settlor in that year.

Expressions used in this sub-paragraph have the same meaning as in section 86.

52.5.2 *Within s.87*

Para 3 Sch 4B TCGA, as inserted by s.92(2) FA 2000, used to provide:

(4) A settlement is "within section 87" in a year of assessment if, assuming—

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10 The words "the other elements of" are otiose: para 3(3)b) requires one to assume that the condition in s.86(1)(e) is met, in other words, the condition need not be met. That makes sense. For this condition, see 50.10 (Section 86 trust gains condition).

(a) there were trust gains for the year within the meaning of subsection (2) of that section, and

(b) that beneficiaries of the settlement received capital payments from the trustees in that year or had received such payments in an earlier year,

chargeable gains would, under that section or section 89(2), be treated as accruing to the beneficiaries in that year.

Expressions used in this sub-paragraph have the same meaning as in section 87.

This para was rewritten by para 130 Sch 7 FA 2008:

> In paragraph 3 of Schedule 4B (transfers of value by trustees linked with trustee borrowing: settlements), for sub-paragraph (4) substitute—
>
> "(4) A settlement is "within section 87" for a tax year if—
>
> (a) section 87 applies to the settlement for that year,[11] or
>
> (b) chargeable gains would be treated under section 89(2) as accruing in that year to a beneficiary who received a capital payment from the trustees of the settlement in that year.
>
> (5) The reference in subsection (4)(b) to chargeable gains treated as accruing includes offshore income gains treated as arising."

The drafter absentmindedly repealed the final sentence of para 4, "Expressions used in this sub-paragraph have the same meaning as in section 87".[12] However, that the context shows that the expressions in para 3(4) are nevertheless to be construed with their s.87 meanings.

52.6 Trustee borrowing

Para 4(1) Sch 4B TCGA provides a wide definition of borrowing:

> For the purposes of this Schedule trustees of a settlement are treated as borrowing if—
>
> (a) money or any other asset is lent to them, or
>
> (b) an asset is transferred to them and in connection with the transfer the trustees assume a contractual obligation (whether absolute or conditional) to restore or transfer to any person that or any other asset.

---

11 See 51.3 (Non-resident settlement condition).

12 Some databases failed to notice this (accidental) repeal and still include this sentence in para 3 Sch 4B TCGA.

> In the following provisions of this Schedule "loan obligation" includes any such obligation as is mentioned in paragraph (b).

RI 259 provides:

> The fact that money was borrowed before 21 March 2000 does not prevent it from being outstanding trust borrowing.
> Where trustees are presented with a bill, for example for repairs to trust property, bona fide delay in payment would not convert this into a borrowing for the purposes of paragraph 4.

The second paragraph is wrong, since a debt on a bill for *repairs* cannot constitute borrowing within para 4; para 4(1)(b) only applies on a loan or transfer of *assets*.

52.6.1 *Trustees borrow from underlying company*

In the following discussion, a company wholly owned by a trust is called **"an underlying company"**.

A loan to a trust from an underlying company constitutes "trustee borrowing" for the purposes of sch 4B TCGA. RI 259 states that HMRC take this point:

> **B4 Paragraph 4(1): meaning of "borrowing"**
> It is not unusual for the trustees of a non-resident trust to borrow money from a non-resident company which they control. In this situation, if the company were resident in the UK, [s.455 CTA 2010] might well be applicable. It has been suggested that in this situation the trustees are effectively "borrowing" from themselves and therefore outside para 4(1). We consider this incorrect, particularly in the light of *Chamberlain v IRC*, 25 TC 357. It does not matter whether the borrowing is from a company controlled by the trustees or their associates, or from an entirely unconnected company. What matters is the use to which the borrowing is put.

At first sight this rule seems unnecessary. If a trust borrows from an underlying company, rather than a third party, and makes a Sch4B-transfer, it seems odd that there should be a Sch4B-disposal and that sch 4C should apply. But in fact a flip-flop scheme could be carried out if trustees borrow from an underlying company, just when they borrow from a third party.

Sympathetic courts have allowed trustees to avoid the unfairness by setting aside loans made in (understandable) ignorance of these

counterintuitive rules.[13] In practice I have not come across a case where HMRC have taken the point but one could in principle avoid it by arranging a capital payment from the company to a beneficiary, rather than a loan to trustees who make the capital payment.

52.6.2 *Amount borrowed*

Para 4(2) Sch 4B TCGA provides:

> The amount borrowed (the "proceeds" of the borrowing) is taken to be—
> (a) in the case of a loan, the market value[14] of the asset;
> (b) in the case of a transfer [ie a transaction within para 4(1)(b)], the market value of the asset reduced by the amount or value of any consideration received for it.

52.7 Sch4B-transfer "linked" with trustee borrowing

52.7.1 *Terminology*

The expression "linked with trustee borrowing" is defined in paras 5-8 Sch 4B. These paragraphs employ the following terms:

(1) **"Linked" with trustee borrowing**
(2) **"Outstanding" trustee borrowing**
(3) **"Normal trust purposes"**
(4) **"Ordinary trust assets"**

These expressions are best regarded as labels for complex sets of rules. In each case the label is not particularly apt and the definition can be

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13 *Re Leumi Overseas Trust* [2007] JRC 248; *Barclays Private Bank v Chamberlain* 9 ITELR 304. The Supreme Court in *Pitt v Holt* [2013] STC 1148 (more or less) abolishes the rule in *Hastings-Bass*, on which these decisions were based; but it seems that offshore jurisdictions are likely to continue regardless: art 47B ff Trusts (Jersey) Law 1984; Smellie, "Dealing with Mistakes of Trustees Or Settlors: the Outlook From the Offshore Bench" (2013) *http://judicial.ky/wp-content/uploads/publications/speeches/2013-11-19-Speech-CJ-DEALINGWITHMISTAKESOFTRUSTEESORSETTLORS.pdf*

14 Defined para 4(3):
"References in this paragraph to the market value of an asset are to its market value immediately before the loan is made, or the transfer is effectively completed, unless the asset does not exist before that time in which case its market value immediately after that time shall be taken.
The effective completion of a transfer means the point at which the person acquiring the asset becomes for practical purposes unconditionally entitled to the whole of the intended subject matter of the transfer."

described as artificial; the labels taken literally would be misleading. The cosy expressions conceal the complex and arbitrary nature of the concepts to which they refer. However it is difficult to think of better terms, and for the purposes of discussion it is best to adopt the statutory terminology *faute de mieux*.

52.7.2 *"Linked" with trustee borrowing*

Para 5(1) Sch 4B TCGA provides:

> For the purposes of this Schedule a transfer of value by trustees is treated as linked with trustee borrowing if at the material time there is outstanding trustee borrowing.

52.7.3 *"Outstanding" trustee borrowing*

Para 5(2) Sch 4B TCGA provides:

> For the purposes of this Schedule there is outstanding trustee borrowing at any time to the extent that—
>
> (a) any loan obligation[15] is outstanding, and
>
> (b) there are proceeds of trustee borrowing that have not been either—
>
> (i) applied for normal trust purposes, or
>
> (ii) taken into account[16] under this Schedule in relation to an earlier transfer of value.

52.7.4 *The material time*

Para 2(2) Sch 4B TCGA provides:

> References in this Schedule to "the material time", in relation to a transfer of value, are to the time when the loan is made, the transfer is effectively completed or the security is issued.
>
> The effective completion of a transfer means the point at which the person acquiring the asset becomes for practical purposes

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15 Defined in para 4(1): see 52.6 (Trustee borrowing).

16 Para 5(3) Sch 4B TCGA provides a commonsense definition:

"An amount of trustee borrowing is "taken into account" under this Schedule in relation to a transfer of value if the transfer of value is in accordance with this Schedule treated as linked with trustee borrowing.

The amount so taken into account is—

(a) the amount of the value transferred by that transfer of value, or

(b) if less, the amount of outstanding trustee borrowing at the material time in relation to that transfer of value."

unconditionally entitled to the whole of the intended subject matter of the transfer.

The CG Manual provides:

> **35128. The material time** [February 2006]
> The expression 'the material time' is important for two reasons.
> The first is that the test whether the transfer of value is linked with trust borrowing is applied at the material time.
> The second is that the deemed disposal by the trustees occurs at the material time.
> [The Manual sets out para 2(2) and continues] So if say trustees appoint a cash sum to a beneficiary, he would become unconditionally entitled when the money had been transferred to his bank account, not when the cheque was handed to him, for at that stage the trustees might have no funds to meet the cheque.[17]

52.8 Normal trust purposes

Para 6(1) Sch 4B TCGA provides:

> For the purposes of this Schedule the proceeds of trustee borrowing are applied for normal trust purposes in the following circumstances, and not otherwise.

There are three types of "normal trust purposes":
(1) Payment for ordinary trust assets
(2) Repayment of loan
(3) Payment of expenses
Para 9 Sch 4B TCGA provides power to amend paras 6-8 by regulation. Presumably HMRC were worried that they might have left some loophole for future tax avoiders. In practice no regulations have been made.

52.9 Normal trust purposes: Payment for ordinary trust assets

Para 6(2) Sch 4B TCGA provides:

> They are applied for normal trust purposes if they are applied by the trustees in making a payment in respect of an ordinary trust asset and the following conditions are met—
>
> (a) the payment is made under a transaction at arm's length or is not more than the payment that would be made if the transaction

17 It would be unusual for trustees to write a cheque if they are not in funds: the point is that a cheque is revocable until payment is made.

were at arm's length;

(b) the asset forms part of the settled property immediately after the material time or, if it does not do so, the alternative condition in paragraph 8 below is met; and

(c) the sum paid is (or but for section 17 or 39 would be) allowable under section 38 as a deduction in computing a gain accruing to the trustees on a disposal of the asset.

52.9.1 *Ordinary trust assets*

The label "ordinary trust assets" is not apt and many common trust assets do not count as "ordinary". Para 7 Sch 4B TCGA provides:

> (1) The following are "ordinary trust assets" for the purposes of this Schedule—
>
> (a) shares or securities;[18]
>
> (b) tangible property, whether movable or immovable, or a lease of such property;
>
> (c) property not within paragraph (a) or (b) which is used for the purposes of a trade, profession or vocation carried on—
>
> (i) by the trustees, or
>
> (ii) by a beneficiary who has an interest in possession in the settled property;
>
> (d) any right in or over, or any interest in, property of a description within paragraph (b) or (c).

Thus securities are ordinary trust assets but interests in securities are not. The distinction between securities and interests in securities raises some deep questions, though there is no reason to think that the drafter gave any thought to them.

If trustees lend to an underlying company they have not incurred normal trust expenditure; if they subscribe for redeemable shares they have done so (though redeemable shares are commercially equivalent to a loan).

RI 259 provides:

> We have been asked to say whether a futures contract relating to commodities is an "ordinary trust asset". Such a contract is not a tangible asset nor does it give the holder an interest in such an asset. Therefore, it is not an "ordinary trust asset".

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18 Defined (after a fashion) in para 7(2): "In sub-paragraph (1)(a) "securities" has the same meaning as in section 132." In this section I use the word "securities" to include shares.

52.9.2 *Grant of lease*

RI 259 provides:

> **B8 What happens when money is borrowed to purchase the freehold interest of a property which is then rented on a commercial basis?**
> ... Under para 13(2) references to the transfer of an asset include references to anything that is a disposal, and under TCGA 1992 s 21(2) references to a disposal include references to a part disposal. Paragraph 13(3) provides that references to a transfer of an asset do not include the transfer of an asset which is created by the part disposal of another asset. The grant of a lease is a part disposal of the freehold interest and therefore the grant of a lease is a transfer of the freehold interest for the purposes of para 2(1)(b) and is not regarded as the transfer simply of the lease. If the freehold interest was bought with borrowed money it meets the test in para 2(4)(a), and the amount of value transferred equals the market value of the freehold.
> Assuming that there is outstanding trustee borrowing at "the material time", which is defined in para 2(2) as the time the transfer is effectively completed, it is then necessary to consider whether the transfer of value is linked with trustee borrowing. Under para 7 tangible property, and any interest in such property falls within the expression "ordinary trust assets". However the property concerned must under para 6(2)(b) either form part of the settled property immediately after the material time, or meet the alternative condition in para 8(1)(b) that it is represented by ordinary trust assets which form part of the settled property immediately after the material time. Paragraph 6(2)(b) and para 8(1)(b) may be looked at together. In this situation we say that the reversion to the lease is still part of the settled property, and the lease itself is represented by the right to the rental stream.
> Therefore where trustees borrow money to acquire the freehold interest in a property which is then let commercially and, at the material time, there are no outstanding trustee borrowings other than those which have been applied for normal trust purposes, Sch 4B does not apply. But the position will be different if at that moment there are outstanding trustee borrowings applied for other purposes.
> The same considerations apply where trustees acquire a long lease which is sublet, and where the asset in question is a chattel rather than land or buildings.

52.9.3 *Asset becoming valueless*

Para 8 Sch 4B TCGA provides:

(1) The alternative condition referred to in paragraph 6(2)(b) in relation to an asset which no longer forms part of the settled property is that—

(a) the asset is treated as having been disposed of by virtue of section 24(1), or

(b) one or more ordinary trust assets which taken together directly or indirectly represent the asset—

(i) form part of the settled property immediately after the material time, or

(ii) are treated as having been disposed of by virtue of section 24(1).

(2) Where there has been a part disposal of the asset, the condition in paragraph 6(2)(b) and the provisions of sub-paragraph (1) above may be applied in any combination in relation to the subject matter of the part disposal and what remains.

(3) References in this paragraph to an asset include part of an asset.

52.10 Normal trust purposes: Repayment of loan

Para 6(3) Sch 4B TCGA provides:

They are applied for normal trust purposes if—

(a) they are applied by the trustees in wholly or partly discharging a loan obligation of the trustees, and

(b) the whole of the proceeds of the borrowing connected with that obligation (or all but an insignificant amount) have been applied by the trustees for normal trust purposes.

52.11 Normal trust purposes: Payment of expenses

Para 6(4) Sch 4B TCGA provides:

They are applied for normal trust purposes if they are applied by the trustees in making payments to meet bona fide current expenses incurred by them in administering the settlement or any of the settled property.

RI 259 provides:

B5 Paragraph 6(4)—application of proceeds to meet current expenses

We have been asked whether trustee borrowings to meet payments on account or provision for future or past expenses are covered by the expression "current expenses". One circumstance in which borrowings are applied for "normal trust purposes" (para 6) is where they are applied by the trustees in making payments to meet bona fide current expenses incurred by them.

One may note that there are three tests to be met—

– The borrowings have been applied by the moment of the transfer of value (para 5(2)(b)(i)).
– They have been applied to meet bona fide "current expenses".
– The expenses are expenses of "administering" the settlement or any of the settled property.

In the case of borrowing to meet future expenses it is hard to see how the borrowings can be said to have been applied. But the time for making the test is not when the money is borrowed, but the time of the transfer of value (this is "the material time", as defined in para 2(2)). In the case of payments on account there would be the requisite application and the liability to pay would have been incurred.

We do not regard "current" as restricting qualification to expenditure which for accounting purposes must fall in the year of borrowing, but we should regard it as excluding borrowing to make a provision for future expenditure or to meet expenditure that was incurred long before but left unpaid. In general where contracts for repairs of an ordinary kind have been entered into, we should regard the expenditure anticipated under those contracts to be current expenses at the moment of borrowing. Where trustees as the owner or tenant of a flat are obliged by contract or under the terms of the lease to make payments into a common fund to meet future maintenance or repair expenditure this would be regarded as a current expense.

The expression "administering the settlement or any of the settled property" should be construed widely to cover not only those expenses properly chargeable to income, or which would be so chargeable but for express provisions of the trust deed, but also capital expenditure such as capital taxes in the UK or elsewhere, or legal costs of a reorganisation, in particular the costs of an application under the Variation of Trusts Act. Other capital expenditure would often be expenditure on the asset itself, and therefore qualify under para 6(2). Contributions to the day-to-day running costs of a nominee company controlled by the trustees would also qualify.

52.11.1 *Unproductive expenditure*

RI 259 provides:

B9 What happens when money is spent unproductively, for example on a planning application that fails?

Under para 6(2) there are three conditions that must be met by a payment in respect of "an ordinary trust asset" if it is to be regarded as applied for normal trust purposes. The third, in para 6(2)(c), is that the sum is allowable under TCGA 1992 s 38 (or would be but for s 17 or 39) as a

deduction in computing a gain accruing to the trustees on a disposal of the asset. If an application for planning permission fails, then when the land is actually sold the costs relating to the application are generally not allowable; this is because they are not "reflected in the state or nature of the asset at the time of the disposal". Paragraph 6(2)(c) however must be referring to a notional disposal not to a real one. In the context of para 6 we consider that the reference can only be to a notional disposal taking place at the time when the expenditure is incurred.
Although one could not lay down as a universal rule that the expenditure would always qualify, the test is whether the existence of the current application for planning permission is reflected in the state or nature of the asset at the time of the notional disposal.

52.12 Sch4B-disposal

Para 1(2) Sch 4B TCGA provides an outline:

> Where this Schedule applies the trustees are treated as disposing of and immediately reacquiring the whole or a proportion of each of the chargeable assets that continue to form part of the settled property (see paragraphs 10 to 13).

I refer to this as a **"Sch4B-disposal"**. Para 10 Sch 4B TCGA provides the details:

> (1) Where in accordance with this Schedule a transfer of value by trustees is treated as linked with trustee borrowing, the trustees are treated for all purposes of this Act—
>
> (a) as having at the material time[19] disposed of, and
>
> (b) as having immediately reacquired,
>
> the whole or a proportion (see paragraph 11) of each of the chargeable assets that form part of the settled property immediately after the material time ("the remaining chargeable assets").
>
> (2) The deemed disposal and reacquisition shall be taken—
>
> (a) to be for a consideration equal to the whole or, as the case may be, a proportion of the market value of each of those assets, and
>
> (b) to be under a bargain at arm's length.[20]

52.12.1 *Chargeable asset*

The key term here is "chargeable asset". Para 10(3) Sch 4B provides:

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19 See 52.7.4 (The material time).

20 This deeming prevents hold-over relief (which might otherwise apply to a UK resident trust).

For the purposes of sub-paragraph (1) an asset is a chargeable asset if a gain on a disposal of the asset by the trustees at the material time would be a chargeable gain.

An offshore fund (within the OIG regime) is not a chargeable asset as no chargeable gain can arise on a disposal.

52.12.2 *The extent of the disposal*

Para 11 Sch 4B TCGA provides:

(1) This paragraph provides for determining whether the deemed disposal and reacquisition is of the whole or a proportion of each of the remaining chargeable assets.
(2) If the amount of value transferred—
(a) is less than the amount of outstanding trustee borrowing, and
(b) is also less than the effective value of the remaining chargeable assets,
the deemed disposal and reacquisition is of the proportion of each of the remaining chargeable assets given by:
VT÷EV
where—
VT is the amount of value transferred, and
EV is the effective value of the remaining chargeable assets.
(3) If the amount of value transferred—
(a) is not less than the amount of outstanding trustee borrowing, but
(b) is less than the effective value of the remaining chargeable assets,
the deemed disposal and reacquisition is of the proportion of each of the remaining chargeable assets given by:
TB÷EV
where—
TB is the amount of outstanding trustee borrowing, and
EV is the effective value of the remaining chargeable assets.
(4) In any other case the deemed disposal and reacquisition is of the whole of each of the remaining chargeable assets.
(5) For the purposes of this paragraph the effective value of the remaining chargeable assets means the aggregate market value of those assets reduced by so much of that value as is attributable to trustee borrowing.
(6) References in this paragraph to amounts or values, except in relation to the amount of value transferred, are to amounts or values immediately after the material time.

52.12.3 *HMRC example: part disposal*

RI 259 provides an example (I have slightly amended the layout for enhanced clarity):

> **B10 How should we compute the base cost of assets for future disposals?**
> ... Suppose that an asset cost £600, the trustees are treated as disposing of two thirds of the asset at the material time (paragraph 10(1)), and the respective values of two thirds and one third immediately after that time are £900 and £450.

HMRC compute the gain on the Sch4B-disposal:

Deemed Proceeds		900
Cost	[two thirds of 600]	-400
Gain		500

HMRC compute the base cost for a future disposal as:

Remaining original cost	600 – 400	200
Deemed Acquisition		900
Revised base cost		1100

52.13 Treatment of gain or loss arising on Sch4B-disposal

If a gain arises on Sch4B-disposal to a trust within s.86, the position is straightforward: the settlor is taxable on the gain.

If a loss arises on a sch4B disposal, it can in some cases be set against other gains of the trustees.

In the HMRC view, if a Sch4B-disposal is deliberately made to realise a loss, the loss is disallowed under s.16A TCGA.[21] CG Manual Appendix 9 provides:

> **Example 18 - trustees make a deliberate transfer of value** [February 2010]
> 1. A body of trustees who fall within the terms of Schedule 4B have outstanding borrowing which has not been used for trust purposes (Schedule 4B is a measure introduced to discourage trustees avoiding capital gains tax by incurring debt and advancing funds from the settlement). The trustees intentionally make a transfer of value which triggers off a charge under Schedule 4B, and as they expect this

21 See 54.13 (Inter-spouse transfer) for a more detailed discussion.

> transaction results in a capital loss. The trustees have realised chargeable gains in the same year, and claim to set the loss against those gains.
> 2. It is necessary to look at the arrangements which have been entered into by the trustees to determine whether these have been entered into with a main purpose of securing a tax advantage. There are arrangements in this case, so the question is whether or not those arrangements were entered into with a main purpose of securing a tax advantage, and to decide this it is necessary to take account of all the circumstances surrounding the transactions. It will be relevant to consider what the trustees' overall economic objective was, and whether that objective is being fulfilled in a straightforward way, or whether additional, complex or costly steps have been inserted. It is significant that Schedule 4B is itself anti-avoidance legislation, intended to counter avoidance of tax on gains by contrived arrangements between settlements. The fact that the trustees have deliberately triggered the operation of the schedule is an indicator that one of their main purposes was to secure the advantage of the capital loss. In such a case, the TAAR [s.16A TCGA] will apply and the loss will not be an allowable loss.

52.14 Schedule 4C: Introduction

A Sch4B-disposal takes a trust from the ordinary s.87 regime to the more complicated rules which I call **"the sch 4C s.87 regime"**.

Section 85A(1) TCGA provides:

> (1) Schedule 4C to this Act has effect with respect to the attribution of gains to beneficiaries where there has been a transfer of value to which Schedule 4B applies.
> (2) Sections 86A to 95 have effect subject to the provisions of Schedule 4C.

Para 1(1) Sch 4C TCGA makes the same point:

> This Schedule applies where the trustees of a settlement ("the transferor settlement") make a transfer of value to which Schedule 4B applies ("the original transfer")....

Thus, The sch 4C s.87 regime applies if the trustees make a Sch4B-transfer which is linked to trustee borrowing.[22]

The Sch4B-transfer is called "the original transfer". For clarity I refer to it as **"the original Sch4B-transfer"**.

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22 See 52.3 (The key conditions).

For completeness, para 1(1) Sch 4C TCGA provides:

> References in this Schedule to a transfer to which Schedule 4B applies include any such transfer, whether or not any chargeable gain or allowable loss accrues under that Schedule by virtue of the transfer.

52.15 Sch4C pool

Para 1 Sch 4C TCGA provides:

> (2) The transferor settlement is regarded for the purposes of this Schedule as having a "Schedule 4C pool".

I abbreviate this to **"Sch4C pool"**.

> (3) The Schedule 4C pool contains the section 2(2) amounts for the settlement that are outstanding at the end of the tax year in which the original [Sch 4B-]transfer is made (see paragraph 1A).

Trust gains accruing in the years after the original Sch4B-transfer do not go into the Sch4C pool (unless there is another Sch4B-transfer). They go into the s.87 trust gain pool.

52.15.1 *"Outstanding section 2(2) amounts"*

We need to ascertain "the section 2(2) amounts for the settlement that are outstanding" at the end of the tax year when the Sch4B-transfer is made.

Para 1A(1) Sch 4C TCGA provides:

> The following steps are to be taken for the purpose of calculating the section 2(2) amounts for a settlement that are outstanding at the end of a tax year ("the relevant tax year").

Step 1 provides a commonsense starting point:

> *Step 1* Find the section 2(2) amount for the settlement for the relevant tax year and earlier tax years, as reduced under section 87A [matching] as it applies for the relevant tax year and earlier tax years....

See 51.5 (Section 2(2) amount).

So far the rules are the same as for the s.87 trust gain pool.

52.15.2 *Transfer between trusts in or before year of Sch4B-transfer*

Para 1A(2) Sch4C TCGA deals with the special case of transfers between settlements:

> For the purposes of Step 1 of sub-paragraph (1) take into account the

> effect of section 90 in relation to any transfer of settled property from or to the trustees of the settlement made in or before the relevant tax year.

Section 90 TCGA does not apply to a Sch4B-transfer, but it would apply if there had been an earlier transfer between trusts which was not a Sch4B-transfer.[23]

So far the rules are still the same as for the s.87 trust gain pool.

52.15.3 *Capital payment to non-resident beneficiary: Effect on Sch4C pool*

Para 1A(1) Sch 4C TCGA provides:

> *Step 2* This Step applies if, by virtue of the matching of the section 2(2) amount for the settlement for a tax year ("the applicable year") with a capital payment, chargeable gains are treated under section 87 or 89(2) as accruing in the relevant tax year to a beneficiary who is not chargeable to tax for that year.
> Increase the section 2(2) amount for the applicable year (found under Step 1) by the amount of the chargeable gains.
> ...
> (3) For the purposes of this Schedule a beneficiary is "chargeable to tax" for a tax year if, as respects that year, the beneficiary meets the residence condition set out in section 2(1A).[24]

Thus capital payments to non-residents which reduce the s.87 trust gain pool[25] are added back to the Sch4C pool. Effectively such payments do not take trust gains out of the Sch4C pool.

The capital payments which are disallowed are those which are matched to s.87 gains accruing in the "relevant tax year". That is, I think, the year of the Sch4B-disposal.

This is consistent with the disallowance of payments to non-residents made out of the sch4C pool.

52.16 "Schedule 4B trust gains"

52.16.1 *Adding Sch4B trust gains to the Sch4C pool*

Section 85A(3) TCGA provides:

> [a] When calculating the section 2(2) amount for a settlement for a tax

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23 See 51.18.4 (Interaction with schedule 4B).

24 See 49.1.2 (CGT residence condition).

25 See 51.34.3 (Mixed UK and foreign beneficiaries: simple capital payments).

> year (within the meaning of section 87), no account is to be taken of any chargeable gains or allowable losses accruing by virtue of Schedule 4B.
> [b] Nothing in this subsection affects any increase in a section 2(2) amount by virtue of paragraph 1(3A) or 7B(2)(b)[26] of Schedule 4C.

When computing the s.2(2) amount (trust gains), s.85A(3)[a] says that one disregards gains on the Sch4B-disposal. Then para 1A(3A) Sch 4C TCGA (flagged by s.85A(3)[b]) puts them back in, though in a remarkably complex manner:

> The section 2(2) amount for that tax year is increased by—
> (a) the amount of Schedule 4B trust gains accruing by virtue of the original [Sch 4B-]transfer (see paragraphs 3 to 7), and
> (b) the total amount of any further Schedule 4B trust gains accruing by virtue of any further transfers of value to which that Schedule applies that are made by the trustees in that tax year.

The key term here is "Sch 4B trust gains". This term is artificially defined: it does not mean the gains accruing on the Sch4B-disposal. For clarity, I write the expression with scare quotation marks.

52.16.2 *Meaning of "sch 4B trust gains"*

Para 3 Sch 4C TCGA provides:

> (1) This paragraph explains what is meant for the purposes of this Schedule by "Schedule 4B trust gains".
> (2) The Schedule 4B trust gains are computed in relation to each transfer of value to which that Schedule applies.
> (3) In relation to a transfer of value the amount of the Schedule 4B trust gains for the purposes of this Schedule is given by—
> CA – SG – AL ...

In short:
CA is **C**hargeable **A**mount
SG is the **S**ettlor's **G**ains
AL is **A**llowable **L**osses

Each of these terms is elaborately defined. Para 3(3) continues with an outline:

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26 See 52.18 (Subsequent Sch4B-disposal).

CA is the chargeable amount computed under paragraph 4 or 5 below,
SG is the amount of any gains attributed to the settlor that fall to be deducted under paragraph 6 below, and
AL is the amount of any allowable losses that may be deducted under paragraph 7 below.

52.16.3 *Chargeable amount: Non-resident trust*

Para 4 Sch 4C TCGA provides:

(1) If the transfer of value is made in a year of assessment during which the trustees of the transferor settlement are at no time resident in the UK the chargeable amount is computed under this paragraph.
(2) Where this paragraph applies the chargeable amount is the amount on which the trustees would have been chargeable to tax under section 2(2) by virtue of Schedule 4B if they had been resident in the UK in the year (and had made the disposals which Schedule 4B treats them as having made).

The wording is based on the s.87 definition of s.2(2) amount.[27]

52.16.4 *Chargeable amount: Dual resident trust*

Para 5 Sch 4C TCGA provides:

(1) If the transfer of value is made in a year of assessment where—
(a) the trustees of the transferor settlement are resident in the UK during any part of the year, and
(b) at any time of such residence they fall to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the UK,
the chargeable amount is computed under this paragraph.
(2) Where this paragraph applies the chargeable amount is the lesser of—
(a) the amount on which the trustees would be chargeable to tax under section 2(2) by virtue of Schedule 4B on the assumption that the double taxation relief arrangements did not apply (and the disposals which Schedule 4B treats them as having made were made), and
(b) the amount on which the trustees would be so chargeable to tax by virtue of disposals of protected assets.

27 See 51.5 (Section 2(2) amount).

> (3) For this purpose "protected assets" has the meaning given by section 88(4).

The wording is based on the s.87 rules for dual resident trusts.[28]

52.16.5 *Settlor's gains*

Para 6(1) Sch 4C TCGA provides:

> For the purposes of this Schedule the chargeable amount in relation to a transfer of value shall be reduced by the amount of any chargeable gains arising by virtue of that transfer of value that—
> (a) are by virtue of section 86(4) treated as accruing to the settlor,

The wording is based on the s.87 rules.[29] Para 6(1)(b) deals with the temporary non-resident rules:

> or
> (b) where section 10A applies, are treated by virtue of that section (as it has effect subject to paragraph 12 below) as accruing to the settlor in the period of return.

For the s.87 equivalent rules, see 52.22.1 (Trust within s.86 TCGA).

52.16.6 *Losses of trust within s.86*

Para 6(2) Sch 4C TCGA provides:

> In determining for the purposes of sub-paragraph (1)(a) the amount of chargeable gains arising by virtue of a transfer of value that are treated as accruing to the settlor, there shall be disregarded any losses which arise otherwise than by virtue of Schedule 4B.

This applies where a trust within s.86 has losses and then realises gains on a Sch4B-disposal. The losses are set against the gains, so those gains are treated as accruing to the settlor. This provision is needed to ensure that those gains are not added to the Sch4C pool.

52.16.7 *Losses accruing on Sch4B-disposal*

Para 7 Sch 4C TCGA provides:

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28 See 51.17 (Dual resident trust - s.88 TCGA).
29 See 51.5 (Section 2(2) amount).

> (1) An allowable loss arising under Schedule 4B in relation to a transfer of value by the trustees of a settlement may be taken into account in accordance with this paragraph to reduce for the purposes of this Schedule the chargeable amount in relation to another transfer of value by those trustees.
> (2) Any such allowable loss goes first to reduce chargeable amounts arising from other transfers of value made in the same year of assessment.
> If there is more than one chargeable amount and the aggregate amount of the allowable losses is less than the aggregate of the chargeable amounts, each of the chargeable amounts is reduced proportionately.
> (3) If in any year of assessment the aggregate amount of the allowable losses exceeds the aggregate of the chargeable amounts, the excess shall be carried forward to the next year of assessment and treated for the purposes of this paragraph as if it were an allowable loss arising in relation to a transfer of value made in that year.
> (4) Any reduction of a chargeable amount under this paragraph is made after any deduction under paragraph 6.

52.17 Restrictions on use of losses

It is necessary to distinguish between losses accruing on a Sch4B-disposal and other losses accruing to trustees.

Section 85A(3) TCGA provides:

> When calculating the section 2(2) amount for a settlement for a tax year (within the meaning of section 87), no account is to be taken of any chargeable gains or allowable losses accruing by virtue of Schedule 4B....

Thus losses on a Sch4B-disposal cannot be set against gains in computing the s.2(2) amount for s.87 purposes.

Section 85A(4) TCGA provides:

> No account shall be taken of any chargeable gains or allowable losses to which sections 87 to 89 apply in computing the gains or losses accruing by virtue of Schedule 4B.

Thus losses on a non-Sch4B-disposal cannot be set against gains accruing on a Sch4B-disposal, in computing the sch4C pool.

I cannot see the reason for these rules, but complication was not of concern to the drafter of sch4C, who clearly regarded loss relief with suspicion.

52.18 Subsequent Sch4B-disposal

Para 7B Sch 4C TCGA provides:

> (1) This paragraph applies if the trustees of the transferor settlement make a further transfer of value to which Schedule 4B applies in a tax year ("the year of the transfer") after the tax year mentioned in paragraph 1(3).[30]
> (2) If the settlement has a Schedule 4C pool at the beginning of the year of the transfer—
>
> (a) the section 2(2) amounts in the Schedule 4C pool are increased by the section 2(2) amounts for the settlement that are outstanding at the end of the year of the transfer, and
> (b) the section 2(2) amount in the pool for the year of transfer is increased (or further increased) by the amount of Schedule 4B trust gains accruing by virtue of the further transfer.
>
> (3) If the settlement does not have a Schedule 4C pool at the beginning of the year of the transfer, this Schedule applies in relation to the further transfer as it applied in relation to the original [Sch 4B-]transfer.
> (4) For the purposes of this paragraph a settlement has a Schedule 4C pool until the end of the tax year in which all section 2(2) amounts in the pool have been reduced to nil.

52.19 Attribution of Sch4C pool gains to beneficiaries

52.19.1 *Exclusion of standard s.87 regime*

Section 85A(2A) TCGA provides:

> For the purposes of sections 87 to 89, no account is to be taken of any section 2(2) amount in a Schedule 4C pool (see paragraph 1 of Schedule 4C).

I refer to the s.2(2) amounts in a Sch 4C pool as **"Sch4C pool gains"**. This provision takes Sch4C pool gains out of the standard s.87 regime. Instead they fall within what I call **"the Sch4C s.87 regime"**.

Trustees therefore need to keep two sets of computations:

(1) a computation of the s.2(2) amounts (trust gains) for the standard s.87 regime; and
(2) a computation of Sch4C pool gains.

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30 "The tax year mentioned in para 1(3)" (sch 4C TCGA) is the tax year in which the original Sch 4B-transfer is made; see 52.15 (Schedule 4C pool).

52.19.2 *Schedule 4C s.87 regime*

Para 8 Sch 4C TCGA[31] provides:

> (1) Chargeable gains are treated as accruing in a tax year ("the relevant tax year") to a beneficiary who has received a capital payment from the trustees of a relevant settlement in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under section 87A as it applies for the relevant tax year) with the section 2(2) amount in the Schedule 4C pool for the relevant tax year or any earlier tax year.

This is best understood by comparing it with the usual s.87 rule. Section 87(2) provides (highlighting the changes):

> (2) Chargeable gains are treated as accruing in the relevant tax year to a beneficiary of the settlement who has received a capital payment from the trustees ~~of a relevant settlement~~ in the relevant tax year or any earlier tax year if all or part of the capital payment is matched (under section 87A as it applies for the relevant tax year) with the section 2(2) amount ~~in the Schedule 4C pool~~ for the relevant tax year or any earlier tax year.

Para 8 continues:

> (2) The amount of chargeable gains treated as accruing is equal to—
>
> (a) the amount of the capital payment, or
>
> (b) if only part of the capital payment is matched, the amount of that part.

This is the schedule 4C equivalent of s.87(3) TCGA.

> (3) Section 87A applies for a tax year for the purposes of matching capital payments received from the trustees of a relevant settlement with section 2(2) amounts in the Schedule 4C pool as if—
>
> (a) references to section 2(2) amounts were to section 2(2) amounts in the Schedule 4C pool,
>
> (b) references to a capital payment received from the trustees by a beneficiary were to a capital payment received from the trustees of a relevant settlement by a beneficiary who is chargeable to tax for that year, and
>
> (c) for section 87A(3)(b) there were substituted—
>
> "(b) all section 2(2) amounts in the Schedule 4C pool have

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31 Flagged (somewhat unnecessarily) in para 1(4): "Paragraphs 8 to 9 provide for the attribution of gains in a settlement's Schedule 4C pool."

been reduced to nil."

Amended as para 8 directs, s.87A provides:

(1) This section supplements s.87.

(2) The following steps are to be taken for the purposes of matching capital payments with s.2(2) amounts in the Schedule 4C pool.

Step 1

Find the s.2(2) amount in the Schedule 4C pool for the relevant tax year.

Step 2

Find the total amount of capital payments received by the beneficiaries who are chargeable to tax for that year from the trustees of a relevant settlement in the relevant tax year.

Step 3

The s.2(2) amount in the Schedule 4C pool for the relevant tax year is matched with—

(a) if the total amount of capital payments received in the relevant tax year does not exceed the s.2(2) amount in the Schedule 4C pool for the relevant tax year, each capital payment so received by the beneficiaries who are chargeable to tax for that year from the trustees of a relevant settlement, and

(b) otherwise, the relevant proportion of each of those capital payments.

"The relevant proportion" is the s.2(2) amount in the Schedule 4C pool for the relevant tax year divided by the total amount of capital payments received in the relevant tax year.

Step 4

[1] If para (a) of Step 3 applies—

(a) reduce the s.2(2) amount in the Schedule 4C pool for the relevant tax year by the total amount of capital payments referred to there, and

(b) reduce the amount of those capital payments to nil.

[2] If para (b) of that Step applies—

(a) reduce the s.2(2) amount in the Schedule 4C pool for the relevant tax year to nil, and

(b) reduce the amount of each of the capital payments referred to there by the relevant proportion of that capital payment.

Step 5

[1] Start again at Step 1 (unless subs.(3) applies).

[2] If the s.2(2) amount in the Schedule 4C pool for the relevant tax year (as reduced under Step 4) is not nil, read references to capital payments received in the relevant tax year as references to capital payments received in the latest tax year which—

(a) is before the last tax year for which Steps 1 to 4 have been undertaken, and

(b) is a tax year in which capital payments (the amounts of which have not been reduced to nil) were received by beneficiaries.

(3) This subsection applies if—

(a) all of the capital payments received by beneficiaries who are chargeable to tax for that year from the trustees of a relevant settlement in the relevant tax year or any earlier tax year have been reduced to nil, or

(b) all section 2(2) amounts in the Schedule 4C pool have been reduced to nil. ~~the section 2(2) amounts for the relevant tax year and all earlier tax years have been reduced to nil~~.

(4) The effect of any reduction under Step 4 of subsection (2) is to be taken into account in any subsequent application of this section.

Para 1A(3) Sch 4C TCGA defines "chargeable to tax":

> For the purposes of this Schedule a beneficiary is "chargeable to tax" for a tax year if, as respects that year, the beneficiary meets the residence condition set out in section 2(1A).

An important difference between the Sch4C s.87 regime and the standard s.87 regime is that capital payments to non-resident beneficiaries do not reduce the sch4C pool. I can see no reason for that. The rule is not needed for the flip-flop schemes at which Schedule 4C was addressed. Perhaps it just reflects a desire to impose harsher rules following a Sch4B-disposal, based on the mistaken view that a Sch4B-disposal only arises in cases of tax avoidance.

52.19.3 *Priority between Sch 4C s.87 regime and standard s.87 regime*

Para 8(4) Sch 4C provides:

> Section 87A applies for a tax year by virtue of this paragraph before it applies for that year otherwise than by virtue of this paragraph; but this is subject to sub-paragraph (5).

Thus the Sch4C s.87 regime has priority.

52.19.4 *Priority between OIG Sch 4C and CGT Sch 4C*

Para 8(5) Sch 4C provides:

> If section 87A applies for a tax year by virtue of section 762(3) of the Taxes Act[32] (offshore income gains), it applies for that year by virtue of that provision before it applies for that year by virtue of this paragraph.

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32 The reference to ICTA is obsolete. However the legislation still works, because the continuity of law provisions in (for example) para 5 Sch 2 CTA 2010 require old references to take effect as references to the rewritten provisions.

52.20 "Relevant settlement"

"Relevant settlement" matters because a capital payment from any relevant settlement falls within sch 4C.

Para 8A Sch 4C TCGA provides:

> (1) This paragraph specifies what settlements are relevant settlements in relation to a Schedule 4C pool.
> (2) The transferor and transferee settlements in relation to the original [Sch 4B-]transfer of value are relevant settlements.
> (3) If the trustees of any settlement that is a relevant settlement in relation to a Schedule 4C pool—
> (a) make a transfer of value to which Schedule 4B applies, or
> (b) make a transfer of settled property to which section 90 applies,
> any settlement that is a transferee settlement in relation to that transfer is also a relevant settlement in relation to that pool.
> (4) If the trustees of a settlement that is a relevant settlement in relation to a Schedule 4C pool make a transfer of value to which Schedule 4B applies, any other settlement that is a relevant settlement in relation to that pool is also a relevant settlement in relation to the Schedule 4C pool arising from the further transfer.

Para 14(2) Sch 4C TCGA defines "Transferor" and "transferee settlement":

> In this Schedule, in relation to a transfer of value—
> (a) references to the transferor settlement are to the settlement the trustees of which made the transfer of value; and
> (b) references to a transferee settlement are to any settlement of which the settled property includes property representing, directly or indirectly, the proceeds of the transfer of value.

52.20.1 *Disregard of certain capital payments*

Para 9 Sch 4C TCGA provides:

> (1) For the purposes of paragraph 8 (and section 87A as it applies for the purposes of that paragraph), no account is to be taken of a capital payment to which any of sub-paragraphs (2) to (4) applies (or a part of a capital payment to which sub-paragraph (4) applies).

There are three disregards:

> (2) This sub-paragraph applies to a capital payment received before the tax year preceding the tax year in which the original [Sch 4B-]transfer is made.

That is relatively straightforward.

> (3) This sub-paragraph applies to a capital payment that—
>
> (a) is received by a beneficiary of a settlement from the trustees in a tax year during the whole of which the trustees—
>
> (i) are resident in the UK, and
>
> (ii) are not Treaty non-resident,
>
> (b) was made before any transfer of value to which Schedule 4B applies was made, and
>
> (c) was not made in anticipation of the making of any such transfer of value or of chargeable gains accruing under that Schedule.

This must be the rare case of a UK trust within the s.87 regime.

> (4) This sub-paragraph applies to a capital payment if (and to the extent that) it is received (or treated as received) in a tax year from the trustees by a company that—
>
> (a) is not resident in the UK in that year, and
>
> (b) would be a close company if it were resident in the UK,
>
> (and is not treated under any of subsections (3) to (5) of section 96 as received by another person).

This is the sch4C equivalent of s.87C TCGA: see 51.9.4 (Disregard of capital payments to companies).

52.20.2 *Residence of trustees from whom capital payment received*

Para 10(1) Sch 4C TCGA provides:

> Subject to paragraph 9(3), it is immaterial for the purposes of paragraph 8 that the trustees of any relevant settlement are or have at any time been resident in the UK.

Why is this needed?

52.21 Remittance basis

Para 8AA Sch 4C TCGA provides:

> Section 87B (remittance basis) applies in relation to chargeable gains treated under paragraph 8 as accruing as it applies in relation to chargeable gains treated under section 87 as accruing.

This incorporates the s.87 remittance basis.[33]

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33 See 51.15 (Section 87 remittance basis).

52.22 Temporary non-resident beneficiaries

52.22.1 *Trust within s.86 TCGA*

Para 12 Sch 4C TCGA provides:

(1) This paragraph applies if—

(a) by virtue of section 10A, an amount of chargeable gains within section 86(1)(e) that accrued in a tax year ("year A") to the trustees of a settlement would be treated as accruing to a person ("the settlor") in the period of return, and

(b) after paragraph 8 has applied for the year of return, the section 2(2) amount for year A that is in the Schedule 4C pool for the settlement is less than the amount mentioned in paragraph (a).

(2) The amount of chargeable gains treated as mentioned in sub-paragraph (1)(a) as accruing to the settlor in the period of return is limited to the section 2(2) amount referred to in sub-paragraph (1)(b).

(4) Where the property comprised in the transferor settlement has at any time included property not originating from the settlor, only so much (if any) of any capital payment taken into account for the purposes of paragraph 8 above as, on a just and reasonable apportionment, is properly referable to property originating from the settlor shall be taken into account in computing the amount charged to beneficiaries.

(5) Expressions used in this paragraph and section 10A have the same meanings in this paragraph as in that section; and paragraph 8 of Schedule 5 shall apply for the construction of the references in sub-paragraph (4) above to property originating from the settlor as it applies for the purposes of that Schedule.

52.22.2 *Trust within s.87*

Para 12A Sch 4C TCGA provides:

(1) This paragraph applies where by virtue of section 10A an amount of gains would (apart from this Schedule) be treated under section 87 as accruing to a person ("the beneficiary") in the period of return by virtue of a capital payment made to him in the temporary period of non-residence.

(2) Where this paragraph applies, a capital payment equal to so much of that capital payment as exceeds the amount otherwise charged shall be deemed for the purposes of this Schedule to be made to the beneficiary in the year of return.

(3) The "amount otherwise charged" means the total of any chargeable gains attributed to the beneficiary under section 87(2) or 89(2) by virtue

of the capital payment.
(4) For the purposes of paragraph 13(5)(b) a deemed capital payment under this paragraph shall be treated as made when the actual capital payment mentioned in sub-paragraph (1) above was made.
(5) Expressions used in this paragraph and section 10A have the same meanings in this paragraph as in that section.

52.23 Interest supplement

Para 13 Sch 4C TCGA provides:

(1) This paragraph applies if—
(a) chargeable gains are treated under paragraph 8 as accruing to a beneficiary by virtue of the matching (under section 87A) of all or part of a capital payment with the section 2(2) amount for a tax year ("the relevant tax year"), and
(b) the beneficiary is charged to tax by virtue of the matching.

(1A) Where part of a capital payment is matched, references in sub-paragraphs (2) and (3) to the capital payment are to the part matched.
(2) The tax payable by the beneficiary in respect of the payment shall be increased by the amount found under sub-paragraph (3) below, except that it shall not be increased beyond the amount of the payment; and an assessment may charge tax accordingly.
(3) The amount is one equal to the interest that would be yielded if an amount equal to the tax which would be payable by the beneficiary in respect of the payment (apart from this paragraph) carried interest for the chargeable period at the specified rate.
The "specified rate" means the rate for the time being specified in section 91(3).
(4) The chargeable period is the period which—
(a) begins with the later of the 2 days specified in sub-paragraph (5) below, and
(b) ends with 30th November in the year of assessment following that in which the capital payment is made.
(5) The 2 days are—
(a) 1st December in the tax year immediately after the relevant tax year, and
(b) 1st December falling 6 years before 1st December in the year of assessment following that in which the capital payment is made.

This is the Sch4C equivalent of the s.87 interest surcharge rules: see 51.13 (Interest surcharge).

52.24 Settlement ceasing to exist after Sch4B-disposal

Para 13A Sch 4C TCGA provides:

> Where a settlement ceases to exist after the trustees have made a transfer of value to which Schedule 4B applies, this Schedule has effect as if a year of assessment had ended immediately before the settlement ceased to exist.

Why is this needed?

52.25 Definitions

There are different sets of definitions for sch 4B and sch 4C.

52.25.1 *"Assets"*

Para 13(1) Sch 4B TCGA provides:

> In this Schedule any reference to an asset includes money expressed in sterling.
> References to the value or market value of such an asset are to its amount.

52.25.2 *"Transfer"*

Para 13 Sch 4B TCGA provides:

> (2) Subject to sub-paragraph (3), references in this Schedule to the transfer of an asset include anything that is or is treated as a disposal of the asset for the purposes of this Act, or would be if sub-paragraph (1) above applied generally for the purposes of this Act.
> (3) References in this Schedule to a transfer of an asset do not include a transfer of an asset that is created by the part disposal of another asset.

52.25.3 *"Settlement" and "trustee"*

"Settlement" in sch 4C means settlement-arrangement (and "trustee" has a similarly extended meaning).[34] Whereas "settlement" in sch 4B has the CGT/IT definition. This reflects the difference between s.87 and s.86.[35] But sch 4C only applies if the trustees make a Sch4B-disposal,[36] so sch 4C can only apply where there is a settlement within the CGT/IT meaning.

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34 See 51.2 ("Settlement" and "trustee").
35 See 50.3.1 ("Settlement" and "settlor").
36 See 52.14 (Schedule 4C: the key condition).

52.25.4 *Misc schedule 4C definitions*

Para 14(1) Sch 4C TCGA provides:

> In this Schedule—
> (a) "transfer of value" has the same meaning as in Schedule 4B; and
> (b) references to the time at which a transfer of value was made are to the time which is the material time for the purposes of that Schedule.

52.25.5 *"Beneficiaries"*

Para 14 Sch 4C TCGA provides:

> (3) References in this Schedule to beneficiaries of a settlement include—
> (a) persons who have ceased to be beneficiaries by the time the chargeable gains accrue, and
> (b) persons who were beneficiaries of the settlement before it ceased to exist,
> but who were beneficiaries of the settlement at a time in a previous year of assessment when a capital payment was made to them.

52.26 Schedule 4B & 4C: Scenarios and HMRC worked example

Suppose:
(1) The settlor lends to a trust.[37]
(2) The trust repays the loan.
The trust does not make a sch4B-transfer, so it does not make a sch4B-disposal, and sch 4C does not apply.

Suppose:
(1) The settlor lends to a trust ("trust 1").
(2) The settlor assigns the debt to another trust ("trust 2").
(3) Trust 1 repays the loan to trust 2.
(4) Trust 2 makes a payment to the settlor.
Trust 1 does not make a sch4B-transfer, so it does not make a sch4B-disposal.
Trust 2 does not borrow, so it also does not make a sch4B-disposal.

Suppose:
(1) The settlor lends to a trust

---

37 I refer for simplicity to the trust, though it would be more correct to refer to the trustees of the trust.

(2) The trustees lend to an underlying company

Schedule 4B and 4C apply.

Suppose:

(1) The settlor gives to a trust ("trust 1").

(2) Trust 1 lends to trust 2.

(3) Trust 2 transfers an asset to the settlor.

Trust 1 does not borrow, so it does not make a sch4B-disposal.

Trust 2 does make a sch4B-disposal. But trust 1 is not a relevant settlement.

52.26.1 *HMRC example*

HMRC s.87 guidance provides:

Example 30 – Paragraphs 138 & 139 Schedule 7 – New last in first out (LIFO) rules for allocating capital payments against gains in post 5 April 2008 Schedule 4C pools. Application of remittance basis to gains treated as accruing to beneficiaries who are non-UK domiciled remittance basis users.

A Schedule 4C TCGA pool of gains was created in 2008-09 as a result of a transfer of value linked with trustee borrowing. The transfer was between two non-UK resident settlements. The Schedule 4C TCGA pool consists of the following gains:

2004-05	Trustees' gains (section 2(2) amount)	£20,000
2005-06	Trustees' gains (section 2(2) amount)	£30,000
2008-09	Trustees' gains (section 2(2) amount) on transfer	£35,000

No capital payments have been made out of either settlement prior to 2009-10. The following capital payments are made subsequently out of the transferee settlement:

2009-10	Payment to non-UK resident and non-UK domiciled beneficiary	£90,000
2010-11	Payment to UK resident but non-UK domiciled beneficiary	£21,000
2010-11	Payment to UK resident and domiciled beneficiary	£42,000

The 2009-10 £90,000 capital payment to a non-UK resident and non-UK domiciled beneficiary is not matched with any of the gains (section 2(2) amounts) in the post 6 April 2008 Schedule 4C TCGA pool. This comes from the wording of the new paragraph 8(3)(b) Schedule 4C TCGA. The capital payment is still available to carry forward to be matched with future gains under section 87 or 89(2) TCGA.

The 2010-11 capital payments total £63,000 (£21,000 + £42,000). As this is less than the £85,000 gains in the post 6 April 2008 Schedule 4C TCGA pool then all the capital payments can be matched. The restriction that does not allow capital payments to a UK resident but non-UK domiciled beneficiary to be matched with gains in a pre 6 April 2008 Schedule 4C TCGA pool does not apply to a post 5 April 2008 Schedule 4C TCGA pool.

The new last in first out (LIFO) rules for matching capital payments with gains in the post 5 April 2008 Schedule 4C TCGA pool apply. These are applied by paragraph 138 Schedule 7 which introduces a new paragraph 8 Schedule 4C TCGA which applies the LIFO rules in section 87A TCGA.

So we look first at the latest gain (section 2(2) amount) in the post 5 April 2008 Schedule 4C TCGA pool. That is the 2008-09 gain of £35,000. This is all matched with capital

payments. Gains of £11,667 (£35,000 × £21,000 / [£21,000 + £42,000]) are attributed to the UK resident but non-UK domiciled beneficiary in 2010-11. Gains of £23,333 (£35,000 × £42,000 / [£21,000 + £42,000]) are attributed to the UK resident and domiciled beneficiary in 2010-11.

Next we look at the 2005-06 gain (section 2(2) amount) of £30,000. There are only capital payments left of £28,000 (£63,000 - £35,000) to match with this. Gains of £9,333 (£28,000 × £21,000 / [£21,000 + £42,000]) are attributed to the UK resident but non-UK domiciled beneficiary in 2010-11. Gains of £18,667 (£28,000 × £42,000 / [£21,000 + £42,000]) are attributed to the UK resident and domiciled beneficiary in 2010-11.

What remains in the post 5 April 2008 Schedule 4C TCGA pool are

2004-05	Trustees' gains (section 2(2) amount)	£20,000
2005-06	Trustees' gains (section 2(2) amount)	£2,000

The UK resident and domiciled beneficiary has attributed to them gains of £42,000 (£23,333 + £18,667). These are all chargeable to tax on the beneficiary for 2010-11.

The UK resident but non-UK domiciled beneficiary has attributed to them gains of £21,000 (£11,667 + £9,333). £9,333 of these are not chargeable to tax because they result from a matching with trustees' gains (section 2(2) amount) of a year before 2008-09 – paragraph 150 Schedule 7. The remaining £11,667 are chargeable to tax on the beneficiary in 2010-11 subject to the remittance basis. Paragraph 139 Schedule 7 introduces a new paragraph 8AA Schedule 4C TCGA which applies the section 87B remittance basis rules.

52.27 OIG sch 4C

Regulation 20(3) OFTR incorporates Sch 4C TCGA rules. So far as relevant, this provides:

> ... Schedule 4C to, TCGA 1992 apply in relation to OIG amounts as if—
>
> (a) references to section 2(2) amounts (except those in paragraph 7B(2)(b) and (4) of Schedule 4C) were to OIG amounts,
>
> (b) references to chargeable gains (except the one in paragraph 1(5) of Schedule 4C) were to offshore income gains,
>
> (c) references to anything accruing were to it arising[38] (and similar references, except the one in paragraph 1(5) of Schedule 4C, were read accordingly),
>
> (d) ... paragraphs 1(3A), 3 to 7 and 12 of Schedule 4C were omitted ...

For the application of s.87-98 TCGA to OIGs, see 35.13 (OIG s.87 charge).

It is necessary to distinguish the CGT sch 4C rules and the OIG sch 4C

38 The terminology of the Taxes Acts is that CGT chargeable gains *accrue;* but OIGs *arise*. There is no difference in meaning so it seems somewhat pedantic to make the change of terminology when incorporating Sch 4C for OIGs; but it does no harm.

rules because the rules are not identical. It might be helpful to use the following terminology:

(1) "**CGT sch 4C**", the provisions of sch 4C TCGA.

(2) "**OIG sch 4C**", the provisions of sch4C as amended, which apply when the trust has "**OIG amounts**".

The omission of para 1(3A) and paras 3-7 Sch 4C makes sense as sch 4B does not apply to OIGs. It would have been logical to omit para 7B; instead the drafter neutralises it by not amending references to it.

The omission of para 12 Sch 4C makes sense, as s.86 TCGA does not apply to OIGs.

52.28 2008 transitional rules for Sch 4C

HMRC s.87 guidance provides:

123. Schedule 4C pools created before 6 April 2008 are dealt with differently from those created after 5 April 2008. In broad terms Schedule 4C pools created before 6 April 2008 continue to be dealt with under Schedule 4C as it applied before Schedule 7 changes – paragraph 152 of Schedule 7. See example 28. It is not possible for post 5 April 2008 trust gains to be added to a pre 6 April 2008 Schedule 4C pool.

124. There are ordering rules for matching capital payments made after 5 April 2008. They are matched in the following order under paragraph 155 of Schedule 7: See example 29.

• First against gains in a Schedule 4C pool created after 5 April 2008

• Second against gains in a Schedule 4C pool created before 6 April 2008

• Third against gains not in a Schedule 4C pool

125. Where capital payments are matched against gains in a Schedule 4C pool created before 6 April 2008 earlier gains continue to be matched with earlier capital payments. In other words FIFO (first in, first out) rules continue to apply rather than the general new LIFO (last in, first out) rules. This is relevant for calculating the "increase in tax" charge under paragraph 13 of Schedule 4C.

Example 28 – Paragraph 152 of Schedule 7 – Pre 6 April 2008 Schedule 4C TCGA pool – Capital payments made post 5 April 2008 to UK domiciled and non-UK domiciled beneficiaries

A Schedule 4C TCGA pool of gains was created in 2006-07 as a result of a transfer of value linked with trustee borrowing. The transfer was between two non-UK resident settlements. The Schedule 4C TCGA pool consists of the following gains:

2004-05	Trustees' gains (section 2(2) amount)	£20,000
2005-06	Trustees' gains (section 2(2) amount)	£30,000
2006-07	Trustees' gains (section 2(2) amount) on transfer	£70,000

No capital payments have been made out of either settlement prior to 2008-09. The following capital payments are made subsequently out of the transferee settlement:

2008-09	Payment to non-UK domiciled beneficiary	£90,000
2009-10	Payment to UK resident and domiciled beneficiary	£60,000

Paragraph 152 Schedule 7 confirms that you apply the pre FA 2008 version of Schedule

4C TCGA when matching post 5 April 2008 capital payments to gains in the pre 6 April 2008 Schedule 4C TCGA pool.

The 2008-09 £90,000 capital payment to a non-UK domiciled beneficiary is not matched with any of the gains (section 2(2) amounts) in the pre 6 April 2008 Schedule 4C TCGA pool. This comes from the pre FA 2008 wording of paragraph 8(3) Schedule 4C TCGA. The capital payment is still available to carry forward to be matched with future gains under section 87 or 89(2) TCGA or gains in a post 5 April 2008 Schedule 4C TCGA pool.

The 2009-10 £60,000 capital payment to a UK resident and domiciled beneficiary is matched with £60,000 of the gains (section 2(2) amounts) in the pre 6 April 2008 Schedule 4C TCGA pool. This results in £60,000 gains being treated as accruing to the beneficiary in 2009-10. The capital payment is matched against gains (section 2(2) amounts) on a first in first out (FIFO) basis. This comes from the pre FA 2008 wording of paragraph 8B(2) Schedule 4C TCGA. So for the purpose of the "increase in tax" charge under paragraph 13 Schedule 4C TCGA the £60,000 capital payment is matched against gains (section 2(2) amounts) in the following order:

- First against the 2004-05 £20,000 gains (section 2(2) amounts)
- Second against the 2005-06 £30,000 gains (section 2(2) amounts)
- Third the remaining £10,000 (£60,000 – [£20,000 + £30,000]) of the capital payment against £10,000 of the 2006-07 gains (section 2(2) amounts)

This leaves £60,000 gains in the Schedule 4C TCGA pool which are all gains (section 2(2) amounts) from 2006-07.

Example 29 – Paragraph 155 of Schedule 7 – Ordering rules for allocating capital payments between different Schedule 4C pools and gains dealt with under section 87 or 89(2)

A pre 6 April 2008 Schedule 4C TCGA pool of gains was created in 2006-07 as a result of a transfer of value linked with trustee borrowing. A post 5 April 2008 Schedule 4C TCGA pool of gains was created in 2008-09 as a result of a further transfer of value linked with trustee borrowing. Paragraph 152 of Schedule 7 applies to keep the Schedule 4C TCGA pools separate. Both transfers were between the same two non-UK resident settlements. Additionally there are unmatched gains (section 2(2) amounts) in the transferee settlement. In summary the gains are:

2004-05	Trustees' gains (section 2(2) amount) in transferee settlement	£10,000
2006-07	Pre 6 April 2008 Schedule 4C pool - gains	£50,000
2008-09	Post 6 April 2008 Schedule 4C pool - gains	£30,000
2009-10	Trustees' gains (section 2(2) amount) in transferee settlement	£20,000

In 2010-11 a capital payment of £95,000 is made from the transferee settlement to a UK resident and domiciled beneficiary. The rules in paragraph 155 Schedule 7 say that the capital payment is allocated against gains in the following order:

- First against the £30,000 gains in the post 5 April 2008 Schedule 4C TCGA pool
- Second against the £50,000 gains in the pre 6 April 2008 Schedule 4C TCGA pool
- Third the remaining £15,000 (£95,000 – [£30,000 + £50,000]) of the capital payment against £15,000 trustees' gains (section 2(2) amount) in the transferee settlement.

Next you go to the new section 87A TCGA matching rules to decide which trustees' gains these £15,000 capital payments are matched with. The last in first out (LIFO) rule there matches it all with £15,000 of the 2009-10 £20,000 trustees' gains (section 2(2) amount). This leaves unmatched trustees' gains (section 2(2) amount) of:

2004-05	Trustees' gains (section 2(2) amount) in transferee settlement	£10,000
2009-10	Trustees' gains (section 2(2) amount) in transferee settlement	£5,000

52.29 Commentary

In accordance with government policy, there was no consultation or discussion on the enactment, or multiple amendments, of Sch 4B and 4C, but it is worth looking back now to assess them.

HMRC would regard Sch 4B and 4C (in their current form) as successful, as they successfully stopped the schemes at which they are addressed.

Measured by any other criteria they are a failure. They are far too wide (applying to arrangements where there is no avoidance). They are so wonderfully complicated and counterintuitive that one could not expect even conscientious trustees to comply, except some of the largest trusts with large budgets for UK professional advice. A full analysis - which would be several times the length of this long chapter - will never be written.

I expect that the drafter only expected HMRC, and taxpayers, to look at the rules in cases of "abuse"; an attitude HMRC have expressed in relation to other over-wide anti-avoidance legislation.[39] They are in practice generally ignored, by HMRC and by taxpayers. They remain like unexploded ammunition from a distant war: exceptionally careful taxpayers avoid it; others disregard it, generally with impunity as HMRC will rarely know and may not care. While never satisfactory, the problems have been made much worse by the extension of the scope of the s.87 charge in 2008. In all these respects, of course, schedules 4B and 4C are not very different from other anti-avoidance legislation of their time.

If a serious attempt is ever made to rationalise the UK taxation of offshore trusts, something much better can be devised. The easiest course would be to restrict the rules with a focussed motive test, ie they only apply where there is a purpose specifically to avoid s.87 or s.86. The schemes at which they are aimed are complex and artificial ones where the avoidance intention is hardly to be denied. The 2013 s.13 amendments offer a precedent.[40]

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39 For an example, see Kessler & Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013), para 3.15 (Can bona fide charities safely ignore the substantial donor rules?) (online version *http://www.taxationofcharities.co.uk*).

40 See 53.19 (S.13 motive defence).

CHAPTER FIFTY THREE

GAINS OF NON-RESIDENT COMPANIES

53.1 Section 13 TCGA: Introduction

Non-resident companies generally pay no UK tax on chargeable gains. This presents an obvious means of CGT avoidance. HMRC's first answer to this is s.13 TCGA. The same problems arise for income of non-resident companies and for income and gains of non-resident trusts, but the statutory solutions are entirely different.

I refer to the gains treated as accruing to a participator under section 13 TCGA as **"s.13 gains"**.

53.1.1 *Cross references*

The following topics are dealt with elsewhere:

39.4 (Gains accruing to unit trust).

59.7 (Double Taxation relief).

51.33.4 (Should trustees hold assets through an underlying company?)

For s.13 gains accruing to charities, see Kessler & Marre, *Taxation of Charities and Nonprofit Organisations*, (9th ed., 2013), para 4.6 (Section 13 TCGA) (online version *http://www.taxationofcharities.co.uk*).

53.2 Non-resident close company

Section 13(1) TCGA provides:

> This section applies as respects chargeable gains accruing to a company—
>
> (a) which is not resident in the UK, and
>
> (b) which would be a close company if it were resident in the UK.

For the definition of close company see 85.19 (Close company: Introduction).

In this chapter when I refer to a company I assume it is a non-resident close company.

53.3 Attribution of s.13 gains to participator

Section 13(2) TCGA provides:

> Subject to this section, every person
> [a] who at the time when the chargeable gain accrues to the company is resident in the UK, and
> [b] is a participator in the company,
> shall be treated for the purposes of this Act as if a part of the chargeable gain had accrued to him.

The sidenote to s.13 calls this "attribution" of gains.[1] Section 13(4)(9)(10) refers to gains "apportioned" to participators. The terms "attribute" and "apportion" are interchangeable.

53.3.1 *Gains accruing in split year of participator*

Section 13(3A) TCGA provides the usual split year rule:

> Subsection (2) does not apply in the case of a participator who is an individual if—
> (a) the tax year in which the chargeable gain accrues to the company is a split year as respects the participator, and
> (b) the chargeable gain accrues to the company in the overseas part of that year.

53.4 Non-resident trustees

Non-resident trustees would not be within s.13(2) TCGA because that only applies to UK residents. However, s.13(10) TCGA provides:

> The persons treated by this section as if a part of a chargeable gain accruing to a company had accrued to them shall include the trustees of a settlement who are participators
> [a] in the company, or
> [b] in any company amongst the participators in which the gain is apportioned under subsection (9) above,
> if when the gain accrues to the company the trustees are not resident in the UK.

Section 13(10) was added to the legislation in 1981, and its clumsy

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1 The sidenote reads: "Attribution of gains to members of non-resident companies". The reference to *members* has been wrong since 1995 and should read *participators* but nothing turns on that.

drafting raises some difficulties, discussed below.

53.5 Computation of non-resident company gains on CT principles

It is necessary to ascertain the amount of the chargeable gains accruing to the non-resident company.

Section 13 applies to chargeable gains, so reliefs (including substantial shareholding relief) which prevent a gain from being a chargeable gain apply for the purposes of s.13.

Section 13(11A) TCGA provides:

> For the purposes of this section the amount of the gain or loss accruing at any time to a company that is not resident in the UK shall be computed (where it is not the case)[2] as if that company were within the charge to corporation tax on capital gains.

Indexation relief is applicable because a company within the charge to CT qualifies for that relief.

Section 295(1) CTA 2009 provides:

> The general rule for corporation tax purposes is that all profits arising to a company from its loan relationships are chargeable to tax as income in accordance with this Part.

Gains on debts and other loan relationships (including life policies and foreign exchange gains) are not within s.13. Applying the deeming provision of s.13(11A) they are chargeable to tax as income, so no chargeable gain accrues on the disposal.[3] The same applies to gains on:

(1) Derivative contracts, chargeable to CT as income under part 7 CTA 2009.
(2) Intangible fixed assets, chargeable to CT as income under part 8 CTA 2009.

For a participator who is an individual or a trust, this seems too good to be true, which raises the question whether a court should construe the deeming provision purposively so as to avoid that result.[4] However, s.13 also applies to a participator which is a company. It would be anomalous if a corporate participator did *not* obtain indexation relief, and somewhat surprising if loan relationship (etc) gains were treated as chargeable gains.

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2 The words in brackets appear to be otiose.

3 Section 37 TCGA 1992.

4 As was done in *De Rothschild v Lawrenson* 67 TC 300.

The battle of the anomalies does not give a clear result, and the deeming provision should be given full effect.

HMRC accept this reasoning. They say:

> As a consequence of the application of the loan relationship rules, a gain which accrues to a non-UK resident company on disposal of a debt represented by a balance in a non-sterling bank account will not be a chargeable gain. If the company has no chargeable gain, section 13 is not engaged, and therefore UK resident participators cannot be liable to tax in respect of such disposals. This difference in treatment between non-sterling bank accounts held directly and those held indirectly via a non-UK resident company is long standing and there are no plans for its amendment.[5]

The 2012 foreign currency reforms were enacted on this basis.[6]

Gains on debts and policies often qualify for other CGT reliefs, so the question whether such gains could fall within s.13 may not arise.

53.6 Identifying the participators

It is necessary to identify the participators in the non-resident company. Section 13(12) TCGA provides:

> In this section "participator", in relation to a company, has the meaning given by section 454 of CTA 2010.

This takes us to the elaborate standard definition; see 85.17 (Definition of participator). It was not drafted with s.13 in mind. One company can have too many participators for s.13 to cope with easily. I refer to this as the problem of "**overlapping participators**".

The problem may arise in the case of trusts,[7] loan creditors[8] and chains of companies.[9] The problem is solved in different ways in each case.

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5 Statement published online 9 Dec 2009 *http://www.hmrc.gov.uk/cnr/remittance-basis.htm*.

6 The 2012 relief on disposals of foreign currency bank accounts applies to individuals, trustees and PRs but not to companies, because companies do not need the relief: see 55.10 (Foreign currency bank accounts: CGT).

7 See 53.7 (Overlapping participators: trustees and beneficiaries).

8 See 53.10 (Overlapping participators: loan creditors).

9 See 53.12 (Chains of companies).

53.7 Overlapping participators: trustees and beneficiaries

Suppose a company is owned by a trust. The trustees are participators. The beneficiaries, except perhaps discretionary beneficiaries, are participators under s.454(1) CTA 2010 since they have an interest in the trust property. See 85.17.4 (Trustees and beneficiaries).

The difficulties this would cause for s.13 TCGA were recognised, and beneficiaries are taken out of s.13 by s.13(14) TCGA:

> For the purposes of this section, where—
>
> (a) the interest of any person in a company is wholly or partly represented by an interest which he has under any settlement ("his beneficial interest"), and
>
> (b) his beneficial interest is the factor, or one of the factors, by reference to which that person would be treated (apart from this subsection) as having an interest as a participator in that company,
>
> the interest as a participator in that company which would be that person's shall be deemed, to the extent that it is represented by his beneficial interest, to be an interest of the trustees of the settlement (and not of that person), and references in this section, in relation to a company, to a participator shall be construed accordingly.

The CG Manual correctly provides:

> **57222 Basic conditions for Section 13 TCGA 1992: Beneficiaries: Section 13(4) TCGA 1992** [April 2011]
>
> Where the trustees of a settlement, whether resident in the UK or not, are participators in a non-resident company then in certain circumstances a beneficiary of the settlement will also be within the definition of participator. The effect of Section 13(14) is that once you reach shares or other interests held by trustees, except in the case of a bare trust, see CG34300, you stop there. In deciding how the chargeable gain of the company should be apportioned, you treat the trustees as if they were the beneficial owners of their shares or other interests and apportion the gain to them as appropriate, ignoring the interests of the beneficiaries. If the trustees are resident then their share of the gain is assessed on them, [or on the settlor under TCGA 1992, S 77 in relevant cases].[10] If the trustees are non-resident then the gain is subject to TCGA 1992, S 86 and TCGA 1992, S 87, see CG57395. Any interest

10 Words in square brackets are out of date since 2008.

> as a participator in the non-resident company which the beneficiary holds in their own right, for example by a personal holding of shares in the non-resident company, will remain within Section 13.

53.8 Foundations

At first sight, a foundation may be a close company[11] and so within s.13. At first sight, s.13(14) does not apply to a foundation as "settlement" in s.13(14) has the IT/CGT meaning: a foundation is not a settlement in that sense..

If that is right, two questions arise:

(1) Are beneficiaries of a foundation participators?[12]
(2) If they are participators, what is the extent of their interest under s.13(3)?

These questions raise imponderable and unexplored sub-issues: what are the rights of the beneficiaries (a matter of the foundation constitution, construed under the law of the foundation); and do those rights amount to "interests" for these purposes (a matter of UK law)?

It is suggested that the presumption against double taxation applies: since a foundation is a settlement for the purposes of s.87, it should not fall within the scope of s.13. The better view is that a foundation is a settlement within the protection of s.13(14); but an alternative route to the same destination is that a foundation is not a company within the meaning of s.13.

In practice the HMRC view is that that foundations should be taxed as trusts, so these questions do not arise.[13]

53.9 Amount of gain attributed to each participator

Once one has identified the participators, one asks how much of the company's gain is attributed to each of them. Section 13(3) TCGA provides:

> That part shall be equal to the proportion of the gain that corresponds to the extent of the participator's interest as a participator in the company.

This takes us to s.13(13) TCGA:

> In this section—

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11 See 84.8 (Foundation/*Stiftung*)
12 See 85.17.4 (Trustees and beneficiaries).
13 See 84.8.7 (HMRC view).

(a) references to a person's interest as a participator in a company are references to the interest in the company which is represented by all the factors by reference to which he falls to be treated as such a participator;...

That is, "interest" in s.13(3) is not construed in a narrow or technical manner. Section 13(13) continues:

(b) references to the extent of such an interest are references to the proportion of the interests as participators of all the participators in the company (including any who are not resident in the UK) which on a just and reasonable apportionment is represented by that interest.

What is just and reasonable? The CG Manual starts with general comments:

57260 Section 13 TCGA 1992: Participators' fractional interests [August 2013]

...

The just and reasonable requirement

It is quite possible for the different criteria by which persons are participators to produce different percentages for one person's interest in a company. So under one test, for example entitlement to income, A may have 60% and B have 40% and under another test, for example entitlement to capital, A have 36%, B have 54% and C have 10%. This can happen even with relatively simple company structures, for example where there are preference shares, or loans. The total amount of gains apportioned cannot exceed the chargeable gain of the non-resident company. In this situation the gain has to be apportioned as is just and reasonable. This includes taking into account the interests of non-residents.

In considering a just and reasonable apportionment you should take into account all relevant factors, and not simply make an arithmetical adjustment. It would not usually be correct merely to average out the interests using the different factors. The aim of the provisions is to ensure that the gain is attributed to the participators who have the real economic interest in the non-resident company and who will derive the benefit of the gain however indirectly. The just and reasonable apportionment prevents an inappropriate part of the gain being attributed to persons without real economic interests, for example commercial loan creditors, see below.

53.10 Overlapping participators: Loan creditors

The problem of overlapping participators including loan creditors is solved, or fudged, by a just and reasonable apportionment. The CG Manual provides:

> **57260. Section 13 TCGA 1992: Participators' fractional interests** [April 2011]
> *Loan creditors*
> Any loan creditor of the non-resident company is within the definition of participator as applied for the purposes of Section 13. The aim of the provisions is to ensure that the gain is attributed to the participators who have the real economic interest in the non-resident company. There will be cases where a loan creditor will be a person or institution (such as a bank or similar financial institution) which has loaned money to the non-resident company as a matter of business on commercial terms. The interest of such a loan creditor acting at arms length will be limited to an expectation of repayment of the amount loaned together with payments of interest at a commercial rate. There will be no expectation that the loan creditor can or will benefit from the profits or gains of the non-resident company. In such a case it would not be just and reasonable to apportion any of the gain to a loan creditor of this type. The attribution should be made to those participators who have a real economic interest in the capital gains.
> Where there are participators who are loan creditors it will be necessary to review all of the circumstances to satisfy yourself that the interests of the loan creditors can be excluded for the reasons in the preceding paragraph. In some cases the persons with the real economic interest in the non-resident company will be loan creditors whether or not they are participators under one or more of the other tests set out in CG57221. In such cases, where there is participation in more than one way, it may be appropriate, depending on the facts of the case, to aggregate the interests of those persons in reaching an apportionment that is just and reasonable.
> In other cases the persons with the real economic interest in the non-resident company may be providing the funds which the loan creditor has loaned to the company, and may be persons who are entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for their benefit, see the test in CG57221, and may be participators in their own right by virtue of that test.

53.11 CG Manual examples: Shareholders v. loan creditors

53.11.1 *Non-resident shareholder*

The CG Manual starts with a very simple example:

> **57280. Computation of TCGA 1992, S 13 charge** [April 2011]
> Facts
> - a non-resident company has issued share capital of 150 Ordinary shares
> - A, B, C and D own 50 shares
> - A, B, C are all resident in the UK. C has never been resident in the UK
> - the non-resident company realises a gain of3200,000
>
> CGT computations
> You compute the TCGA 1992, S 13 charge as follows.
> ***STEP 1***
> Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 300,000.[14]
> ***STEP 2***
> Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances. In this case each of the three participators has a 33 1/3 per cent interest.
> ***STEP 3***
> Calculate the proportion of the gain apportionable to the interests of each participator. Calculate the interests of all participators, including any who are not resident in the UK. In this case the proportion for each participator is 33 1/3% interest
> ***STEP 4***
> Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is just and reasonable. Gains of 100,000 are attributed to each of A and B and treated as gains accruing to them on the date on which the gain actually accrued to the company.
> C is not liable to UK taxation. But it would not be just and reasonable to reapportion C's gain of 100,000 to A and B as C has a real economic interest in the non-resident company.

14 Chargeable gains can accrue whether or not a company is UK resident. See 49.1 (Territorial scope of CGT), but the method of computation of the gain is different for a UK resident company. However this does not make any difference to the examples.

53.11.2 *Examples with loan creditors*

The CG Manual then gives two examples involving loan creditors. The first involves a loan on commercial terms:

> **57281. Computation of TCGA 1992, S 13 charge** [October 2013]
> Facts
> • A and B each own 50 shares
> • A and B are both resident in the UK
> • C is a loan creditor for 400,000. The loan is an arm's length commercial transaction and interest is payable at a fully commercial rate on the loan
> • the non-resident company realises a gain of 500,000
> • the total capital of the non-resident company after the gain is 1,000,000

The solution is to disregard the loan creditor, though the Manual takes many lines to reach this conclusion:

> **CGT computations**
> You compute the TCGA 1992, S 13 charge as follows.
> STEP 1
> Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 500,000.[15]
> STEP 2
> Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.
> A is a 50% participator by reference to the shareholding of 50 shares
> B is a 50% participator by reference to the shareholding of 50 shares
> C is a participator as a loan creditor, being entitled to an amount of 400,000 out of the total capital of 1,000,000
> STEP 3
> Calculate the proportion of the gain apportionable to the interests of each participator. In this case the proportion for each participator is
> A (as shareholder) 500,000×50% = 250,000
> B (as shareholder) 500,000×50% = 250,000
> C (as loan creditor) 500,000×40% = 200,000
> STEP 4
> Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is not just and

15 See above footnote.

reasonable as the total of the gains under the initial apportionment exceeds the actual gain. C is a participator only by virtue of being a commercial loan creditor, see CG57265. C's entitlement as loan creditor should be ignored, subject to a review of the circumstances to establish that C is merely a commercial loan creditor and has no entitlement to a share of profits or gains, and that there are no other arrangements. In this example it is assumed that there are no other arrangements and therefore the whole of the gain should be apportioned by reference to the interests in shares. The final apportionment becomes
A (as shareholder) 500,000×50% = 250,000
B (as shareholder) 500,000×50% = 250,000

The second example is the same but the loan is interest-free and from a shareholder:

57282. Computation of TCGA 1992, S 13 charge [October 2013]
Facts
- a non-resident company has issued share capital of 100 Ordinary shares
- A and B each own 50 shares
- A and B are both resident in the UK
- A is a loan creditor for 200,000. No interest is payable on the loan
- the non-resident company realises a gain of 500,000.
- the total capital of the non-resident company after the gain is 1,000,000

The solution is *still* to disregard the loan creditor, though the Manual is not quite so confident in its answer:

CGT computations
You compute the TCGA 1992, S 13 charge as follows.
STEP 1
Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 500,000.[16]
STEP 2
Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.
A is a 50% participator by reference to the shareholding of 50 shares
B is a 50% participator by reference to the shareholding of 50 shares
A is also a participator as a loan creditor, being entitled to an amount of

16 See above footnote.

200,000 out of the total capital of 1,000,000. If all of the assets of the company were to be distributed immediately after the accrual of the gain the entitlements of A and B would be
A: 200,000 (as loan creditor) plus 50% of the balance of 800,000 (as shareholder), a total of 600,000 or 60% of the assets.
B: 400,000, 50% of the balance of 800,000 (as shareholder), or 40 % of the assets.
STEP 3
Calculate the proportion of the gain apportionable to the interests of each participator. In this case there are two possible apportionments.
A: 500,000×50% = 250,000
B: 500,000×50% = 250,000
or
A: 500,000×60% = 300,000
B: 500,000×40% = 200,000
STEP 4
Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. As there are at least two possible apportionments we must consider all of the facts relating to the arrangements under which A's loan was made and the arrangements regarding profits and gains of the company. For instance:
- Does the loan agreement give A any preferential rights to profits or gains, or simply to a repayment of the capital?
- Is B entitled to an equal share of profits or gains?

In such cases there is no easy answer and a full consideration of all of the relevant circumstances is necessary. On the bare facts of this example A has no preferential rights and consequently an apportionment by reference to the shareholdings, effectively excluding A's participation as loan creditor, may be just and reasonable. If so, the gain would be attributed
A: 500,000×50% = 250,000
B: 500,000×50% = 250,000

53.11.3 *Two classes of shares*

The CG Manual's next example concerns a company with two classes of shares:

57283. Computation of TCGA 1992, S 13 charge [October 2013]
Facts
- a non-resident company has issued share capital of 100 A shares and 100 B shares.
- both classes of shares carry equal voting rights but the B shares carry

no entitlement to dividends or distributions in a winding-up.

- the A shares are owned by X who is resident in the UK
- the B shares are owned by Y who has never been resident in the UK
- the non-resident company realises a gain of 200,000.

CGT computations

You compute the TCGA 1992, S 13 charge as follows.

STEP 1

Calculate the gain that would have arisen if the non-resident company had been resident in the UK. This is 200,000.[17]

STEP 2

Determine the interests of all participators, including any who are not resident in the UK, by applying the tests of participation appropriate to the circumstances.

Participator	Voting rights	Distributions
X	50%	100%
Y	50%	0%

X is a 50% participator by reference to voting rights attached to the shareholding in A shares.

Y is a 50% participator by reference to voting rights attached to the shareholding in B shares.

X is a 100% participator by reference to rights to dividends and distributions attached to the shareholding in A shares.

STEP 3

Calculate the proportion of the gain apportionable to the interests of each participator.

X (rights to income and capital)	200,000×100% = 200,000
Y (voting rights)	200,000×50% = 100,000

STEP 4

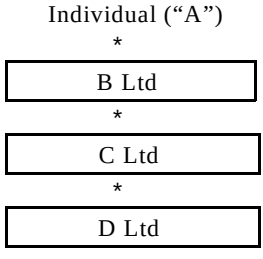
Consider whether the gains calculated in Step 3 represent a just and reasonable apportionment. In this case the apportionment is not just and reasonable as the total of the gains under the initial apportionment exceeds the actual gain. A full review of all of the circumstances would be necessary. It appears that the true economic interest in the non-resident company is held solely by X. Y's entitlement should be ignored, and the whole of the gain apportioned to X.

53.12 Chains of companies

53.12.1 *Overlapping participators: Chains of wholly owned companies*

Suppose a chain of wholly owned companies:

17 See above footnote.

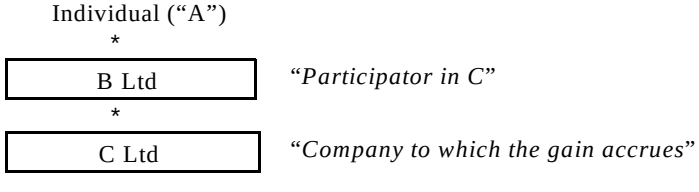


C Ltd is a participator in D Ltd under s.454(1) CTA 2010. But A and B Ltd are also participators, under s.454(2)(c) CTA 2010.[18] This is so wherever the companies are resident. Chains of wholly owned companies raise the problem of overlapping participators.

Section 13(9) TCGA provides:

> [a] If a person who is a participator in the company at the time when the chargeable gain accrues to the company is itself a company which
> [i] is not resident in the UK but which
> [ii] would be a close company if it were resident in the UK,
> [b] [i] an amount equal to the amount apportioned under subsection (3) above out of the chargeable gain to the participating company's interest as a participator in the company to which the gain accrues
> [ii] shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and
> [c] subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned,
> [d] and so on through any number of companies.

Suppose a simple chain of two wholly owned non-resident companies:



If a gain accrues to C, what is apportioned to A? Under s.13(9)[b][i] it is "an amount equal to the amount apportioned under s.13(3)" to B as a

18 See 85.17.2 (Chain of wholly owned companies).

participator in C. This is not well drafted, as nothing is apportioned under s.13(3) to B. No apportionment can be made since B is not UK resident![19] But the courts must correct that infelicity and construe the words to mean, the amount that would have been apportioned to B, had it been UK resident.

The CG Manual provides:

> **57290. Indirect interests: Introduction** [April 2011]
> Without special rules UK resident shareholders or participators could avoid the TCGA 1992, S 13 charge by placing another non-resident company between themselves and the company making the gain. TCGA 1992, S 13(9) prevents this by allowing the Revenue to look through a chain of non-resident companies. The gain is apportioned to the first tier of UK residents or non-resident trusts in the chain of interests. For TCGA 1992, S 13(9) to apply each company in the chain must itself satisfy the basic conditions outlined in CG57220.
> Therefore each company must be
> • a company that is not resident in the UK and
> • a company that would be a close company if it was resident in the UK.

The CG Manual begins with a straightforward example:

> EXAMPLE 1[20]
>
> Mr A — *UK resident and domiciled shareholder*
> *
> B Ltd — *non-resident close company*
> *
> C Ltd — *non-resident close company*
> *
> D Ltd — *non-resident close company*

Gains accruing to D Ltd are not attributed to C under s.13(2) because C is not UK resident. See s.13(2)[a]. But the CG Manual correctly notes:

> Any gains of D Ltd can be apportioned to Mr A because TCGA 1992, S 13(9) allows you to look through the chain of non-resident closely controlled companies.

The next example concerns a chain including a resident company:

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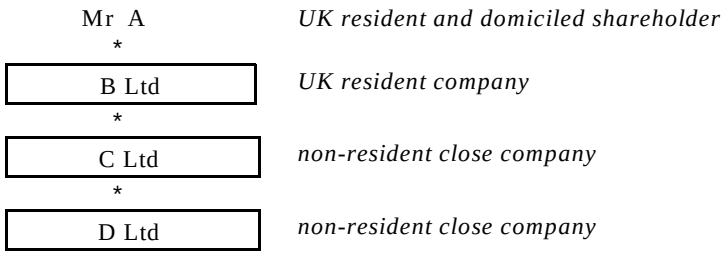
19 One might also argue that apportionment is under s.13(2) and not s.13(3).

20 I have added the diagrams to increase clarity.

EXAMPLE 2

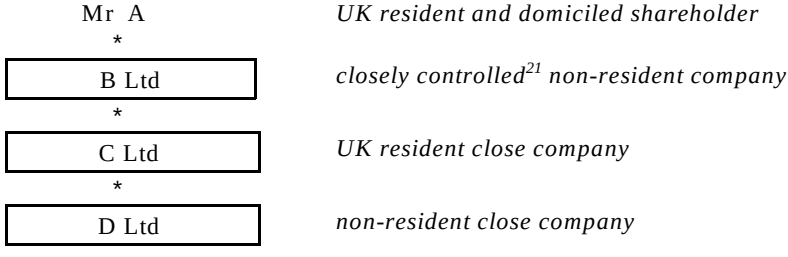


The Manual analyses this as follows:

> Any gains of D Ltd can be apportioned to B Ltd but not Mr A. This is because B Ltd is the first UK resident shareholder in the chain.

This was correct before 1995, when s.13(2) and (9) TCGA only apportioned gains to a *shareholder* in a non-resident company. A is not a shareholder of D Ltd. But why can't A be assessed now under s.13(2) or (9)? A *is* a participator in D Ltd. Perhaps this restricted rule is implied by s.13(9) TCGA. Or if not, perhaps it would be just and reasonable to apportion under 13(2) to company B and to no-one else. One way or the other, the problem of overlapping participators in chains of companies is solved by stopping at the first UK resident company.

EXAMPLE 3



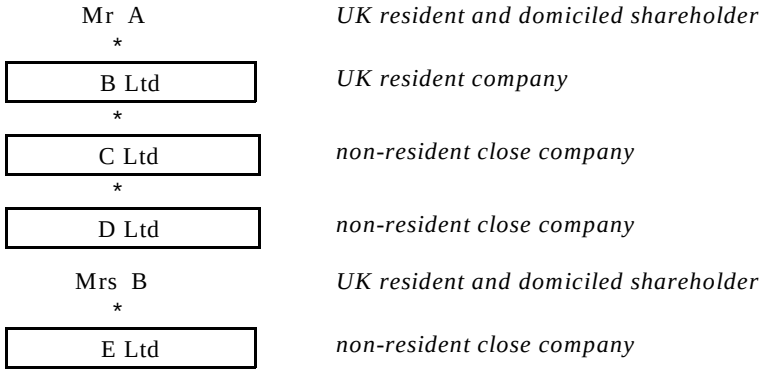
> Any gains of D Ltd can be apportioned to C Ltd but not Mr A even though Mr A owns shares in B Ltd a closely controlled non-resident company. (Gains which accrue to B Ltd in its own right on disposal of its own assets can be apportioned to Mr A.)

The next Manual example is a straightforward variation on the above:

---

21 The express "closely controlled" is used here (somewhat unhelpfully) as a synonym of "close".

57291. Indirect interests: UK resident shareholder in the chain of participators [April 2011]
When considering the operation of TCGA 1992, S 13(9) each chain of shareholdings must be considered separately.
Example



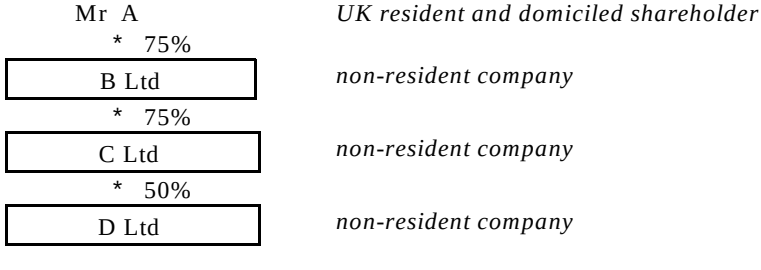
The gains of [E Ltd][22] can be apportioned to Mrs B because she is the first UK resident shareholder in that chain of shareholdings. The gains of D Ltd cannot be apportioned to Mr A because B Ltd is the first UK resident shareholder in that chain of shareholdings.

53.13 Chains of companies not wholly owned

We have so far considered simple chains of wholly owned companies. The CG Manual continues with an example of a less than 100% chain:

57291. Indirect interests: UK resident shareholder in the chain of participators [April 2011]
... You calculate the extent of a person's indirect interest on a particular test of participation by multiplying the proportional interest in the assets of each company in the chain.

EXAMPLE



22 The original reads "D Ltd" which must be a slip for "E Ltd", if the diagram is correct.

> If D Ltd makes gains of 100,000 the TCGA 1992, S 13 charge on Mr A is £100,000×50%×75%×75% = £28,125.

Mr A is a participator in B Ltd. Mr A is not a participator in D Ltd but that does not matter because C Ltd is a participator in D Ltd, B Ltd is a participator in C Ltd, and gains of D Ltd are attributed to Mr A under s.13(9) TCGA. It is assumed for the purposes of the example that D Ltd is close, which is not necessarily the case; it depends on the other shareholdings, which are not specified in the example.

53.14 Section 13 remittance basis

Section 14A TCGA provides a relief which I call "**the s.13 remittance basis**". Section 14A(1) provides:

> This section applies if—
>
> (a) by virtue of section 13, part of a chargeable gain that accrues to a company on the disposal of an asset is treated as accruing to an individual in a tax year, and
>
> (b) the individual is not domiciled in the UK in that year.

In short, the relief applies to a remittance basis taxpayer.

Section 14A(2) provides the relief:

> The part of the chargeable gain treated as accruing to the individual ("the deemed chargeable gain") is a foreign chargeable gain within the meaning of section 12 if (and only if) the asset is situated outside the UK.

Although the statutory term is "deemed chargeable gains" I prefer to use the term"**s.13 gains**" to distinguish them from other deemed chargeable gains. Section 14A(2) brings s.12 TCGA into application and so provides for the remittance basis.

Section 14A(3) TCGA provides:

> For the purposes of Chapter A1 of Part 14 of ITA 2007 (Remittance Basis)—
>
> (a) treat any consideration obtained by the company on the disposal of the asset as deriving from the deemed chargeable gain, and
>
> (b) unless the consideration so obtained is of an amount equal to the market value of the asset, treat the asset as deriving from the deemed chargeable gain.

In the absence of express provision, it might be argued that the s.13 gain

could not be remitted as it does not exist. Section 14A(3)(a) deals with that problem.

Section 14A(3)(b) is necessary since the equivalent rule in s.809T ITA only applies to gains accruing on a disposal by an individual.

Suppose:

(1) A non resident company ("OC") disposes of a foreign situate asset and realises a gain.
(2) The gain (or part) is deemed to accrue to T (an individual taxable under the remittance basis).

T is subject to tax on the gain if OC brings/receives/uses the sum in the UK, if a company is a relevant person in relation to T. A company within s.13 will in principle be a relevant person in relation to T.

If OC distributes the sum by way of dividend and T brings/receives/uses the sum in the UK then T is arguably subject to two charges:

(1) CGT on the s.13 gain (for what F receives is derived from the gain) and
(2) IT on the distribution.

The same applies if OC is held by an IIP trust.

Likewise if OC is wound up and the liquidator distributes the sum by way of capital distribution, and F brings/receives/uses the sum in the UK then F is arguably subject to two charges:

(1) CGT on the s.13 gain (for what F receives is derived from the gain) and
(2) CGT on the disposal of the shares in OC.

If there are two charges, company distribution relief may apply. But the better view is that there is only a single charge to tax in these cases. One receipt cannot give rise to two charges under the remittance basis.[23]

53.15 EU law compliance

In 2011 the European Commission formally requested the UK to amend s.13 TCGA (and the ToA provisions[24]). The request took the form of reasoned opinions, the second step of the infringement procedure.[25] The text of the reasoned opinions was not published, but an EC press release provided the main details:

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23 See 11.15.11 (Income from income/gains).

24 See 28.15.1 (EC infringement proceedings).

25 Art.258 TFEU.

> The second infringement relates to the attribution gains to member of non-UK resident companies regime [s.13 TCGA]. Under this legislation, if a UK-resident company acquires more than a 10%[26] share of a company in another Member State, and the latter company realises capital gains from the sale of an asset, the gains are immediately attributed to the UK company, which becomes liable for corporation tax on these capital gains. If, on the other hand, the UK company had invested in another UK resident company, only the latter would be taxable on its capital gains.

The EC analysis was as follows:

> In both cases, the Commission considers there to be discrimination, seeing as investments outside the UK are taxed more heavily than domestic investments. The difference in tax treatment between domestic and cross-border transactions restricts two fundamental principles of the EU's Single Market, namely of the freedom of establishment and the free movement of capital ....
>
> The Commission is of the opinion that both restrictions are disproportionate, in the sense that they go beyond what is reasonably necessary in order to prevent abuse or tax avoidance and any other requirements of public interest.[27]

The background can be traced through HMRC consultation and response documents[28] but these are now mainly of historic interest.

In response, the FA 2013 made three changes:

(1) Increasing the minimum holding requirement from 10% to 25%.

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26 The figure is now 25%.

27 IP/11/158, 16 February 2011. The CIOT had lobbied the EC to take this step.

28 HMRC, "Reform of two anti-avoidance provisions (i) the attribution of gains to members of closely controlled non-resident companies, and (ii) the transfer of assets abroad" (July 2012).

HMRC, "Reform of two anti-avoidance provisions: (i) the attribution of gains to members of closely controlled non-resident companies, and (ii) transfer of assets abroad Summary of Responses" (December 2012) *https://www.gov.uk/government/consultations/reform-of-an-anti-avoidance-provision-transfer-of-assets-abroad*

HMRC, "Reform of an anti-avoidance provision: Transfer of Assets Abroad" (July 2013) *http://www.hmrc.gov.uk/budget-updates/11dec12/774-776.pdf*

HMRC, "Reform of an anti-avoidance provision: Transfer of Assets Abroad Outcome of Consultation" (December 2013) *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/267976/Transfer_of_assets_outcome_of_consultation.pdf*

(2) Extending the defence for trading companies
(3) A new defence for economically significant activities

EN FB 2013 provides:

> An infraction notice (Reasoned Opinion) was issued to the United Kingdom by the European Commission on 16 February 2011. ...
> 13. These changes aim to ensure that the legislation is compatible with the Treaty while maintaining effective protection against tax avoidance.

In January 2014 the CIOT wrote to the EC contending that the amended rules are still not EU law compliant. The CIOT's main complaints are:
(1) The 25% minimum holding requirement is inadequate as it may be diluted by the connected person rule.
(2) The economically significant activities defence is inadequate as it only applies to activities carried on by the company wholly or mainly outside the UK, and does not extend to UK activities.
(3) The s.13 charge (if applicable) may be disproportionate in that:
    (a) A minimal breach of the requirements results in a charge by reference to the whole gain.
    (b) A person who has just owned the shares for a very short period could have gains attributed to him which relate to periods before they had any interest in the company.
    (c) The rate of tax on s.13 gains is the CGT rate which exceeds the CT rate applicable to UK companies.

The EC complaint has not been withdrawn. It will be interesting to see how the dispute develops.

53.16 25% minimum holding requirement

Section 13(4) TCGA provides:

> Subsection (2) above shall not apply in the case of any participator in the company to which the gain accrues where the aggregate amount falling under that subsection to be apportioned
> [a] to him and
> [b] to persons connected with him
> does not exceed one quarter of the gain.

I refer to this as **"the 25% minimum holding requirement".**

Suppose a non-resident trust holds less than 25% of a non-resident company. Does the trust meet the minimum holding requirement? The difficulty is that s.13(4) does not in terms disapply the whole of s.13: it

disapplies s.13(2). The provision governing a non-resident trust is s.13(10) which provides:

> The persons treated *by this section* as if a part of a chargeable gain accruing to a company had accrued to them shall include the trustees of a settlement who are participators
>
> [a] in the company, or
>
> [b] in any company amongst the participators in which the gain is apportioned under subsection (9) above,
>
> if when the gain accrues to the company the trustees are not resident in the UK.

The words "by this section" must refer in particular to section 13(2), for that is the provision which treats persons as a part of the chargeable gain accruing to the non-resident company had accrued to them. Accordingly, the disapplication of s.13(2) must also disapply the attribution in subsection (10).

53.16.1 *Aggregation of connected person's interest*

In order know whether a participator ("A") in a non-resident company ("OC") meets the 25% minimum holding requirement, it is necessary to identify all persons connected with A (ie co-participators in OC) to whom gains fall to be apportioned under s.13(2).

In deciding whether A meets the 25% minimum holding requirement, one does not add up the interests in OC of A and *all* persons connected with A and ask if that amounts to more than 25% of OC. One only counts connected persons *to whom gains fall to be apportioned under s.13(2).* One ignores connected co-participators if gains do not fall to be apportioned to them under that subsection.

For example, assume OC is a straightforward non-resident company and:

(1) A owns 8% of the shares in OC. (Unless the connected person rule applies, A would not meet the 25% minimum holding requirement.)

(2) C (the only participator in OC who is connected with A) owns 3% of the shares in OC. (So if the interest of C is aggregated with the interest of A, A does meet the minimum holding requirement.)[29]

It is necessary to consider separately the cases where C is an individual, a company and a trust, and the cases where C is resident and non-resident,

---

29 Similarly, C would meet the 25% minimum holding requirement, but we focus on the position of A.

so there are at least six possibilities.

A does meet the 25% minimum holding requirement if C is:

(1) a UK resident individual taxed on the arising basis[30]

(2) a UK resident company, or

(3) a UK resident trust.

In all these cases the gains of OC do fall to be apportioned to C under s.13(2).

A does not meet the 25% minimum holding requirement if C is a *non-resident individual*. In this case, gains cannot be apportioned to C under s.13(2). This is the case even if C is within the temporary non-residence rules.

A does not meet the 25% minimum holding requirement if C is a non-resident *company*. In this case, gains of OC might be apportioned to participators in C, but that does not cause A to meet the 25% minimum holding requirement unless those participators are themselves connected with A. Lastly, does A meet the 25% minimum holding requirement if C is a non-resident *trust*? The question is whether gains of OC fall to be apportioned to the trust, under s.13(2). Section 13(10) says (or assumes) that the trustees are treated *by this section* as if gains of OC had accrued to them. The gains are attributed to the trustees under the combined effect of subsection (2) and subsection (10). Whether or not that could be described as an attribution *under s.13(2)* is a matter that could be answered either way, depending on context. In this context, it is suggested that A does not meet the 25% minimum holding requirement. This result is consistent with the position for non-resident companies and non-resident individuals. If this result was contrary to common sense (particularly in a tax avoidance context) a court might construe section 13(4) more loosely. But there may be many connected co-participators and A may not be able to know whether they are trustees or not, particularly in the case of non-residents. So it is sensible to disregard the interests of non-resident trustees for the purposes of the aggregation test.

Even adopting this approach, it will often not be possible for a participator to know whether the 25% minimum holding requirement is satisfied, but one must do the best one can.

Interests held by pension funds cannot be aggregated for the 25%

30 Further consideration would be needed if C were a remittance basis taxpayer who did not remit the s.13 gain.

minimum holding requirement. See 53.21 (Pension schemes).

53.16.2 *EU law aspects*

The FA 2013 increased the figure from 10% to 25%. The object is to enable HMRC to argue that s.13 is primarily directed at freedom of establishment, so that challenges are not possible under free movement of capital.[31] But the effect of the economically significant activities and ;motive defences seems to be that s.13 is sufficiently well targeted to satisfy EU law, whether the challenge comes under FoE or FMC, so the question of which is the applicable freedom should not arise.

53.17 Non-resident trading company

Section 13(5) TCGA provides some relief for a non-resident trading company:

> This section shall not apply in relation to ...
>
> (b) a chargeable gain accruing on the disposal of an asset used, and used only—
>
> (i) for the purposes of a trade carried on by the company wholly outside the UK, or
>
> (ii) for the purposes of the part carried on outside the UK of a trade carried on by the company partly within and partly outside the UK.

53.17.1 *Furnished holiday letting*

This relief is extended to include furnished holiday letting (which is not strictly classified as a trade). Section 13A TCGA provides:

> (1) For the purposes of section 13(5)(b) a disposal of an asset is to be regarded as a disposal of an asset used for the purposes of a trade carried on wholly outside the UK by a company if—
>
> (a) the asset is accommodation, or an interest or right in accommodation, which is situated outside the UK, and
>
> (b) the accommodation has for each relevant period been furnished holiday accommodation of which a person has made a commercial letting.
>
> (2) For the purposes of subsection (1)(b) each of the following is "a relevant period"—
>
> (a) the period of 12 months ending with the date of the disposal

31 See 60.3.1 (FoE or FMC?)

and each of the two preceding periods of 12 months, or

(b) if the company has been the beneficial owner of the accommodation (or interest or right) for a period longer than 36 months, the period of 12 months ending with the date of the disposal and each of the preceding periods of 12 months throughout which the company has been the beneficial owner of the accommodation (or interest or right).

(3) The reference in subsection (1)(b) to the commercial letting of furnished holiday accommodation is to be read in accordance with Chapter 6 of Part 4 of CTA 2009, but—

(a) as if sections 266, 268 and 268A were omitted, and

(b) as if, in section 267(1), the reference to an accounting period were a reference to a relevant period as defined by subsection (2) above.

The definition of furnished holiday accommodation needs a chapter to itself, and is not discussed here.

This relief is one of the changes introduced in 2013 to make s.13 EU-law compliant.[32] The change operates retrospectively to 2012/13.

53.18 Economically significant activities

Section 13(5) TCGA provides a relief for companies carrying on economically significant activities. This provides:

> This section shall not apply in relation to ...
>
> (ca) a chargeable gain accruing on the disposal of an asset used, and used only, for the purposes of economically significant activities carried on by the company wholly or mainly outside the UK

I refer to this as **"the economically significant activities defence"**. This relief is one of the changes introduced in 2013 to make s.13 EU-law compliant.[33] The change operates retrospectively to 2012/13.

53.18.1 *"Economically significant activities"*

Section 13A(4) TCGA provides:

> For the purposes of section 13(5)(ca) activities carried on by a company are "economically significant activities" if they are activities which

32 See 53.15 (EU law compliance).

33 See 53.15 (EU law compliance).

consist of the provision by the company of goods or services to others on a commercial basis and involve—

(a) the use of staff[34] in numbers, and with competence and authority,

(b) the use of premises and equipment, and

(c) the addition of economic value, by the company, to those to whom the goods or services are provided, commensurate with the size and nature of those activities.

The wording is the same as in the ToA EU law defence: see 28.15.8 ("Genuine": commercial substance requirement).

53.18.2 *Activities carried on by the company "outside the UK"*

The defence requires one to identify where the company's activities are carried on, or at least, whether they are wholly or mainly carried on outside the UK. If the activities are in the UK, or partly in the UK, this defence does not apply. The CIOT have complained to the EC that this restriction is in breach of EU law.

53.19 S.13 motive defence

Section 13(5) TCGA provides a motive defence which I call **"the s.13 motive defence"**. This provides:

> This section shall not apply in relation to ...
>
> (cb) a chargeable gain accruing to the company on a disposal of an asset where it is shown that neither—
>
> (i) the disposal of the asset by the company, nor
>
> (ii) the acquisition or holding of the asset by the company,
>
> formed part of a scheme or arrangements of which the main purpose, or one of the main purposes, was avoidance of liability to capital gains tax or corporation tax

The wording is based on the wording of the ToA motive defence condition A. There are two important differences:

(1) Only CGT/CT avoidance matters; eg an intention to avoid IHT would not disqualify the s.13 motive defence. By contrast, the ToA motive defence refers to the avoidance of "taxation".

(2) The s.13 motive defence depends on the purpose of the *arrangements*

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34 Section 13A(5) TCGA provides a definition: "In subsection (4) "staff" means employees, agents or contractors of the company."

(of which the disposal and acquisition of the asset forms part); the ToA motive defence depends on the purpose of the *transfer and associated operations* (relevant transactions); that could be different.

CGT/CT means UK CGT/CT, and does not include corresponding foreign taxes.[35]

If an offshore company is used to hold a property which would (if held directly) qualify for private residence relief, the s.13 motive defence will apply, for there can be no CGT avoidance: no CGT would be payable if the property had been held directly in the trust or directly by the occupier.

The s.13 motive defence does not require a formal claim. If the arrangements did not have a CGT/CT avoidance purpose, a taxpayer is entitled and indeed required to complete tax returns on the basis that the motive defence applies; one is not required to show the motive defence applies before completing the tax return on that basis.

If an individual completes a self assessment return, it is necessary to indicate on that return that they have taken advantage of the ToA motive defence by an entry in the relevant box.[36] There does not seem to be a comparable box for the s.13 motive defence.

This relief is one of the changes introduced in 2013 to make s.13 EU-law compliant.[37] It operates retrospectively to 2012/13.

53.20 Non-resident company within CT

Section 13(5) TCGA provides:

> This section shall not apply in relation to ...
>
> (d) to a chargeable gain in respect of which the company is chargeable to tax by virtue of section 10B.[38]

Thus the CT charge has priority over a s.13 charge.

53.21 Pension schemes

Pension schemes qualify for CGT relief under s.271(1)(c) and (1A) TCGA:

> (1) The following gains shall not be chargeable gains—
>
> ...

35 See 32.9 (Meaning of "taxation" in the motive defence).

36 See 32.45 (Tax return: disclosure of motive defence claim).

37 See 53.15 (EU law compliance).

38 See 86.1 (Why does permanent establishment matter?).

(c) any gain accruing to a person from his acquisition and disposal of assets held by him as part of a fund—
  (i) mentioned in section 614(2) of the Taxes Act,
  (ii) to which section 615(3) of the Taxes Act applies, or
  (iii) mentioned in section 648, 649, 650, 651 or 653 of ITEPA 2003;

...

(1A) A gain accruing to a person on a disposal of investments held for the purposes of a registered pension scheme is not a chargeable gain.

This does not confer relief from s.13 gains but s.13(10B) TCGA provides relief:

A chargeable gain that would be treated as accruing to a person under subsection (2) above shall not be so treated if—
(a) it would be so treated only if assets that are assets of a pension scheme[39] were taken into account in ascertaining that person's interest as a participator in the company, and
(b) at the time the gain accrues a gain arising on a disposal of those assets would be exempt from tax by virtue of section 271(1)(c) or (1A).

A beneficiary of a pension scheme might be a participator in a non-resident company held by the scheme, but they are protected by the exclusion for beneficiaries.[40]

Section 13(10B) also prevents aggregation of a pension scheme's interest with the interest of a person connected with the trustees of the pension scheme, for the purposes of the 25% minimum holding requirement. That will not normally arise, as trustees of a pension scheme are not usually connected to other persons, but it could happen, eg if the trustees were partners in an investment partnership.

53.22 Partnership holding non-resident company

Suppose a partnership holds a non-resident company to which a gain accrues. Section 59(1) TCGA provides:

---

39 This expression is defined in s.13(10B):
"In para (a) above 'assets of a pension scheme' means assets held for the purposes of a fund or scheme to which any of the provisions mentioned in para (b) above applies."

40 See 53.7 (Overlapping participators: trustees and beneficiaries).

> Where 2 or more persons carry on a trade or business in partnership—
>
> (a) tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall, in Scotland as well as elsewhere in the UK, be assessed and charged on them separately, and
>
> (b) any partnership dealings shall be treated as dealings by the partners and not by the firm as such.

This does not apply to a s.13 gain, which is not a gain on the disposal of a partnership asset. But the partners are participators in the company, and it is just and reasonable (because it fits the scheme of the TCGA) to attribute the s.13 gain to the partners under s.13(2) TCGA. That is, HMRC do not need s.59 TCGA to tax the partners.

53.23 Company distribution relief

53.23.1 *Terminology*

Section 13 could often give rise to double taxation and there are three reliefs to prevent this. Statute does not provide names for the reliefs, so I coin the following terminology:

Name of relief	**Section**	**Description**
Company distribution relief	s.13(5A)	Distribution by non-resident co
Company disposal relief	s.13(7)	Disposal of non-resident co
Reimbursement relief	s.13(11)	Reimbursement by non-resident co

53.23.2 *Company distribution relief*

Section 13(5A) TCGA provides:

> Where—
>
> (a) an amount of tax is paid by a person in pursuance of subsection (2) above, and
>
> (b) an amount in respect of the chargeable gain is distributed (either by way of dividend or distribution of capital or on the dissolution of the company) before the end of the period specified in subsection (5B) below,
>
> the amount of tax (so far as neither reimbursed by the company nor applied as a deduction under subsection (7) below) shall be applied for reducing or extinguishing any liability of that person to income tax, CGT or corporation tax in respect of the distribution.

In short, the s.13 tax is set against tax on the distribution.

The CG Manual provides:

> **57351. Gains accruing on/after 28/11/95: Outline of tax credit relief** [April 2011]
> [The manual summarises s.13(5A) and continues] It is important to note that relief under Section 13(5A) TCGA 1992 is only due where a charge arises under Section 13 in respect of a gain and a further charge arises in respect of a distribution of an amount in respect of the same gain, and that both charges arise on the same person. Where a gain is attributed to participator A and the distribution is made to participator B no relief can be given to B as B has not paid tax under Section 13...
> **57360. Quantifying tax set-off available following capital dividends or distributions** [April 2011]
> ... Once capital gains tax has been paid under section 13(2), then the whole of that tax is available for set-off against any tax liability on a subsequent distribution where the conditions for relief are met. Should only half of the gain be distributed this does not mean that only half of the section 13 capital gains tax can be set off. The section 13 tax represents a pool of tax credit to be used up against tax liability arising from appropriate distributions in respect of the same gain. Thus if only half of the gain is distributed but the tax liability on the distribution is at a higher rate than the tax on the section 13 gain, the tax credit relief will be more than half of the Section 13 tax.
> **57362. Need to have paid tax under Section 13(2)** [April 2011]
> It is a condition of section 13(5A) relief that the tax arising on the gain attributed under section 13 must have been paid. In some cases the liability on the section 13 gain and on the distribution will arise in the same year of assessment or accounting period, and in other cases the tax on the section 13 gain will not have been paid.
> In practice relief may be given by set off providing that the only reason preventing relief being given is that tax on the section 13 gain is unpaid.

For the purpose of s.13(5A) it is necessary to ascertain the liability of the participator to income tax in respect of the distribution from the company.

Section 13(7A) TCGA provides:

> In ascertaining for the purposes of subsection (5A) or (7) above the amount of CGT[41] or income tax chargeable on any person for any year

41 The reference to CGT is not appropriate after the FA 2008 repealed s.13(7A)(b) (c) (d) because s.13(7A) now deals with income tax only. Similarly, the reference to s.13(7) is not appropriate as from 2008, s.13(7A) is only relevant for the purposes of company distribution relief in s.13(5A) and does not apply to company disposal relief in s.13(7). The references made sense before the former paragraphs (b) to (d) were part of s.13(7A). Before 2008, s.13(7A) continued:

on or in respect of any chargeable gain or distribution—

(a) any such distribution as is mentioned in subsection (5A)(b) above and falls to be treated as income of that person for that year shall be regarded as forming the highest part of the income on which he is chargeable to tax for the year;

Most forms of distribution by a non-resident company are exempt in the hands of a corporate investor so they do not benefit from company distribution relief.

53.23.3 *HMRC examples*

The CG Manual tries to provide two straightforward worked examples.

"(b) any gain accruing in that year on the disposal by that person of any asset representing his interest as a participator in the company shall be regarded as forming the highest part of the gains on which he is chargeable to tax for that year;
(c) where any such distribution as is mentioned in subsection (5A)(b) above falls to be treated as a disposal on which a gain accrues on which that person is so chargeable, that gain shall be regarded as forming the next highest part of the gains on which he is so chargeable, after any gains falling within para (b) above; and
(d) any gain treated as accruing to that person in that year by virtue of subsection (2) above shall be regarded as the next highest part of the gains on which he is so chargeable, after any gains falling within para (c) above."

The CG Manual provides:

57375. Tax adjustment and reliefs: Tax relief ordering rules: Section 13(7A) TCGA 1992 [April 2011]

Before tax year 2008-09, where the events which could give rise to relief under section 13(5A) and (7) occurred within a single tax year, there could, in certain circumstances, be computational problems. To prevent this subsection (7A) set out the order of priority to be given to each tax charge. In ascertaining for the purposes of subsections (5A) and (7) the amount of CGT or IT which is chargeable on a person for a year, the order was

a. any distribution which is chargeable as income is treated as the top slice of income for that year

b. any gain accruing on the disposal of any asset representing the participator's interest in the non- resident company is treated as the top slice of gains for that year

c. any gain accruing on a capital distribution is treated as the second slice of gains for that year

d. the gain attributed to the participator under Section 13 is treated as the third slice of gains for that year.

In 2008-09 and later years Capital Gains Tax is charged at a fixed rate regardless of an individual's income and so these priority rules are not necessary. [Author's note: the provision might have been retained to deal with the CGT annual exemption, but that is trivial.]

The first sets s.13 tax against a dividend. The second sets it against a capital distribution:

> **57365. Examples of relief under Section 13(5A) TCGA 1992 on a distribution to participators** [April 2011]
> This example illustrates the operation of Section 13(5A) TCGA 1992 if the company realises a gain and distributes an amount in respect of the gain to participators.
> ***Facts***
> - A UK resident shareholder owns half the shares in a non-resident close company. The company structure is straightforward and the UK resident is a 50% participator. The shareholder does not claim the remittance basis.
> - In January 2009 the non-resident company sells an asset realising a gain of £100,000.
> - The UK resident has no other gains in 2008-09 but is chargeable to Capital Gains Tax at 18%.
> - In June 2009 the company makes a distribution of £100,000 to its shareholders. The UK resident is chargeable at 40% on the amount received.[42]
>
> ***Capital Gains Tax treatment***
> January 2009 - The ordinary rules of Section 13 TCGA 1992 apply. Half the gain of £100,000 is attributable to the shareholder and is chargeable to Capital Gains Tax in 2008-09. The tax due is
>
> | | |
> |---|---|
> | Section 13 gain | £50,000 |
> | less annual exempt amount | -£ 9,600 |
> | Gain | £40,400 |
> | **CGT @ 18%** | **£ 7,272** |
>
> June 2009 – The tax paid under section 13(2) is available for set off. The Income Tax due on the distribution for 2009-10 is
>
> | | |
> |---|---|
> | Distribution | £50,000 |
> | IT @ 40% | £20,000 |
> | less Section 13 tax | -£ 7,272 |
> | Tax due | £12,728 |

42 The rate of tax would not normally be 40%. The error arose because the author amended the dates of the text of the example in order to appear up to date (the earlier text is preserved in the 7th edition of this work) but (somewhat negligently) did not make the consequential amendment to the rate which should follow from the change of date.

57366. Examples of relief: Section 13(5A) TCGA 1992: Company dissolved: Payment to participators [September 2012]

This example illustrates the operation of Section 13(5A) TCGA 1992 if the company realises a gain, is then dissolved and there is a payment to the participators.

Facts

A UK resident shareholder owns half the shares in a non-resident close company. The company structure is straightforward and the UK resident is a 50% participator.

- The shares cost £10,000 in July 2009.
- In March 2010 the non-resident company sells an asset realising a gain of £100,000.
- The UK resident has no other gains in 2009-2010 but is chargeable to Capital Gains Tax at 18%.
- In July 2011 the non-resident company is dissolved. There is an excess of assets over liabilities. The liquidator makes a capital distribution to shareholders. The total sum distributed to shareholders is £200,000.
- The UK resident has no other gains in 2011-12 but is chargeable to Capital Gains Tax at 28%.

Capital Gains Tax treatment

March 2010 - The ordinary rules of Section 13 TCGA 1992 apply. Half the gain of £100,000 is attributable to the shareholder and is chargeable to Capital Gains Tax in 2009-10. The tax due is:

Section 13 gain	£50,000
Less annual exempt amount (say)[43]	-£10,000
	£40,000
CGT @ 18%	£ 7,200

June 2011 - As an amount in respect of the whole of the gain has been distributed, the whole of the tax paid is available for set off. But a capital gain has now accrued to the shareholder because a capital distribution has been received from the liquidator. Section 122 TCGA 1992 applies. The Capital Gains Tax liability for 2011-12 is

Proceeds	£100,000
Less cost	- £ 10,000
Gain	£ 90,000

43 The correct figure is £10,100 but the author presumably composed the example before the amount of the annual exemption was known.

Less annual exempt amount (say)[44]	-£ 10,500
	£ 89,500[45]
CGT @ 28%	£ 25,060
Less Section 13 tax	-£ 7,200
Tax due	£ 17,860

53.23.4 *Time limit for distribution*

Section 13(5B) TCGA sets out the time limit for company distribution relief:

> The period referred to in subsection (5A)(b) above is the period of three years from—
>
> (a) the end of the period of account of the company in which the chargeable gain accrued, or
>
> (b) the end of the period of twelve months beginning with the date on which the chargeable gain accrued,
>
> whichever is earlier.

The drafting is convoluted, but in plain English the time limit is the earlier of:

(1) three years from the end of the accounting period; or

(2) four years from the date of the gain.

The CIOT have argued that this time restriction has no logical rationale and should be removed.[46] But no-one has taken any notice.

53.23.5 *Remittance basis taxpayer participator*

Company distribution relief applies to foreign s.13 gains which are taxed on a remittance basis, but the relief only sets tax on the s.13 gain against tax on the distribution, so the relief does not apply unless the s.13 gain is remitted (so tax is paid on it), and the distribution is remitted (so tax actually paid on the distribution qualifies for relief). Thus suppose:

(1) Year 1: A company realises a gain deemed to accrue to a remittance

---

44 The correct figure is £10,600 but the author presumably composed the example before the amount of the annual exemption was known.

45 The author of the Manual appears to have made a careless arithmetical mistake here. The reader is invited to speculate what penalty HMRC would think appropriate if a tax return contained as many errors as the two worked examples in the HMRC Manual.

46 CIOT, "Reform of two anti-avoidance provisions" (October 2012) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2012/10/121002_s13_trans_assets_CIOT.pdf*

basis taxpayer under s.13 but not taxed as it is not remitted.

(2) Year 3: The company declares a dividend in respect of the gain. The dividend is RFI but not taxable as it is not remitted.

(3) Year 10: the gain and the dividend are remitted.

The relief applies. The time limit is met as the distribution was within 3 years of the relevant time, the time that the gain accrued to the company. The date of the remittance is not relevant.

53.24 Company disposal relief

"Company disposal relief" is my term for the relief under s.13(7) TCGA which provides:

> The amount of CGT paid by a person in pursuance of subsection (2) above (so far as neither reimbursed by the company nor applied under subsection (5A) above for reducing any liability to tax) shall be allowable as a deduction in the computation under this Act of a gain accruing on the disposal by him of any asset representing his interest as a participator in the company.

This sets tax against the gain, so it is not generous. The CG Manual provides:

> **57370. Tax adjustment and reliefs: disposal of interest by UK resident participator: Section 13(7) TCGA 1992** [April 2011]
> [The manual summarises s.13(7) and continues] No deduction is due if the tax was paid by the non-resident company, see CG57390. Indexation allowance is not given on the tax paid. Although the tax is allowed as a deduction in computing the gain it is not expenditure within Section 38(1)(a) TCGA 1992 or Section 38(1)(b) TCGA 1992. Therefore it is not relevant allowable expenditure for indexation allowance purposes, see CG17240.
> NOTE. If a taxpayer is within the charge to Capital Gains Tax, neither indexation allowance nor taper relief apply to disposals of assets on or after 6 April 2008. Previously indexation allowance had been frozen at April 1998. For indexation allowance see CG17207+ and for taper relief see CG17895+.

The point about indexation would only be relevant to a corporate taxpayer.

> **57371 Disposal of interest/shares by UK resident** [April 2011]
> This example illustrates the deduction under Section 13(7) TCGA 1992 if the taxpayer sells shares in a non-resident company whose gains have been apportioned under Section 13 TCGA 1992.
> **Facts**

- June 2008 a taxpayer buys 500 out of the 750 issued shares in X Ltd, a non-resident close company, at a cost of £100,000.
- March 2009 X Ltd realises a gain of £6,000. 500/750×£6,000 = £4,000 is apportioned to the taxpayer. The amount is included in the 2008-09 Capital Gains Tax assessment. The taxpayer is liable at 18% and tax of £720 is due.
- August 2010 the taxpayer sells the shares for £130,000.

Chargeable Gain

		£
Disposal proceeds		130,000
less Cost	100,000	
less Section 13(7) deduction	720	-100,720
Chargeable gain		**29,280**
less Annual exempt amount (say)		-10,200
Amount chargeable		19,080

NOTE. If a taxpayer is within the charge to Capital Gains Tax, neither indexation allowance nor taper relief apply to disposals of assets on or after 6 April 2008. Previously indexation allowance had been frozen at April 1998. For indexation allowance see CG17207+ and for taper relief see CG17895+.

This is wholly theoretical as in this situation the taxpayer would and should claim company distribution relief under s.13(5A). The only possible use of company disposal relief would be
(1) to increase an allowable loss, or
(2) in cases where the disposal gave rise to a loss or relief for other losses would obviate the gain.

53.25 Reimbursement by non-resident company

Tax on the s.13 gain is due from the UK resident participator and not from the company. The participator has no statutory right of indemnity against the company. But it is possible that the company might pay the tax on the s.13 gain voluntarily, or perhaps a participator might protect himself by entering into a contract requiring the company to pay the tax.

Section 13(11) TCGA provides what I call "reimbursement relief":

> If any tax payable by any person by virtue of subsection (2) above is paid
> [a] by the company to which the chargeable gain accrues,
> [b] or in a case under subsection (9) above is paid by any such other company,
> the amount so paid shall not for the purposes of income tax, CGT or corporation tax be regarded as a payment to the person by whom the tax was originally payable.

The CG Manual provides a précis:

57390. Payment of UK tax by NR company [April 2011]
The non-resident company may pay the UK tax due from a UK resident when gains have been apportioned to him under TCGA 1992, S 13. If so, TCGA 1992, S 13 (11) provides that the payment of the tax on behalf of the UK resident does not give rise to any further liability in the hands of the UK resident. You do not treat the payment as income of the resident or as a capital distribution in respect of the shares in the non-resident company. TCGA 1992, S 13 (11) will also apply if the liability arises because a UK resident has an indirect shareholding in the non-resident company. The liability can be paid by any of the non-resident close companies in the chain.

Reimbursement is better than an income distribution in respect of the gain as the reimbursement is tax free, whereas an income distribution is subject to income tax (at income tax rates) with the benefit of CGT relief (at CGT rates). Of course, the non-resident company will need to consider whether it would be proper to make the reimbursement as a matter of company law (eg are there other shareholders who may be prejudiced?).

53.26 Loss accruing to non-resident company

A participator may deduct losses which accrue to them personally against s.13 gains in accordance with the usual rules.

Different rules apply to losses accruing to the non-resident company which I call **"company losses"**.

53.26.1 *Arising basis participator*

Section 13(1)(2) TCGA only attributes the company's gains (not losses) to a participator, so in the absence of further provision a participator would have no relief for company losses. Section 13(8) TCGA provides some relief for company losses:

> [a] So far as it would go to reduce or extinguish chargeable gains accruing by virtue of this section to a person in a year of assessment this section shall apply in relation to a loss accruing to the company on the disposal of an asset in that year of assessment as it would apply if a gain instead of a loss had accrued to the company on the disposal,
> [b] but shall only so apply in relation to that person;
> [c] and subject to the preceding provisions of this subsection this section shall not apply in relation to a loss accruing to the company.

The CG Manual correctly provides:

> **CG57295 - NR companies: losses: - general** [April 2011]
> S13 TCGA 1992 is concerned with the apportionment of gains not losses. If the disposal by the non-resident company gives rise to a loss then that loss cannot be apportioned to UK residents for them to set it off against their other gains. However, the loss can be set-off
> - against gains made by the same company in the same year of assessment
> - against gains made by other non-resident companies which have been apportioned to the taxpayer in the same year of assessment.
>
> *Losses of the same company (S13(8) TCGA 1992)*
> If the non-resident company makes gains and losses in the same year of assessment the losses can be set off against the gains. Any surplus losses cannot be carried forward or back to set-off against gains arising in a different year of assessment.
> *Losses of different companies*
> If the UK resident is a participator in more than one non-resident company the proportion of the gains and losses of those companies apportioned to the UK resident can be set off against each other in the same year of assessment. Any surplus loss cannot be carried forward or back to set against the gains arising in different years of assessment.

Careful timing of disposals is needed to ensure that the loss relief is used: company losses should not exceed s.13 gains in any year.

What is the meaning of s.13(8)[b] that loss relief shall only so apply in relation to that person? Perhaps it is intended to cover the situation where:

(1) A owns a company.
(2) The company disposes of asset 1 and realises a loss.
(3) A transfers the company to B.
(4) The company disposes of asset 2 and realises a gain (in the same year).

Perhaps the intention is that the loss is not available to B. Though that is far from clear.

53.26.2 *Remittance basis participator*

Section 14A(4) TCGA 1992 provides:

> If—
>
> (a) the deemed chargeable gain is a foreign chargeable gain (within the meaning of section 12),
> (b) section 809B, 809D or 809E of ITA 2007 (remittance basis)

applies to the individual for the year mentioned in subsection (1), and

(c) any of the deemed chargeable gain is remitted to the UK in a tax year after that year,

the chargeable gain treated under section 12(2) as accruing may not be reduced or extinguished under section 13(8).

Careful planning is needed to ensure that relief is available for company losses.

53.26.3 *Non resident trust participator*

The position is similar as for a UK participator. The aim should be that company losses should not exceed s.13 gains in any year, so that the losses can be set against the gains under s.13(8) TCGA.

53.26.4 *Loss relief: Policy issues and reform*

At first sight the rules for company losses are unfair and anomalous compared to other losses:

(1) Company losses can only be set against s.13 gains.

(2) Company losses can only be set against current year s.13 gains and cannot be carried forward.

However there is a good reason not to apportion company losses in the same way as gains, as there may be scope for acquisition of companies in order to acquire their losses; in the corporate area there are rules for pre-acquisition losses, but no-one would want to introduce that complexity into CGT.

There is a better case for carry forward of company losses, to set against other s.13 gains, but even here the possibility of buying in losses prevents reform. Section 16A TCGA prevents more obvious planning but is not a substitute for properly targeted rules.

A reasonable reform would be to allow company losses to be set only against s.13 gains but to be carried forward for a limited period, say 4 or 6 years Indeed it would be reasonable to restrict all losses from being carried forward for more than that period.

53.27 Negligible value claims

Section 24 TCGA provides:

(1A) A negligible value claim may be made by the owner of an asset ("P") if condition A or B is met.

The usual case is condition A:

> (1B) Condition A is that the asset has become of negligible value while owned by P.[47]

The claim should be made by the non-resident company, though in practice HMRC have accepted claims by UK resident participators.[48] It is possible that the non-resident company might authorise a person to make claims on its behalf, especially if that person is the direct or indirect owner and subject to tax under s.13 on 100% of the company's gains.

Section 24(2)(a) TCGA provides the relief:

> Where a negligible value claim is made:
>
> (a) this Act shall apply as if the claimant had sold, and immediately reacquired, the asset at the time of the claim or (subject to paragraphs (b) and (c) below) at any earlier time specified in the claim, for a consideration of an amount equal to the value specified in the claim.

Section 24(2)(b) TCGA specifies the limit of the carry back:

> (b) An earlier time may be specified in the claim if:
>
> (i) the claimant owned the asset at the earlier time; and
>
> (ii) the asset had become of negligible value at the earlier time; and either
>
> (iii) for capital gains tax purposes the earlier time is not more than two years before the beginning of the year of assessment in which the claim is made; or
>
> (iv) for corporation tax purposes the earlier time is on or after the first day of the earliest accounting period ending not more than two years before the time of the claim.

The time limit here is that in (iv), on or after the first day of the earliest accounting period of the non-resident company ending not more than two years before the time of the claim, since s.13(11A) TCGA provides:

> For the purposes of this section the amount of the gain or loss accruing at any time to a company that is not resident in the UK shall be computed (where it is not the case) as if that company were within the charge to corporation tax on capital gains.

---

47 Condition B (not discussed) arises when the disposal by which P acquired the asset was a no gain/no loss disposal.

48 Private correspondence.

53.28 Group relief

A full discussion of CG group relief requires a book to itself. This section focusses on the problems of non-resident groups within s.13.

53.28.1 *Definition of group*

In outline, the definition of group is in s.170(3) TCGA:

> Subject to subsections (4) to (6) below—
>
> (a) a company (referred to below and in sections 171 to 181 as the "principal company of the group") and all its 75 per cent subsidiaries form a group and, if any of those subsidiaries have 75 per cent subsidiaries, the group includes them and their 75 per cent subsidiaries, and so on, but
>
> (b) a group does not include any company (other than the principal company of the group) that is not an effective 51 per cent subsidiary of the principal company of the group.

Under this definition both resident and non-resident companies may form a group.

53.28.2 *UK group relief*

However s.171 TCGA, which provides CG group relief, (more or less) restricts the relief to UK group companies:

> (1) Where—
>
> (a) a company ("company A") disposes of an asset to another company ("company B") at a time when both companies are members of the same group, and
>
> *(b) the conditions in subsection (1A) below are met,*
>
> company A and company B are treated for the purposes of corporation tax on chargeable gains as if the asset were acquired by company B for a consideration of such amount as would secure that neither a gain nor a loss would accrue to company A on the disposal.
>
> *(1A) The conditions referred to in subsection (1)(b) above are—*
>
> *(a) [i] that company A is resident in the UK at the time of the disposal, or*
>
> *[ii] the asset is a chargeable asset*[49] *in relation to that company*

49 "Chargeable asset" has a commonsense definition in s.171(1A)(b) TCGA: " For this purpose an asset is a "chargeable asset" in relation to a company at any time if, were the asset to be disposed of by the company at that time, any gain accruing to the

immediately before that time, and

(b) [i] that company B is resident in the UK at the time of the disposal, or

[ii] the asset is a chargeable asset in relation to that company immediately after that time.

I refer to this as **"UK group relief"**.

The relief only applies where a member of a group of companies disposes of an asset to another member of the same group. The general requirement is therefore that there should be both a disposal by a group company and an acquisition by a group company. Suppose A Ltd owns B Ltd, B Ltd is put into liquidation and its asset is transferred to A Ltd. There are two disposals:

(1) B Ltd disposes of the asset which is transferred to A Ltd: this disposal qualifies for group relief.

(2) A Ltd disposes of its shares in B Ltd (s.122 TCGA). That disposal does not qualify for group relief.

Section 171 goes on to set out 11 exceptions where group relief does not apply; these are not discussed here.

Group relief is compulsory but it should be possible to arrange that companies are not part of a group, by issuing shares or arranging some other breach of the definition of a group, and so exclude the relief.

53.28.3 *Non-resident group relief*

Section 14 TCGA provides:

> (1) This section has effect for the purposes of section 13.
> (2) The following provisions ...
> (b) section 171 (except subsections (1)(b) and (1A)) ...
> shall apply in relation to non-resident companies which are members of a non-resident group of companies as they apply in relation to companies which are members of a group of companies.

This extends UK group relief to a transfer from a non-resident group company to another non-resident group company. I refer to this as **"non-resident group relief"**.

---

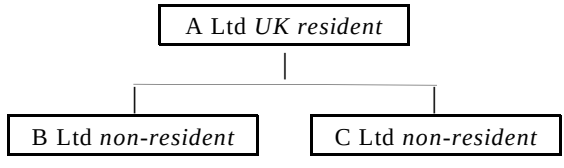
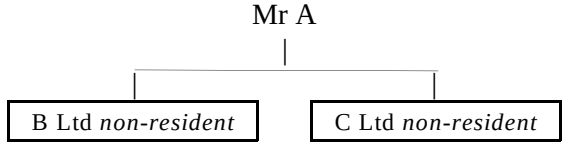
company would be a chargeable gain and would by virtue of section 10B form part of its chargeable profits for corporation tax purposes."

53.28.4 *Meaning of "non-resident group"*

Section 14(4) TCGA provides a commonsense definition:

> For the purposes of this section—
>
> (a) a "non-resident group" of companies—
>
> (i) in the case of a group, none of the members of which are resident in the UK, means that group, and
>
> (ii) in the case of a group, 2 or more members of which are not resident in the UK, means the members which are not resident in the UK;
>
> (b) "group" shall be construed in accordance with section 170.[50]

The CG Manual provides 3 examples:

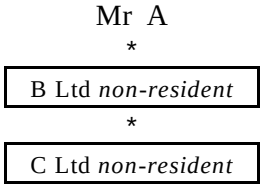
> **57401. NR group** [September 2012]
> ...[51]
>
> EXAMPLE 1
>
> 
>
>
> B Ltd and C Ltd form a non-resident group.
> A Ltd is not a member of the non-resident group but it does have the effect of overseas "grouping" B Ltd and C Ltd.
>
> EXAMPLE 2
>
> 
>
>
> B Ltd and C Ltd do not form a non-resident group because they are not members of any group.

---

50 See 53.28.1 (Definition of group).

51 I omit some text, which has not been properly updated since the FA 2000; however the points made in the HMRC examples are correct. I have created the diagrams to increase clarity.

EXAMPLE 3



B Ltd and C Ltd form a non-resident group because all of the companies in the group are not resident.

53.28.5 *Scope of non-resident group relief*

The CG Manual raises the question whether non-resident group relief applies for all participators or just for company participators subject to corporation tax:

> **57404. Section 14 – UK resident** [April 2011]
> As shown in Example 3 in CG57401 [set out above] Section 14 TCGA 1992 applies even if the UK resident shareholder[52] is not a company. Some taxpayers and tax advisers are uncertain about this because Section 171 TCGA 1992 includes the words 'so far as relates to Corporation Tax on chargeable gains'.[53] They suggest this means Section 14 can only apply if the Section 13 TCGA 1992 charge would be to Corporation Tax on chargeable gains. We do not take this restrictive view. This practice was published in Tax Bulletin, Issue 7, page 74.[54]

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52 This should read: "participator".

53 The Manual is more than a decade out of date; since 2000 the wording is "for the purposes of corporation tax on chargeable gains". But it comes to the same thing.

54 May 1993, now classified as RI 43 which provides:

> "**Non-resident companies: attribution of gains to UK shareholders: 'non-resident groups'**
> In some circumstances gains realised by non-resident companies may be attributed to shareholders who are resident or ordinarily resident in the UK. The main provisions are in TCGA 1992 s 13. The scope of the legislation is not quite as wide ranging as it may seem because some of the group provisions which apply to UK groups for the taxation of gains—for example those relating to intra-group transfers—are imported for s 13 purposes from elsewhere in TCGA 1992 (see s 14). An intra-group transfer by members of a 'non-resident group' would thus be treated as taking place at no gain and no loss so there would be no gain on the disposal to attribute to UK shareholders.
> In relation to the application of the no gain/no loss rule in these circumstances [HMRC] have been asked whether the words 'so far as relates to corporation tax on

At the time it was published, this seemed a somewhat cavalier view; HMRC did not explain why one should apply to non-companies (not within CT) a relief restricted by the (then) words 'so far as relates to CT on chargeable gains'. But the legislation has since changed, and from 1998 the HMRC view is supported by s.13(11A) TCGA which provides that the non-resident company's gain is computed as if the non-resident company were within the charge to CT.[55]

Normally the HMRC view favoured the taxpayer and so it was never challenged. Now the pre-1998 position is (more or less) of historic interest only; though one could imagine cases where it would be in a taxpayer's interest to argue that group relief did not apply on a pre-1998 inter-group disposal.

What about a disposal from a non-resident group company to a UK resident group company? Non-resident group relief does not apply because the companies are not both members of a non-resident group; it is suggested that relief is available under UK group relief, since the disposing company's gain is (for s.13 purposes) deemed to be within the charge to CT. In practice this question may not arise, as a transfer from a non-resident company (within the scope of s.13) to a UK company in the same group would be unusual.

53.29 Group relief clawback charge

Section 14(3) TCGA provides:

> Section 179 (except subsections (1)(b) and (1A)) shall apply for the purposes of section 13 as if for any reference therein to a group of companies there were substituted a reference to a non-resident group of companies, and as if references to companies were references to companies not resident in the UK.

So the clawback rules for which apply to UK group relief are incorporated

---

chargeable gains' in TCGA 1992 s 171 limit its application to situations where the gain on the intra-group transaction would otherwise be within the charge to corporation tax.

In [HMRC's] view the no gain/no loss rule is not limited in this way. The benefit of the rule is given whether the shareholder is assessable to CGT or to corporation tax. A similar view is also taken when considering the operation of any of the other sections referred to in TCGA 1992 s 14."

55 See 53.5 (Computation of non-resident company gains on CT principles).

into non-resident group relief. Amended as s.14(3) directs, s.179 TCGA (in outline) provides:

> (1) This section applies where—
>
> (a) a company not resident in the UK ("company A") acquires an asset from another company not resident in the UK ("company B") at a time when company B is a member of a non-resident group,
>
> ...
>
> (c) company A ceases to be a member of that non-resident group within the period of six years after the time of the acquisition.
>
> References in this section to a company not resident in the UK ceasing to be a member of a non-resident group of companies not resident in the UK do not apply to cases where a company not resident in the UK ceases to be a member of a non-resident group in consequence of another member of the non-resident group ceasing to exist...

53.29.1 *Two or more associated companies leave group at same time*

Amended as s.14(3) directs, s.179 TCGA (in outline) provides:

> (2) Where 2 or more associated[56] companies not resident in the UK cease to be members of the non-resident group at the same time, subsection (1) above shall not have effect as respects an acquisition by one from another of those associated companies not resident in the UK.
>
> (2A) Where—
>
> (a) a company not resident in the UK ("company A") that has ceased to be a member of a non-resident group of companies not resident in the UK ("the first non-resident group") acquired an asset from another company not resident in the UK ("company B") which was a member of that non-resident group at the time of the acquisition,
>
> (b) subsection (2) above applies in the case of company A's ceasing to be a member of the first non-resident group so that subsection (1) above does not have effect as respects the acquisition of that asset,
>
> (c) company A subsequently ceases to be a member of another non-resident group of companies not resident in the UK ("the second non-resident group"), and
>
> (d) there is a connection between the two non-resident groups,
>
> subsection (1) above shall have effect in relation to company A's ceasing to be a member of the second non-resident group as if it had been the second non-resident group of which both companies not resident in the UK had been members at the time of the acquisition.
>
> (2B) For the purposes of subsection (2A) above there is a connection between

---

56 "Associated" is defined in s.179(10) TCGA: "For the purposes of this section (a) 2 or more companies not resident in the UK are associated companies not resident in the UK if, by themselves, they would form a non-resident group of companies not resident in the UK".

the first non-resident group and the second non-resident group if, at the time when company A ceases to be a member of the second non-resident group, the company not resident in the UK which is the principal company of that non-resident group is under the control[57] of—

(a) the company not resident in the UK which is the principal company of the first non-resident group or, if that non-resident group no longer exists, which was the principal company of that non-resident group when company A ceased to be a member of it;

(b) any person or persons who control the company not resident in the UK mentioned in para (a) above or who have had it under their control at any time in the period since company A ceased to be a member of the first non-resident group; or

(c) any person or persons who have, at any time in that period, had under their control either—

(i) a company not resident in the UK which would have been a person falling within para (b) above if it had continued to exist, or

(ii) a company not resident in the UK which would have been a person falling within this paragraph (whether by reference to a company not resident in the UK which would have been a person falling within that paragraph or to a company not resident in the UK or series of companies not resident in the UK falling within this subparagraph)...

53.29.2 *The clawback charge*

Amended as s.14(3) directs, s.179 TCGA (in outline) provides:

(3) If, when company A ceases to be a member of the non-resident group, company A, or an associated company not resident in the UK also leaving the non-resident group, owns, otherwise than as trading stock—

(a) the asset, or

(b) property to which a chargeable gain has been carried forward from the asset on a replacement of business assets,

then, subject to subsection (4) below, company not resident in the UK A shall be treated for all the purposes of this Act as if immediately after its acquisition of the asset it had sold, and immediately reacquired, the asset at market value at that time.

(4) Any chargeable gain or allowable loss accruing to company A on the sale referred to in subsection (3) above shall be treated as accruing to company A at whichever is the later of the following, that is to say—

(a) the time immediately after the beginning of the accounting period of that company not resident in the UK in which or, as the case may be, at the end of which the company not resident in the UK ceases to be a member of the non-resident group; and

(b) the time when under subsection (3) above it is treated as having

57 "Control" is defined in s.179(9A) TCGA.

reacquired the asset;

and sections 138 to 142 of CTA 2010 have effect accordingly as if the actual circumstances were as they are treated as having been.

53.29.3 *Principal company becomes member of another group*

Amended as s.14(3) directs, s.179 TCGA (in outline) provides:

(5) Where, apart from subsection (6) below, a company not resident in the UK ceasing to be a member of a non-resident group by reason only of the fact that the principal company of the non-resident group becomes a member of another non-resident group would be treated by virtue of subsection (3) above as selling an asset at any time, subsections (6) to (8) below shall apply.

(6) The company in question shall not be treated as selling the asset at that time; but if—

(a) within 6 years of that time the company in question ceases at any time ("the relevant time") to satisfy the following conditions, and

(b) at the relevant time, the company in question, or a company not resident in the UK in the same non-resident group as that company, owns otherwise than as trading stock the asset or property to which a chargeable gain has been carried forward from the asset on a replacement of business assets,

the company in question shall be treated for all the purposes of this Act as if, immediately after its acquisition of the asset, it had sold and immediately reacquired the asset at the value that, at the time of acquisition, was its market value.

(7) Those conditions are—

(a) that the company not resident in the UK is a 75 per cent subsidiary of one or more members of the other non-resident group referred to in subsection (5) above, and

(b) that the company not resident in the UK is an effective 51 per cent subsidiary of one or more of those members.

(8) Any chargeable gain or allowable loss accruing to the company not resident in the UK on that sale shall be treated as accruing at the relevant time.

(9) Where—

(a) by virtue of this section a company not resident in the UK is treated as having sold an asset at any time, and

(b) if at that time the company not resident in the UK had in fact sold the asset at market value at that time, then, by virtue of section 30, any allowable loss or chargeable gain accruing on the disposal would have been calculated as if the consideration for the disposal were increased by an amount,

subsections (3) and (6) above shall have effect as if the market value at that time had been that amount greater.

53.30 Reorganisation relief

A full discussion of CGT reorganisation relief requires a book to itself. This section focusses on the problems where a reorganisation is carried out by a non-resident company within s.13.

For individuals and trustees, the TCGA distinguishes between:

(1) a qualifying corporate bond ("QCB")

(2) a non-qualifying corporate bond ("NQCB")

A bond which would otherwise be a QCB be drafted so as not to meet the requirements of a QCB, eg by a provision allowing the holder to redeem in a currency other than sterling. So on a reorganisation, individual or trustee shareholders can opt out of the QCB regime into the NQCB regime.

However, s.117(A1) TCGA provides:

> For the purposes of corporation tax "qualifying corporate bond" means any asset representing a loan relationship of a company;

This rule applies for s.13 purposes. A corporate bond is in principle a loan relationship of a company. Suppose:

(1) A non-resident company within s.13 ("H") holds a subsidiary ("S").

(2) H sells S to a purchaser ("P") in consideration of loan notes of P.

The loan notes may be drafted so as to constitute a NQCB in the hands of individual or trustee shareholders, but for s.13 purposes gains are computed as if the loan note were a QCB.

53.31 Private residence relief

Suppose T owns a non-resident company, which holds residential property that is T's main residence ("the residence"). If the company disposes of the W, and a gain accrues to T, does private residence relief apply? Section 222(1) TCGA provides:

> This section applies to a gain accruing to an individual so far as attributable to the disposal of, or of an interest in—
>
> (a) a dwelling-house or part of a dwelling-house which is, or has at any time in *his* period of ownership been, his only or main residence, or
>
> (b) land *which he has* for his own occupation and enjoyment with that residence as its garden or grounds up to the permitted area.
>
> (emphasis added)

The gain does accrue to an individual, and it is attributable to the disposal of the residence. However, no relief applies because:

(1) the condition in (b) is not met: there is no land which T *has*;

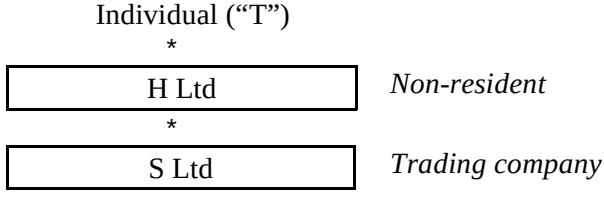
(2) the condition in (a) is not met: the company's period of ownership is not *his* period of ownership.

T might argue that the section should be read non-literally, but it is not absurd to deny private residence relief when a residence is held through a company. The policy is consistent with s.13(11A) TCGA which computes gains as if the company were within the charge to CT, and no-one suggests a UK resident company qualifies for private residence relief.

Likewise if the company is held by a trust, no relief applies to the trustees and the gain on a disposal of the property by the company is a s.2(2) amount (s.87 trust gain) or a s.86 trust gain.

53.32 Entrepreneurs' relief: Trading co held by non-resident company

Suppose an individual holds a non-resident company which holds a trading company, thus:



If T owned the shares in S personally, T can in principle qualify for entrepreneurs' relief on a disposal of S, assuming the necessary conditions are satisfied.[58]

Suppose H disposes of S. The s.13 gain which will accrue to T on that disposal does not qualify for entrepreneurs' relief, because it is not a

58 See 49.5 (Interaction of remittance basis and entrepreneurs' relief).

material disposal of business assets (as defined in s169I TCGA).

Suppose H is wound up after the disposal of S. The gain accruing to T on the disposal of H can qualify for entrepreneurs' relief and so in principle qualifies for the 10% rate.

T will also be able to claim company distribution relief[59] so that tax charged under s13 on the disposal of S will be set against tax on the gain from disposal of H. However the s.13 gain will be charged at 28% and the gain on the disposal of H will be charged at 10%. The former is likely to eliminate the latter but the benefit of entrepreneurs' relief will be lost.

53.33 Administration and appeals

The CG Manual provides:

> **57270. Liaison: other offices** [December 2011]
> As you are required to make an apportionment that is just and reasonable by reference to the interests of all of the participators, you will need to liaise with other officers dealing with participators in the non-resident company. In appropriate cases you should agree that a single nominated officer co-ordinate the progress of the enquiries, or conduct the enquiry in respect of some or all of the participators, for example, where all of the participators are represented by the same agent. In any case where a non-resident trust is involved Specialist PT (Residence), see CG57395, should be notified and will normally act as the office co-ordinating HMRC's enquiries.
> ... It will usually be appropriate to ensure that all appeals relating to the extent of the interests of participators with regard to a particular gain are heard at the same hearing, see AH1795.

53.34 Tax return: Disclosure of s.13 gains

S.13 gains are entered in box 33 of SA108 (Capital Gains summary) 2013/14. SA108 Notes 2014 provides:

> In certain circumstances, you may have to pay CGT on gains made by a company ... in which you have an interest. These include gains made by certain types of company not resident in the UK and in which you are a participator... Include all such gains in box 33...
> **Box 33 Gains in the year, before losses**
> Enter here the total figure of all gains on disposals of property and other assets. This figure should be the gains after any relief, claims or

59 See 53.23 (Company distribution relief).

elections have been taken into account but before any losses are deducted

Also include gains attributed to you where personal losses can be set off ... Please note that gains in the list above [including s.13 gains] do not result from a disposal of an asset in the year and should not include disposal proceeds for such gains in box 31.

CHAPTER FIFTY FOUR

CAPITAL LOSSES

54.1 Capital losses: Introduction

This chapter considers CGT relief for losses.

In this chapter:

"**Personal losses**" means losses accruing to individuals.

"**Trust losses**" means losses accruing to trustees.

I concentrate on the themes of this book, but it is necessary to look at the general rules first. I do not consider the rules for losses arising on disposals to connected persons.

54.1.1 *Cross references*

The following topics are considered elsewhere:

35.21 (Losses)

53.26 (Loss accruing to non-resident company)

49.9.4 (Losses accruing to person who qualifies for DT relief on gains)

54.2 Deduction of losses

Section 2(2) TCGA provides for the deduction of losses against gains:

> Capital gains tax shall be charged on the total amount of chargeable gains accruing to the person chargeable in the year of assessment or, where subsection (1B) applies, the UK part of that year, after deducting—
>
> (a) any allowable losses accruing to that person in that year of assessment or that part (as the case may be), and
>
> (b) so far as they have not been allowed as a deduction from chargeable gains accruing in any previous year of assessment, any allowable losses accruing to that person in any previous year of assessment (not earlier than the year 1965–66).

Section 2(2) refers to a "person", so it applies to individuals, trustees,

companies and PRs.

Section 2(2)(a) deducts current year losses and s.2(2)(b) deducts brought forward losses. Section 2(3) TCGA disallows carry-back of losses (unnecessarily) and provides two commonsense restrictions on loss relief:

> [a] Except as provided by section 62,[1] an allowable loss accruing in a year of assessment shall not be allowable as a deduction from chargeable gains accruing in any earlier year of assessment, and
> [b] relief shall not be given under this Act more than once in respect of any loss or part of a loss, and
> [c] shall not be given under this Act if and so far as relief has been or may be given in respect of it under the Income Tax Acts.

The restriction on carry-back of losses means that careful timing of disposals may make the difference between losing and using the losses.

54.3 Allowable loss

Section 2(2) TCGA refers to "allowable" losses. This is a label which brings in a large number of rules; for whenever the drafter wishes to disallow a loss they direct that it is not allowable.

Section 16(1) TCGA first provides a fairly commonsense rule to compute the amount of a loss:

> Subject to sections 261B, 261D and 263ZA and except as otherwise expressly provided the amount of a loss accruing on a disposal of an asset shall be computed in the same way as the amount of a gain accruing on a disposal is computed.

Section 16(2) TCGA then defines "allowable loss":

> Except as otherwise expressly provided, all the provisions of this Act which distinguish gains which are chargeable gains from those which are not, or which make part of a gain a chargeable gain, and part not, shall apply also to distinguish losses which are allowable losses from those which are not, and to make part of a loss an allowable loss, and part not; and references in this Act to an allowable loss shall be construed accordingly.

Section 16(2A) TCGA requires a claim to be made when the loss accrues (which may be some years before the loss is used):

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1 See 54.5 (Carry-back of losses on death).

> A loss accruing to a person in a year of assessment shall not be an allowable loss for the purposes of this Act unless, in relation to that year, he gives a notice to an officer of the Board quantifying the amount of that loss; and sections 42 and 43 of the Management Act shall apply in relation to such a notice as if it were a claim for relief.

In this chapter I assume losses are allowable.

54.4 Loss accruing to non-resident

Section 16(3) TCGA provides:

> [a] A loss accruing to a person in a year of assessment where the residence condition is not met (see section 2(1A))[2] shall not be an allowable loss for the purposes of this Act
> [b] unless, under section 10 or 10B, he would be chargeable to tax in respect of a chargeable gain if there had been a gain instead of a loss on that occasion.[3]

In short, a loss accruing to a non-resident is not an allowable loss. This gives a symmetry with the rule that a gain accruing to such a person is not in principle subject to CGT.

Section 16(3) refers to a "person", so it applies to individuals, trustees, companies and PRs. However, there is some relief for losses of non-resident trusts within s.86, 87 TCGA,[4] and non-resident companies within s.13 TCGA.[5]

54.4.1 *Loss accruing in split year*

Section 16 (3A) TCGA provides:

> If the person is an individual and the year is a split year as respects that individual, subsection (3) also applies to a loss accruing to the individual in the overseas part of that year.

This disallows a loss accruing in the overseas part of a split year.

54.4.2 *Planning*

The realisation of losses outside the scope of CGT is wasteful. Unless the

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2 See 49.1.2 (CGT residence condition).
3 The situation in s.16(3)[b] is very rare: see 49.8 (Non-resident trade with UK branch).
4 See 54.6 (Loss accruing to non-resident trustees).
5 See 53.26 (Loss accruing to non-resident company).

temporary non-residence rules apply:

(1) An individual leaving the UK may consider realising losses before they become non-resident.

(2) An individual planning to come to the UK may postpone the disposal of assets with inherent losses until they become UK resident.

54.5 Carry-back of losses on death

Section 62(2) TCGA provides for carry-back of losses on death:

> Allowable losses sustained by an individual in the year of assessment in which he dies may, so far as they cannot be deducted from chargeable gains accruing in that year, be deducted from chargeable gains accruing to the deceased in the 3 years of assessment preceding the year of assessment in which the death occurs, taking chargeable gains accruing in a later year before those accruing in an earlier year.

This rule perhaps made more sense when introduced in 1965, as a quid pro quo for the CGT charge on death. However following the introduction of the tax free uplift on death in 1971, it seems unnecessary; its repeal would be a small but useful simplification.

Section 62(2A) TCGA provides:

> Amounts deductible from chargeable gains for any year in accordance with subsection (2) above shall not be so deductible from any such gains so far as they are gains that are treated as accruing by virtue of section 87 or 89(2) (read, where appropriate, with section 10A).

Thus the disallowance of personal losses against s.87 gains continues on death. That is consistent with the general rule.[6]

54.6 Loss accruing to non-resident trustees

54.6.1 *Section 87 and trust losses*

Section 87(4) TCGA provides:

> The section 2(2) amount for a tax year for which this section applies to the settlement is—
>
> (a) the amount upon which the trustees would be chargeable to tax under section 2(2) for that year if they were resident in the UK in that year ...

6 See 54.7 (Disallowance of personal losses of beneficiary against s.87 gains).

Under this provision, trust losses in a tax year could be set against trust gains in the same year, in computing the s.2(2) amount. But trust losses of an earlier year in which the trustees were not resident could not be carried forward and set against trust gains of a later year, because s.16(3) TCGA disallows such losses.[7] However s.97(6) TCGA allows losses to be carried forward:

> Section 16(3) shall not prevent losses accruing to trustees in a year of assessment for which section 87 of this Act or section 17 of the 1979 Act applied to the settlement from being allowed as a deduction from chargeable gains accruing in any later year (so far as they have not previously been set against gains for the purposes of a computation under either of those sections or otherwise).

Carried forward trust losses will usually be used to reduce s.2(2) amounts of a subsequent year. If the trust became UK resident they could be set against gains to reduce the trustees' own liability. A trust is therefore sometimes better than absolute ownership by a remittance basis taxpayer, whose personal losses may be disallowed.

For the interaction of trust losses and sch 4C TCGA, see 52.16.6 (Losses of trust within s.86).

54.6.2 *Section 86 and trust losses*

Under s.86 TCGA the settlor is taxed on what I call "**s.86 trust gains**", which is the amount on which trustees would be charged to tax if UK resident.[8] Under this provision trust losses in a tax year could be set against trust gains in the same year, in computing the s.86 gains. But trust losses of an earlier year in which the trustees were not resident could not be carried forward and set against trust gains of a latter year because s.16(3) TCGA disallows such losses. However para 1(2) sch 5 TCGA provides:

> In construing section 86(1)(e) as regards a particular year of assessment [that is, in order to ascertain the s.86 trust gains] —
>
> (a) any deductions provided for by section 2(2) shall be made in respect of disposals of any of the settled property originating from the settlor, and

7 See 54.4 (Loss accruing to non-resident).

8 See 50.10 (Section 86 trust gains condition).

(b) section 16(3) shall be assumed not to prevent losses accruing to trustees in one year of assessment from being allowed as a deduction from chargeable gains accruing in a later year of assessment (so far as not previously set against gains).

For losses and sch 4B TCGA, see 52.16.6 (Losses of trust within s.86).

54.6.3 *Loss accruing before s.86 conditions satisfied*

Para 1(6) sch 5 TCGA provides:

> The following rules shall apply in construing section 86(1)(e) as regards a particular year of assessment ("the year concerned") in a case where the trustees fall within section 86(2)(a)—
>
> (a) if the conditions mentioned in section 86(1) are not fulfilled as regards the settlement in any year of assessment falling before the year concerned, no deductions shall be made in respect of losses accruing before the year concerned;
>
> (b) if the conditions mentioned in section 86(1) are fulfilled as regards the settlement in any year or years of assessment falling before the year concerned, no deductions shall be made in respect of losses accruing before that year (or the first of those years) so falling,
>
> but nothing in the preceding provisions of this sub-paragraph shall prevent deductions being made in respect of losses accruing in a year of assessment in which the conditions mentioned in section 86(1)(a) to (d) and (f) are fulfilled as regards the settlement.

54.6.4 *Loss on disposal before 19 March 1991*

For completeness, para 1(7) Sch 5 TCGA provides:

> In construing section 86(1)(e) as regards a particular year of assessment and in relation to a settlement created before 19th March 1991, no account shall be taken of disposals made before 19th March 1991 (whether for the purpose of arriving at gains or for the purpose of arriving at losses).

54.7 Disallowance of personal losses of beneficiary against s.87 gains

Section 2(4) TCGA provides:

> If chargeable gains are treated by virtue of section 87 or 89(2)[9] as

9 Section 2(5) TCGA provides: "In subsection (4) the reference to section 87 or 89(2) is to that section read, where appropriate, with section 10A."

accruing to a person in a tax year ("the relevant deemed gains")—
(a) subsection (2) has effect as if the relevant deemed gains had not accrued, and
(b) the amount on which the person is charged to capital gains tax for that year is the sum of—
(i) the amount given by subsection (2) as it has effect by virtue of para (a), and
(ii) the amount of the relevant deemed gains.

This is clumsily expressed.[10] The drafting technique is to isolate the "relevant deemed gains" (ie the s.87 gains) from the loss relief in s.2(2) TCGA. The effect is that personal losses may not be set against s.87 gains accruing to the individual.

54.7.1 *Personal losses & s.87 gains: Commentary*

The disallowance of personal losses against s.87 gains was introduced in 1998 because of the difficulties of interaction with taper relief.[11] The repeal of taper in 2008 should have allowed personal losses to be set once again against s.87 gains. Presumably this point was overlooked or perhaps a deliberate decision was made to discourage the use of trusts. It is suggested that the rule disallowing personal losses against s.87 gains should be repealed.

54.8 Personal losses of settlor and s.86 gains

The settlor can set their personal losses against s.86 gains, under s.2(2) TCGA.

For completeness, s.2(7) TCGA deals with the situation where a settlor has made two or more settlements:

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10 Section 62(2A) TCGA illustrates how the point could be clearly expressed; see 54.5 (Carry-back of losses on death).
Obscurity in statutory drafting *does* matter. In *Futter v Futter* [2011] STC 890 trustees made an appointment in the mistaken belief that personal losses could be set against s.87 gains. If s.2 had been clearly drafted, it is unlikely that the mistake would have been made.

11 The CG Manual formerly provided: "**34272 Personal losses** [June 2005]
... For 1998–99 onwards the beneficiary's personal allowable losses are not available to reduce these attributed gains. It is not possible to identify any particular gain with a capital payment and so the changes introduced for Section 77 and Section 86 gains, see CG34865+, for 2003–04 onwards could not be extended to Section 87 gains."

Where in any year of assessment—

(a) there are amounts treated as accruing to a person by virtue of section 86,

(b) two or more of those amounts, or elements of them—

(i) relate to different settlements,

(c) losses are deductible from the amounts or elements mentioned in para (b) above but are not enough to exhaust them all,

the deduction applicable to each of the amounts shall be the appropriate proportion of the aggregate of those losses.

The "appropriate proportion" is that given by dividing the amount in question by the total of the amounts.

This is only necessary to ascertain what amount can be recovered under the settlor's indemnity against each settlement.

54.9 Loss accruing to remittance basis taxpayer

54.9.1 *"Foreign/UK loss" "Foreign/UK gain"*

The legislation distinguishes between foreign losses and other losses. Section 16ZA(6) TCGA gives "**foreign loss**" a commonsense meaning:

> In this section "foreign loss" means a loss accruing from the disposal of an asset situated outside the UK.

The legislation also distinguishes between foreign chargeable gains and other gains. This expression has its usual commonsense meaning. Section 12(4) TCGA provides:

> In this section "foreign chargeable gains" means chargeable gains accruing from the disposal of an asset which is situated outside the UK.

This only applies for the purposes of s.12, so the definition has to be incorporated by reference where it is used elsewhere.[12]

In this chapter, "**UK loss**" means a loss which is not a foreign loss, ie a loss on a disposal of a UK situate asset; and **"UK gain"** means a gain which is not a foreign gain, ie a gain on a disposal of a UK situate asset

54.9.2 *Background*

The complex rules can be better understood if one understands the constraints faced by the drafter. It is difficult to think of a satisfactory rule

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12 Section 16ZB(5) and again in s.16ZC(7) TCGA. If the drafter had made this a TCGA-wide definition, this would not have been necessary.

for losses of a remittance basis taxpayer. Relief for all losses is too generous when only some gains are taxable. Relief for foreign losses remitted to the UK is not satisfactory, as it would usually be easy to remit the losses to the UK, so that amounts to a relief for (almost) all losses, at least for a well advised taxpayer. Moreover in the case of the extinction of an asset there may be nothing to remit.

The pre-2008 solution was to disallow relief on foreign losses on foreign domiciliaries (to whom the remittance basis applied compulsorily – there was no claim needed). The CGT remittance basis was a package with advantages and this disadvantage. This was a rough and ready solution, but simple and workable. However the introduction of the claim for the CGT remittance basis in 2008 changed the situation. If foreign losses of foreign domiciliaries were disallowed only in years that the individual claimed the remittance basis, then individuals may claim the remittance basis in the year that they realise gains and not in the year that they realise losses. On the other hand, the failure to claim would often be expensive in other ways, and as a simple and pragmatic solution it has much to commend it.

The FD draft clauses 2007 proposed to disallow all foreign losses of foreign domiciliaries, but that was EU non-compliant (not to mention unfair). HMRC presumably agreed, and a new solution had to be devised in the rushed weeks between publication of the FD draft clauses and the Finance Bill, allowing insufficient time for HMRC to consider the issues, and none at all for consultation.

54.9.3 *Summary*

EN FB 2008 provides this summary:

> 355. The overall effect of these new rules is that:
> [1] on the first occasion when a non-UK domiciled individual claims remittance basis for a tax year, the individual may make an election in relation to their foreign losses;
> [2] if the individual does not make an election, foreign losses of that tax year and all future tax years will not be allowable losses; and
> [3] if the individual makes an election, special rules apply to the deduction of allowable losses where there are foreign chargeable gains.
> 356. The effect of the special rules is that:
> [1] where foreign chargeable gains are remitted to the UK in a tax year later than that in which the asset was disposed of:
> [a] no losses of that later year, or of any year later than that in which

they arose, are deductible from those gains, and

[b] [those gains] may not be covered by the [CGT annual exemption] of the year in which they are remitted; and

[2] if remittance basis is claimed for the tax year in which foreign chargeable gains arise, the allowable losses available for deduction from gains of that year are deducted

[a] first from foreign chargeable gains that both arise and are remitted in that year,

[b] then against foreign chargeable gains arising but not remitted in that year, and

[c] only then from any other (non-foreign) chargeable gains arising in that year.

The CG Manual provides:

CG25330 - Remittance basis: losses: introduction [November 2012]

Losses on non-UK assets arising before 6 April 2008 to remittance basis users were not allowable losses. For tax year 2008-09 onwards an individual may elect that such "foreign losses" which arise in the year of election or subsequent years are allowable, subject to certain special rules, against chargeable gains (TCGA92/S16ZA). The election is irrevocable and has effect in the year it is made and all subsequent years.

The special rules for giving relief in respect of foreign losses have two main effects:

- They prevent any loss (not just a foreign loss) of a later year being allowed against a foreign chargeable gain which arose in an earlier year but which is not remitted (and so not taxed) until the year of the loss or later (TCGA92/S16ZB). This is analogous to the "no carry back" rule where the remittance basis is not in point.
- They limit the amount of losses available for relief against chargeable gains in a year by imposing a strict order in which they are matched with gains of various classes, including unremitted foreign chargeable gains (TCGA1992/S16ZC).

Correct operation of these rules is likely to demand careful record-keeping by the taxpayer.

The CG Manual provides:

CG25330C - Remittance basis: matching rules for relieving losses: TCGA92/S16ZC [April 2010]

If an election has been made for foreign losses to remain allowable losses (see CG2530A) then, in a tax year in which the remittance basis applies and the individual is not domiciled in the United Kingdom, special rules apply to determine how gains are to be relieved by losses. In summary, the allowable losses deductable under TCGA92/S2 are matched:

- Firstly, against foreign chargeable gains accruing in the tax year to the extent that they are remitted to the United Kingdom in that year

- Secondly, against foreign chargeable gains accruing in that year to the extent that they are not so remitted and
- Thirdly, against chargeable gains accruing in that year other than foreign chargeable gains (this does not include chargeable gains treated as accruing under TCGA92/S12 ie on the remittance basis).

And then the amount on which Capital Gains Tax is charged in the year is the total amount of chargeable gains accruing in the year less the losses matched against gains in the first and third categories only.

This means in effect that allowable losses which are matched with unremitted foreign chargeable gains are not available for relief against gains on UK assets, which therefore remain chargeable. The unremitted foreign chargeable gains are reduced by the losses matched with them, and so will not give rise to any tax charge if or when they are remitted (TCGA92/S16ZD(3)).

Chargeable gains which are treated as accruing under TCGA92(S87) (attribution of gains to beneficiaries) or TCGA92/S89(2) (migrant settlements etc) are not within any of these three categories of gain. This means that relief for losses is not available against these sorts of gain.

A taxpayer will need to keep records to allow the correct operation of these provisions to be verified.

54.9.4 *"Relevant tax year"*

Section 16ZA(1) TCGA provides the definition:

> In this section "the relevant tax year", in relation to an individual, means the first tax year for which—
>
> (a) section 809B of ITA 2007 (claim for remittance basis) applies to the individual, and
>
> (b) the individual is not domiciled in the UK.[13]

In short, the relevant tax year is the first year that the individual claims the remittance basis (it does not matter whether or not the individual is a long-term resident, ie whether or not the remittance basis claim charge is due).

The expression "relevant year" is opaque; I refer to it as **"a relevant (s.809B remittance basis claim) year"**.

One can put off the relevant (s.809B RB claim) year by not making a s.809B remittance basis claim, but that is not generally going to be worthwhile. In straightforward cases the relevant tax year will be 2008/09 or the earliest year of UK residence if later.

An individual within s.809D or 809E (sub-£2k taxpayer or non-taxpayer) is not within s.809B so all losses are allowable in the usual way.

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13 Para (b) is otiose as (from 2013) an individual must be non-UK domiciled in order to fall within (a). But it does no harm.

54.9.5 *Loss election*

Section 16ZA TCGA provides:

> (2) An individual may make an election under this section for the relevant tax year (in which case sections 16ZB and 16ZC have effect in relation to the individual for the relevant tax year and all subsequent tax years). ...
> (4) Sections 42 and 43 of the Management Act (procedure and time limit for making claims), except section 42(1A) of that Act, apply in relation to an election under this section as they apply in relation to a claim for relief.
> (5) An election under this section is irrevocable.

Thus a taxpayer on claiming the remittance basis has a once in a lifetime opportunity to make an election under s.16ZA (which I call a "**loss election**") and this election (if made) applies for the rest of their life. It is impossible to know what will be the best choice and the taxpayer will have to guess. This is almost unprecedented in tax legislation.

RDR Manual provides:

> **32060 - Foreign chargeable gains loss election** [July 2010]
> The election should be made for the first year for which the remittance basis is claimed, irrespective of whether the individual has any foreign chargeable gains or overseas losses in that year. The election will usually be made within the white space in the Capital Gains supplementary pages of the same SA Return as the first remittance basis claim is made.

54.9.6 *Time limits*

Section 16ZA(4) TCGA provides:

> Sections 42 and 43 of the Management Act (procedure and time limit for making claims), except section 42(1A) of that Act, apply in relation to an election under this section as they apply in relation to a claim for relief.

Thus the usual time limits apply. The best approach may be to wait until the time limit approaches and make the decision then to elect or not, with the benefit of four year's hindsight.

54.10 Disallowance of foreign losses if no election is made

Section 16ZA(3) TCGA provides:

> If an individual does not make such an election, foreign losses accruing to the individual in–
>
> (a) the relevant [s.809B remittance basis claim] tax year, or
>
> (b) any subsequent tax year except one in which the individual is domiciled in the UK
>
> are not allowable losses.

In short, if no election is made, foreign losses accruing to a foreign domiciliary are not allowable:

(1) in the year that a s.809B remittance basis claim is made; or

(2) in any subsequent year (even if no claim is made in that year).

There are therefore four distinct periods for a UK resident foreign domiciled individual, assuming no loss election is made:

(1) Before 2008/09: foreign losses are disallowed.[14]

(2) From 2008/09:

(a) Period when UK resident but before making a s.809B remittance basis claim: foreign losses are allowable.

(b) Section 809B remittance basis claim year, and subsequently while non-domiciled: foreign losses are disallowed.

(c) After becoming UK domiciled: foreign losses are allowable.

A long term resident who stops claiming the remittance basis (because the remittance basis claim charge is too high) and who is not concerned about IHT (eg because IHT deemed domiciled) may wish to acquire a UK domicile, if the circumstances permit.

If no election is made, UK losses are allowable in the normal way, and so:

(1) Set against (a) UK gains and (a) foreign gains (whenever realised) in the year that they are remitted to the UK; or

(2) Carried forward.

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14 Section 16(4) TCGA as it had effect before 2008/09 provided:

> "In accordance with section 12(1), losses accruing on the disposal of assets situated outside the UK to an individual resident or ordinarily resident but not domiciled in the UK shall not be allowable losses."

This wording is confusing. It means that losses accruing to a foreign domiciliary on a disposal by the foreign domiciliary of foreign situated property are not allowable. It does not mean that losses are not allowable on a disposal (by any person) to a foreign domiciliary.

54.10.1 *Planning*

Consider the position before disposing of an asset on which an (otherwise) non-allowable loss will accrue. Possibilities are:
(1) making assets UK situate prior to disposal;[15]
(2) an inter-spouse transfer.[16]
A foreign domiciliary who claims the remittance basis may be worse off than if they had not made the claim, if (1) they fail to make the loss election (2) they realise disallowed foreign losses; and (3) they remit sufficient gains to the UK.

An individual who comes to the UK may consider:
(1) realising historic foreign losses in the first year of residence (or in the UK part of a split year); and
(2) not making a s.809B remittance basis claim until after the first year of residence (or after the UK part of a split year).

54.11 Position if loss election is made

For the purposes of the following discussion a remittance basis taxpayer has three types of foreign gains:
"Promptly remitted gains" means gains which are remitted in the year that the gains actually accrue.
"Postponed remitted gains" means gains which are remitted in a year after the gains actually accrue. Statute calls these "relevant gains" which is an opaque label; I expand it to **"relevant (postponed remitted) gains"**.
"Unremitted gains" means gains which are not remitted and so (un)taxed on the remittance basis.

Section 16ZB TCGA provides:

> **16ZB Individual who has made election under section 16ZA: foreign chargeable gains remitted in tax year after tax year in which accrue**[17]
> (1) This section applies to an individual for a tax year ("the applicable tax year") if—
> (a) the individual has made an election under section 16ZA,
> (b) foreign chargeable gains accrued to the individual
> [i] in or after the relevant [s.809B remittance basis claim] tax

15 Contrast 83.24 (CGT planning: making UK situate property non-UK situate).
16 See 54.13 (Inter-spouse transfer).
17 *Sic*: the heading is incoherent.

year (within the meaning of section 16ZA)
[ii] but before the applicable tax year, and

(c) by reason of the remission[18] of any of the foreign chargeable gains to the UK, chargeable gains are treated under section 12 as accruing to the individual in the applicable tax year or a part of the applicable tax year ("the relevant gains").

In short, s.16ZB applies to postponed remitted gains accruing in or after the s.809B remittance basis claim year. The rules do not apply to gains which accrued before that year. In particular, the rules do not apply to pre-2008 gains, since no s.809B claim was made in those years.

At this point the drafting becomes exceptionally clumsy.[19]

Section 16ZB(2) TCGA continues:

> Section 2(2) or (4) has effect for the applicable tax year as if the relevant [postponed remitted] gains had not accrued.

Section 16ZB(2) isolates the postponed remitted gains from the loss relief in s.2(2) TCGA. Then s.16ZB(3) TCGA provides:

> The amount on which the individual is charged to capital gains tax for the applicable tax year is (instead of the amount given by section 2(2) or (4)(b), as reduced under section 3) the sum of—
>
> (a) the adjusted taxable amount, and
>
> (b) the amount of the relevant [postponed remitted] gains.

54.11.1 *The adjusted taxable amount*

Section 16ZB(4) TCGA provides:

> "The adjusted taxable amount" is—
>
> (a) if section 3(1) (annual exempt amount) does not apply to the individual for the applicable tax year, the amount given by section 2(2) or (4)(b) as it has effect by virtue of subsection (2), and
>
> (b) otherwise, so much of that amount as exceeds the exempt amount for the applicable tax year (within the meaning of section 3).

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18 Section 16ZB(6) TCGA provides (somewhat unnecessarily): "For the purposes of subsection (1)(c) foreign chargeable gains are remitted to the UK if they are regarded as so remitted for the purposes of section 12."

19 The drafter had adopted the clumsy drafting technique of s.2(4) TCGA which it is helpful to read first, in order to understand s.16ZB; see 54.7 (Disallowance of personal losses of beneficiary against s.87 gains).

In short, the adjusted taxable amount is the amount of gains less losses (and less the CGT annual exemption if available) apart from the postponed remitted gains.

So in short, if one makes the loss election:

(1) all losses (UK and foreign losses) are allowable against:
  (a) UK gains
  (b) foreign gains if
    (i) taxed on an arising basis (because no s.809B remittance basis claim is made in the year that the gains accrue); or
    (ii) promptly remitted gains (remitted in the year that the gains accrue).

(2) under s.16ZB postponed remitted gains do not qualify for:
  (a) *any* loss relief (either UK losses or foreign losses) or
  (b) the CGT annual exemption.[20]

The CG Manual provides an example:

> **CG25330B - Remittance basis: no effective carry back of foreign allowable losses: TCGA92/S16ZB** [April 2010]
> If an election has been made for foreign losses to remain allowable losses (see CG25330A) then a loss may not be set against chargeable gains taxable on the remittance basis in a tax year - known as the applicable tax year- after the foreign chargeable gains which are being remitted arose, if the foreign chargeable gain arose in a year before the loss. This means that a loss cannot be "carried back" and set against a foreign chargeable gain of an earlier year, even if that gain is not taxed until the year of loss because of the remittance basis.
> *Example: (Henri)*
> H elects to use the remittance basis in 2008-09 and has an unremitted foreign chargeable gain of £1m in that year. He also elects for his foreign losses to remain allowable losses.
> In 2010-11 he remits the gain to the UK and has a foreign loss of £500,000. He does not elect to use the remittance basis in 2010-11.

The HMRC analysis is as follows:

> The relevant [s.809B remittance basis claim] tax year is 2008-09 and the applicable tax year is 2010-11. Foreign chargeable gains accrued in or after the relevant tax year but before the applicable tax year and a

20 Where the CGT annual exemption is disapplied, the usual relief for reporting small losses is likewise disapplied; see 47.5.1 (Reporting small gains).

chargeable gain is treated as accruing in the applicable tax year when those gains are remitted. The conditions of TCGA92/S16ZB(1) are therefore satisfied. The remitted gains are known as relevant [postponed remitted] gains and are excluded from the total amount of chargeable gains from which losses are deducted under TCGA92/S2. The relevant gains are nonetheless included in the amount on which Capital Gains Tax is charged for the applicable tax year (TCGA92/S16ZB(2)-(3)). So the £500,000 loss may not be set against the chargeable gain of £1m treated as accruing to H in 2010-2011.

Note that this prohibition of carry-back applies to all losses, not just to foreign losses.

Note also that this prohibition applies whether or not the remittance basis applies in the applicable year, ie the year in which the foreign chargeable gain is remitted.

54.11.2 *Setting losses against gains*

Section 16ZC TCGA directs that losses are to be used in a manner which is not the most favourable to the taxpayer:

16ZC Individual who has made election under section 16ZA and to whom remittance basis applies

(1) This section applies to an individual for a tax year if—

(a) the individual has made an election under section 16ZA for the tax year or any earlier tax year,

(b) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for the tax year, and

(c) the individual is not domiciled in the UK in the tax year.[21]

In short, the section applies to a remittance basis taxpayer who makes a loss election.

Section 16ZC continues:

(2) The following steps apply for the purpose of calculating the amount on which the individual is to be charged to capital gains tax for the tax year.

Step 1 Deduct any relevant allowable losses from the chargeable gains referred to in subsection (3) in the order in which they appear there (starting with para (a) of that subsection).

"Relevant allowable losses" simply means allowable losses. (The drafter

21 Para (b) is otiose as (from 2013) an individual must be non-UK domiciled in order to fall within (a). But it does no harm.

is fond of the word "relevant"). Section 16ZC(7) TCGA provides:

> In this section "relevant allowable losses" means the allowable losses that section 2(2) provides may be deducted from chargeable gains accruing to the individual in the tax year or a part of the tax year.

54.11.3 *The loss deduction order*

This takes us to s.16ZC(3) TCGA which sets out the deduction order:

> The chargeable gains are—
> (a) foreign chargeable gains accruing to the individual in the tax year, to the extent that they are remitted[22] to the UK in that year or, if that year is a split year as respects the individual, in the UK part of that year,
> (b) foreign chargeable gains accruing to the individual in that year, to the extent that they are not so remitted in that year or they are so remitted in that year but it is a split year as respects the individual and they are so remitted in the overseas part of the year, and
> (c) chargeable gains accruing to the individual in that year (other than foreign chargeable gains).

Section 16ZC(5) TCGA provides:

> Chargeable gains treated as accruing under s.12 are not within subsection (3)(c).

This is referring to foreign gains which actually accrue at the time of the disposal but are treated as accruing at the time of remittance.

So in my terminology, losses are set against gains in this order:

(a) promptly remitted gains;
(b) unremitted foreign gains;
(c) UK gains.

Losses set against (b) may not be wasted but they are not used until the unremitted gains are remitted.

54.11.4 *Use of deductions*

Our journey takes us to Step 2:

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22 Section 16ZC(6) TCGA provides (somewhat unnecessarily): "For the purposes of subsection (3) foreign chargeable gains are remitted to the UK if they are regarded as so remitted for the purposes of section 12."

> *Step 2* Treat the amount referred to in section 2(2) or (4)(a) or 16ZB(3)(a) as being equal to—
>
> (a) the amount it would be if there were no relevant allowable losses, minus
>
> (b) the total amount deducted under Step 1 from chargeable gains within subsection (3)(a) or (c).

This effectively confirms the deduction made in Step 1.

Section 16ZC(4) TCGA provides:

> Chargeable gains treated as accruing under section 87 or 89(2) (read, where appropriate, with section 10A) are not within any paragraph of subsection (3).

This maintains the disallowance of personal losses against s.87 gains.[23]

Section 16ZD TCGA provides:

> (1) This section applies if section 16ZC applies to an individual for a tax year.
>
> (2) Any allowable loss deducted under step 1 of section 16ZC(2) is to be regarded (for the purposes of section 2(2)(b)) as allowed as a deduction from chargeable gains accruing to the individual in the tax year.
>
> (3) If a deduction is made under step 1 of section 16ZC(2) from a foreign chargeable gain within section 16ZC(3)(b), the amount of the foreign chargeable gain is reduced by the amount deducted.

I am not sure why it was necessary to say this, but it does no harm.

54.11.5 *Losses insufficient to set against all the gains*

It may be that the losses are set against unremitted gains but the losses are not sufficient to set against all the unremitted gains. In that case one needs to know which gains they are set against, in case some gains are later remitted and some are not.

Step 1 in s.16ZC(2) provides:

> If allowable losses are deductible from the chargeable gains referred to in subsection (3)(b) but are not enough to exhaust them all—
>
> (a) those chargeable gains are to be ordered according to the day on which they accrued,
>
> (b) the losses are to be deducted from those gains in reverse

23 See 54.7 (Disallowance of personal losses of beneficiary against s.87 gains).

chronological order (starting with the last chargeable gain to accrue), and

(c) if allowable losses are deductible from chargeable gains that accrued on a particular day but are not enough to exhaust all of the chargeable gains that accrued on that day, the amount deducted from each of those chargeable gains is the appropriate proportion of the losses.

In para (c) "the appropriate proportion", in relation to a chargeable gain, is the amount of that gain divided by the total amount of the chargeable gains that accrued on the day in question.

54.11.6 *HMRC example*

The CG Manuel provides:

> **CG25330D - Remittance basis: matching rules for relieving losses: example: Section S16ZC TCGA 1992**
>
> *Example (Johann)*
>
> J is a remittance basis user in all years. He has made an election under Section 16ZA TCGA 1992 so his foreign losses are allowable, subject to the rules in Section 16ZB TCGA 1992 and Section 16ZC TCGA 1992. His history of gains and losses is as follows:

	UK gains	UK losses	Foreign gains	Cash brought to UK	Foreign losses
2008-09	100,000	25,000	30,000	0	0
2009-10	17,000	5,000	50,000	60,000[24]	30,000
2010-11	0	0	12,000	20,000[25]	25,000

The HMRC analysis is as follows:

> **2008-09**
>
> Relevant allowable losses are £25,000 (Section 16ZC(7) TCGA 1992)
>
> Chargeable gains classified and ordered according to Section 16ZC(3) TCGA 1992:

a) 2008-09 foreign chargeable gains remitted	Nil
b) 2008-09 foreign chargeable gains not remitted	30,000
c) 2008-09 other chargeable gains [UK gains]	100,000

> **Step 1**: deduct relevant allowable losses from the gains so ordered. The net gains are therefore:

a) 2008-09 foreign chargeable gains remitted	Nil
b) 2008-09 foreign chargeable gains not remitted	5,000
c) 2008-09 other chargeable gains	100,000

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24 [HMRC's note] accepted after enquiry to establish facts and application of mixed fund rules ... as being £30,000 from 2008-09 plus £30,000 from 2009-10

25 [HMRC's note] accepted after enquiry to establish facts and application of mixed fund rules ... as being all from 2009-10

Step 2: the total amount of chargeable gains on which tax is charged by Section 2(2) TCGA 1992 is equal to the amount it would be if there were no relevant allowable losses (i.e. £100,000 UK gains) LESS the total amount deducted at step 1 from gains in classes (a) and (c) (i.e. £Nil).

So in 2008-09 Capital Gains Tax is charged on £100,000. The effect of the rules is to use allowable losses to frank unremitted foreign chargeable gains even though that leaves UK gains in charge.

The foreign chargeable gain not remitted is reduced by the allowable UK loss deducted from it at step 1 so going forward it becomes £5,000 (Section 16ZD (3) TCGA 1992). This is important to remember if it is remitted in a later year (see below).

2009-10

Relevant allowable losses are £35,000 (Section 16ZC(7) TCGA 1992)

Chargeable gains classified and ordered according to Section 16ZC(3) TCGA 1992:

a) 2009-10 foreign chargeable gains remitted	30,000
b) 2009-10 foreign chargeable gains not remitted	20,000
c) 2009-10 other chargeable gains	17,000

Step 1: deduct relevant allowable losses from the gains so ordered. The net gains are therefore:

a) 2009-10 foreign chargeable gains remitted	Nil
b) 2009-10 foreign chargeable gains not remitted	15,000
c) 2009-10 other chargeable gains	17,000

Step 2: the total amount of chargeable gains on which tax is charged by Section 2(2) TCGA 1992 is equal to the amount it would be if there were no relevant allowable losses(i.e.

£35,000 remitted gains[26]

£17,000 UK gains

£52,000

LESS the total amount deducted at step 1 from gains in classes (a) and (c) (i.e. £30,000).

So in 2009-10 Capital Gains Tax is charged on £22,000 (52,000 - 30,000). The effect of the rules is to use allowable losses to frank unremitted foreign chargeable gains even though that leaves UK gains in charge.

The foreign chargeable gain not remitted (category (b)) is reduced by the loss deducted from it at step 1, so it becomes £15,000 (Section 16ZD(3) TCGA 1992). This will be significant if it is remitted in a later year (see below).

2010-11

Relevant allowable losses are £25,000 (Section 16ZC(7) TCGA 1992)

Chargeable gains classified and ordered according to Section 16ZC(3) TCGA 1992:

a) 2010-11 foreign chargeable gains remitted	Nil
b) 2010-11 foreign chargeable gains not remitted	12,000
c) 2010-11 other chargeable gains	Nil

26 £5,000 from 2008-09 (after set-off of 2008-09 losses) plus £30,000 from 2009-10

Step 1: deduct relevant allowable losses from the gains so ordered. The net gains are therefore:

a) 2010-11 foreign chargeable gains remitted	Nil
b) 2010-11 foreign chargeable gains not remitted	Nil
c) 2010-11 other chargeable gains	Nil

Step 2: the total amount of chargeable gains on which tax is charged by Section 2(2) TCGA 1992 is equal to the amount it would be if there were no relevant allowable losses (i.e.
£15,000, the adjusted residue of the 2009-10 gain; see above)
LESS the total amount deducted at step 1 from gains in classes (a) and (c) (i.e. £Nil).
So in 2010-2011 Capital Gains Tax is charged on £15,000. Note that none of the foreign loss arising in 2010-2011 can be relieved against the chargeable gain which accrued in the earlier year, even though that gain was not remitted until the year of loss. This is consistent with the fact that UK losses cannot be carried back to set against gains of earlier years.
The foreign chargeable gain not remitted (category (b)) is reduced by the loss deducted from it at step 1, so it becomes £Nil (Section 16ZD (3) TCGA 1992). It has been franked by the loss of the period and will not give rise to a taxable remittance if cash etc representing it is brought to the UK in a later year.
The unused balance of allowable losses (£25,000 – 12,000 = £13,000) is carried forward and may be used to relieve chargeable gains of later years. (Section 16ZD(2) TCGA 1992).

54.11.7 *Record-keeping*

Record-keeping from 2008 is extremely onerous. Before 2008 a taxpayer had only to keep a total of brought forward losses and remitted gains. But now (if a taxpayer makes a loss election) they need to keep track of which year losses accrue, and which day and year postponed remitted gains accrue, in order to apply these loss rules.

54.12 When is a loss election worthwhile?

Careful timing of realisation of losses and of remittances is necessary in order to maximise loss relief if a loss election is made. A few general points can be made.

A person who will realise UK losses and not foreign losses should not make a loss election.

A person who will realise UK losses and foreign losses, but can use inter-spouse transfers to avoid disallowable foreign losses should not make an election.

A person who will realise foreign losses and not UK losses should make an election.

In other cases it is a matter of guesswork.

54.13 Inter-spouse transfer

Inter-spouse transfers are on a no gain no loss basis for CGT.[27]

Suppose a foreign domiciled individual ("H") owns an asset which will give rise to a loss. It will often happen that the loss on the disposal by H will not be allowable or (if a loss election has been made) it may be set against foreign gains and so wasted. Suppose:

(1) H gives the asset to H's spouse ("W").

(2) W disposes of the asset, and so realises the loss.

W's loss may be allowable loss (for instance if W has not made a s.809B remittance basis claim, or a loss election).

However s.16A TCGA provides:

> (1) For the purposes of this Act, "allowable loss" does not include a loss accruing to a person if—
>
> (a) it accrues to the person directly or indirectly in consequence of, or otherwise in connection with, any arrangements, and
>
> (b) the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage...
>
> (3) For the purposes of subsection (1) it does not matter—
>
> (a) whether the loss accrues at a time when there are no chargeable gains from which it could otherwise have been deducted, or
>
> (b) whether the tax advantage is secured for the person to whom the loss accrues or for any other person.[28]

54.13.1 *"Tax advantage"*

"Tax advantage" has the standard definition. Section 16A(2) TCGA provides:

> "tax advantage" means—
>
> (a) relief or increased relief from tax,
>
> (b) repayment or increased repayment of tax,
>
> (c) the avoidance or reduction of a charge to tax or an assessment to tax, or
>
> (d) the avoidance of a possible assessment to tax,

---

27 See 73.10 (CGT spouse exemption).

28 What is the point of s.16A(3)(b) TCGA? How can a tax advantage be secured for any person *other* than the person to whom the loss accrues? The answer is if the loss accrues to a non-resident company or trustee, for the tax advantage might be enjoyed by a settlor (under s.86) or a beneficiary (under s.87) or a participator (under s.13). But this is not relevant to inter-spouse transfers.

> and for the purposes of this definition "tax" means capital gains tax, corporation tax or income tax.

Looking at the words of the section, one would think that the position was as follows. An allowable loss is a "tax advantage" within (a) or (c). So if one of the main purposes of an inter-spouse transfer is to obtain the loss, the loss is disallowed.

It depends on the facts whether that is actually a main purpose, but in many (I think, most) cases it would be so.

HMRC have issued guidance on s.16A[29] which I call **"HMRC loss guidance"**. This comments on identifying the main purpose:

> 16. Hence it will be relevant to draw a comparison in order to consider whether, in the absence of the tax considerations:
> • the transaction giving rise to the advantage would have taken place at all;
> • if so, whether the tax advantage would have been of the same amount; and
> • whether the transaction would have been made under the same terms and conditions.

It will very often be the case that the inter-spouse transfer is made only for tax reasons and would not be made in the absence of tax. However, HMRC loss guidance provides:

> 17. ... Nor will the new legislation *ordinarily* prevent a genuine loss on a real disposal of an asset from being set off against a person's own gains, including the case where, before the real disposal that gives rise to the genuine loss, the person acquires the relevant asset from a spouse or civil partner at no gain/no loss under section 58 [TCGA].[30]

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29 HMRC, "CGT - Avoidance of tax through the creation and use of capital losses" . The guidance passed through various drafts and versions to the current guidance of July 2007, accessible *http://www.hmrc.gov.uk/cgt/cgt-recent-developments.pdf* and reprinted (with variations) in the CG Manual Appendix 9 [February 2010].

30 See too example 5:

> "40. Mr H has shares in S plc which are standing at a loss. Mrs H has shares in a separate company, T plc, standing at a gain. Mr H transfers his shares to Mrs H under the no-gain, no-loss rule in section 58 TCGA, and she then sells both holdings of shares. The loss on the shares in S plc covers the gain arising from the shares in T plc, and so no CGT is payable by Mrs H.
>
> 41. Taking the spouses together, Mr and Mrs H each have shares which they want to sell. What happens in fact is that they do sell their shares, and the economic consequence is that they realise a gain on one set of shares and a loss on the other

(Emphasis added)

According to this, s.16A does not (in short) apply to genuine losses, and the loss following an inter-spouse transfer is regarded as genuine.

The question this raises is: what is meant by genuine loss and why is the spouse's loss genuine? At first the unlawyerlike term "genuine" seems almost impossible to pin down, but I suggest that the concept intended here is the tax avoidance/mitigation distinction.[31] A loss is genuine (in the intended sense) if it is in accordance with the intention of Parliament, a special tax regime, and has economic consequences. The inter-spouse transfer in principle meets those criteria. This view is confirmed by para 13 of the HMRC loss guidance:

> The straightforward use of a statutory relief does not of itself bring arrangements within the TAAR.

The straightforward use of a statutory relief could obviously be and frequently is done with the purpose of obtaining a tax advantage, but it is not tax avoidance.[32]

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set. To decide whether or not the TAAR applies, it is necessary to consider whether there have been arrangements, and whether a main purpose of those arrangements was the securing of a tax advantage. In this case, it seems clear that there have been arrangements, namely the transfer of the shares from Mr H to Mrs H. It is then necessary to look at what the main purpose of Mr and Mrs H in entering into these arrangements was. This can be determined only by looking at all the circumstances surrounding the arrangements. In the present example, Mr and Mrs H wanted to dispose of their shareholdings, and they did this in a straightforward way. They made use of the provisions of section 58 TCGA, which provides the opportunity for spouses (or civil partners) to bring together gains and losses, but again the straightforward use of a statutory relief in this way does not (of itself) bring arrangements within the TAAR. Moreover, the tax outcome of the transactions reflects the economic reality of Mr and Mrs H's situation. In all the circumstances, this suggests that there was no main purpose of achieving a tax advantage, and where there is no such main purpose the rule does not apply."

But the factual inference in the last sentence is implausible, for the reasons explained above.

31 See 32.17.3 ("Genuine").

32 Para 5 of HMRC loss guidance issued on 27 March 2007 stated this expressly: "5. The effect of the legislation will be to restrict the use of capital losses resulting from the arrangements where *tax avoidance* is the main purpose or one of the main purposes of the arrangements." But presumably HMRC noticed the inconsistency and the guidance note of 19 July 2007 was amended to read: "The legislation is intended to have effect where a person enters deliberately and knowingly into

The guidance at para 17 uses the word "ordinarily". When will it not apply? An example is if there is an arrangement under which the donee spouse immediately returns the proceeds of the disposal to the donor spouse. In that case the inter-spouse gift has no "economic consequences".

The difficulty is to reconcile that guidance with the words of the statute. One might simply give up at this point:

> We think that the words "**tax avoidance**" should be substituted for "**tax advantage**"... the guidance contradicts the legislation. Some transactions (such as transfers between spouses) are stated in the guidance not to be caught by the TAAR,[33] when it is strongly arguable that they are caught.[34]

If that is right, then the decision whether or not to apply the legislation in relation to inter-spouse transfers (and indeed many other cases) is made by HMRC with no redress by the taxpayer (outside judicial review discussed below). However, it is suggested, having regard to *Pepper v Hart*, that the reference to "tax advantage" should be read to mean tax avoidance in the strict sense. The fact that the definition here is based on words which in other contexts have been understood differently[35] does not determine the issue.

The reader may wonder whether this discussion matters, given that HMRC have stated that they will not normally challenge the transfer of losses by inter-spouse transfers. On a constitutional level it matters to those who believe that tax should be based on law and not concession and discretion. On a practical level it matters if HMRC decide to change their practice (which as the IR20 debacle shows is not a theoretical possibility) or if they apply it inconsistently.

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arrangements to gain a tax advantage."

33 A note on terminology. The label which HMRC give to anti-avoidance provisions of the s.16A type is *targeted* anti-avoidance rule ("**TAAR**"). This terminology was coined by HMRC and first used in a press release of 5 December 2005. "TAAR" is a technical term somewhat detached from its literal meaning, so that the IFS can say without obvious irony that "TAARs need to be well targeted ... costs can outweigh the expected amount of lost revenues when a poorly targeted TAAR is compared with a well-targeted TAAR". The same report refers later to a "wide-ranging TAAR". IFS, "Countering Tax Avoidance in the UK" TLRC discussion paper no.7, (March 2009) para 8.18 accessible *http://www.ifs.org.uk/comms/dp7.pdf*.

34 Response of CIOT to consultation (8 February 2007).

35 See 32.14 (Consequence and Purpose).

54.13.2 *Section 16A: Commentary*

The IFS commentary deserves to be set out in full:

> 7.4 However, the width of this relatively simple provision [s.16A TCGA] meant that HMRC needed to publish 17 pages of detailed Explanatory Notes to explain how the legislation would be applied. So, considering the example of the person who sells shares standing at a loss in order to set the loss against a gain on another disposal, the Explanatory Notes explain that this transaction will not be prevented, albeit that the legislation could be used to prevent this.
> 7.5 There are several problems with this approach. First, the Explanatory Notes are not themselves subject to the scrutiny and care in drafting given to legislation. By their nature, Explanatory Notes are not drafted in the precise way required for legislation.
> 7.6 Second, HMRC does not have the power to legislate: taxation can only be imposed by the legislature[36] and while HMRC may decide upon its own interpretation of the legislation, that interpretation is not binding on taxpayers save to the extent confirmed by the courts. 'HMRC's role is to administer the UK's tax and customs systems.'
> 7.7 Third, the ability of taxpayers to rely on the guidance depends upon the type of transaction involved: if it is a single transaction entered into in reliance on specific guidance, the taxpayer can rely on the guidance (although enforcement may be cumbersome, for the reasons explained below). In contrast, if the taxpayer is seeking to rely on guidance in relation to a continuing state of affairs, the taxpayer is exposed to changes in that guidance. ... [37]

The IFS then discuss the important issue of whether the guidance is enforceable. I omit the passage here, with regret, but the law on the point continues to develop, and a proper discussion needs a long chapter to itself.[38] But HMRC loss guidance para 26 is intended to give HMRC maximum freedom to disregard their guidance (or at least to give freedom to decide when it should or should not apply, which comes to the same thing):

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36 [footnote original] Article 4 Bill of Rights 1689: ["That levying money for or to the use of the Crown by pretence of prerogative, without grant of Parliament, for longer time, or in other manner than the same is or shall be granted, is illegal."]

37 Countering Tax Avoidance in the UK, TLRC discussion paper no.7, March 2009, accessible *http://www.ifs.org.uk/comms/dp7.pdf.*

38 It is set out in the 2012/13 edition of this work para 51.13.

> Examples of how the legislation will apply in particular circumstances are set out below. These examples are intended to show how different factors will be taken into consideration in deciding whether or not the TAAR applies in a given set of circumstances. They are not designed as templates for deciding whether a loss is or is not caught by the TAAR in any particular case.

Thus unless my view on the construction of s.16A TCGA is adopted, the guidance is for all practical purposes unjusticiable. The position is that there is no law, only discretion. The uncertainty caused by provisions such as s.16A (which apply for corporation tax as well as CGT) is a factor which encouraged companies such as WPP, Shire, Regus, Henderson, Charter, Beazley, Brit Insurance and UBM to leave the UK for Ireland or Switzerland.[39] Nevertheless, HMRC regard the provision as "successful"[40] (which if the sole measure of success is preventing avoidance it no doubt is). So the current position will continue until HMRC change their view that preventing tax avoidance is a priority that trumps other policy considerations such as certainty and the rule of law.

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39 A majority of Main Survey respondents expressed exasperation with the complexity and unpredictability of current anti-avoidance rules, all but one asserting that this was a phenomenon hindering the competitiveness of the UK economy. Freedman et al, Alternative Approaches to Tax Risk and Tax Avoidance: analysis of a face-to-face corporate survey (September 2008) accessible *ideas.repec.org/p/btx/wpaper/0814.html*.

40 OECD "Engaging with High Net Worth Individuals on Tax Compliance" (September 2009) para 135; see: *http://www.oecd.org/document/5/0,3746,en_2649_33749_42902277_1_1_1_1,00.html*

CHAPTER FIFTY FIVE

FOREIGN CURRENCY ISSUES

55.1 Foreign currency issues: introduction

It is generally accepted that UK tax is assessed in sterling. For instance, the RDR Manual provides:

> **31190 Exchange Rates** [June 2010]
> All entries on the SA Return should be in pounds sterling.

Foreign currency must be translated into sterling. For this purpose it is obviously necessary to decide the date(s) on which the exchange rate is determined ("**the currency conversion date**").

HMRC have put their views in a technical note dated 12 October 2009 ("**the HMRC currency technical note**").

Once one has identified the currency conversion date, one needs to ascertain the exchange rate on that date. Exchange rates at 31 March and 31 December can be found on the HMRC website.[1] Daily rates can be found on commercial websites. These may use slightly different criteria, and disagree slightly among themselves, but I expect in practice any published rate would be acceptable.[2]

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1 *http://www.hmrc.gov.uk/exrate*. This will not assist in the matters discussed in this chapter except for transactions which happen to occur on 31 March or 31 December.

2 The BI Manual provides:
"**39507. Exchange rate for tax purposes** [January 2010]
... Traders may use London closing rates (BIM39505) when translating foreign currency amounts into sterling in their accounts. Equally they may use other exchange rates, such as an exchange rate quoted by their bank, or the monthly average rates published by HMRC for VAT purposes. You only need to query the rate of exchange used if, exceptionally, it diverges markedly from rates obtained from reputable sources of this nature."
Similarly, the SAI Manual provides:
"**4310. Special calculations: Foreign currency securities** [July 2007]

55.1.1 *Cross references*

The following topics are considered elsewhere see:
33.3.5 (Computation of gains)
38.3 (Securities Denominated in foreign currency)
62.20 (Non-residents foreign currency bank accounts)
56.5 (Position if no claim is made for unremittable income relief)
The position of UK resident companies is not considered.

55.2 CGT: Currency conversion date

There are two possible ways to compute the gain where an asset is purchased and sold in a foreign currency.
Method 1:
(a) Compute the gain using the foreign currency prices. For instance, suppose an asset is purchased for $100 and sold for $200; the gain is the $ sale price less the $ acquisition price = $100;
(b) then convert that foreign currency gain to sterling at the date of disposal.
Method 2: Compute:
(a) The sale price converted to sterling at the rate on the date of disposal; less
(b) The acquisition cost converted to sterling at the rate on the date of acquisition.

...Although the London closing rate should in strictness be used in all the above cases, figures of rates of exchange supplied by taxpayers or their agents should normally be accepted, provided that they come from a reputable source (for example, an exchange rate quoted by the taxpayer's bank for the day in question) and the basis is used consistently."
Similarly, International Manual provides:
"**162620. Rate of exchange to use** [January 2014]
... Any reasonable established basis of conversion which has previously been applied in any particular case may continue to be used in that case if the customer agrees to its consistent application. If there is a dispute which cannot be resolved within the terms of the established practice, the general basis described above should be adopted."
Where the official rate of exchange is different, it is considered that one should use commercial (black market) rates; this view is adopted in the USA: *Cinelli v Commissioner of Internal Revenue* (1974) 502 F2d 695 United States Court of Appeals, Sixth Circuit.

For CGT it is well settled that the second solution is correct. In *Bentley v Pike* 53 TC 590 the taxpayer inherited German property when it was worth DM132k, and later sold it for DM152k. She argued that the gain was the difference between the two Deutschmark values, ie DM30k, and the currency conversion date was the date of disposal. The Court held that the gain was the sterling equivalent of the DM proceeds (currency conversion date at the date of disposal) less the value of the property at the time of acquisition. This decision was approved in *Capcount Trading v Evans* 65 TC 545 where the issue was argued more fully before the Court of Appeal. In short, the taxpayer acquired shares for $85m and sold them for $50m. The taxpayer argued that they made a loss of $35m. That was rejected. The gain was calculated as the value of the proceeds (converted into sterling at the date of disposal) less the acquisition cost (converted into sterling at the date(s) of acquisition).

The CG Manual provides:

> **25391 - Remittance basis: gains to be computed in Sterling** [April 2010]
> Sterling is the currency in which capital gains computations are carried out (see *Bentley v Pike*, (53 TC 590) and *Capcount Trading v Evans* (65 TC 545)). You should therefore carry out a computation of the gain arising on the disposal of the foreign assets in sterling. Where transactions take place in foreign currency you should convert each separate entry for the computation into sterling using the spot rate applying at the date that part of the transaction occurred.

This approach is used whether the gain is taxed on an arising or the remittance basis. The RDR Manual provides:

> **31190 Exchange Rates** [June 2010]
> *Foreign Chargeable Gains*
> Foreign chargeable gains are calculated using sterling translations at the date of acquisition and the date of disposal. So the consideration received will be translated into sterling using the exchange rate at the time of disposal and allowable deductions will be translated using the exchange rate(s) at the time the expenditure was incurred (for example, when the asset was acquired). Thus the gain will be denoted in pounds sterling and will be the same whether taxed on the arising or the remittance basis.
> If the gain is held as foreign currency, the taxable sterling amount of the gain will not change, but separate gains or losses may accrue if the foreign currency gains or loses value with respect to sterling before the

gain is remitted.

55.3 Trading income and property income

The position for trading income is governed by SP 2/02 (not discussed here).

Property income is computed on the accountancy principles, just like trading income, so the same practice ought to apply.

55.4 Income taxed on arising basis: Currency conversion date

The RDR Manual 31190 provides:

> **31190 Exchange Rates** [June 2010]
> *Foreign Income*
> Foreign income taxed on the arising basis is converted to pounds sterling at the exchange rate applicable on the day that it arose overseas.

This is not controversial. HMRC accept the use of the average rate for a tax year where income arises regularly through the year.[3]

55.5 Sterling income converted to foreign currency

The HMRC currency technical note provides:

> 6. Income that is regarded as 'foreign income' may be received offshore in sterling. It may later be converted into a foreign currency, for example if paid into a non-sterling account. In such cases the amount of a remittance basis user's foreign taxable income will be the amount actually due and originally received in sterling. It is of no relevance whether the eventual 'taxable remittance' that is, or that is derived from, that income is made in a foreign currency or is converted back into sterling before being remitted.

This is not controversial.

55.6 Income taxed on remittance basis: Currency conversion date

Where income is taxed on the remittance basis, there are two possible views:

(1) The currency conversion date is the date of remittance. I refer to this as "**the HMRC view**".

(2) The currency conversion date is the date that the income arises. I refer

3 Private correspondence.

to this as "**the practitioners view**" since it is adopted by the ICAEW and the great majority of practitioners.

55.6.1 *HMRC view*

The RDR Manual 31190 provides:

> **31190 Exchange Rates** [June 2010]
> *Foreign Income*
> ... Foreign income taxed on the remittance basis ... is subject to UK tax only when it is remitted to the UK. This remitted income should be translated into sterling at the exchange rate prevailing on the date of remittance.

The Manual gives a straightforward example.[4]

Similarly, the EI Manual provides:

> **40033: General earnings taxable when remitted to the UK** [January 2009]
> For earnings that are taxable when remitted to the UK the conversion should be made at the date they were remitted.

55.6.2 *Basis for HMRC view*

The HMRC currency technical note sets out HMRC's arguments in support of the view that the currency conversion date is the date of remittance and not the date of receipt.

> 5. [1] Remittance basis users may receive income offshore in a foreign currency.
> [2] Such foreign income and earnings which are chargeable to tax on the remittance basis only become chargeable to UK tax when they are remitted to the UK. The remittance to the UK is the event that triggers the UK tax charge.
> [3] It is only at this point that it is necessary to ascertain the taxable amount (in sterling) remitted to the UK that is taxable as

4 "*Example (remittance) - Christophe*
C is a remittance basis user and has €8,000 income paid into his French bank account in June 2011 when the exchange rate is €0.705 to the pound, the equivalent of £5,642. He remits all €8,000 of this foreign income on 1 May 2013 when the exchange rate was €0.681.
He uses this 1 May exchange rate to convert this amount, giving a remitted amount of foreign income of £5,453; this is the amount he is taxed on."

> foreign income.
> [4] It follows that it is the date on which that amount is treated as remitted to the UK that the translation to sterling should occur.

Para 5[2] is not correct in relation to RFI. RFI is chargeable whether or not remitted, though the amount of the charge is limited to what is remitted.[5] The same applies for RFE. It is arguable that chargeable gains are only chargeable on remittance but HMRC do not say that gains are converted at the date of remittance

Para 5[3] is correct but [4] does not follow from it. For CGT it is likewise only necessary to ascertain the taxable amount when there is a remittance but no-one suggests that gains are converted at the date of remittance.

The HMRC technical note contains a lengthy discussion of case law, but there are no cases which address the issue, and analogies from CGT and IT cases in other contexts are not decisive. HMRC say:

> 15. There is little case law that addresses this point directly. Some early case law from the 1920s and 1930s deals with the taxation of companies and whether foreign exchange gains or losses should be regarded as capital or investment items, or form part of the company's trade. It is possible to draw only tentative principles from this, especially as in many cases the issue of arising or remittance basis was not in point.
> 16. The 1933 case of *Magraw v Lewis* (18 TC 222) concerned a pension of 229 South African pounds, paid to a UK resident, which had been awarded by the Government of the Union of South Africa and was paid by them through the High Commissioner of the Union Government in London. At the time such foreign income was chargeable when received in the UK. The case concerned certain deductions made by the SA Government from the pension, but during the case the issue of how much should be taxed in British pound sterling was raised. In Magraw, the *pension was actually paid to the appellant in the UK in sterling*, so the exchange issue was a little different.[6] In the course of his judgement at the High Court Finlay J said, at page 225,
>
> > What happened was this. The Appellant was paid a particular sum in UK pounds and by reason of the state of the exchange, the amount which he was paid in UK pounds was larger-a greater number of pounds-than the pension awarded to him in South Africa reckoned in South African pounds.
> > He says that he ought not to pay Income Tax upon the amount which he has received in this country. I am bound to say that in regard to that the law appears to be as plain as in the other case...It is clear that the Income Tax

5 See 10.12 (Nature of charge on remitted RFI).

6 [Author's note] Since the pension was paid in sterling, the exchange issue did not arise at all.

> authorities can have regard only to what is paid. What is paid is a pension of a particular amount in UK pounds, £268 I think it is -but the exact amount does not matter- that is paid to the Appellant.
>
> That is what he has to pay tax upon, and he has to pay on that in the appropriate number of pounds in British currency. As I say, about that point there does not appear to be any legal difficulty-indeed, I do not think there is any legal difficulty about either point...I cannot myself see that any one, even a layman, could conceive that there was any grievance when he gets a particular income in UK pounds, in paying tax in UK pounds at the appropriate rate upon that income.

17. In *Thomson v Moyse* 39 TC, whilst addressing a point about whether a remittance required a transmission from abroad, at the House of Lords Lord Reid said at p329 (bold emphasis added)

> Before considering these authorities, I think it well to see what the effect would be if this view were right. I take a case which no one has ever even suggested would not be within the scope of these provisions - the case of a bank acting as a collecting agent. If a customer hands to an English bank for collection a cheque drawn on a foreign bank, the English bank will send the cheque abroad for collection and, when notified that the money has been collected, it will give to the customer in this country the equivalent in sterling **at the current rate of exchange.**

18. References to other case law have been made to HMRC with regard to this issue.

Bentley v Pike [1981] STC 360 and *Capcount Trading v Evans* [1993] STC 11 - these concern Capital Gains Tax on chargeable gains accruing on the disposal of an asset, and therefore have no bearing on the issue of overseas income. They state that where there is an acquisition and disposal in a foreign currency the taxable capital gain is calculated by deducting the sterling value of the acquisition at the time of acquisition from the sterling value of the sale proceeds at the time of sale.

Pattison v Marine Midland 57 TC 219 related to tax on trading profits and the House of Lords upheld the decision of the Court of Appeal rejecting HMRC's contention that, with respect to a loan made by a company, the difference in sterling terms between the value of the dollars at the time of the loan and the time of the repayment represented a taxable trading profit of the company.

In *Capcount* the Court of Appeal specifically distinguished *Marine Midland* on the basis that it was concerned with trading profits whereas *Capcount* was concerned with capital gains. Nolan LJ states:

> "Against that background I do not find it surprising that, in the case of trading companies operating abroad the commercial accounting procedures which, it seems, commonly result in the profit being first computed in the particular overseas currency and then translated into sterling for tax purposes should be adopted and accepted by the Revenue...the income tax legislation, unlike the capital gains tax legislation, is not generally concerned with the measurement of a gain or loss on a single disposal but with a balance at the year end and computed on accounting principles."

> 19. The calculation of gains arising on non-sterling acquisitions and/or disposals in sterling is different from the calculation of the amount of taxable income in sterling; it is clear from *Bentley v Pike* that the sterling translation must be made using the exchange rate in force at the dates of the transaction (i.e. date of acquisition for acquisition cost, and disposal for disposal proceeds) and the calculation completed in sterling. This is understandable for CG calculation purposes, as CG is fundamentally a transaction-based tax.
> 20. Apart from the £2,000 threshold (see below), this note only concerns remittances of foreign income. *Bentley* and *Capcount* concern capital gains, not income, and are therefore not relevant. *Marine Midland* supports the approach taken by HMRC in the guidance. *Marine Midland* concerned trading profits rather than income but an individual's income is more on a par with the profits of a business than with capital gains because neither an individual's income nor the profits of a business require individual disposals. Consequently, there is no conflict between the principles established in *Marine Midland* and HMRC's position on the treatment of an individual's income.

For completeness, the HMRC currency technical note also states:

> 7. In all cases HMRC will tax the individual's foreign income as income; the question is simply what sterling value to give that income, and more importantly, when is it necessary to calculate that value. HMRC will never tax an amount greater than the income received; for example, if $50,000 US dollars are received then only $50,000 US dollars will ever be subject to tax - that is, the sterling equivalent of that $50,000 for income tax purposes at the time at which the UK tax liability occurs.
> 8. For a remittance basis user whose foreign income is received offshore in, say, dollars, there is no requirement to value the dollars twice (that is on date of receipt offshore and on the date an amount becomes taxable by virtue of being remitted to the UK). In other words, for income tax purposes, in order to tax the income received in dollars the conversion into sterling should only be made once, namely on the occasion that the income comes into charge...
> 12. This approach is in the remittance basis user's favour. This is because, whether the exchange rate on the date the income arises or the date it is remitted is used to translate the foreign income into sterling, there has to be consistency between the two - it has to be one or the other. An individual has an element of control over the date of remittance and can choose to remit income when the exchange rate is in his favour or not to remit income when the exchange rate is not in his favour. An individual does not generally have similar control over the date on which foreign income arises.

These are not arguments, or at least not arguments to be taken seriously.

55.6.3 *Currency conversion date: The correct view*

Since there is no statutory guidance and no clear guidance from the case law, the right answer is that which best suits the scheme of the provisions.

It is considered that the correct view (which I have called "the practitioners view") is that the currency conversion date is the time the income arises not the date of remittance.

The HMRC view gives rise to many anomalies. Firstly, contrast the arising basis where the currency conversion date is the date income arises. Secondly, contrast the CGT remittance basis where the currency conversion date is (in short) when the gain arises. The anomaly is more striking when one bears in mind that some offshore income gains are computed on CGT principles but subject to income tax on remittance. Thirdly, contrast the IT remittance basis where income is received in sterling and immediately converted into a foreign currency.[7] Fourthly, contrast tax credits in a foreign currency where the currency conversion date is the date the income arises, or near that date.[8]

The next set of problems arises on the HMRC view if a remittance basis taxpayer receives foreign currency income and converts it into another asset, rather than paying it directly into a bank account. Suppose T receives income in euros and converts the euros into sterling and remits the sterling.

(1) Does T adopt the euro rate at the time of conversion into sterling? Then tax depends on administrative acts such as how the receipt is dealt with.

(2) Does T then adopt the euro rate at the time of remittance? That would be absurd and also gives rise to this further problem: Suppose T receives equal amounts of (a) foreign interest in euros and (b) foreign interest in sterling; T converts the euros to sterling and pays all the interest into one foreign sterling account, and later remits one half of the account to the UK. If one converts at the time of remittance T needs to decide whether T has remitted the sterling or the (formerly) euro interest. The answer is far from clear. On the practitioners view of course no problem arises.

Section 731 raises further problems on the HMRC view. If relevant income arises in a foreign currency, when does one convert that to sterling? If one converts at the time the income arises there is a further

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7 The HMRC view assumes that one always knows what currency income is received, but in the case of deemed income that is not the case, and in the case of trading income it may depends on the arbitrary choice or accounting practice.

8 See 55.9 (Tax credit relief: currency conversion date).

anomaly between s.731 and ordinary income. If one converts at the time there is a benefit, then a currency conversion may have to be done every time a benefit is conferred, which is unworkable.

55.6.4 *Problems arising when foreign currency depreciates against sterling*

HMRC say that their view (currency conversion date is the date of remittance) produces the right result where foreign currency depreciates against sterling, whereas the practitioners view causes an additional tax charge for taxpayers which they are concerned to avoid. The technical note provides:

> 13. ... Compare two taxpayers: Mr A is taxed on the arising basic. Mrs R on the remittance basis. Both receive RFE:
> *Exchange rates:*
> 1 May Year 1 $1 = £1.20.
> 1 May Year 2 $1 = £1.10.
> 1 May Year 3 $1 = £1.50
> Mr A and Mrs R receive $100,000 on 1 May in Year 1.
> Mr A will have to pay tax on £120,000 in Year 1. Whether he brings the $100,000 in to the UK on 1 May in Year 1 when it is worth £120,000, or on 1 May in Year 2 when it is worth £110,000, or on 1 May in Year 3, when it is worth £150,000, has no impact on Mr A's income tax liabilities.
> If Mrs R, on the other hand, translates her foreign income into sterling on 1 May Year 1 she will, on [the practitioners view], be said to have taxable RFE of £120,000.
> - In Year 2, she could remit every one of the $100,000 dollars received, which would translate only to £110,000 and yet still pay tax on £120,000 - which would appear that we are taxing an additional $9090,[9] or we are applying a tax rate of c.43.5%.
>
> 14. ...Theoretically, given large fluctuations in currency exchange rates, or with changes in higher tax rates, a situation could arise in which the tax due is actually more than the monies the individual actually receives in the UK ...

It is indeed unfair for a remittance basis taxpayer to be taxed on a sum larger than the sum which they remits to the UK. But this observation does not much support the HMRC view. First, this is in the HMRC view the position in relation to CGT. For CGT, HMRC appear to have no compunction in taxing a larger amount than remitted. In the HMRC view "a situation could arise in which the tax due is actually more than the monies the individual actually receives in the UK."

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9 The correct figure appears to be $10,000.

The RDR Manual provides an example where the essential facts[10] are as follows:

> **35030 Conditions A and B - remittances derived from foreign income or gains** [January 2014]
> *Example 4 (Marianne)*
> M used £25,000 of her foreign chargeable gains to purchase a car.
> M kept the car outside the UK.
> M later brings the car to the UK. The market resale value of the car is then £14,000.

The HMRC analysis is as follows:

> The amount remitted is still £25,000, that being the amount equal to the chargeable gains from which the property – the car – derived.

If - which is open to doubt - the HMRC CGT analysis is right, there is (on the practitioners view) a consistent unfairness and on the HMRC view an anomalous distinction between CGT and IT.

More fundamentally, HMRC have overlooked the mixed fund rules. The remittance is a transfer from a mixed fund, and s.809Q(3) ITA defines the extent to which such a remittance is to be regarded as income or capital. The rule is that such a remittance is to be regarded as income first, not income *and* capital gain. Further, under the mixed fund rule, the amount of the remittance does not exceed the value of the sum remitted.

55.7 Sub-£2k taxpayer: Currency conversion date

The RDR Manual provides:

> **31190 Exchange Rates** [June 2010]
> *Remittance basis users below the "£2,000 threshold"*
> ... For the purposes of determining whether the amount of an individual's foreign income which is "not remitted" in a tax year is below £2,000 they obviously cannot apply [what HMRC regard as] the usual principle

10 The example in full (including its irrelevant detail) is as follows:
In example 1 above, Marianne, a remittance basis user, used £25,000 of her foreign chargeable gains to purchase a car. The car is regarded as derived from foreign income and gains.
Instead of bringing it straight to the UK, Marianne kept the car at her Italian villa for use on her visits to Italy. A few years later she then decides to bring the car to the UK for her and her daughter to use. At this time the approximate market resale value of the car is £14,000.

> for remittance basis users of using the exchange rate at time of remittance. Instead the balance of the unremitted foreign income is converted to pounds sterling *at the rate of exchange prevailing on the date last day of the tax year*.
> ITA07/s809D(2) provides that the amount of an individual's "unremitted" foreign income and gains for a tax year is-
> (a) the total amount of what would (if this section applied) be the individual's foreign income and gains for that year, minus
> (b) the total amount of those income and gains that are remitted to the UK in that year.
> So the above formula may be carried out in the foreign currency, looking at total income received and total income remitted, per currency, during the tax year. The balance which is left is the "unremitted foreign income". This is translated into sterling using the exchange on the last day of the tax year (5 April) to ascertain whether the 'unremitted foreign income' is below the £2,000 limit.

Thus the currency conversion date is that on 5th April of each year. I refer to this as "**the 5 April conversion view**". This practice only applied for the purposes of the £2k test and only for income, not for gains:

> This practice applies for the purposes of deciding whether ITA07/s809D applies ONLY. All of the individual's foreign income amounts for a tax year must be taken into account.
> *Example: Michaela*
> M received foreign income on 10 April of $5,000 when the exchange rate was (£1=$2).
> She remitted $1,500 to the UK on 15 May when the exchange rate was £1=$1.50 She will pay tax on the sterling amount of £1,000.
> At the end of the tax year, M's 'unremitted foreign income' will be calculated using the exchange rate at the end of the tax year, which is £1=$1.80.
> This is calculated as follows:
>
> | | |
> |---|---|
> | Total foreign income and gains for that year | $5,000 |
> | less | |
> | Amount of that foreign income remitted during year | ($1,500) |
> | Unremitted foreign income | $3,500 |
>
> If the exchange rate at the end of the year was £1=$1.50 then the $3,500 unremitted foreign income would be £2,333, which is above the threshold. ...

The HMRC currency technical note provides the reason for the 5 April

conversion view:

> 29. On further consideration of the wording of s809D, HMRC took the view that for foreign income, this calculation can only be made on the last day of the tax year, as that is the only date an individual's total and unremitted foreign income for a tax year can be ascertained. Consequently the foreign currency should be translated into sterling on that date also, for both the total foreign income and the remitted foreign income for the purposes of s.809D only.
> 30. Although UK income tax is charged on sterling amounts, it does not follow that the calculations to get to an income threshold such as this in s809D necessarily have to be made in sterling. Consequently the formula of deducting the remitted income from the total income can be carried out in the foreign currency on the last day of the tax year and then the balance which is left namely the "unremitted foreign income" can be translated into sterling on that date to ascertain whether it is below the £2,000 limit.

Thus the basis for the 5 April conversion view is the (erroneous) HMRC view that the currency conversion date for remitted income is the date of remittance. If the practitioners view is accepted, that the currency conversion date is the date that the income arises, s.809D does not raise any problem, as obviously the same approach should apply there also.

55.8 Nominated income and gains: Currency conversion date

The RDR Manual provides:

> **31190 Exchange Rates** [June 2010]
> *Nominated income and gains*
> Nominated income and gains are charged to UK tax on the arising basis... This means that any foreign income that is nominated for the purpose of the Remittance Basis Charge is converted to pounds sterling at the exchange rate that applied on the date the income arose.
> Foreign chargeable gains are always calculated in pounds sterling at the rate of exchange that applied on the date the gain is realised.

The Manual gives a straightforward example.[11]

55.9 Tax credit relief: Currency conversion date

International Manual provides:

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11 "*Example (Francoise)*
F is a non-domiciled individual who is subject to the Remittance Basis Charge. She decides to nominate €20,000 of foreign income. The exchange rate on the date the income arose was €0.744 to the pound. She uses this rate to calculate the equivalent nominated amount of foreign income in sterling, which is £14,880."

> **162620. Rate of exchange to use** [January 2014]
> For the purpose of computing tax credit relief, foreign tax, payable directly or by deduction, should be converted into sterling at the rate of exchange obtaining on the date when the foreign tax for which credit is to be allowed becomes payable.
> *In practice*
> 1. Officers need not make enquiries in all cases in order to establish the precise date on which the foreign tax became payable under the foreign country's laws. Where the date is not known, the date of payment of the tax can normally be taken as the payable date. Where the foreign tax has been deducted at source from income, for example, from dividends, interest or royalties, the payable date will normally be the same date as the date on which the income is paid. If, however, the customer objects, or a substantial amount of tax is involved, the actual payable date should be determined. In many cases the date can be obtained from the demand note, provided that there has been no appeal against the foreign charge. If any difficulty arises in determining the payable date, in a case where such date is material, or if the customer objects to this basis, the case should be submitted to the Offshore Personal Tax Team (part of Charity, Assets & Residence) in the case of individuals and to CTIS Business International, Foreign Profits Team in all other cases....

The Manual does not distinguish between an arising basis taxpayer and a remittance basis taxpayer. So on the HMRC view, the currency conversion date for remitted income is the date of remittance, but the currency conversion date for the tax credit on the same income is the date that the tax was paid, which may not even be close. That is yet another anomaly arising from the HMRC view that the currency conversion date is the date of remittance.

55.10 Foreign currency bank accounts: CGT

The legislation deals separately with foreign currency bank accounts and foreign currency not in a bank account (coins and banknotes).[12] But bank accounts are the usual way to hold money, so that is the more important area.

A bank account is a debt, and a chargeable gain does not usually arise from a debt. Section 251 TCGA provides:

> Where a person incurs a debt to another, whether in sterling or in some

12 See 55.11 (Foreign currency held in coins or banknotes).

> other currency, no chargeable gain shall accrue to that (that is the original) creditor or his personal representative or legatee on a disposal of the debt...

Until 2012 this relief was disapplied for foreign currency bank accounts.[13] Section 252 TCGA now provides:

> (1)[A] Section 251(1) does not apply in relation to a gain accruing to a person on a disposal of a foreign currency debt (or an interest in such a debt)
> [B] unless that person is--
> (a) an individual,
> (b) the trustees of a settlement, or
> (c) the personal representatives of a deceased person.
> (2) A "foreign currency debt" is a debt–
> (a) owed by a bank[14] in a currency other than sterling, and
> (b) represented by a sum standing to the credit of an account holder in an account in that bank.[15]

Section 252(1)[A] TCGA still notionally disapplies the relief, but para [B] then adds an exception so large that the relief is in effect wholly restored: The relief in para [B] does not apply to companies, but that does not matter, as:

(1) UK companies are governed by the loan relationship rules (not discussed here)
(2) Foreign currency debts of non-resident companies are essentially outside the scope of CGT.[16]

It would have been simpler to apply the relief to all persons, but there it is.

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13 Another exception concerns a debt on a security but that is not relevant to bank accounts.

14 "Bank" is not defined, but it does not matter.

15 The CG Manual 78330 formerly provided: "Foreign currency certificates of deposit in bearer form are not within TCGA 1992, s.252." The passage was deleted in April 2010. One is left to speculate as to whether HMRC have changed their view. The issue would require an examination of the nature of certificates of deposit.

16 See 53.5 (Computation of non-resident company gains on CT principles).
HMRC say: "There is no need to include companies in the exemption because companies' returns from FCBAs are not liable to tax on capital gains." Reform of the taxation of non-domiciled individuals: summary of responses to consultation (December 2011) para 2.102 accessible *http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_responses_non_domicile_reform.pdf*

The label "foreign currency debt" is not apt; "foreign currency bank account debt" would be better; but there it is. There could be a CGT charge on a foreign currency debt which is not a bank account debt, if s.251 relief did not apply, such as a secondhand debt or a debt on a security.

The problems which arose under the pre-2012 law have become (more or less) academic. It is just possible to envisage circumstances in which they might still arise, eg on secondhand debts, but it is not necessary to consider the topic here.[17]

55.11 Foreign currency held in coins or banknotes

Foreign currency is an asset on which a gain may accrue. Section 21(1) TCGA provides:

> All forms of property shall be assets for the purposes of this Act, ... including ...
>
> (b) currency, with the exception (subject to express provision to the contrary) of sterling ...

CG Manual provides:

> **78316 Identification of disposals with acquisitions** [April 2010]
> Foreign currency is subject to the same rules of identification and pooling as unquoted shares and securities. See CG50500+.

Here the share matching rules[18] do apply.

55.11.1 *Foreign currency for personal expenditure*

There is an exemption for foreign currency needed for personal expenditure abroad. This is not likely to affect remittance basis taxpayers, as gains on disposals of this kind are not likely to be remitted, but it is important for others. Section 269 TCGA provides:

> A gain shall not be a chargeable gain if accruing on the disposal by an individual of currency of any description acquired by him for the personal expenditure outside the UK of himself or his family or dependants (including expenditure on the provision or maintenance of any residence outside the UK).

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17 See the 2011/12 edition of this work.

18 The rules are discussed in the 2011/12 edition of this work.

55.11.2 *Commentary*

The taxation of foreign currency should be the same as foreign currency bank accounts, and the relief in s.251 should be extended. However in practice this is not so important as it would be unusual for a person to hold substantial foreign currency outside a bank account (except perhaps as trading receipts outside CGT).

55.12 Interaction with mixed fund rules and HMRC examples

The CG Manual provides examples of the following:
(1) Remittance of part of FC account holding capital gain (Fatima)
(2) Ditto with previous offshore transfer (example 2)
(3) Remittance of part of FC account holding income & gain (example 3)
The RDR Manual provides examples of the following:
(4) Remittance of part of FC account holding income (Julius).
(5) Remittance of part of FC account holding RFI and RFE (Tom)
(6) Ditto with previous offshore transfer (Gelda)
The examples are discussed in the 2011/12 of this work, but this is not set out here as it is overtaken by the 2012 reforms.

55.13 Commentary: Solution to remaining foreign currency problems

The 2012 reform, which was advocated in the 2011/12 edition of this book, genuinely deserves the title of simplification. The problems which remain could be solved as follows.

Yearly exchange rate averaging The problem (for arising basis and remittance basis taxpayers) is the general impracticability when there are a significant number of transactions of converting foreign currency to sterling at a variety of moments during the year: the moment that income arises, the moment that gains arise, and the moment that capital expenditure is incurred. The solution is in the HMRC practice to allow use of an annual average rate in any currency during the year and to average out acquisitions and disposals. HMRC should publish rates each year for every currency. Provided taxpayers are not allowed to switch adventitiously between accurate and average exchange rates, this would have no significant cost implications.

Currency conversion date The second set of problems (for remittance basis taxpayers only) arise from HMRC's mistaken view that the currency conversion date for income of a remittance basis taxpayer is the date of remittance. The solution is to recognise the existing law, or (if that is not

accepted) to amend the law to the practitioners view. This would have no cost implications.

CHAPTER FIFTY SIX

UNREMITTABLE INCOME: EXCHANGE CONTROL

56.1 Unremittable income and exchange control: Introduction

The SAIM provides:

> **SAIM1150 - Savings and investment income: foreign income: unremittable income** [May 2012]
> Some countries impose exchange controls to regulate the flow of money. Where a person has income arising in one of these countries, it may be impossible to bring the income into the UK either because it is not permitted by the authorities in that country or because it is difficult to obtain foreign currency there. In these circumstances, tax could become due on income that was not available to pay the tax bill and hardship could result. Special rules in Chapter 4 Part 8 of ITTOIA 05 allow an individual or trustee to claim that unremittable income should not be brought into charge when it arises.
> The most common example is that of a UK resident who has a bank account in a country that imposes restrictions on the movement of currency...

There are five reliefs for receipts which cannot be received in the UK due to exchange control:

(1) Section 842 ITTOIA (unremittable income)
(2) Chapter 13 part 2 ITTOIA (unremittable trading receipts)
(3) Section 668, 669 ITA (accrued income scheme)
(4) Section 279 TCGA (capital gains)
(5) Sections 1275 CTA 2009 (CT)

In this chapter I focus on the first of these reliefs, which I call **"unremittable income relief"** and the capital gains relief (**"unremittable gains relief"**).

56.2 Unremittable income relief

Section 841(1) ITTOIA provides:

> This Chapter applies if—
>
> (a) a person is liable for income tax on income arising in a territory outside the UK, and
>
> (b) the income is unremittable.

ITTOIA EN provides:

> The relief [in chapter 4] applies only to income charged on the arising basis so does not apply to income charged on the remittance basis.[1]

This was the case in the pre-ITTOIA legislation. The former s.584 ICTA1988 applied:

> *Where a person is chargeable to tax by reference to the amount of any income arising in a territory outside the UK ...*

That relief only applied to arising basis taxpayers.[2] Now it is arguable that an individual who is a remittance basis taxpayer at the time the unremittable income arises may also qualify for unremittable income relief; but that issue only arises in circumstances where the income is:

(1) is unremittable (for the purposes of unremittable income relief) but

(2) is treated as remitted under the ITA remittance basis (so a claim is needed for unremittable income relief).

That will not often happen. If it does, there is no good reason for not applying the relief, and that would be consistent with the position for unremittable gains relief. But in practice a person who is a remittance basis taxpayer at the time the income arises may prefer not to claim the relief.

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1 The same point was made in the former HMRC6 para 12.27 (Unremittable income): "Unremittable income should not be confused with unremitted foreign income and gains which is relevant only if you use the remittance basis.
Having unremittable income is relevant to your tax affairs only if you use the arising basis."

2 Contrast the former s.585 ICTA 1988 which applied if: "A person charged or chargeable for any year of assessment in respect of income from any source with tax which (apart from this section) falls to be computed ... on the amount of income received in the UK..."

56.2.1 *"Unremittable" income*

Section 841(2) ITTOIA provides:

> For the purposes of this Chapter, income is unremittable if conditions A and B are met.

I refer to **"unremittable income conditions A and B"**.

56.2.2 *Unremittable income condition A*

Section 841(3) ITTOIA provides:

> Condition A is that the income cannot be transferred to the UK by the person who is liable for income tax in respect of the income because of—
>
> (a) the laws of the territory where the income arises,
>
> (b) executive action of its government, or
>
> (c) the impossibility of obtaining there currency that could be transferred to the UK.

56.2.3 *Unremittable income condition B*

Section 841(4) ITTOIA provides:

> Condition B is that the person who is liable for income tax in respect of the income has not realised it outside that territory for an amount in sterling or in another currency which the person is not prevented from transferring to the UK.

56.3 The relief

Section 842(1) ITTOIA provides:

> If a person liable for income tax on unremittable income makes a claim for relief under this section in respect of that income, it is not taken into account for income tax purposes.

56.3.1 *Procedure and time limit for claim*

The claim (for individuals) is made by ticking box 1 of form SA106 (Tax return: Foreign Pages) 2013/14. The caption by the box reads: "**If you were unable to transfer any of your overseas income to the UK**– *read the notes and give details in the 'Any other information' box on your tax return or on a separate sheet*".

Section 842(5) ITTOIA provides:

> A claim under this section must be made on or before the first anniversary of the normal self-assessment filing date for the tax year for which the income would be charged to tax if no claim were made.

ITTOIA EN provides:

> The time limit is tied to the tax year for which the income would otherwise be chargeable, rather than to the tax year in which the income arises (as in the source legislation). This brings the time limit into line with the normal time limit for claims. See Change 140 in Annex 1.

But following the abolition of the preceding year basis, I cannot think of a case where the income arises in one year and is chargeable in another.

The SAIM provides:

> **SAIM1160 - Savings and investment income: foreign income: unremittable income: claims**
> ... Unremittable income: claims and withdrawal of relief
> A claim under ITTOIA/S842 does not mean that the income can be omitted from the tax return. The income must still be declared on the tax return but it will not be brought into charge if the claim is valid. This ensures that the amount of the income for each year is known so it can be assessed when the income becomes remittable.

That follows from s.42(1A) TMA: see 10.7 (Procedure and time limits for remittance basis claim).

56.3.2 *ECGD payments*

Section 842 ITTOIA provides:

> (3) No claim under this section may be made in respect of any income so far as an ECGD payment has been made in relation to it.
> (4) In subsection (3) "ECGD payment" means a payment made by the Export Credit Guarantee Department under an agreement entered into as a result of arrangements made under—
> (a) section 2 of the Export and Investment Guarantees Act 1991 (insurance in connection with overseas investment), or
> (b) section 11 of the Export Guarantees and Overseas Investment Act 1978.

56.4 Withdrawal of unremittable income relief

Section 843(1) ITTOIA provides:

> This section applies if—

(a) a claim under section 842[3] has been made in relation to any income, and
(b) either—
(i) the income ceases to be unremittable, or
(ii) an ECGD payment is made in relation to it.

If these conditions are satisfied, the relief is withdrawn. Section 843(3) ITTOIA[4] provides:

> If income ceases to be unremittable, the income is treated as arising on the date on which it ceases to be unremittable.

56.4.1 *Remittance basis taxpayer at time of withdrawal of relief*

The rules here are odd. The position depends on whether or not the source of income exists at the time that the income becomes remittable. If it does, then the income is relevant foreign income and if the individual is a remittance basis taxpayer at the time the income arises, the remittance basis will apply.

If the source has ceased, however, the income is within s.844 ITTOIA, and s.830(3) ITTOIA provides:

> But "relevant foreign income" does not include income chargeable as a result of section 844 (unremittable income: income charged on withdrawal of relief after source ceases).

The surprising consequence is that the remittance basis does not apply on a withdrawal of relief after the source of the income has ceased.[5]

The reason for this anomaly is historical. ITTOIA EN provides:

> Income charged by virtue of [section 844] is not "relevant foreign income", as defined in section 830 (see subsection (3) of that section). In the source legislation, the charge is under Schedule D Case VI (rather than Schedule D Cases IV or V). The potential relevance of such income to relief under section 392 of ICTA (Case VI losses) has been preserved by the appropriate entry in section 836B of ICTA (introduced by paragraph 340 of Schedule 1 to this Act).

It is obvious that s.830(3) serves no useful purpose, and should be

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3 This will include a claim made under the pre-2005 legislation, if the income ceases to be unremittable after 2005.

4 Flagged by s.842(2) ITTOIA.

5 The law ought to be simplified by repealing s.830(3): see 10.3.2 (Let's simplify the definition of RFI).

repealed, if only for the sake of simplification; in practice I expect the point will rarely if ever arise; if it does, it would often be overlooked. There is certainly no tax at stake here.

56.4.2 *Non-resident taxpayer at time of withdrawal of relief*

As the income is foreign source income, there is no tax charge if the taxpayer is then non-resident.

56.4.3 *Taxpayer has died at time of withdrawal of relief*

Section 843(7) ITTOIA provides:

> If a person who would have become liable for income tax as a result of this section has died—
>
> (a) the personal representatives are liable for the tax instead, and
>
> (b) the tax is a debt due from and payable out of the estate.

That seems reasonable as the PRs should receive the income. In the case of a remittance basis taxpayer, it could work unfairly as the PRs will not qualify for the remittance basis. But a remittance basis taxpayer will not normally claim unremittable income relief.

56.4.4 *Valuation of income on withdrawal of relief*

Section 843(5) ITTOIA provides:

> The income treated as arising under subsection (3) or (4), and any tax payable in respect of it under the law of the territory where it arises, are taken into account for income tax purposes at their value at the date on which the income is treated as arising.

The SAIM provides:

> **SAIM1160 - Savings and investment income: foreign income: unremittable income: claims**
>
> ...Relief continues until the income becomes remittable. Exchange controls do change so anyone who makes a claim must check that the conditions for relief continue to be satisfied each year.
>
> **Withdrawal of relief**
>
> The income is assessable at the time it becomes possible to remit the income to the UK (ITTOIA05/S843). There is no requirement that the income must actually be remitted in order for the charge to arise. If the source has ceased, the income is taxed as if the source had not ceased (ITTOIA05/S844).
>
> The income is treated as arising on the date on which the qualifying

conditions cease to be satisfied. The foreign currency amount is translated into sterling at the market rate on that date, or if there is no market in the currency, the official exchange rate for the country concerned (ITTOIA05/S845).

Example (Martin)

M has income from an interest-bearing account in Ruritania. Ruritania has exchange controls, and he cannot remit the income to the UK. The income first arises in 2002/03, when the account earns interest of 1,000 Ruritanian doubloons (RUD). RUD 1,250 arises in 2003/04, and RUD 1,600 in 2004/05. In March 2005, M travels to Ruritania, closes the account and spends the money.

On 1 January 2008, Ruritania lifts the exchange controls and the income becomes remittable. M has validly claimed relief under ITTOIA/S842 (1). But in 2007/08, the income is brought back into charge under ITTOIA/S843. It does not matter that he no longer possesses the source of income (ITTOIA05/S844 (4)). M must include total income of RUD 3,850 (1,000 + 1,250 + 1,600), translated into sterling at the exchange rate prevailing on 1 January 2008, in his 2007/08 self-assessment.

56.4.5 *Prevention of double charge*

Section 843(6) ITTOIA provides:

> Subsections (3) to (5) do not apply so far as the income has already been treated as arising as a result of this section.

ITTOIA EN provides:

> For example, if relief has been withdrawn because an ECGD payment is received, there is no further charge under this section – to the extent of that payment – if the income itself subsequently becomes remittable.

56.4.6 *ECGD payments*

Section 843 ITTOIA provides:

> (2) In this section "ECGD payment" has the meaning given by section 842(4).
>
> (4) If an ECGD payment is made in relation to income, the income is treated, to the extent of the payment, as arising on the date on which the ECGD payment is made.

56.4.7 *Source ceased*

Section 844 ITTOIA provides:

> (1) This section applies if—

(a) income is treated as arising as a result of section 843, and
(b) at the time it is so treated the person who would have become liable for income tax as a result of that section—
(i) has permanently ceased to carry on the trade, profession, vocation or property business from which the income arises, or
(ii) in the case of income from another source, has ceased to possess that source.

(2) In the case of income from a trade, profession or vocation—
(a) the income is treated as a post-cessation receipt for the purposes of Chapter 18 of Part 2 (trading income: post-cessation receipts), but
(b) in the application of that Chapter to that income, section 243 (extent of charge to tax) is omitted.

(3) In the case of income from a property business—
(a) the income is treated as a post-cessation receipt from a UK property business for the purposes of Chapter 10 of Part 3 (property income: post-cessation receipts), but
(b) in the application of that Chapter to that income, section 350 (extent of charge to tax) is omitted.

(4) In the case of income from another source, the income is taxed as if the person continued to possess that source.

56.5 Position if no claim is made for unremittable income relief

A claim should normally be made, but it may occasionally be better not to claim, to avoid clawback issues when unremittable income will subsequently become remittable:

(1) Bunching income and bringing it into a higher rate.
(2) If it is anticipated that the foreign currency may appreciate against sterling.
(3) A person who is a remittance basis taxpayer at the time the income arises does not usually need the relief.

If no claim is made for the relief, an arising basis taxpayer will be chargeable, but on what amount? Section 845 ITTOIA provides:

> (1) If no claim is made under section 842 in relation to unremittable income arising in a territory outside the UK, the amount of the income to be taken into account for income tax purposes is determined as follows.
> (2) If the currency in which the income is denominated has a generally recognised market value in the UK, the amount is determined by reference to that value.

(3) In any other case, the amount is determined according to the official rate of exchange of the territory where the income arises.

56.6 Unremittable trading and property income receipts

The former ESC B38 explains the limits of s.841 unremittable income relief:

> 1. A person resident in the UK who carries on a trade partly overseas and partly in the UK is normally liable to UK income or corporation tax on all the profits from that trade. For this purpose the calculation of profits will include, in respect of overseas transactions–
> (i) amounts paid to the trader which are not remittable to the UK
> (ii) amounts owed to the trader which temporarily cannot be paid, and
> (iii) amounts owed to the trader which even when paid will not be remittable to the UK.
> solely as a consequence of local foreign exchange control restrictions.
> 2. Relief from tax is not available for such amounts under [s.841 unremittable income relief] ... because the profits of the trader of which they are a component part do not arise outsider the UK. Nor does the fact that the amounts are unremittable to the UK entitle the trader to relief under [s.35 ITTOIA] (bad and doubtful debts).

Instead, Chapter 13 Part 2 ITA 2007 provides relief. Section 272 ITTOIA applies that Chapter for the purposes of Part 3 of ITTOIA (property income). This is too specialist a topic to consider further here.

56.7 Accrued income profits

Section 841 would not apply to accrued income profits as the proceeds of the sale of accrued income securities are not the income. But in any event, s.841(5) ITTOIA provides:

> This Chapter does not apply to accrued income profits which a person is treated as making under Chapter 2 of Part 12 of ITA 2007, but see sections 668 and 669 of that Act (which make similar provision).

Instead, ss 668, 669 ITA provide relief. This is too specialist a topic to consider in detail here.

56.8 Unremittable gains relief

56.8.1 *The relief*

Section 279(1) TCGA sets out the requirements for unremittable gains relief:

Subsection (2) below applies where—

(a) chargeable gains accrue from the disposal of assets situated outside the UK, and

(b) the person charged or chargeable makes a claim, and

(c) the conditions set out in subsection (3) below are, so far as applicable, satisfied as respects those gains ("the qualifying gains");...[6]

(3) The conditions are—

(a) that the claimant was unable to transfer the qualifying gains to the UK, and

(b) that the inability was due to the laws of the territory where the assets were situated at the time of the disposal, or to the executive action of its government, or to the impossibility of obtaining foreign currency in that territory, and

(c) that the inability was not due to any want of reasonable endeavours on the part of the claimant.

The SAIM provides a comment on s.279(3)(c):

> SAIM1150 - Savings and investment income: foreign income: unremittable income
> For years before 2005-06 claims are made under ICTA88/S584 (2). The earlier rules also required that the income should no be unremittable due to 'want of reasonable efforts' on the taxpayer's part, but this requirement was omitted from ITTOIA05 and should not be interpreted harshly for 2004-05 and earlier years.
> Example *(Laura)*
> L has a bank account in another country where money is deposited from her mother's estate. She cannot bring the money back to the UK because of strict exchange controls. She has the option of putting the money into low yield government bonds in that country, and income from these bonds can be remitted to the UK. HMRC will accept that it is not reasonable for L to have to put the money in low yield bonds, and that the interest on the account is unremittable.

Unremittable gains relief (unlike unremittable income relief) may apply to a remittance basis taxpayer.

Section 279(2)(a) TCGA sets out the relief:

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6 For completeness: s.279(1) concludes with provision for pre-TCGA 1992 claims (which will now be very rare): "... and subsection (2)(b) also applies where a claim has been made under section 13 of the 1979 Act."

For the purposes of capital gains tax—

(a) the amount of the qualifying gains shall be deducted from the amounts on which the claimant is assessed to capital gains tax for the year in which the qualifying gains accrued to the claimant, but..

56.8.2 *Withdrawal of relief*

Section 279(2)(b) TCGA provides for withdrawal of the relief:

(b) the amount so deducted shall be assessed to capital gains tax on the claimant (or his personal representatives) as if it were an amount of chargeable gains accruing in the year of assessment in which the conditions set out in subsection (3) below cease to be satisfied.

Unlike unremittable income relief, the remittance basis may apply on a clawback of the relief.

The CG gives this example:

CG78408 - Foreign currency: example

In 1983, Ms A who is both resident and domiciled in the UK buys a property overseas for foreign currency, which she acquired for £50,000 on the date of purchase of the property (that is, there was no gain or loss on the acquisition and disposal of the currency).

In 1986-87 she sells the property for 3,000,000 units of the foreign currency at a time when the exchange rate is 40 to £1. The sterling equivalent of the currency so obtained is therefore £75,000.

The chargeable gain (subject to expenses) is £75,000 less £50,000 equals £25,000, before indexation, and this is assessable for 1986-87.

Ms A makes a claim under TCGA92/S279 and establishes that she is unable to transfer any of the sale proceeds to the UK because of the foreign country's currency regulations. The gain of £25,000 less indexation is no longer assessable for 1986-87, and any assessment which may have been made should be adjusted accordingly.

In 1991-92, the foreign country relaxes its currency regulations and Ms A is then able to transfer the sale proceeds to the UK. She becomes assessable for that year (whether or not she remits the sale proceeds to the UK) on £25,000 less indexation (that is, the amount by which the assessment for 1986-87 was reduced).

If she disposes of the currency at a time when the exchange rate is 32 to £1, the gain on the currency (that is, the separate chargeable asset) is [text omitted as there is now a relief for foreign currency]

This gain is assessable for the year in which the currency is disposed of.

If the currency regulations for the foreign country had allowed remittance to the UK of only 1,000,000 units in 1986-87, the part of the gain assessable for that year would be computed as follows
Amount assessable (1,000,000 ÷ 3,000,000) × £25,000 = £8,330
...

56.8.3 *Supplemental provisions*

Section 279 continues:

(4) Where under an agreement entered into under arrangements made by the Secretary of State in pursuance of section 1 of the Overseas Investment and Export Guarantees Act 1972 or section 11 of the Export Guarantees and Overseas Investment Act 1978 any payment is made by the Exports Credits Guarantee Department in respect of any gains which cannot be transferred to the UK, then, to the extent of the payment, the gains shall be treated as gains with respect to which the conditions mentioned in subsection (3) above are not satisfied (and accordingly cannot cease to be satisfied).
(5) No claim under this section in respect of a chargeable gain shall be made—

(a) in the case of a claim for the purposes of capital gains tax, at any time not more than 4 years after the end of the year of assessment in which the gain accrues; or
(b) in the case of a claim for the purposes of corporation tax, more than 4 years after the end of the accounting period in which the gain accrues.

(6) The personal representatives of a deceased person may make any claim which he might have made under this section if he had not died.
[Subsections (7)(8) have transitional provisions for pre-1991 income which are not now likely to have effect.]

56.9 Interaction with anti-avoidance provisions

The interaction of unremittable income relief and the various anti-avoidance provisions raises a fine set of puzzles which fortunately do not often have to be considered.

The only reported case is *Van-Arkadie v Plunket* 56 TC 310. The taxpayer was a minority shareholder in a company resident in Rhodesia. The company realised a gain, part of which was treated as accruing to her under s.13 TCGA. The gain could not be transferred to the UK. The taxpayer claimed relief under (what is now) s.279 TCGA but failed:

Section [279] is concerned only with the case where a chargeable gain

> accruing on an actual or deemed disposal is represented by something, money or money's worth, which comes into the hands of the taxpayer. It is only in respect of that money or money's worth that it can be sensibly asked whether the taxpayer was unable to transfer it to the UK, and if he was whether the inability was due to the laws of the territory where the gain accrued and whether, if it was, that inability was due to any want of reasonable endeavours on his part. That last requirement seems to me in itself conclusive against the Respondent's case. In this case the Respondent's inability to remit the gain on which he is chargeable was not due to any want of reasonable endeavours to remit moneys to the UK; it was due to the fact that the company did not distribute and that he could not as a minority shareholder compel it to distribute the gain.[7]

If the shareholder had held a majority of the company, she could have compelled the company to distribute, and in those circumstances it is suggested that unremittable gain relief should be available.

If the income is unremittable income of a settlor-interested trust, it is suggested that unremittable income relief is available if the income is received by the settlor who is unable to remit it.

If a beneficiary receives a benefit within s.731 or s.87, and is unable to remit the benefit, it is suggested that unremittable income or gain relief applies, but in any event, the benefit must be valued taking into account the restriction on remittance, so it may have much value.

7 56 TC 310 at p.316.

CHAPTER FIFTY SEVEN

DOUBLE TAXATION ARRANGEMENTS: INTRODUCTION

57.1 DT reliefs: Introduction

The UK has more than 100 double tax treaties. A full discussion would need almost as many volumes.

The discussion in this book is mainly by reference to the OECD Model Double Taxation Convention on Income and on Capital ("**the OECD model**") though I refer at points to specific treaties.

The OECD model is a good starting point, because it has been the basis for tax treaties between developed countries since published (in draft in 1963, and finally in 1977). In any particular case the DTA concerned would need to be reviewed.

A full discussion of the OECD model would itself need a volume for every article (except article 7 which would require several volumes). Many books have been written on the topic; as the issues are worldwide, we benefit in the UK from the work of scholars, practitioners and Revenue authorities across the world.

Before the OECD model there was a **"Colonial Model"** and a few treaties of this form still survive, of which the most important are those with the Channel Islands and the Isle of Man. The Colonial Model was not published as such; the expression is used to refer to early UK treaty practice within the Commonwealth.

I only consider the UK side of the matter, ie whether a DTA provides exemption from UK tax and whether foreign tax can be used as a credit against UK tax. In any particular case it will also be necessary to consider the foreign tax position.

57.1.1 *Cross references*

In this chapter I consider general aspects of DTAs. The next two chapters

consider foreign tax credit relief, and the interaction of DT relief with UK tax legislation (especially anti-avoidance legislation).

Specific DT exemptions are considered in the chapter on that type of income; see:

22.36 (DT Relief: employment exercised outside UK)
15.24 (DT relief for trading income)
16.6 (DT relief for property income)
14.8 (Alimony and maintenance income)
18.17 (DT relief for interest income)
18.22.1 (Credit for EUSD withholding tax) - EU savings directive
20.7 (DT relief for dividend income)
21.7 (DT relief for royalty income)
24.7 (Double Taxation relief for pension income)
37.15 (Double Taxation relief) - accrued income scheme

The following topics are dealt with elsewhere:

6.1 (Three concepts of residence)
41.10 (DT relief for partnership)

For discretionary trusts, see 25.9 (Discretionary trusts treated as transparent to allow beneficiary reliefs); 25.11 (UK trust - non resident beneficiary: DT relief); 25.12 (Are discretionary trusts "beneficial owners" for DTA purposes?).

For IIP trusts, see 26.7 (DT reliefs).

For charities, see Kessler & Marre, *Taxation of Charities & Non-profit Organisations*, Chapter 14 (Double Taxation Treaties and Charities).[1]

I do not consider corporation tax.

57.2 Treaty terminology

The terms DT treaty/convention/arrangement/agreement are synonymous. The OECD Model use the word "convention" and UK tax legislation uses the term "double taxation arrangements". I prefer the word "treaty" as it seems clearest, but adopt the abbreviation DTA which has become standard usage.

Treaties commonly refer to income (or gains) **"derived by"** a person where the usual UK tax terminology would be that the income (or gains) arise or accrue to the person, or are received by the person; the meaning

1 (9th ed., 2013), online version *http://www.taxationofcharities.co.uk*.

is the same.[2] In American English the verb can be used transitively, eg: "*a resident is treated as deriving the income.*"

Treaties similarly refer to income **"derived from"** a state where the usual UK tax terminology would be income arising in a state or having a source in the state.

DTAs refer to "contracting state" but I abbreviate this to **"treaty state"** or just **"state"** and where that state is not the UK, I refer to it as **"the foreign state"**. The state where the source of income arises is **"the source state"** and the state where the individual is treaty-resident is **"the residence state"**.

57.3 Types of DT relief

There are two main types of DT relief:

(1) In some cases income/gains are taxable in one state (almost always the residence state) only:

(a) art 7 business profits (in absence of a PE)
(b) art 8 shipping and air transport
(c) art 11 interest (in some treaties)
(d) art 12 royalties
(e) art 13 gains (most types)
(f) art 18 pensions
(g) art 19 Government service
(j) art 21 other income

(2) In other cases income can be taxed in both states, in the case of dividends and interest with a limit on the source state's tax, but (under article 23) the residence state gives credit for the foreign tax:

(a) art 6 income from immovable property
(b) art 7 business profits where there is a PE in the other state
(c) art 10 dividends
(d) art 15 employment income
(e) art 17 artistes and athletes

We need terms for the various types of DT relief, and in this chapter I use the following terminology.

"DT exemption" applies where a DTA provides an exemption from tax.

"Foreign tax credit relief" applies where foreign tax is set against UK

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2 Wheeler, *The Missing Keystone of Income Tax Treaties* (2012) para 2.4.2 (The OECD Model).

tax. This may be

(a) **"DTA tax credit"** where a DTA confers a credit or

(b) **"Unilateral tax credit"** where UK tax law (not a DTA) confers a credit.

The terms sometimes used are the "exemption" and the "set-off" methods of relief.

"IT/CGT computation deduction" applies where foreign tax is deducted in computing income or gains.

I refer to all these reliefs together as **"DT reliefs"**.

57.4 Types of residence and dual residence

The starting point is to note that there are (at least) three distinct concepts of residence. We need terms to describe them, and I coin the following terminology.

(1) **"UK-law residence"** means residence as defined in UK tax law.
   (a) A person who is resident in the UK within the UK tax law definition is **"UK-law UK resident"**
   (b) A person who is not resident in the UK within the UK tax law definition is**"UK-law non-UK resident"**.

(2) **"Treaty-residence"** means residence as defined in a DTA.
   (a) A person who is a resident of the UK within a DTA definition is **"treaty-resident in the UK"**.
   (b) A person who is resident in the foreign state within a DTA definition is **"treaty-resident in the foreign state"**. One could use the term "treaty-resident outside the UK." Statute sometimes calls this *"treaty non-resident"* but I think my term is clearer.

"Foreign-law residence" means residence as defined in some foreign tax law.

"Domestic law" means the law of the UK, or of a foreign state, as opposed to treaty law or international law.

Since UK-law residence and treaty-residence are distinct concepts,[3] a person who is UK-law UK resident may be:

(1) treaty non-UK resident (under the tie-breaker test);[4] or

---

3 See 6.2 (Relationship between treaty-residence and UK-law residence).

4 It would be useful to have a short term to describe someone who is UK-law UK resident but treaty-resident outside the UK (= treaty non-UK resident). But *dual resident* and *semi-resident* do not encapsulate the concept; *treaty tie-breaker non-UK resident*" does encapsulate the concept but it is so long-winded it seems better just to

(2) not treaty non-UK resident: described as having **"sole UK residence"**.[5]

These are somewhat clumsy terms but it is difficult to think of better. For a discussion of these terms, see 6.1 (Three concepts of residence).

"Dual residence" means residence in two countries, but is an ambiguous term until one specifies what type(s) of residence are involved. In its widest sense it means a person who is UK-law UK resident and also foreign-law resident in a foreign state. A dual resident person in that sense may be:

(a) treaty-resident in a foreign state
(b) treaty-resident in the UK or
(c) not treaty-resident anywhere (if there is no applicable DTA).

The term "dual resident" is sometimes used specifically to mean a person within (a)[6] and that may be a convenient shorthand when the meaning is clear; but that usage is not adopted in this chapter.

These are clumsy terms but it is difficult to think of better.

57.5 Significance of DT reliefs to different classes of residents

DT reliefs matter to all individuals, but different classes of individual are interested in different aspects of the reliefs. The permutations can be summarised thus:

Case (1): Individuals who are UK-law UK resident and not treaty-resident in a foreign state. Where there is an applicable DTA they will also be treaty-resident in the UK.

Case (2): Individuals who are UK-law UK resident and also resident in a foreign state under the tax laws of that state. These may be:

(a) treaty-resident in a foreign state
(b) treaty-resident in the UK or
(c) not treaty-resident anywhere (if there is no applicable DTT).

Case (3): Individuals who are not UK-law UK resident. These may be:

(a) treaty-resident in a foreign state
(b) not treaty-resident anywhere (if there is no applicable DTA).

Case 1: UK-law UK resident and not treaty-resident in a foreign state.

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use the full expression when it is needed.

5 See 9.3.3 ("Sole UK residence").

6 See 51.17 (Dual resident trust: s.88 TCGA).

These do not directly qualify for any DT exemption but they may qualify for foreign tax credit relief (or IT/CGT computation deduction). They may also qualify for indirect DT relief if income or gains accruing to a trust or company which is treaty-resident in a foreign state are deemed to accrue to them under an anti-avoidance provisions such as s.624, TOA, s.13, etc.

Case (2)(a): UK-law UK resident and treaty-resident in a foreign state. As UK residents they are in principle subject to IT or CGT on all UK and foreign income and gains (subject where applicable to the remittance basis). However as treaty-resident in a foreign state they may qualify for DT exemptions from UK and foreign source income and gains. This category has become much more important from 2008/09, for two reasons. First, many individuals who before 2008 would have claimed the remittance basis now prefer to claim treaty relief, as a remittance basis claim will incur the remittance basis claim charge. Secondly following the withdrawal of IR20 and its replacement by the hopelessly vague HMRC 6, many more individuals find that they may possibly be UK-law UK resident and since they may be UK resident they claim treaty relief just in case. (This should cease to be such a problem when the statutory residence test takes effect in 2013/14).

Case (2)(b)(c): UK law UK resident and treaty-resident in the UK or not treaty-resident anywhere. These are in the same position as case 1.

Case (3)(a): Not UK-law UK resident and treaty-resident in a foreign state. As non-residents they are in principle subject to IT on UK source income only. As treaty-resident in a foreign state they may qualify for some DT exemptions (eg the OECD other income article and relief for UK source interest under the some treaties).

Case (3)(b) Not UK-law UK resident and not treaty-resident anywhere. As non-residents they are in principle subject to IT on UK source income (though the non-residents exemption will mitigate this). They will not qualify for any DT exemptions.

57.6 Interpretation of DTAs: Ordinary meaning & purposive construction

Short formulations of the principles of interpretation can only be expressed at a high level of generality which makes their application doubtful and their usefulness to the practitioner questionable. In short, as Voltaire observed, language is difficult to put into words. Nevertheless most cases start with these generalities so it is worth a brief summary here.

The starting point is article 31(1) of the Vienna Convention on the law

of treaties:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

The following statement of principles has often been approved:

> (1) It is necessary to look first for a clear meaning of the words used in the relevant article of the convention, bearing in mind that "consideration of the purpose of an enactment is always a legitimate part of the process of interpretation"... . A strictly literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty .... A literal interpretation may be obviously inconsistent with the purposes of the particular article or of the treaty as a whole. If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the convention, looking at it as a whole by reference to its language as set out in the relevant UK legislative instrument....
>
> (2) The process of interpretation should take account of the fact that--
>
> "The language of an international convention has not been chosen by an English parliamentary draftsman. It is neither couched in the conventional English legislative idiom nor designed to be construed exclusively by English judges. It is addressed to a much wider and more varied judicial audience than is an Act of Parliament which deals with purely domestic law. It should be interpreted,... 'unconstrained by technical rules of English law, or by English legal precedent, but on broad principles of general acceptation"...
>
> (3) Among those principles is the general principle of international law, now embodied in Article 31(1) of the Vienna Convention on the Law of Treaties. [The Judge sets out article 31 and continues] A similar principle is expressed in slightly different terms in McNair on the Law of Treaties (1961) at page 365, where it is stated that the task of applying or construing or interpreting a treaty is "the duty of giving effect to the expressed intention of the parties, that is, their intention as expressed in the words used by them in the light of the surrounding circumstances". It is also stated at page 366 of that work that references to the primary necessity of giving effect to "the plain terms" of a treaty or construing words according to their "general and ordinary meaning", or their "natural signification" are to be a starting point or prima facie guide and "cannot be allowed to obstruct the essential quest in the application of treaties, namely the search for the real intention of the contracting parties in using the language employed by them".

(4) If the adoption of this approach to the article leaves the meaning of the relevant provision unclear or ambiguous or leads to a result which is manifestly absurd or unreasonable recourse may be had to "supplementary means of interpretation" including travaux préparatoires: ...

(5) Subsequent commentaries on a convention or treaty have persuasive value only, depending on the cogency of their reasoning. Similarly, decisions of foreign courts on the interpretation of a convention or treaty text depend for their authority on the reputation and status of the Court in question...

(6) Aids to the interpretation of a treaty such as travaux préparatoires, international case law and the writings of jurists are not a substitute for study of the terms of the convention. Their use is discretionary, not mandatory, depending, for example, on the relevance of such material and the weight to be attached to it...[7]

57.7 Context of treaties

Article 31(2) of the Vienna convention provides:

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32 Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its

7 *IRC v Commerzbank* 63 TC 218 at p.235; I omit some references given in the original.

conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

(a) leaves the meaning ambiguous or obscure; or

(b) leads to a result which is manifestly absurd or unreasonable.

57.8 Treaties in two languages

Article 33 of the Vienna convention provides:

> 1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.
> 2. A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.
> 3. The terms of the treaty are presumed to have the same meaning in each authentic text.
> 4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

57.9 Variations between DTAs

The Australian revenue discuss this issue:

> 46. It is important for interpretation purposes to remember that each DTA is the product of a separate bilateral negotiation process. While, therefore, there is a general template structure to Australia's DTAs, each contains variations in terms from other DTAs because they are negotiated against the background of the particular languages, legal systems, tax rules, tax treaty and wider economic policies and expectations of the respective countries at the time, as well as some historical influences.
> 47. Those factors, and the fact that treaty negotiations are conducted against the general background of the OECD and United Nations Model Tax Conventions (which, being products of international compromise and consensus, are couched in comparatively broad terms) mean that the Australian negotiators, administrators and courts cannot expect the terms of the DTAs to be expressed with the same precision as our ordinary domestic tax legislation. Nor is it possible to always maintain consistency in how the terms of a particular Article are expressed in the

various DTAs, because of the different 'mix' of the above factors in different negotiations and the 'give and take' that is a necessary incident of international negotiations.

48. This is an important point to bear in mind, because it means that the network of DTAs is not drafted in an absolutely uniform manner in relation to residents of all treaty partners, or in relation to similar activities or situations.

49. Differing wording in two DTAs may represent the same intended meaning (such as, in the ATO's view, the terms 'beneficial entitlement' in the Dividends, Interest and Royalties Articles of some DTAs and 'beneficial ownership' in the corresponding Articles in other DTAs). Often such differences exist because a country wants to avoid unintentionally 'picking up' a domestic law usage for an undefined term that may be different to the international tax meaning of the phrase more usually relied on. Alternatively, it may be because a country does not recognise a particular concept and regards the use of a term as potentially creating uncertainty before its courts and in the administration of the DTA.[8]

50. In other cases, differences in wording may represent specific negotiating intentions (e.g., the reference simply to 'income' rather than 'income, profits or gains' in many of our pre-capital gains DTAs is, in the ATO's view, significant as is noted in Taxation Ruling TR 2001/12).[9]

51. It is sometimes possible that the same wording in different DTAs could present a different intended meaning. DTA negotiators will generally seek to identify the differences between a DTA under negotiation and their existing treaty network wording and as far as possible avoid the same wording having different usages, but that will not always be possible.

52. One practical example of the potential significance of different wording between DTAs is that, although the business profits/ permanent establishment ('PE') principle is common to all the DTAs, the definition of a PE in one DTA may be substantively different to the definition in another DTA.

53. For example, the definition of a PE in the United States Convention

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8 [Footnote original] Such as the concepts of 'citizenship' and 'nationality' - frequently only one or the other of these has a clear domestic law meaning for a DTA party, or the meaning may differ as between the Parties. Because of this, an Article such as the Government Service Article in the Austrian Agreement and some of Australia's other DTAs refers to 'a citizen or national' of a country.

9 [Footnote original] At paragraphs 56 and 59.

> is wider than the definition in the Japanese Agreement. Accordingly, Australia may have a taxing right under the Business Profits Article of the United States Convention in respect of certain profits of a United States enterprise but not under the Business Profits Article of the Japanese Agreement in respect of like profits of a comparable Japanese enterprise.[10]

A UK tribunal adopted the same view:

> [109] Comparison of the language of the DTA which we are called upon to construe with the language of another double taxation convention ... would be a very unsure basis to reach a conclusion contrary to the one we have reached by reference to directly related materials (particularly the exchange of notes) and we reject it.[11]

57.9.1 *Foreign court decisions*

The Australian revenue discuss this issue:

> 119. Since Australian courts have recognised that interpretation in a way conducive to producing a uniform international interpretation is an important goal in interpreting treaties,[12] it follows that foreign court decisions on similar provisions may give valuable guidance about the meaning of a term. They need to be treated with some caution, since they may be founded on different interpretative principles or approaches. Some courts may, for example, less strictly follow the Vienna Convention rules, or may apply a domestic law meaning of a term when they should apply an accepted international tax meaning. A court may also, quite properly, apply a domestic law meaning to a term left undefined by the DTA, whereas the same approach before Australian courts may lead to a different domestic law meaning being 'picked up'.
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> 120. Nevertheless, a foreign court's decisions, including on the foreign language text, may provide important insights. Some foreign courts have considerable experience and expertise in interpreting DTAs. In *Lamesa*, the Full Federal Court did not need to (or wish to) express a concluded view on the issue. The Court noted, however, that:[13]
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> We would, however, express our agreement with the distinction drawn

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10 Taxation Ruling TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements.

11 *Macklin v HMRC* [2014] SFTD 290 at [109]. The decision is not yet final.

12 See paragraph 87.

13 97 ATC 4229 at 4757.

by Lindgren J in *Allstate Life Insurance Co v. Australia & New Zealand Banking Group (No 6)* (1996) 64 FCR 79 between the content of foreign law which is receivable in evidence and the application of that law to facts once its content has been ascertained which is not. However, where the construction of an international treaty arises, evidence as to the interpretation of that or subsequent treaties in one of the participating countries forms part of a matrix of material to which reference could properly be made in an appropriate case. As presently advised we would not wish it to be thought that a limited view of the material to which reference could be made in interpreting a double tax treaty should be taken. Had there been some decision of an appropriate Dutch court interpreting a treaty with identical or similar language, then, in our view, evidence of such a decision might well have been admissible.

121. There are also strong reasons to consider, as a matter of practice, the decisions of courts from countries other than the treaty partner (an issue not addressed by the Lamesa Court). Any such consideration would need to be consistent with the comments of the High Court in *Cook v Cook*[14] that:

> Subject, perhaps, to the special position of decisions of the House of Lords given in the period in which appeals lay from this country to the Privy Council, the precedents of other legal systems are not binding and are useful only to the degree of the persuasiveness of their reasoning.[15]

57.9.2 *Foreign revenue guidance*

The Australian revenue discuss this issue:

> 125. Extrinsic materials of various types are extensively relied on by some countries. Some, such as the 'Technical Explanations' which are a feature of United States domestic procedures for consideration of a DTA, may help explain the views being put by the relevant DTA partner or a taxpayer. As the 'Technical Explanations' are, however, developed as part of the internal processes of the United States when implementing a DTA, they are of little or no usefulness in objectively proving the intent of both parties to a DTA. They are primarily designed to reflect the views of the United States negotiators, upon which there may not necessarily be a consensus ad idem ('meeting of minds'), but they may

14 (1986) 162 CLR 376 at 390.

15 Taxation Ruling TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements.

in some cases provide useful signposts to that consensus.[16] Even if they might not be admissible in court, or might be of little probative value, they may better inform an understanding of the DTA as a whole.[17]

57.10 Status of OECD commentary

The OECD have adopted the following formal recommendation:

> THE COUNCIL ... RECOMMENDS the Governments of Member countries:
> 1. To pursue their efforts to conclude bilateral tax conventions on income and on capital with those Member countries, and where appropriate with non-member countries, with which they have not yet entered into such conventions, and to revise those of the existing conventions that may no longer reflect present-day needs;
> 2. When concluding new bilateral conventions or revising existing bilateral conventions, to conform to the Model Tax Convention, as interpreted by the Commentaries thereon;
> 3. That their tax administrations follow the Commentaries on the Articles of the Model Tax Convention, as modified from time to time, when applying and interpreting the provisions of their bilateral tax conventions that are based on these Articles.[18]

The OECD commentary provides:

> 29. As the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of Member countries, they are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes.
> 29.1 The tax administrations of Member countries routinely consult the

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16 [footnote original] See on the use of United States materials and the different approaches taken to such materials by the courts of other countries, Edwardes-Ker *Tax Treaty Interpretation* (1994) at paragraph 25.04. Edwardes-Ker notes, importantly, that this does not supplant the rule that a treaty must be interpreted in accordance with the common intention of both States.

17 Taxation Ruling TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements.

18 C(97)195/FINAL 23 October 1997; I omit the recitals.

Commentaries in their interpretation of bilateral tax treaties. The Commentaries are useful both in deciding day-to-day questions of detail and in resolving larger issues involving the policies and purposes behind various provisions. Tax officials give great weight to the guidance contained in the Commentaries.

29.2 Similarly, taxpayers make extensive use of the Commentaries in conducting their businesses and planning their business transactions and investments. The Commentaries are of particular importance in countries that do not have a procedure for obtaining an advance ruling on tax matters from the tax administration as the Commentaries may be the only available source of interpretation in that case.

29.3 Bilateral tax treaties are receiving more and more judicial attention as well. The courts are increasingly using the Commentaries in reaching their decisions. Information collected by the Committee on Fiscal Affairs shows that the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge's deliberations. The Committee expects this trend to continue as the world-wide network of tax treaties continues to grow and as the Commentaries gain even more widespread acceptance as an important interpretative reference.

30. Observations on the Commentaries have sometimes been inserted at the request of Member countries that are unable to concur in the interpretation given in the Commentary on the Article concerned. These observations thus do not express any disagreement with the text of the Convention, but usefully indicate the way in which those countries will apply the provisions of the Article in question. Since the observations are related to the interpretations of the Articles given in the Commentaries, no observation is needed to indicate a country's wish to modify the wording of an alternative or additional provision that the Commentaries allow countries to include in their bilateral conventions.

Reservations of certain Member countries on some provisions of the Convention

31. Although all Member countries are in agreement with the aims and the main provisions of the Model Convention, nearly all have entered reservations on some provisions, which are recorded in the Commentaries on the Articles concerned. ... It is understood that insofar as a Member country has entered reservations, the other Member countries, in negotiating bilateral conventions with the former, will retain their freedom of action in accordance with the principle of reciprocity.

> 32. The Committee on Fiscal Affairs considers that these reservations should be viewed against the background of the very wide areas of agreement that has been achieved in drafting this Convention.

The Australian revenue refer to the OECD resolution and say:

> 101. ... While not binding (since they are not formal OECD 'Decisions', binding on OECD Members under the OECD Constitution), the OECD Model and Commentaries create a general or 'quasi-political', rather than 'legal', expectation that OECD Members will basically comply, subject to specific 'Observations' and 'Reservations' lodged with the OECD. Those Observations and Reservations place on record that the relevant DTA policies and practices of the countries concerned are based on a different approach than that indicated in the OECD Model or its Commentaries. Australia has lodged various Observations and Reservations to the OECD Model and Commentaries over time which (like Observations and Reservations lodged by other OECD Member countries) are reproduced in the OECD Commentaries. The status and interpretative relevance of Observations and Reservations is considered further below.[19]
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> 102. In *Thiel*, the High Court judges all accepted that the OECD Model Taxation Convention's official Commentaries may be relevant to the interpretation of DTAs based on the OECD Model. In *Thiel*, McHugh J (with whom the majority agreed in their joint judgment) approved recourse to the OECD Model and Commentaries under Article 32 of the Vienna Convention (that is, as supplementary means only available for consideration when there is ambiguity or the like, or to confirm a meaning reached by examining Article 31 materials).[20]
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> 103. Dawson J also approved reference to the Model and Commentaries 'as a supplementary means of interpretation to which recourse may be had under Article 32 of the Vienna Convention'.[21]His Honour went further than the other judges, however, by expressing the view that the OECD Model and Commentaries were also relevant under Article 31 of the Vienna Convention, as primary materials to be considered even when there was no ambiguity or the like.[22] In so doing, Dawson J

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19 At paragraph 109ff.

20 *Thiel v FC of T* (1990) 90 ATC 4717, at 4727 and 4720.

21 *Ibid*, at 4723.

22 [Footnote original] Dawson J, in his discussion of Article 31 of the Vienna Convention at 4723, had stated: "For my part, I do not see why the OECD model convention and commentaries should not be regarded as having been made in connection with and accepted by the parties to a bilateral treaty *subsequently*

nevertheless acknowledged that 'some doubts have been expressed about the applicability, as a matter of language, of Article 31 to the Commentaries in the case of a bilateral treaty such as a double taxation agreement'.[23]

104. The Commentaries, with the various Observations and Reservations of OECD Member countries which they reproduce (and which are further considered below),[24] therefore provide important guidance on interpretation and application of the OECD Model and as a matter of practice will often need to be considered in interpretation of DTAs, at least where the wording is ambiguous, which (as noted above)[25] is inherently more likely in treaties than in general domestic legislation.

105. In addition, the Commentaries, with the Observations and Reservations, do provide part of the historical context of the DTA negotiations. They also have a role in testing the interpretation reached by other means, although if they conflict with, rather than confirm, that interpretation there may be an issue of whether this would be admissible in a court, since the matter was left unresolved by the *Thiel* judgments.

...

Observations & Reservations

109. A further point which needs to be considered is the relevance for interpretation purposes of the previously mentioned Observations and Reservations of individual OECD Member countries to the OECD Model Tax Convention and its Commentaries, as Australia, like some of its DTA partners, sometimes depart significantly from the OECD Model. OECD Member Countries lodge ' Reservations' when they do not agree with either the relevant text of an OECD Model Article or any variations in text permitted by the Commentaries (and where they therefore wish to put other countries on notice of their views and intentions in negotiating the terms of the DTA). Countries enter 'Observations' if they do not object to the Model Article's text, but do not concur with the interpretation of that text set out in the Commentaries.

110. The theory behind the Observations and Reservations is most

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concluded in accordance with the framework of the model". (emphasis added).

23 [Footnote original] *Thiel v FC of T* (1990) 90 ATC 4717, at 4723. He cited, as to the doubts, Avery Jones et al Part II at 92. Edwardes-Ker *Tax Treaty Interpretation* (1994) similarly considers that the OECD Commentaries do not fall within the meaning of Article 31(2) of the Vienna Convention: paragraph 15.03.

24 Paragraph 109ff.

25 Paragraph 109ff.

clearly stated in the Introduction to 'Non-Member Positions'[26] section in the OECD Model Convention Commentaries. The Introduction reads:

> 2. ... Recognising that non-Member countries could only be expected to associate themselves to the development of the Model Tax Convention if they could retain their freedom to disagree with its contents, the Committee also decided that these countries should, like Member countries, have the possibility to identify the areas where they are unable to agree with the text of an Article or with an interpretation given in the Commentary. ...
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> 5. ... For each Article of the Model Tax Convention, the positions that are presented in this document indicate where a country disagrees with the text of the Article and where it disagrees with an interpretation given in the Commentary in relation to the Article.

111. Observations and Reservations may be of considerable relevance in explaining variations from the OECD Model, both when interpreting implementing legislation under section 15AA of the Acts Interpretation Act 1901 and when applying Article 31 of the Vienna Convention. They may not ultimately be admissible in court except to confirm the interpretations otherwise reached under those provisions or when considering ambiguous provisions under Article 32 of the Vienna Convention or, possibly, under section 15AB of the Acts Interpretation Act 1901.[27]

57.10.1 *Changes to OECD commentary*

The OECD model commentary provides:

> 33. When drafting the 1977 Model Convention, the Committee on Fiscal Affairs examined the problems of conflicts of interpretation that might arise as a result of changes in the Articles and Commentaries of the 1963 Draft Convention. At that time, the Committee considered that existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries, even though the provisions of these conventions did not yet include the more precise wording of the 1977

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26 [Footnote original] The term 'positions' is used since countries that are not OECD Members cannot formally lodge Observations or Reservations to the OECD Model.

27 Taxation Ruling TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements.
See Lang and Brugger "The role of the OECD Commentary in tax treaty interpretation"(2008) 23 Australian Tax Forum, accessible *http://www.wu.ac.at/taxlaw/institute/staff/publications/langbrugger_australiantaxforum_95ff.pdf*

Model Convention. It was also indicated that Member countries wishing to clarify their positions in this respect could do so by means of an exchange of letters between competent authorities in accordance with the mutual agreement procedure and that, even in the absence of such an exchange of letters, these authorities could use mutual agreement procedures to confirm this interpretation in particular cases.

34. The Committee believes that the changes to the Articles of the Model Convention and the Commentaries that have been made since 1977 should be similarly interpreted.

35. Needless to say, amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended Articles. However, other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific situations.

36. Whilst the Committee considers that changes to the Commentaries should be relevant in interpreting and applying conventions concluded before the adoption of these changes, it disagrees with any form of a contrario interpretation that would necessarily infer from a change to an Article of the Model Convention or to the Commentaries that the previous wording resulted in consequences different from those of the modified wording. Many amendments are intended to simply clarify, not change, the meaning of the Articles or the Commentaries, and such a contrario interpretations would clearly be wrong in those cases.

36.1 Tax authorities in Member countries follow the general principles enunciated in the preceding four paragraphs. Accordingly, the Committee on Fiscal Affairs considers that taxpayers may also find it useful to consult later versions of the Commentaries in interpreting earlier treaties.

Avery Jones says:

If the OECD suddenly came up with a better model, it would be a long time before it generally was adopted in practice and meanwhile, there would be a long transition while the existing 1,400 treaties were renegotiated. There is therefore a tendency to change the Commentary instead. The hope is that the new Commentary then will apply to all the existing treaties. As someone said, it is like the Bible; the words stay the same, only the commentary changes. Does anyone know what courts

will do when they are faced with interpreting a treaty when the Commentary makes fundamental changes subsequent to the treaty? There are few cases so far, probably because many of the fundamental changes are recent. Unless there is a reasonable expectation that courts will give effect to some of the fundamental changes that are being made to the Commentary, and I doubt if this is the case, there is no point in making fundamental changes to the Commentary. In fact, from the point of view of the tax authority, changing the Commentary in this way could make matters worse. In light of statements in the Introduction to the Model Treaty that existing treaties should be interpreted in light of new Commentaries, the tax authority may feel that it cannot properly argue against the interpretation contained in Commentaries made later than the treaty in question, but the taxpayer can, and probably will succeed if he does. It follows that the only fundamental changes that can have effect are those in favour of the taxpayer, which may not be quite what tax authorities sitting round the OECD table in Paris intend.

[Avery Jones sets out the comments of the Commentary on the issue and continues]: It seems to me that too little attention is paid to the legal effect of later Commentaries in internal law, and I am doubtful about whether any legal weight should be given to the Committee's retrospective views about proper interpretation. Tax treaties are different from normal international treaties under which the contracting states can agree to any interpretation;[28] they are also part of internal tax law affecting taxpayers and subject to interpretation by courts in that country. In relation to the latter, these statements in the Introduction may be wishful thinking on the part of the members of the Committee rather than a statement of what the legal position actually is. ...I think we would say in the United Kingdom, that later Commentaries should not even be considered.

...On the other hand, it does seem odd that if a country makes a new treaty today, which in a particular respect is in exactly the same form as an older one made with another country at the time of an earlier Commentary, the two treaties will have different meanings, which does seem contrary to the whole principle of having Commentaries. It is not as if parliaments (certainly in my country) take any notice of changes in the Commentary in approving treaties, particularly so when there is no mention of the Commentary in the treaty. If - and this may be a big if - parliaments were prepared to approve a statement in the treaty that it

28 Under art. 31(3) of the Vienna Convention on the Law of Treaties, subsequent agreements between the parties have the same status as context.

was to be interpreted in the light of the Commentaries from time to time in force, would this be desirable? It effectively would be a statement that the parties intended that a special meaning, determined in the future by the OECD, should apply, which as far as the two tax authorities are concerned, is of course exactly what they do intend, as the Introduction makes clear.[29]

There must be a boundary between interpretation and change. If the later Commentary says that black now means white, there seems little doubt that article 32 will not help to give a treaty that interpretation. If, on the other hand, the parties have stated in advance that, as a special meaning to be determined later, black does mean white, a court might give effect to it. You may say that this is so extreme an example that it would never happen. Unfortunately, there are examples of the Commentary changing its meaning from black to white....[30]

If changes in the Commentary in the past had been restricted to what might be argued to be interpretation, there would be a strong case for an approach giving effect to future Commentaries as a special meaning, always assuming that parliaments would accept it. But, as the OECD has made such major changes to later Commentaries, it is very doubtful that this solution will now be acceptable. ... The extent to which the later Commentary has effect is in the hands of the court, which will not accept that a change from black to white is confirming the ordinary meaning or resolving ambiguities or obscurity, or avoiding manifestly absurd or unreasonable results. On the other hand, it is likely that more minor changes will be effective, which will assist the harmonization of interpretation of treaties. It is already the case that courts in many countries do refer to later Commentaries in the case of minor changes and including something to that effect in the treaty will encourage courts in all countries to do so.[31]

The Australian revenue say:

Subsequent revisions to OECD Commentaries

106. There is some debate over whether subsequent changes to the OECD Commentaries should be used as an aid to interpretation of earlier DTAs. On one hand, there is the view that the OECD Commentaries are only relevant to those DTAs subsequently concluded.

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29 OECD Commentary, note 31, Introduction, PP33-36.

30 Avery Jones gives an example from Article 15 (employment income); see 22.41 (Who is the employer?).

31 Avery Jones, "Are Tax Treaties Necessary?" 53 Tax Law Review 1.

Einfeld J expressed this view in the Federal Court decision of the first instance in *Lamesa Holdings BV v FC of T*. His Honour referred to the Full High Court decision in *Thiel* and to the comments made by Dawson J in that case:[32]

> Further extrinsic material, referred to in Thiel as permissible by Mason CJ, Brennan and Gaudron JJ, who agreed with McHugh J, is consideration of the 1977 OECD Model and Commentaries in construing a double tax agreement. Dawson J added an important caveat to this view, namely that the OECD model and commentaries are only applicable to those bilateral treaties subsequently concluded.

107. On the other hand, the Introduction to the OECD Commentaries now indicates more clearly that the later Commentaries are intended by OECD Member states to be used for interpretation and application of DTAs concluded before their adoption, except where the OECD Model has been changed in substance. The Year 2000 update to the OECD Model and Commentaries states: [text set out above]...

108. These changes to the Commentaries reflect the fact that the Commentaries are usually expressed not as forming an agreement between countries as to a new meaning but as reflecting a common view as to what the meaning is and always has been. Accordingly, unless it is apparent that the substance of the OECD Model has itself changed since a DTA was negotiated or the treaty in question does not conform to the OECD Model, or unless the Commentaries make clear that a former interpretation has actually been substantively altered, rather than merely elaborated, the ATO considers it appropriate, as a matter of practice, to consider, at least, the most recently adopted/published OECD Commentaries (currently the Year 2000 Commentaries) as well as others which may have been available at the time of negotiation.[33] Often, if a DTA provision is to be fully understood, the changes that have occurred to the relevant OECD Commentaries over time will need

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32 97 ATC 4229 at 4237.

33 [Footnote original] This approach may also be justified in terms of Article 31(3) of the Vienna Convention, with the Commentaries representing either 'a subsequent agreement between the parties regarding the interpretation of the treaty' (Article 31(3)(a)) or 'any subsequent practice in the application of the treaty which establishes the agreement of the parties relating to its interpretation' (Article 31(3)(b)). In *Lamesa*, Einfeld J in fact referred to the 1977 OECD Commentaries when interpreting the 1976 Netherlands Agreement (Schedule 10 to the Agreements Act) on the basis that the relevant part was based on an OECD Report released in 1974 and widely available.

to be examined and considered.[34]

57.10.2 *Summary*

A great deal of ink has been spilt on this topic, but all it comes down to is that a Judge may ignore any OECD commentary if sufficiently minded to do so, and may ignore post-treaty amendments to the commentary with a relatively easy conscience.

57.11 Undefined terms have domestic law meanings

Article 3(2) OECD model convention provides:

> As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Avery Jones states:

> At first sight, it seems obvious that a treaty term should mean the same in both states, rather than have different internal law meanings in each of them; indeed, there are those who advocate this. But this approach overlooks that the tax systems in internal law do not have the same scope. Article 3(2) has the effect that the relieving provisions of the treaty correspond exactly to the taxing provisions of internal law. If expressions meant the same in both countries, this would not be the result. It would not lead to a sensible result if one country had a wider meaning of a type of income that it had to exempt than the other, and the treaty meaning was the same in both countries. The likely result would be that something covered by the internal law charge would not be exempt as a result of the treaty, or, less importantly, part of the treaty

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34 [Footnote original] An example is the amendment to paragraph 8 of the 1977 Model Commentaries on Article 5 (permanent establishments) by the 1992 Commentaries (in response to a 1983 Report). The amendments treated the leasing of industrial, scientific and commercial equipment as a matter for the Business Profits Article, rather than the Royalties Article. Australia and some other countries disagreed, and lodged a 'Reservation' (a concept discussed at paragraph 109ff) to the OECD Model Royalties Article, to this effect: see paragraph 39 of the OECD Model Commentary on Article 12. The history of the OECD Model and Commentaries is found in Volume 1 of the loose-leaf (and most authoritative) version of the OECD Model.

> meaning would have no effect.
>
> A problem that article 3(2) appears to encourage is for each state to use its own meaning of terms not only when relieving tax in the source state, which is mainly what the treaty is about, but also when it is giving relief as the residence state. This can lead to double taxation when the residence state says that if it had been the source state, it would not have taxed, so it will not give any relief for the tax that the source state, in fact, has charged because on its interpretation, the treaty does not prevent it. Or the reverse, when the residence state says that it would have taxed if it had been the source state, and so it will exempt the income even though the source state did not tax (although at least this problem does not arise in our countries as we, as the residence state, would tax and give credit for nothing). I do not believe that either result is intended by the Model Treaty; it would be a strange model treaty if it did. It would be nice if the Commentary said so plainly, rather than implying the reverse in an obscure section dealing with thin capitalization.[35] I shall not set out the arguments here as my co-authors and I have written extensively about it.[36] It would be a considerable improvement to the Model Treaty and Commentaries if this point were clarified.[37]

The wording of article 3(2) has changed slightly over time but the changes were intended to clarify rather than to alter the meaning, so older treaties using the older wording should not have a different effect.

The first change clarifies that the meanings of words are contemporary meanings rather than those historically used at the date of the treaty (known as an ambulatory approach to construction). The OECD commentary provides:

> 11. This paragraph provides a general rule of interpretation for terms used in the Convention but not defined therein. However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make

35 [Footnote original] OECD Commentary, note 31, art. 23, P68.

36 [Footnote original] See Avery Jones *et al* "Credit and Exemption Under Tax Treaties in Cases of Differing Income Characterization", (1996) 36 European Taxation 118.

37 Avery Jones, "Are Tax Treaties Necessary?" 53 Tax Law Review 1.

> this point explicitly.
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> 12. However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.
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> 13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).

The second change clarifies that the meanings of words are the tax meanings and not other meanings. The OECD commentary provides:

> 13.1 Paragraph 2 was amended in 1995 to conform its text more closely to the general and consistent understanding of member states. For purposes of paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws.

The wording of the clause may be changed in line with a mutual agreement clause, if there is one. The OECD commentary recognises that:

> States that are able to enter into mutual agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof)[38] that establish the meanings of terms not defined in the Convention should take those agreements into account in interpreting those terms.

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38 This provides: "The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention..."

The Australian revenue follow the OECD model commentary approach.[39]

57.12 Tax avoidance using DTAs

57.12.1 *OECD commentary*

The Commentary to OECD treaty article 1 provides:

> **Improper use of the Convention**
> 7. The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion.
> 7.1 Taxpayers may be tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws. ...

The OECD Commentary gives two examples of abuse. The first example may be described as treaty-shopping:

> 9.[1] This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly.

The second example is emigration by an individual to a treaty-state:

> [2] Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 5 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.[40]

I find it surprising that emigration by an individual should be categorised as abusive. Perhaps an individual approaches the abusive end of the spectrum if the period of treaty non-residence is kept as short as the

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39 TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements para 63-76 *http://law.ato.gov.au/atolaw/view.htm?Docid=TXR/TR200113/NAT/ATO/00001*

40 This particular scenario envisages a state which (subject to treaty relief) imposed CGT on non-residents who disposed of shares situate in that state. As the UK does not do this, this scenario does not arise in the UK.

"permanent home" requirement may permit.[41] The concept of abuse is not just vague and subjective but may also be very fact sensitive. The OECD Commentary continues:

> 9.1 This raises two fundamental questions that are discussed in the following paragraphs:
> - whether the benefits of tax conventions must be granted when transactions that constitute an abuse of the provisions of these conventions are entered into (cf. paragraphs 9.2 and following below); and
> - whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax conventions (cf. paragraphs 22 and following below).

In short, do domestic law anti-avoidance rules conflict with a treaty? In the UK, it does not help taxpayers if there is a conflict, as domestic law overrides treaty obligations. In others states it matters more, as treaty obligations override general law. But even in the UK, the issue matters, as:

(1) It affects construction: the courts should seek to construe domestic law consistently with treaty obligations.
(2) It affects policy debate and law reform, at least to the extent that those framing UK taxation are concerned to comply with treaty obligations.

The OECD analysis is as follows:

> 9.2 For many States, the answer to the first question is based on their answer to the second question. These States take account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases, broadened) by the provisions of tax conventions. Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied. For these States, the issue then becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law, which is the second question above. As indicated in paragraph 22.1 below, the answer to that second question is that to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not

41 That may be quite short: see 6.9.2 ("Permanent"). In the UK that planning would now be caught by the TNR rules.

addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions.

The UK is a state of this type, since a DTA must be given effect under general law. Another possible solution rests on construction of the treaty. The OECD commentary concludes:

9.4 Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.

The commentary formerly did not say this. It said (more or less) the opposite. Before 1995, paragraph 7 read as follows:

7. ... taxpayers have the possibility, double taxation conventions being left aside, to exploit differences in tax levels between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.

9.5 It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where

[a] a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and

[b] obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties, which is the second question mentioned in paragraph 9.1 above.

22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict.

Treaty-shopping was in the OECD view an improper use of tax treaties at least as far back as 1986. The Conduit Report said:

> **D. Main characteristics of "conduit configurations"**
> 6. Through the configurations described above, the conduit company takes advantage of the treaty provisions under its own name in the State of source; economically, however, the benefit goes to persons not entitled to use that treaty. A net tax advantage results because little or no taxation occurs in the State(s) of conduit.
> The advantage arises in the source country. As its tax laws deal adequately with the situation (it generally taxes all non-residents including the conduit company), the problem is created exclusively by the treaty itself and therefore can only be dealt with under the treaty.
> 7. This situation is unsatisfactory in several ways:
> a) treaty benefits negotiated between two states are economically extended to persons resident in a third State in a way unintended by the contracting States; thus the principle of reciprocity is breached and the balance of sacrifices altered;
> b) Income flowing internationally may be exempted from tax altogether or be subject to inadequate taxation in a way unintended by the contracting states. This situation is unacceptable because the granting by a country of treaty benefits is based, except in specific circumstances, on the fact that the respective income is taxed in the other State or at least falls under the normal taxing regime of that State;
> c) The State of residence of the ultimate beneficiary has little incentive to enter into a tax treaty with the State of source, because the residents of the State of residence can indirectly receive treaty benefits from the state of Source without the need for the State of Residence to provide reciprocal benefits.

57.12.2 *UN Model Commentary Concerning Anti-abuse Rules in Domestic Law*

In 2011, significant revisions were made to the UN Model Commentary concerning the relationship between domestic law and treaties in the context of specific and general anti-abuse rules found in domestic law. This commentary is substantially the same as the OECD Commentary, although it contains a more complete and clearer discussion of the relationship between domestic tax rules and treaty rules. The UN model commentary approves the OECD conclusion that"States do not have to grant the benefits of a double taxation convention where arrangements that

constitute an abuse of the provisions of the convention have been entered into." It then says:

> 23. That conclusion leads logically to the question of what is an abuse of a tax treaty. The OECD did not attempt to provide a comprehensive reply to that question, which would have been difficult given the different approaches of its member countries. Nevertheless, the OECD presented the following general guidance, which was referred to as a "guiding principle" (2) [Paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention]:
>
> > A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.
>
> 24. The members of the Committee endorse that principle. They considered that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers. Clearly, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.
>
> 25. Under the guiding principle presented above, two elements must therefore be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:
>
> - a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and
> - obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions.
>
> 26. These two elements will also often be found, explicitly or implicitly, in general anti-avoidance rules and doctrines developed in various countries.
>
> 27. In order to minimize the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not solely the alleged intention of the parties. Thus, the determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same

transactions or arrangements.

This is similar to EU law concepts of abuse: see 60.5.2 (abuse). That is not surprising.

57.12.3 *Construing DTAs to defeat avoidance schemes*

The OECD commentary discusses states whose domestic anti-avoidance provisions overrides DTAs, and concludes that they may do so. It then raises a different technique for combatting avoidance: construction of the treaty itself:

> 9.3 Other[42] States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith.[43]

The OECD approves of this approach to construction:

> 9.4 Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.

In a tax avoidance context, HMRC will argue for a non-literal approach, and in some cases this submission has fallen on fertile soil:

> [16] In this case, the preamble to the Treaty is very brief and states simply that the parties are "Desiring to conclude a new Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains."
> [17] These words, however, make it clear that the primary purposes of the Treaty are, on the one hand, to eliminate double taxation and, on the other hand, to prevent the avoidance of taxation. In seeking a purposive

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42 Strictly the reference to "other" states cannot be right: *all* states should seek to construe DTAs the same way. But the commentary is pragmatically correct. A state with domestic anti-avoidance rule need not bother about construction of the treaty: it does not matter what the treaty says.

43 The OECD refer to Article 31 of the Vienna Convention on the Law of Treaties; see 57.6 (Interpretation of DTAs: Ordinary meaning & purposive construction).

> interpretation, both these principles have to be borne in mind. Moreover, the latter principle, in my judgment, means that the Treaty should be interpreted to avoid the grant of double relief as well as to confer relief against double taxation.[44]

Similarly the GAAR guidance provides:

> The express purpose of DTAs is to avoid double taxation and prevent fiscal evasion, not to facilitate double non-taxation. This is clear from the judgment of the High Court and the Court of Appeal in *R oao Huitson v HMRC*,[45] and the Court of Appeal in the case of *Bayfine UK v HMRC*.[46]

That is too broad: abuse is not quite so easily identified. Sometimes DTAs allow taxing rights to both states and seek only to avoid double taxation. Sometimes they assign taxing rights to one state alone. If that state does not take advantage of the taxing rights, that alone does not allow the first state to tax. An example is foreign alimony payments. These are from foreign tax under OECD model, but the UK does not seek to tax them: see 19.9 (Alimony). That is not contrary to the treaty.

57.12.4 *Express unallowable purpose tests in DTAs*

Recent treaties frequently include an unallowable purpose test, applicable to dividend, interest and royalty articles.[47] For instance, the France/UK DTA has express provisions in the dividends, interest, royalties, and other income articles: eg art.11(6):

> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.[48]

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44 *Bayfine UK v HMRC* [2011] STC 717.

45 [2011] STC 1860.

46 [2011] STC 242.

47 A search (in 2013) shows the expression "main purpose or one of the main purposes" is found 245 times in the LexisNexis DTA database and that figure can be expected to increase.

48 For French guidance, see Bulletin Officiel Des Impôts, 14 B-1-11 "Commentaires de la Convention Fiscale Signee Avec le Royaume-uni le 19 Juin 2008" accessible *http://www11.minefi.gouv.fr/boi/boi2011/14aipub/textes/14b111/14b111.pdf*

Some treaties have a wide anti-avoidance provision applicable to the treaty generally, not just to specific provisions. For instance, article 28C(1) of the UK/India DTA provides:

> Benefits of this Convention shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain benefits under this Convention.

Sometimes the point is dealt with by an extra-treaty agreement. For instance, a Joint Declaration by UK and Germany provides that the two countries have reached the following understanding:

> **1. Improper use of the Convention**
> Having regard to paragraphs 7 to 12 of the Commentary to Article 1 of the OECD model tax convention, it is understood that this Convention shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of tax evasion or tax avoidance where those provisions are used to challenge arrangements which constitute an abuse of the Convention.
> It is further understood that an abuse of the Convention takes place where a main purpose for entering into certain transactions or arrangements is to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions of the Convention.

This was based on the OECD commentary.

57.12.5 *DTAs and the GAAR*

DTAs may be within the scope of the GAAR. The GAAR guidance provides:

> B5.2 Many of the established rules of international taxation are set out in double taxation treaties. These cover, for example, the attribution of profits to branches or between group companies of multi-national enterprises, and the allocation of taxing rights to the different States where such enterprises operate. The mere fact that arrangements benefit from these rules does not mean that the arrangements amount to abuse, and so the GAAR cannot be applied to them. Accordingly, many cases of the sort which have generated a great deal of media and Parliamentary debate in the months leading up to the enactment of the

> GAAR cannot be dealt with by the GAAR.[49]
> B5.3 However, where there are abusive arrangements which try to exploit particular provisions in a double tax treaty, or the way in which such provisions interact with other provisions of UK tax law, then the GAAR can be applied to counteract the abusive arrangements.[50]

The guidance gives the scheme in *Huitson* as an example of an arrangement which would be caught by the GAAR. As is quite common in the GAAR guidance examples, that is an easy case, and somewhat academic as the scheme has been stopped by legislation.[51]

It seems that the Courts in other common law jurisdictions have not been as obliging in categorisation of abuse as tax administrators would desire.. The Canadian Revenue say:

> ... the leading Canadian treaty shopping case involving the GAAR was decided in favour of the taxpayer. In *MIL (Investments) SA*,[52] the corporate taxpayer was continued from Cayman Islands (a jurisdiction with which Canada does not have a tax treaty) to Luxembourg (a treaty country) shortly before it realized capital gains on the disposition of taxable Canadian property.[53]

In UK legal terminology, the company migrated to Luxembourg and became treaty-resident there.

> Upon its continuance to Luxembourg, the corporate taxpayer became a resident of Luxembourg for purposes of the Canada-Luxembourg Convention, positioning it to make a claim under the Convention to exempt the capital gain from tax in Canada. The Crown argued that this case involved treaty shopping and, as such, represented an abuse of the provisions of the Convention that exempted the capital gain from tax in Canada. The Tax Court of Canada concluded that the GAAR was not applicable and that there was no inherent anti-abuse rule in the Convention. The Tax Court stated:

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49 [Footnote original] However, there is work underway in the OECD on the erosion of the tax base and on profit shifting.

50 HMRC GAAR Guidance (April 2013).

51 HMRC GAAR Guidance (April 2013) para D12; see 41.10 (DT relief for partnership).

52 [2007] DTC 5437 (Federal Court of Appeal))

53 [Footnote original] A non resident of Canada is taxable in Canada on, among other things, capital gains arising on the disposition of taxable Canadian property, subject to the provisions of an applicable tax treaty.

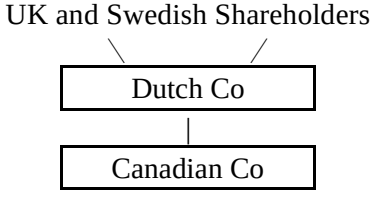
> "…I do not agree that Justice Iaccobucci's obiter dicta can be used to establish a prima facie finding of abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the use of the selected treaty that must be examined."[54]

In a short decision, the Federal Court of Appeal dismissed the Crown's appeal in MIL (Investments) on the basis that it was unable to find an object or purpose of the exempting provision of the Convention whose abuse would justify a departure from the plain meaning of the words of the provision. This decision is a particularly strong statement by the Federal Court of Appeal, indicating that the courts in Canada require further legislative direction before finding that treaty shopping is an improper (and abusive) use of tax treaties.

Next a conduit case:

In *Prevost Car Inc.*,[55] the CRA challenged a treaty shopping case on the basis that a conduit entity was not the "beneficial owner" of the Canadian-source income on which treaty benefits were sought. The case involved dividends paid on the shares of a Canadian resident corporation that were held by a Dutch corporation which in turn was owned by corporate shareholders in Sweden and the United Kingdom.

Diagrammatically:



The withholding tax rate on dividends paid to the Dutch holding company were lower than would have been the case had dividends been

54 See at [72].
55 2009 D.T.C. 5053.

paid directly to the corporate shareholders in Sweden and the United Kingdom. Even though the terms of the shareholders agreement essentially required the Dutch holding company to pass through as dividends to its shareholders any dividends received from its Canadian subsidiary, the Tax Court found that the intermediary Dutch holding corporation was the beneficial owner of the dividends and the Federal Court of Appeal affirmed the Tax Court's interpretation of beneficial ownership.

The narrow meaning ascribed to beneficial owner in *Prevost Car Inc.* means that the beneficial ownership requirement in this context is not sufficient to deny treaty benefits to an intermediary entity. In particular, even though the intermediary foreign holding company in this case was effectively a direct conduit (i.e., it did not pay tax on dividends received, distributed substantially all of its income to third country residents who owned it, and had no employees or activities other than with respect to the ownership of shares of a subsidiary), it was not denied treaty benefits on the basis of beneficial ownership.

Similarly, the notion of beneficial owner was also argued by the Government in *Velcro Canada*[56] as the basis on which to deny treaty benefits in a treaty shopping case. In Velcro Canada, a corporation resident in the Netherlands Antilles, which would have been subject to a withholding tax rate in Canada of 25% on royalties paid by a Canadian company, incorporated an intermediary company in the Netherlands and essentially assigned to it the right to receive royalty payments from the Canadian company. The intermediary company in the Netherlands remitted 90% of the royalties received to its parent in the Netherland Antilles within 30 days, pursuant to a sub-licencing agreement between the Dutch intermediary and the Netherlands Antilles company. This was a classic "stepping stone" conduit structure.[57] The Government argued the case on the basis that the Dutch intermediary was not the beneficial owner of the royalties received. The Court followed the decision in *Prevost Car Inc.*

Collectively, these three cases indicate in relatively strong terms that the courts in Canada are not currently inclined to find against taxpayers in treaty shopping cases. In other words, the courts in Canada require clearer legislative direction to the effect that treaty shopping is an

56 2012 D.T.C. 1100.

57 [Footnote original] See footnote 4 above and paragraph 4 of the OECD Report Double Taxation Convention and The Use of Conduit Companies (adopted by the OECD Council on 27 November 1986).

improper use of Canada's tax treaties.[58]

57.12.6 *The 2011 reform proposals*

In 2011 HMRC proposed draft legislation of a kind which has become familiar:

> *(1) This section applies if, but for provision made by double taxation arrangements. income of a UK resident would be chargeable to relevant UK tax ...*
> *(2) Where the avoidance conditions are met, the provision does not prevent the income being ... chargeable to relevant UK tax ...*
> *(3) The avoidance conditions are.*
> *(a) that a scheme is put in place by one or more persons,*
> *(b) that the provision would not apply to the income in the absence of that scheme, and*
> *(c) that the main purpose, or one of the main purposes, of a person in putting the scheme in place is to ensure that the provision does apply to the income. scheme in place is to ensure that the provision does apply to the income, profits or gains.*[59]

This is wider than the OECD commentary guiding principle, which required an objective test as well as a motive test.[60] If this were the law, then in general no-one would have any idea whether tax treaty relief applied, and relief would depend to a large extent on HMRC practice. In this respect the anti-avoidance provision is no different from most others introduced since HMRC under the Blair/Brown administrations started its campaign against tax avoidance.[61] If the legislation were adopted by our treaty partners, then the availability of foreign tax relief (eg whether UK tax could be set against foreign tax) under a DTA would be similarly unknowable.

The proposed reform was precipitately abandoned. The consultation period expired 22 September 2011, but on 9 September we read:

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58 Department of Finance Canada "Consultation Paper on Treaty Shopping – The Problem and Possible Solutions" (2013) *http://www.fin.gc.ca/activty/consult/ts-cf-eng.asp*

59 Tax Treaties Anti-avoidance Technical Note (1 August 2011) accessible *http://www.kessler.co.uk/tfd-archive*. The reader is invited to speculate whether the 1st August publication date was co-incidental. (The 6 week consultation period ought to be extended to exclude the holiday break but that is not the practice.)

60 See 57.12.1 (OECD commentary).

61 Eg CGT losses anti-avoidance: see 54.13 (Inter-spouse transfer).

> **The Exchequer Secretary to the Treasury (Mr David Gauke)**:
> On 1 August HMRC published for consultation a technical note and draft legislation outlining a proposed approach to combatting tax avoidance arrangements which exploit the provisions of double taxation agreements. The responses so far received have made it clear that the proposed legislation, as drafted, could cause significant uncertainty for compliant[62] UK businesses and overseas investors about its intended scope and its practical effect.
> The Government is committed to providing certainty to taxpayers and acknowledges the concerns raised in the responses to the consultation. It has therefore decided not to proceed further with the consultation on the proposed legislation and will not include it in Finance Bill 2012.

What happened? The matter did not take the usual course of consultation, responses and decision. In the absence of an explanation it is tempting to speculate. The most likely explanation is quiet but effective high level lobbying, not by the tax practitioner organisations (which are (more or less) ignored, especially in the area of avoidance) but by multi-national companies who bypassed HMRC and dealt with ministers. Or possibly the OECD pointed out the breach of its guiding principle.

57.12.7 *The future: EU and OECD reform proposals*

The EC have made a different recommendation:

> **3. Limitation to the application of rules intended to avoid double taxation**
> 3.1. Where Member States, in double taxation conventions which they have concluded among themselves or with third countries, have committed not to tax a given item of income, Member States should ensure that such commitment only applies where the item is subject to tax in the other party to that convention.
> 3.2. To give effect to point 3.1, Member States are encouraged to include an appropriate clause in their double taxation conventions. Such clause could read as follows:
>
> > "Where this Convention provides that an item of income shall be taxable only in one of the contracting States or that it may be taxed in one of the contracting States, the other contracting State shall be

62 On this usage of the contested word "compliant", see 44.6.4 (Investment manager condition E: customary remuneration)

> precluded from taxing such item only if this item is subject to tax[63] in the first contracting State."
>
> In case of multilateral conventions, the reference to the "other contracting State" should be replaced by a reference to the "other contracting States".
>
> 3.3. Where, with a view to avoid double taxation through unilateral national rules, Member States provide for a tax exemption in regard to a given item of income sourced in another jurisdiction, in which this item is not subject to tax, Member States are encouraged to ensure that the item is taxed.[64]

The OECD say:

> **ACTION 6 Prevent treaty abuse** Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.[65]

Action is promised for September 2014.[66]

57.13 Incorporation of DTAs into UK law

International treaties (including DTAs) do not automatically become part of UK law, but must be incorporated into UK law by authority of statute. Accordingly, s.2 TIOPA provides:

> (1) If Her Majesty by Order in Council declares—
>
> (a) that arrangements specified in the Order have been made in relation to any territory outside the UK with a view to affording

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63 The expression "subject to tax" is problematic; see 59.17 ("Subject to tax"). The EC recommendation provides: "3.4. For the purposes of points 3.1, 3.2 and 3.3 an item of income should be considered to be subject to tax where it is treated as taxable by the jurisdiction concerned and is not exempt from tax, nor benefits from a full tax credit or zero-rate taxation."

64 EC "Recommendation of 6.12.2012 on aggressive tax planning" C(2012) 8806 *http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8806_en.pdf*

65 OECD, "Action Plan on Base Erosion and Profit shifting" (2013) p.19 *http://www.oecd.org/ctp/BEPSActionPlan.pdf*

66 OECD Action Plan, p.32.

relief from double taxation in relation to taxes within subsection (3), and

(b) that it is expedient that those arrangements should have effect,

those arrangements have effect...

(3) The taxes are—

(a) income tax,

(b) corporation tax,

(c) capital gains tax,

(d) petroleum revenue tax, and

(e) any taxes imposed by the law of the territory that are of a similar character to taxes within paragraphs (a) to (d)...

Section 3(1) TIOPA authorises retrospective relief:

> Section 2(1) gives effect to arrangements even if the arrangements include—
>
> (a) provision for relief from tax for periods before the passing of this Act, or
>
> (b) provision for relief from tax for periods before the making of the arrangements.

Section 3(2) TIOPA extends this:

> Section 2(1) gives effect to arrangements even if the arrangements include—
>
> (a) provision as to income that is not subject to double taxation,
>
> (b) provision as to chargeable gains that are not subject to double taxation ...

Under s.2(2) TIOPA provides:

> If arrangements have effect under subsection (1), they have effect in accordance with section 6.

So we turn to s.6 TIOPA. Section 6(1) provides that DTAs override UK tax legislation:

> Subject to this Part and Part 18 of ICTA, double taxation arrangements have effect in accordance with subsections (2) to (4) despite anything in any enactment.

Section 6(2) TIOPA sets out seven matters which a DTA can achieve:

> Double taxation arrangements have effect in relation to income tax and corporation tax so far as the arrangements provide—
>
> (a) for relief from income tax or corporation tax,

This is what one would expect. Section 6(2) continues:

> (b) for taxing income of non-UK resident persons that arises from sources in the UK,
> (c) for taxing chargeable gains accruing to non-UK resident persons on the disposal of assets in the UK,

In practice, as far as I am aware, DTAs are not used to impose taxes.

> (d) for determining the income or chargeable gains to be attributed to non-UK resident persons,
> (e) for determining the income or chargeable gains to be attributed to agencies, branches or establishments in the UK of non-UK resident persons,
> (f) for determining the income or chargeable gains to be attributed to UK resident persons who have special relationships with non-UK resident persons, or
> (g) for conferring on non-UK resident persons the right to a tax credit under section 397(1) of ITTOIA 2005 in respect of qualifying distributions made to them by UK resident companies.

Section 6(3) TIOPA provides equivalent rules for CGT:

> Double taxation arrangements have effect in relation to capital gains tax so far as the arrangements provide—
> (a) for relief from capital gains tax,
> (b) for taxing capital gains accruing to non-UK resident persons[67] on the disposal of assets in the UK,
> (c) for determining the capital gains to be attributed to non-UK resident persons,
> (d) for determining the capital gains to be attributed to agencies, branches or establishments in the UK of non-UK resident persons, or
> (e) for determining the capital gains to be attributed to UK resident persons who have special relationships with non-UK resident persons.

Because treaties are made law by statutory instrument, the Parliamentary process is brief, and it is not usual to produce a lengthy explanation of the treaty. But treaty partners may produce such material, which is relevant in the UK, if only as a status like a textbook.

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67 Defined by reference in ss(7): "In subsection (3) 'UK resident person' and 'non-UK resident person' have the meaning given by section 989 of ITA 2007."

57.14 Claim for DT relief

Section 6(6) TIOPA provides:

> Relief under subsection (2)(a), (3)(a) or (4) requires a claim.

Form HS302 (Dual residents) provides a claim form for individuals who are UK resident and treaty-resident in a foreign state.

57.15 Interaction of DT reliefs and the remittance basis

The commentary to Art.1 OECD model treaty provides:

> 26.1 ...[Remittance basis taxpayers are not] subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:
>
> "Where under any provision of this Convention income[68] arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State."

Although this text was only added to the OECD Commentary in 2003, some provision of this kind is standard in UK DTAs. A provision of this kind is included in the US/UK DTA, on which the IRS comment:

> For example, if a UK resident who is not domiciled in the UK maintains a brokerage account in Ireland into which is paid $100 in U.S.-source dividend income, the United States may impose withholding tax at the statutory rate of 30% because the dividend income will not be taxed in the UK as it has not been remitted to the UK. If the dividend income

68 Author's note: The draft clause refers only to income, but in the UK foreign gains also qualify for the remittance basis so DTAs with a capital gains article generally extend the rule to gains. If the applicable DTA fails to do this then there may be double non-taxation in that gains which are (un)taxed in the UK on the remittance basis are not taxed in the foreign state because of DT relief.

> instead is paid into a brokerage account in London, the UK resident will be subject to tax in the UK and the United States will reduce the rate of withholding tax to 15%.[69]

Note that it is US tax, not UK tax, which is in issue here. UK tax issues only arise where the UK has a treaty with another state where the *foreign* state has a remittance basis. The only examples of which I am aware are Ireland[70] and Japan.

69 Department of the Treasury Technical Explanation of the Convention, accessible *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

70 Ireland/UK DTA art.6 (Limitation of relief) and art.14(5) (gains).

CHAPTER FIFTY EIGHT

FOREIGN TAX CREDIT RELIEF

58.1 Foreign tax credit relief

This chapter considers foreign tax credit relief. For an introduction to DTAs and terminology, see 57.1 (DT reliefs: Introduction).

58.1.1 *"Unilateral relief arrangements"*

Section 8(1) TIOPA provides:

> In this Part [Part 2 TIOPA] "unilateral relief arrangements", in relation to a territory outside the UK, means the rules set out in sections 9 to 17.

I prefer the term "**unilateral tax credit**", which seems clearer.

58.1.2 *"Tax"*

Section 8(2) TIOPA provides:

> In sections 11 to 17, and in Chapter 2 (except section 29) in its application to relief under unilateral relief arrangements, references to tax payable or paid under the law of a territory outside the UK include only—
>
> (a) taxes which are charged on income and which correspond to income tax,
>
> (b) taxes which are charged on income or chargeable gains and which correspond to corporation tax, and
>
> (c) taxes which are charged on capital gains and which correspond to capital gains tax.

Since this is expressed to apply only for the specified sections, the rules have to be set out again in s.9.

58.1.3 *"Corresponding to IT, CT or CGT"*

Section 8(3) TIOPA provides:

For the purposes of subsection (2), tax may correspond to income tax, corporation tax or capital gains tax even though it—

(a) is payable under the law of a province, state or other part of a country, or

(b) is levied by or on behalf of a municipality or other local body.

58.1.4 *Rule 1: Unilateral entitlement to credit for non-UK tax*

Section 9(1) TIOPA provides the rule for IT:

Credit for tax—

(a) paid under the law of the territory,

(b) calculated by reference to income arising, or any chargeable gain accruing, in the territory,[1] and

(c) corresponding to UK tax,

is to be allowed against any income tax or corporation tax calculated by reference to that income or gain.

Section 9(2) TIOPA is the equivalent for CGT:

Credit for tax—

(a) paid under the law of the territory,

(b) calculated by reference to any capital gain accruing in the territory, and

(c) corresponding to UK tax,

is to be allowed against any capital gains tax calculated by reference to that gain.

For rule 2 (accrued income profits) see 37.15 (Double taxation relief).

58.1.5 *"Corresponding to UK tax"*

Section 9 TIOPA provides:

(4) For the purposes of subsection (1)(c), tax corresponds to UK tax if—

(a) it is charged on income and corresponds to income tax, or

(b) it is charged on income or chargeable gains and corresponds to corporation tax.

(5) For the purposes of subsection (2)(c), tax corresponds to UK tax if it is charged on capital gains and corresponds to capital gains tax.

(6) For the purposes of subsections (4) and (5), tax may correspond to income tax, corporation tax or capital gains tax even though it—

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1 For the issue of where income arises, see 15.5 (Trading income of non-resident) or the chapters on the type of income concerned.

(a) is payable under the law of a province, state or other part of a country, or
(b) is levied by or on behalf of a municipality or other local body.

This repeats s.8(2)(3) and is necessary because those sections do not apply for the purposes of s.9.

58.1.6 *Channel Islands and Isle of Man*

Section 9(7) TIOPA provides:

> If the territory is the Isle of Man or any of the Channel Islands, subsections (1)(b) and (2)(b) have effect with the omission of "in the territory".

Amended as these subsections direct, s.9(1)(2) TIOPA provide:

> (1) Credit for tax—
> (a) paid under the law of the territory,
> (b) calculated by reference to income arising, or any chargeable gain accruing, ~~in the territory~~, and
> (c) corresponding to UK tax,
> is to be allowed against any income tax or corporation tax calculated by reference to that income or gain.
> (2) Credit for tax—
> (a) paid under the law of the territory,
> (b) calculated by reference to any capital gain accruing ~~in the territory~~, and
> (c) corresponding to UK tax,
> is to be allowed against any capital gains tax calculated by reference to that gain.

Since the Channel Islands and the IoM do not have a CGT, it is not immediately obvious what is the role of s.9(2). Maybe it applies where a gain is subject to IT in the Islands but subject to CGT in the UK.

58.1.7 *Rule 3: Interaction between DTAs and unilateral tax credit*

Section 11 TIOPA provides:

> (1) Credit for tax paid under the law of the territory is not allowed under section 9 or 10 in the case of any income or gains if any credit for that tax is allowable in respect of that income or those gains under double taxation arrangements made in relation to the territory.
> (2) If credit in respect of an amount of tax may be allowed under double taxation arrangements made in relation to the territory, credit is not

allowed under section 9 or 10 in respect of that tax.

(3) If double taxation arrangements made in relation to the territory contain express provision to the effect that relief by way of credit is not to be given under the arrangements in cases or circumstances specified or described in the arrangements, credit is not allowed under section 9 or 10 in those cases or circumstances.

58.1.8 *Rule 4: Credit for dividends*

Section 12 TIOPA provides:

(1) Credit under section 9 for overseas tax on a dividend paid by a company ("P") resident in the territory is allowed only if section 13, 14, 15 or 16 so provides.

(2) If credit is allowed in principle as a result of at least one of sections 14, 15 and 16, any tax in respect of P's profits that is paid by P under the law of the territory is to be taken into account in considering whether any, and (if so) what, credit is in fact to be allowed under section 9 in respect of the dividend.

(3) If credit is allowed in principle as a result of at least one of sections 15 and 16, there is to be taken into account, as if it were tax payable under the law of the territory, any tax that would be so taken into account under section 63(5) if the recipient of the dividend—

(a) directly or indirectly controlled, or

(b) were a subsidiary of a company that directly or indirectly controlled,

at least 10% of the voting power in P.

(4) For the purposes of subsection (3), the recipient is a subsidiary of another company if the other company controls, directly or indirectly, at least 50% of the voting power in the recipient.

58.1.9 *Rule 5: Credit for tax charged directly on dividend*

Section 13 TIOPA provides:

(1) This section applies for the purposes of section 12(1).

(2) Credit under section 9 for overseas tax on a dividend paid by a company ("P") resident in the territory is allowed if—

(a) the overseas tax is charged directly on the dividend (whether by charge to tax, deduction of tax at source or otherwise), and

(b) neither P nor the recipient of the dividend would have borne any of that tax if the dividend had not been paid.

That is straightforward.

58.1.10 *Rule 6: Credit for underlying tax on dividend paid to 10% associate of payer*

Section 14 TIOPA provides:

(1) This section applies for the purposes of section 12(1).
(2) Credit under section 9 for overseas tax on a dividend paid by a company ("P") resident in the territory is allowed if conditions A and B are met.
(3) Condition A is that—
(a) the recipient of the dividend is a company resident in the UK, or
(b) the recipient is a company resident outside the UK but the dividend forms part of the profits of a permanent establishment of the recipient in the UK.
(4) Condition B is that the recipient—
(a) directly or indirectly controls, or
(b) is a subsidiary of a company which directly or indirectly controls,
at least 10% of the voting power in P.
(5) For the purposes of subsection (4), the recipient is a subsidiary of another company if the other company controls, directly or indirectly, at least 50% of the voting power in the recipient.

58.1.11 *Rule 7: Credit for underlying tax on dividend paid to sub-10% associate*

Section 15 TIOPA provides:

(1) This section applies for the purposes of section 12(1).
(2) Credit under section 9 for overseas tax on a dividend paid by a company ("P") resident in the territory is allowed if each of conditions A to C is met.
(3) Condition A is that—
(a) the recipient of the dividend is a company resident in the UK, or
(b) the recipient is a company resident outside the UK but the dividend forms part of the profits of a permanent establishment of the recipient in the UK.
(4) Condition B is that the recipient—
(a) directly or indirectly controls, or
(b) is a subsidiary of a company which directly or indirectly controls,
less than 10% of the voting power in P.
(5) If condition B is met, in subsection (6) "the held percentage" means the voting power in P which is directly or indirectly controlled by—

(a) the recipient, or
(b) a company of which the recipient is a subsidiary.

(6) Condition C is that—
(a) the held percentage has been reduced below 10%,
(b) the recipient shows that the reduction below the 10% limit (and any further reduction)—
(i) could not have been prevented by any reasonable endeavours on the part of the recipient, a parent or an associate, and
(ii) was due to a cause or causes not reasonably foreseeable by the recipient, a parent or an associate when control of the relevant voting power was acquired, and
(c) the recipient shows that no reasonable endeavours on the part of the recipient, a parent or an associate could have restored, or (as the case may be) increased, the held percentage to at least 10%.

(7) For the purposes of subsection (6) a company is an "associate" if—
(a) the company is neither the recipient nor a parent,
(b) before the reduction, the voting power in P that is in question was controlled otherwise than directly by the recipient, and
(c) the company is relevant for determining whether, before the reduction, the recipient—
(i) indirectly controlled, or
(ii) was a subsidiary of a company which directly or indirectly controlled,
at least 10% of the voting power in P.

(8) In subsections (6) and (7) "parent" means a company of which the recipient is a subsidiary.

(9) In subsection (6) "the relevant voting power" means—
(a) the voting power in P as a result of which relief was due under section 14 before the reduction, or
(b) if control of the whole of that voting power was not acquired at the same time, that part of the voting power of which control was last acquired.

(10) For the purposes of this section, the recipient is a subsidiary of another company if the other company controls, directly or indirectly, at least 50% of the voting power in the recipient.

58.1.12 *Rule 8: Credit for underlying tax on dividend paid by exchanged associate*

Section 16 TIOPA provides:

(1) This section applies for the purposes of section 12(1).

(2) Credit under section 9 for overseas tax on a dividend paid by a company ("P") resident in the territory is allowed if each of conditions A to C is met.

(3) Condition A is that—

(a) the recipient of the dividend is a company resident in the UK, or

(b) the recipient is a company resident outside the UK but the dividend forms part of the profits of a permanent establishment of the recipient in the UK.

(4) Condition B is that the recipient—

(a) directly or indirectly controls, or

(b) is a subsidiary of a company which directly or indirectly controls,

less than 10% of the voting power in P.

(5) If condition B is met, in subsection (6) "the held percentage" means the voting power in P which is directly or indirectly controlled by—

(a) the recipient, or

(b) a company of which the recipient is a subsidiary.

(6) Condition C is that—

(a) the held percentage has been acquired in exchange for voting power in another company ("X"),

(b) before the exchange, the recipient—

(i) directly or indirectly controlled, or

(ii) was a subsidiary of a company which directly or indirectly controlled,

at least 10% of the voting power in X,

(c) the recipient shows that the exchange (and any reduction after the exchange)—

(i) could not have been prevented by any reasonable endeavours on the part of the recipient, a parent or an associate, and

(ii) was due to a cause or causes not reasonably foreseeable by the recipient, a parent or an associate when control of the relevant voting power was acquired, and

(d) the recipient shows that no reasonable endeavours on the part of the recipient, a parent or an associate could have restored, or (as the case may be) increased, the held percentage to at least 10%.

(7) For the purposes of subsection (6) a company is an "associate" if—

(a) the company is neither the recipient nor a parent,

(b) before the exchange, the voting power in X that is in question was controlled otherwise than directly by the recipient, and

(c) the company is relevant for determining whether, before the exchange, the recipient—

(i) indirectly controlled, or
(ii) was a subsidiary of a company which directly or indirectly controlled,

at least 10% of the voting power in X.

(8) In subsections (6) and (7) "parent" means a company of which the recipient is a subsidiary.

(9) In subsection (6) "the relevant voting power" means—

(a) the voting power in X as a result of which relief was due under section 14 before the exchange, or

(b) if control of the whole of that voting power was not acquired at the same time, that part of the voting power of which control was last acquired.

(10) For the purposes of this section, the recipient is a subsidiary of another company if the other company controls, directly or indirectly, at least 50% of the voting power in the recipient.

58.1.13 *Rule 9: Credit in relation to dividends for spared tax*

Section 17 TIOPA provides:

(1) Subsection (2) applies if—

(a) under the law of the territory, an amount of tax ("the spared tax") would, but for a relief, have been payable by a company resident in the territory ("company A") in respect of any of its profits,

(b) company A pays a dividend out of those profits to another company resident in the territory ("company B"),

(c) company B, out of profits which consist of or include the whole or part of that dividend, pays a dividend to a company resident in the UK ("company C"), and

(d) the circumstances are such that, had company B been resident in the UK, it would have been entitled, as a result of the operation of section 20(2) in relation to double taxation arrangements made in relation to the territory, to treat the spared tax for the purposes of Chapter 2 as having been payable.

(2) The spared tax is to be taken into account—

(a) for the purposes of sections 9 to 16, and

(b) subject to section 31(4), for the purposes of Chapter 2 in its application to relief under these rules in relation to the dividend paid to company C,

as if it had been payable and paid.

(3) References in these rules and that Chapter—

(a) to tax payable or chargeable, or

(b) to tax not chargeable directly or by deduction,

are to be read in accordance with subsection (2).

(4) Except as provided by subsection (2), in relation to any dividend paid—

(a) by a company resident in the territory,

(b) to a company resident in the UK,

credit as a result of these rules is not to be given under section 63(5) in respect of tax which would have been payable under the law of the territory, or under the law of any other territory outside the UK, but for a relief.

(5) Subsection (4) has effect despite any double taxation arrangements—

(a) made in relation to the territory, or

(b) made in relation to any other territory outside the UK,

which make provision about a relief given, under the law of the territory in relation to which the arrangements are made, with a view to promoting industrial, commercial, scientific, educational or other development in a territory outside the UK.

(6) In this section "these rules" means sections 9 to 16 and this section.

58.1.14 *Quantum of income/gains*

The INT Manual provides:

165030 Computation – assessable amount [January 2011]

Where credit is claimed against UK Income Tax for foreign tax paid on income from a foreign source, the amount of that income for all UK tax purposes is:

a) Foreign income assessable on the arising basis

No direct foreign tax is to be deducted. Where, exceptionally, the double taxation agreement provides for relief for underlying tax on a dividend (see INTM164410) the underlying tax should be added to the amount of the income. Treat the whole of a foreign pension as chargeable to UK tax notwithstanding the deduction of one tenth under Section 65(2) ICTA 1988.

Example:

An individual receives a dividend of 100 from which 15 foreign withholding tax was deducted. The amount of income assessable is 100.

b) Foreign income assessable on the remittance basis

Add the amount of direct foreign tax attributable to the amount of income remitted. Where, exceptionally, the agreement provides for relief for underlying tax on a dividend (see INTM164410), the underlying tax should also be added to the amount of the dividend remitted. If you have difficulty in determining the amount of foreign tax attributed to income remitted, refer to the Personal Tax Team International - Advisory (part of Charity, Assets & Residence).

Example	
[Gross foreign income]	£1,000
Foreign tax	£400
Net foreign income	£600
Remitted to UK	£300
UK measure of the income	
Income remitted	£300
Plus foreign tax (300/600×400)	£200
Therefore UK measure is	£500

This summarises the rules in s.31, 32 TIOPA.

Similarly for CGT; the INT Manual provides:

> **169080. Remittance basis** [September 2011]
> An individual who is resident or ordinarily resident but not domiciled in the UK and who makes a chargeable gain on the disposal of an asset situated outside the UK is only liable on the amount of the gain received in the UK (Section 12 TCGA 1992 see CG25300 onwards). When such an individual is chargeable on the gain received in the UK and claims credit for foreign tax charged on the same gain, the liability in the UK will be on the sum of the amount remitted to the UK plus the foreign tax attributable to the amount remitted.
> Any difficulty in determining the correct addition for the foreign tax, should be referred to Personal Tax International (part of Charity, Assets & Residence).

58.1.15 HMRC practice: Quantum of relief

The INT Manual provides:

> **169100. Amount of foreign tax credit relief – general** [January 2011]
> Similar principles to those set out in INTM161210 onwards for Income Tax apply to Capital Gains Tax. The amount of credit for foreign tax is not to exceed the lesser of the foreign tax charged on the foreign gain and the UK tax charged on the doubly taxed gain at the taxpayer's marginal rate.
> If the foreign tax exceeds the UK tax, the excess can neither be deducted from the amount of the gain chargeable to Capital Gains Tax, nor can it be repaid.
> The foreign tax should not be increased by any indexation allowance.
> A taxpayer's marginal rate for Capital Gains Tax is the rate at which the tax is charged for the year of assessment.
> **169110. Amount of foreign tax credit relief – more than one gain** [January 2011]

The amount of foreign tax credit relief must be calculated separately for each gain. An excess of foreign tax over UK tax on one gain cannot be credited against UK tax on another foreign gain or on the gain on the disposal of a UK asset.

169120. Amount of foreign tax credit relief – losses [September 2011]
Allowable losses should be set firstly against chargeable gains on which no foreign tax credit relief is due. It would normally be to the taxpayer's advantage to set any balance of losses, in order, against the gains on which the lowest level of foreign tax has been paid. This should secure the maximum amount of foreign tax credit relief.

169130. Amount of foreign tax credit relief – exemption from tax [September 2011]
Where the total of the chargeable gains in any year of assessment exceeds the exempt amount provided by TCGA 1992 Section 3, the exempt amount should, as far as possible, consist of gains on which no foreign tax has been charged. This will enable credit for foreign tax charged on the gains to be allowed against the UK Capital Gains Tax charged on those gains.
The following example demonstrates the application of this paragraph and of INTM169120
In 2009–10, an individual has the following chargeable gains:

UK	£10,000	
Country X	£20,000	Foreign tax £2,000
Country Y	£6,000	Foreign tax £2,700

He has losses of £6,000 available for deduction. The exemption limit for 2009–10 is £9,600. The computation of his liability is as follows:

	UK Gain	**Country X Gain**	**Country Y Gain**
	£10,000	£20,000	£6,000
Less Loss	£6,000		
	£4,000	£20,000	£6,000
Less Exempt Amount	£4,000	£5,600	
	0	£14,400	£6,000
Tax at 18%	0	£2,592	£1,080
Less FTCR	0	£2,000	£1,080
Tax Payable	Nil	£592	Nil

The balance of Country Y's tax of £1,620 (2,700 less 1,800) cannot be set off against the Capital Gains Tax payable on the Country X gain and cannot be repaid.

169140. Amount of foreign tax credit relief – extent to which a gain is doubly taxed [January 2011]
As mentioned in INTM169100, credit for foreign tax cannot exceed the

UK tax due on the doubly taxed gain. There may be situations where the amount of the UK gain is different from the amount of the gain that is taxed in the other country; or where the period of ownership of the asset that is taken into account in computing the UK gain is different from the period of ownership of the asset that is taken into account in computing the gain in the other country. In either case, the amount of the foreign tax allowable for foreign tax credit relief may need to be restricted. For further details on this, see CG14395 –CG14425.

169150. Amount of foreign tax credit relief – basis of allowance [September 2011]

Credit may be claimed for the foreign tax paid on foreign capital gains against the UK tax due on the same gain, irrespective of the tax year in which the foreign tax is charged.

Where credit is claimed on any other basis or where there are difficulties in determining the amount of foreign tax credit relief due, advice may be sought from Personal Tax International (part of Charity, Assets & Residence).

However HMRC changed their minds in Brief 17/10:

Introduction

The purpose of this brief is to publicise a change to the established practice of restricting the amount of Foreign Tax Credit Relief (FTCR) that can be deducted when calculating the amount of UK tax due on a chargeable gain.

Background

Where a gain is chargeable to UK Capital Gains Tax or UK Corporation Tax and the same gain has also been taxed in another country then FTCR can be claimed in respect of the foreign tax paid.

Our practice has been to restrict the amount of FTCR if different periods of ownership of the asset are considered when arriving at the gain assessable in the UK and the foreign gain, or if the amount of the UK gain is less than the foreign gain.

We have reconsidered our view and are revising our practice so that the whole of the foreign tax is allowable as FTCR up to the amount of the UK tax on the gain.

The current practice

The established practice has been to restrict the amount of FTCR in the following two situations:

Situation one

The amount of gain charged to foreign tax may be calculated by reference to a longer period of ownership than the period on which the gain charged to UK tax is based. The most common instance is where

assets were acquired before the 31 March 1982 and the gain chargeable in the UK is based only on the period from 31 March 1982 onwards. In such cases the established practice has been to restrict the FTCR due by the following calculation:

((period of time assessed by UK) ÷ (period of time assessed by foreign authority)) × foreign tax = allowable FTCR

For example, where the asset was acquired on 31 March 1971 and disposed of on 31 March 1993, with foreign tax of £10,000 charged then the maximum amount of FTCR would be restricted as follows:

31 March 1993 minus 31 March 1982 equals 11 years

Divided by 31 March 1993 minus 31 March 1971 equals 22 years

multiplied by £10,000 equals £5,000

Situation two

Where the gain charged in the UK is less than the gain charged to foreign tax, the established practice has been to restrict the maximum amount of FTCR due by the following calculation:

(amount of UK assessment) ÷ (amount of foreign assessment)

multiplied by foreign tax = allowable FTCR

For example, where

the UK assessed a gain of £55,000,

the gain charged to foreign tax was £75,000 and

the foreign tax was £15,000 then the FTCR would be restricted as follows:

(£55,000 ÷ £75,000) × £15,000 = £11,000

How we intend to implement the revised practice

From 19 March 2010 the practices described above that restrict the allowable FTCR will end. In all cases where FTCR is claimed against UK tax on chargeable gains, the whole of the foreign tax will be allowable up to the amount of the UK tax on the gain, provided that the gain charged in both countries relates to the same disposal.

In the examples above, the maximum allowable FTCR would now be the full £10,000 of foreign tax in the first case and the full £15,000 of foreign tax in the second, provided, in each case, that this amount was less than or equal to the UK tax.

This change will bring the chargeable gains practice in line with the Income Tax practice, which does not restrict the amount of FTCR allowed where the amount assessed in the UK is less than the amount of income assessed to foreign tax.

Implications

If tax returns were submitted with a claim to FTCR on the basis that the FTCR should be restricted, and those returns are still open or within the self-assessment window for amendment, they may be amended to reflect

the change in practice. In other cases where FTCR has been restricted a claim can be made for additional relief within the normal time limits...

See too 55.9 (Tax credit relief: currency conversion date).

58.2 Foreign tax credit relief: Property income

The Property Income Manual provides:

> **PIM4705 - Rent from property outside the UK: CT** [February 2006]
> ***Credit for foreign tax***
> If the overseas income has suffered foreign tax and a claim to tax credit relief is made, it will be necessary, for the purposes of the source by source rule (see INTM161210) to identify the amount of UK tax attributable to income from each particular property. Where, therefore, tax credit relief is claimed separate computations of profits and losses for each property will be required. For the purposes of calculating tax credit relief, losses should be deducted in the order most favourable to the company's claim. Normally this will mean that losses should be allocated first against the source which has suffered at the lowest rate of foreign tax.
> A company's flexibility in deciding how to allocate the deduction set out in Section 797(3) ICTA 1988, subject to the limitations in respect of deficits on non-trading loan relationships set out at Section 797(3)(A) and (B) ICTA 1988, is unaffected by any of the changes.

58.3 CGT/IT computation deduction

Section 112 TIOPA provides:

> **112 Deduction from income for foreign tax (instead of credit against UK tax)**
> (1) The amount of any income arising in any place outside the UK is reduced for the purposes of the Tax Acts—
> (a) by any amount which has been paid in respect of non-UK tax[2] on that income in the place where the income arose, or
> (b) if subsection (2) applies, by the lesser amount mentioned in that subsection.
> (2) This subsection applies if credit would, were it allowable in respect of the income, be reduced under section 39 (reduction by reference to accrued income losses) to the lesser amount given by section 39(5).
> (2A) But if X is less than Y, an amount equal to the difference between

2 Section 112(6) TIOPA provides a commonsense definition: "In subsection (1) "non-UK tax" means tax under the law of a territory outside the UK."

X and Y must be subtracted from the amount by which any income of a person ("the relevant income") is reduced under subsection (1)(a).
(2B) In subsection (2A)—
X is the amount of the relevant income that the person would (disregarding this section) be required to bring into account for income tax or corporation tax purposes, less any deduction that the person would be allowed to make for the amount paid in respect of non-UK tax, and
Y is the amount of the relevant income (that is to say, the amount on which the amount in respect of non-UK tax is paid).

Credit must be given for a foreign tax repayment:

(3) If—
(a) income of any person ("P") is reduced under subsection (1) by an amount paid in respect of tax on that income in the place where the income arose, and
(b) a payment is made by a tax authority to P, or any person connected[3] with P, by reference to that tax, the amount of P's income is increased by the amount of the payment.
(4) Subsection (1)—
(a) has effect subject to section 31(2)(a) (no deduction for foreign tax if credit allowed and UK tax calculated otherwise than by reference to the amount received in the UK),
(b) has effect subject to section 143(5) and (6) (no deduction for special withholding tax if UK tax calculated otherwise than by reference to the amount received in the UK),
(c) does not apply to income the tax on which is to be calculated by reference to the amount of income received in the UK, and
(d) does not require any income to be reduced by an amount of underlying tax which, under section 60(3), is to be left out of account for the purposes of section 57.

Section 113 TIOPA has the equivalent rule for CGT:

113 Deduction from capital gain for foreign tax (instead of credit against UK tax)
(1) Subsection (2) applies to tax if it is—
(a) chargeable under the law of any territory outside the UK on the disposal of an asset, and
(b) borne by the person making the disposal.

3 Defined s.112(7) TIOPA: "For the purposes of subsection (3), whether a person is connected with P is determined in accordance with section 1122 of CTA 2010."

(2) The tax is allowable as a deduction in the calculation of the gain.
(3) Subsection (2) is subject to—
(a) Chapters 1 and 2 so far as they apply for corporation tax purposes (see, in particular, section 31),
(b) Chapters 1 and 2 so far as they apply for capital gains tax purposes (see, in particular, section 31), and
(c) section 143 (which includes provision about taking account of special withholding tax when calculating a gain for capital gains tax purposes).
(4) In subsection (1) "asset" and "disposal" have the same meaning as in TCGA 1992 (see, in particular, section 21 and the following provisions of TCGA 1992).

Thus foreign tax credit relief (if claimed) has priority over an IT/CGT computation deduction.

At first sight it is not obvious when an IT/CGT computation deduction would be better than foreign tax credit relief. One case is where foreign CGT is payable but UK CGT is not (because of a difference in valuation rules or because some UK relief applies). In such a case the computation deduction may increase the loss allowable for UK CGT purposes (similarly for IT). But that must be a rare case.

The INT Manual provides:

169090. Deduction not credit [January 2011]
A deduction for the foreign tax should be made in the computation of the gain or loss when there is no claim to foreign tax credit relief or when no UK tax is chargeable on a gain; for example, when the UK computation shows a loss on the disposal and consequently there is no UK tax against which credit for any foreign tax can be given. No deduction is due, however, when credit relief is claimed, for any part of the foreign tax paid on a gain which does not qualify for credit because it exceeds the UK tax chargeable on the same gain.

INT Manual provides:

161050. Deduction instead of credit [June 2013]
It may sometimes be to the taxpayer's advantage not to make a claim to tax credit relief, for example where a business's trading profits are wholly covered by capital allowances so that there is no Income Tax or Corporation Tax payable on those profits, or where the trading results show a loss. If, for any reason, tax credit relief is not claimed, the foreign tax paid must be deducted from the income from the foreign source in computing the amount of the income for UK tax purposes (Section 112-

115 TIOPA 2010). This may serve to create or increase a loss which can be dealt with under the normal provisions for losses.

Section 112 refers to 'any sum which has been paid in respect of non-UK tax' on income. This means tax alone and not, for example, interest paid in the foreign country for late payment of the foreign tax. Nor may a deduction be allowed for 'tax spared' (INTM161270) as it is not tax which has been paid; nor for underlying tax (INTM164060 and INTM164360) as it is not paid on the dividend in question; nor for taxes similar to UK VAT (see, however, INTM161080). Refer to CTISA Business International (Outward Investment Team), any case where it is not clear that the tax for which a deduction is sought under Section 112 is a tax on income.

Section 112 allows a deduction for foreign tax paid on income 'in the place where the income arose'. Refer to CTISA Business International (Outward Investment Team), any case where a deduction is sought for foreign tax paid on income which arises wholly or partly from work carried out in the UK.

Some foreign taxes, if not deductible under sections 112 to 115, may still be allowable expenses in computing the profits of a trade or profession (see INTM161080, BIM45900 onwards)...

CHAPTER FIFTY NINE

DTAs: INTERACTION WITH UK TAX LEGISLATION

59.1 Indirect DT reliefs

This chapter considers the interaction of DTAs and UK tax provisions, especially anti-avoidance legislation.

For an introduction to DTAs and terminology, see 57.1 (DT reliefs: Introduction).

59.1.1 *Third party claiming DT exemption*[1]

Article 1 OECD Model provides:

> This Convention shall apply to persons who are residents of one or both of the Contracting States.

DT exemptions are not in principle restricted to the person to whom the income/gains accrue. Where a DT provides that income of a person treaty-resident in the foreign state shall be taxable only in the foreign state, a settlor or transferor who is treaty-resident in the UK cannot be taxable on that income. Sections 2 and 6 TIOPA authorise DT exemptions to apply in this way, for they simply provide "relief", ie relief for anyone.[2] I refer to this as "**indirect DT exemption**".

This is self-evident, but authority can be cited if necessary. In *Lord Strathalmond v IRC*,[3] US source income arose to Lady Strathalmond. The rule at that time (only repealed in 1988) was that income of a married

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1 Wheeler discusses this issue in *The Missing Keystone of Income Tax Treaties* (2012) para 3.2 (Subjective/objective nature of treaties) but her proposed terminology (Objective/subjective) is not the most helpful.

2 One might also refer to s.6(2)(f) TIOPA; but DTAs usually take the form of providing relief, rather than the form of disattributing income otherwise attributable to a settlor or transferor.

3 48 TC 537.

woman was deemed to accrue to her husband, so in the absence of treaty relief, Lord Strathalmond would have been taxable. The wife was treaty-resident in the USA but the husband was treaty-resident in the UK. Nevertheless he was entitled to DT exemption. The treaty exempted the income, not the treaty-resident individual, so a third party otherwise taxed on the income could claim the benefit of treaty relief even though not treaty-resident in the USA. Lord Millett summarised the point:

> [*Strathalmond*] shows that the relief from UK tax accorded by a double taxation agreement can enure for the benefit of a third party.[4]

Again, in *Padmore v IRC*[5] a partner was entitled to DT exemption on income of a Jersey partnership where the partnership was a person treaty-resident in Jersey but the partner was not.

Other countries adopt the same view.[6]

I stress this because there is a comment to the contrary by the Special Commissioner in *IRC v Willoughby*[7] but that must be dismissed as erroneous.

Indirect DT exemption is restricted in the case of trading income: see 15.24.4 (Treaty override for trading income).

59.1.2 *Third party claiming foreign tax credit relief*

The position is the same for DTA tax credit. The position is the same for unilateral tax credit, because s.9(1) TIOPA allows "relief" or "credit" ie relief and credit for anyone.

SP 6/88 provides:

> **Double taxation relief: chargeable gains**
> [The SP cites the relevant statutory provisions and continues:]
> 3 The principal requirement for the granting of credit for overseas tax against liability to capital gains tax (or corporation tax on chargeable gains) is therefore that the overseas tax should be computed by reference

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4 *Bricom v IRC* 70 TC 272 at p.290.

5 62 TC 352.

6 *Canada v. Sommerer* 2012 FCA 207 accessible *http://www.canlii.org*. This case concerned a Canadian provision similar to s.86 TCGA. A gain accrued to trustees who were treaty-resident in the foreign state. Under the Canadian tax legislation, the gain was deemed to accrue to the Canadian resident settlor. The Canadian Federal Court of Appeal held that the settlor could claim treaty relief under a treaty with a CG provision in OECD model form.

7 [1995] STC 143 at p.169.

to the same gain as the UK tax. There is no requirement that the respective tax liabilities should arise at the same time nor that they should be charged on the same person.

The SP gives four examples:[8]

> 4 The Revenue's view is that the following sets of circumstances fall within the terms of the standard credit article and TA 1988 s 790 and may therefore give rise to a credit for overseas tax against UK capital gains tax or corporation tax on chargeable gains.
>
> (i) The overseas tax charges capital gains as income.
>
> (ii) Overseas tax is payable on a disposal falling within TCGA 1992 s 171 (transfers within a group of companies treated as taking place on a no gain/no loss basis) and a liability to UK tax arises on a subsequent disposal.[9]
>
> (iii) An overseas trade carried on through a branch or agency is domesticated (ie transferred to a local subsidiary) and relief is given under TCGA 1992 s 140. There is a subsequent disposal of the securities (or the subsidiary disposes of the assets within six years) giving rise to a liability to UK tax and overseas tax is charged in whole or in part by reference to the gain accruing at the date of domestication.[10]

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8 INTM 169040 gives a fifth example, where "overseas tax is payable in its country of residence by a non-resident company on the disposal of an asset and in the UK the gain is charged on a UK resident individual under s.13 TCGA". See 59.9 (Foreign tax credit: s.13 TCGA).

9 The former International Tax Handbook para 619 explains the point more clearly: "A similar situation could occur with transfers under Section 171 TCGA 1992 between UK group companies. If the assets involved are situated abroad and the foreign tax authority taxes the UK company making the transfer, the benefit of that tax can be taken by the transferee group company when there is a disposal outside the group generating a UK tax charge on the relevant asset."

10 The former International Tax Handbook para 619 explains the point more clearly: "An example of this situation is found in Section 140 TCGA 1992 which deals with the charge on capital gains where a branch or agency overseas is domesticated, that is to say transferred to a non-resident company in exchange for shares. In those circumstances a charge on the gains on branch assets transferred is deferred until either the transferor sells the shares or the transferee sells the assets (in the latter case the sale has to be within six years of the acquisition). In that latter instance where the transferee sells the asset, any foreign tax on the gains is paid by the transferee. But the UK company is charged in respect of the capital gains on those same assets and qualifies for credit relief because the gain has been taxed abroad, although the tax has actually been charged on the transferee."

(iv) Overseas tax is payable by reference to increases in the value of assets although there has been no disposal. There is a subsequent disposal of the assets on which a liability to UK tax arises.

5 It will be seen that relief is conditional upon the subject of the overseas tax being identified with the gains on which the UK tax liability arises. In contrast, where roll-over relief is claimed, for example under TCGA 1992 s 152, the gain on disposal of the old asset is not subjected to UK tax. The gain on realisation of the new asset remains a gain separate from that realised on sale of the old asset and overseas tax payable as a result of the sale of the old asset is not creditable against UK tax payable on the gain realised on sale of the new asset. However, in such circumstances [s.113 TIOPA] allows the overseas tax to be claimed as a deduction in computing the gain for roll-over relief purposes.

This raises the issue of characterisation.

59.2 Characterisation

DT reliefs provide relief for particular types of income, and so relief only applies if the taxpayer receives that type of income. The characterisation of income in the hands of the UK taxpayer is a central question. I refer to this as "**the characterisation issue**".

Hughes v Bank of New Zealand[11] concerned exemption for interest on FOTRA securities, not a DTA, but the characterisation issue is not restricted to DT reliefs: it can arise wherever an exemption applies to a particular type of income. This case concerned a non-resident bank with a UK branch. The branch's profits were taxable. The branch's trading receipts included interest from FOTRA securities (exempt from UK tax in the hands of a non-resident). The interest retained its exemption.[12] Lord Millett summarised:

> [*Hughes*] is authority for the proposition that exempt interest retains its character as interest even when it is taxable as a component element of the recipient's trading profits. ... Interest from exempt securities does not cease to be such by being included as a component element of the recipient's taxable profit.[13]

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11 21 TC 472.

12 The law has changed and nowadays the FOTRA exemption is restricted so as not to apply in this type of case. But that does not alter the general principle.

13 *Bricom v IRC* 70 TC 272 at p.290.

On the other side of the line, according to Lord Millett, is *IRC v Australian Mutual Provident Society*.[14] This concerned a non-resident life assurance company with a UK branch. The branch's profits were taxable. The taxable profits were calculated in an unusual way: the relevant rule provided that an unidentifiable portion of the world-wide income of the company derived from the investment of its life assurance fund, calculated in accordance with a mathematical formula, should be charged to tax as income derived from business in the UK. It was held that the rule did not tax the company's investment income as such but something different, described as "a conventional sum calculated in accordance with the rule"; the sum to be taxed was not interest, even though interest from FOTRA securities constituted one of the elements in the calculation.

Millett LJ summarised:

> ... the question turns on the nature of the statutory process... where tax is charged on a conventional or notional sum which exists only as the product of a calculation, the fact that one of the elements in the calculation is measured by reference to the amount of exempted income does not make the exempted income the subject of the tax: *Australian Mutual Provident Society*.[15]

The characterisation issue often arises in cases where indirect DTA exemption is sought (though it is not restricted to such cases). Assuming the income in the hands of the treaty-resident recipient third party qualifies for DT relief, is the income which the UK taxpayer receives (or better, is deemed to receive) the *same* income? Or has the income "changed its character" (in which case DT reliefs do not apply)?

IRC v Willoughby offers an example. Here the transferor ("T") paid a premium to a life assurance company which was treaty-resident in the Isle of Man. Under s.720 T was (in principle) subject to tax on the income arising to the life assurance company from the premium. The IOM DTA provided relief for the commercial profits of the life assurance company; but the income on which T was subject to tax could not be characterised as the commercial profits of the life assurance company; T's income was merely one (in the context of the whole, trivial) element by reference to which those profits were computed. So for this reason (there could be

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14 28 TC 388 "as explained by Lord Radcliffe" in *Ostime v Australian Mutual Society* [1960] AC 459 at p.479, 38 TC 492.

15 *Bricom v IRC* 70 TC 272 at p.290..

others) T could not claim indirect DTA exemption.[16]

59.2.1 *The correct approach to characterisation*

Suppose:

(1) Income accrues to A ("A's actual income").

(2) A statutory provision ("the deeming provision") provides that income is deemed to accrue to B ("B's deemed income").

The deeming provision may or may not change the character of the income, that is, B's deemed income may or may not be a different type from A's actual income. It is a question of construction of the deeming provision.

The question is similar to the question of whether an entity is classified as transparent or opaque[17] but here the focus is on the deeming provision rather than on the nature of the entity.

In straightforward cases, where B's deemed income is exactly equivalent to A's actual income, it is suggested that the courts should normally conclude that the legislation does not change the character of the income. That is, if there is a change in the character of the income, the legislation needs to say so expressly or by implication. One reason that this is the case is that otherwise there would be a breach of the treaty. If a DTA provides income is exempt, Parliament may breach the treaty in a straightforward manner and provide that the income is still taxable. Parliament may also breach the treaty in a more subtle manner, by recharacterising the income and taxing it under its new name. However that is still a breach of the treaty. DTAs are not construed so technically. While the UK can breach a treaty, tax legislation should be construed in a treaty-consistent manner where possible.

A second reason is that in a simple case where B's deemed income is exactly equivalent to A's actual income, there is no rational distinction to be drawn between A's income and B's deemed income.

This is consistent with a purposive approach. Lord Steyn said:

> The tendency should therefore generally speaking be against literalism. What is literalism? It will depend on the context. But an example is given in The Works of William Paley... the tyrant Temures promised the

16 Though this is not quite the way that the Special Commissioner dealt with the point: 70 TC 57 at p.90. The taxpayer wisely did not appeal on the DTA issue.

17 See 84.2 ("Transparent" and "opaque").

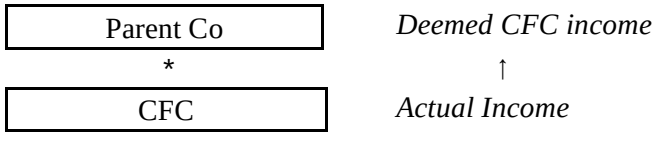
> garrison of Sebastia that no blood would be shed if they surrendered to him. They surrendered. He shed no blood. He buried them all alive. This is literalism. If possible it should be resisted in the interpretative process.[18]

It is worth stepping back to remember that the purpose of double tax treaties is to allocate taxing rights between countries.

59.2.2 *Bricom*

Bricom v IRC concerned a claim for indirect DT exemption where:

(1) Income accrued to a subsidiary company treaty-resident in a foreign state ("the CFC").
(2) The parent company ("the parent") was domestic-law UK resident and not treaty-resident in a foreign state.
(3) The parent was subject to tax under the Controlled Foreign Company ("CFC") provisions.



The CFC provisions operate in three stages:

> Stage 1. *Ascertainment:* the CFC's chargeable profits are ascertained.
> Stage 2. *Apportionment:* the CFC's chargeable profits (less any creditable tax) are apportioned among its shareholders. In *Bricom* the CFC was a wholly-owned by the parent, so all its chargeable profits were attributed to the parent.
> Stage 3. *Assessment:* The parent is assessed on "a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits" (less the apportioned amount of creditable tax) and the sum assessed is recoverable from the parent "… as if it were an amount of corporation tax chargeable on the parent".

The Special Commissioners held that interest received by the CFC lost its character as interest at stage 1. Millett LJ disagreed:

> It is ... a reflection of the Revenue's unsuccessful argument in *Hughes,*

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18 *Sirius International Insurance v FAI General Insurance* [2004] 1 WLR 3251 at [19]. But for a defence of Temures see Goldberg, "The Problem is the Perception" GITC Review Vol. 4 No. 2 accessible *http://www.taxbar.com* ("Of course, the garrison should have been advised by a lawyer before accepting the surrender terms.")

> viz: that interest from exempt securities loses its character as income by being included in the computation of the recipient's trading profits.

So far so good. But the interest lost its character at stage 2:

> The correct analysis is that the interest received by [the CFC] is not included in the sum apportioned to the taxpayer on which tax is chargeable. It merely provides a measure by which an element in a conventional or notional sum is calculated, and it is that conventional or notional sum which is apportioned to the taxpayer and on which tax is charged. ...

Bricom was on the wrong side of the distinction because "the chargeable profits" as defined by s.747(6)(a) are *a notional sum.* Why are they more notional than the profits of any company?

> They do not represent any profits of [the CFC] on which UK corporation tax is chargeable, for there are no such profits.

Obviously correct, but not relevant. The question is not whether the CFC income of the parent represents profits of the CFC *on which UK corporation tax is chargeable*. The question is whether it represents the profits of the CFC (or more accurately, whether its type is the same as those profits). The judgment then turns to this:

> Nor do they represent any actual payments or receipts of [the CFC], whether of interest or anything else.

Why not?

> They are merely the product of a mathematical calculation made on a hypothetical basis and making counterfactual assumptions.[19] The "chargeable profits" which are defined by s.747(6)(a) exist only as a measure of imputation. What is apportioned to the taxpayer and subjected to tax is not [the CFC's] actual profits but a notional sum which is the product of an artificial calculation.

The mere fact that taxable profits are ascertained by a mathematical calculation does not by itself change the character of the profits. The amount of profits on which tax is charged is in every case the product of a mathematical calculation.[20]

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19 Millett wisely does not state what the hypothetical and counterfactual assumptions are: one must assume that the CFC is UK resident.

20 For CGT the tax charge is on gains less losses; for IT the charge is on total income.

Bricom is authority for the following propositions:

(1) The application of DT reliefs requires that the income of the taxpayer is the same income as that which qualifies for relief. (This is right and could not be doubted.)

(2) The characterisation issue is a matter of construction of the relevant provisions.

(3) The CFC provisions specifically did alter the character of the income received by the parent.[21] This decision does not, it is submitted, shed a great deal of light on the question of construction of the other provisions considered in this chapter.

One would like to think that the unfairness of *Bricom* was a factor in the ECJ decision that the CFC legislation was contrary to EU law.[22] That would have been just.

59.2.3 *Four types of deeming*

Tax provisions often use the word "deem" or its plain English equivalent, "treated as". When considering the characterisation issue in relation to deeming provisions, it is important to bear in mind that there are several different fictions that deeming provisions may be used to achieve:

(1) *Deeming which changes the recipient:* Statute may deem that whereas income actually arose to A, it is deemed to arise to B.

(2) *Deeming which changes the timing:* Statute may deem that whereas income actually arose at one time, it is deemed to arise at another time.

(3) *Deeming which changes quantum:* Statute may deem that whereas the amount of income which actually arose to A was £x, it is deemed to be of a different amount, £y.

(4) *Deeming which changes character:*
   (a) Statute may deem that whereas income which actually arose was of type A, the taxpayer is deemed to receive income of another type (type B).
   (b) Statute may deem that whereas what arises is gains, it is deemed to be income.

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21 I do not consider how convincing is the reasoning, but note that in France the opposite view was reached: *Re Société Schneider Electric* (2002) 4 ITLR 1077 (Conseil d'Etat).

22 See 60.5 (Public policy exemption to restriction on FoE).

(c) Statute may deem that whereas no income or gains arise to anyone, the taxpayer is deemed to receive income or gains.

Case (1) does not by itself change the character of the income. This is (I think) self-evident, but there is authority:

> Exempt income does not change its character or lose its exemption merely because it is deemed to be the income of another person or is imputed to him: *Strathalmond.*[23]

The same applies if the UK provision apportions income to the taxpayer: "apportion" has the same meaning as "deems to accrue to" or "impute".[24] The term "attribute" is also the same.[25]

Likewise in cases (2) and (3) DT reliefs will still apply.

In case (4)(a) DT relief applicable to type A income only (not type B income) will not exempt the taxpayer. Cases (4)(b)(c) need further consideration.

So the mere fact that the legislation uses the terminology or technique of deeming does *not* mean that DT reliefs cease to apply. One must ask what is the deeming, and in particular, is it deeming which changes the character of the income?

In *Huitson* the point is correctly stated but in somewhat pejorative language:

> [The DTA] issue has spawned a somewhat metaphysical debate as to whether the "notional" income under section 739 is different from the "real" income in the hands of the foreign resident, so that taxation of the "notional" does not conflict with relief of the "real".[26]

The debate should be no more metaphysical than any question raised by deeming provisions, which are very common in taxation, but it has perhaps been confused by an argument based on the words "an amount equal to".

59.2.4 *"An amount equal to" the income*

In Bricom:

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23 *Bricom v IRC* 70 TC 272 at p.290.

24 *Bricom v IRC* 70 TC 272 at p.290.

25 The terms "apportion" and "attribute" are used synonymously in s.13 TCGA; see 53.3 (Attribution of s.13 gains to participator).

26 *R oao Huitson v HMRC* [2010] STC 715 at [64]. The point was not discussed in the Court of Appeal.

> The taxpayer lays stress on the fact that what is apportioned under s.747(3) is not "a sum equal to the chargeable profits" but the chargeable profits themselves; and that the subject of the charge to tax in s.747(4)(a) is not "a sum equal to the apportioned part of the chargeable profits" but the apportioned part of the chargeable profits itself.

The distinction proposed is between statutory provisions referring to "the profits" provisions referring to "an amount equal to the profits." The taxpayer (it seems) raised this distinction but it did not help. The characterisation of income may be altered even though the statute does not use the expression "an amount equal to". That is, the absence of that expression does not determine the characterisation issue. Conversely, the use of the expression "an amount equal to" does not conclude the characterisation issue. While it is apt to describe a change of character, it does not necessarily do so. The issue is one of construction, and must be decided in the context of the provisions as a whole. I identify below some cases where this phrase is used without changing the character of the income. Indeed, a distinction between income and "an amount equal to" the income strikes me as a distinction without a difference, a foolish distinction to introduce into tax jurisprudence, which is bound to lead to confusion, muddle and uncertainty.

59.3 DT reliefs and gains of remittance basis taxpayer

After this lengthy theoretical discussion, we can turn to some practical questions. Section 12 TCGA provides:

> (1) This section applies to foreign chargeable gains accruing to an individual in a tax year ("the foreign chargeable gains") if—
>
> (a) section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the individual for that year, and
>
> (b) the individual is not domiciled in the UK in that year.
>
> (2) Chargeable gains are treated as accruing to the individual in any tax year in which any of the foreign chargeable gains are remitted to the UK.
>
> (3) The amount of chargeable gains treated as accruing is equal to the full amount of the foreign chargeable gains so remitted in that year.

Art.13(5) OECD Model provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a [treaty-resident].

Suppose:

(1) a remittance basis taxpayer is domestic-law UK resident and treaty-resident in a state with a standard capital gains article.

(2) the taxpayer receives gains which are in principle subject to CGT.

Can the individual claim DT relief? This raises a characterisation issue. (The individual is not claiming indirect treaty relief but as noted, the characterisation point is not restricted to that.) However, everyone agrees that DT exemption applies to gains taxable on the remittance basis. Section 12(2) TCGA imposes a deeming which changes timing, that is, the gains which actually accrue on disposal are deemed to accrue when remitted. Section 12(3) imposes a deeming which changes the amount. The character of the gains is not altered. That is, the chargeable gains which are "treated as accruing" are the actual gains which accrued to the individual, and not different (notional) gains.

59.3.1 *Timing: Interaction with remittance basis*

DT relief requires in principle that the alienator is treaty-resident in the foreign state at the time the gain accrues.[27] What if the gain is a foreign gain of a remittance basis taxpayer? The gain is deemed to accrue at the time that the gain is remitted. If that deeming applies for DT purposes, then odd consequences would follow. In the following examples, assume that foreign gains accrue to a remittance basis taxpayer who is domestic-law UK resident throughout. Suppose two cases:

(1) The individual is not treaty-law resident in a foreign state when the gains accrue but is treaty-law resident when the gains are remitted.

(2) The individual is treaty-law resident in a foreign state when the gains accrue but is not treaty-law resident when the gains are remitted.

If the timing rule applies for DT purposes, DT relief applies in case (1) and not in case (2). That is absurd. It would often lead to double taxation or double non-taxation. So it is considered that the timing rule does not apply for DT purposes, so DT relief can apply in case (2) but not in case (1).

59.4 DT reliefs: s.624 ITTOIA

This section considers the position of a settlor-interested trust whose settlor is domestic-law UK resident. There are four states potentially

27 *Smallwood v HMRC* [2009] STC 1222.

involved:
(1) the state where the settlor is resident (here assumed to be the UK)
(2) the state where the trustees are resident
(3) the state where a beneficiary is resident
(4) the state where the source of the income arises

Thus there are many ways s.624 could lead to double taxation. In addition to the settlor's UK tax liability under s.624:
(1) The trustees may be subject to foreign tax in another state
    (a) on income with a source in that state
    (b) on any income if they are resident in that state.
(2) In the case of an IIP trust, the life tenant may be subject to foreign tax in another state
    (a) on income with a source in that state
    (b) on any income if they are resident in that state.

59.4.1 *Foreign tax credit relief*

Where trust income is subject to a foreign tax, foreign tax credit relief in principle applies for the benefit of a settlor within s.624. That follows from first principles but if authority were needed, see s.623 ITTOIA.[28] HMRC agree. The TSE Manual provides:

> **TSEM4017 - Calculation of Income - S623 ITTOIA** [April 2010]
> Section 623 ITTOIA allows the settlor 'the same deductions and reliefs' the settlor would have been entitled to had the settlor actually received the income. Thus reliefs which can only be set against a particular type of income, such as a credit under a DTA for foreign tax suffered by the trustees on foreign source income, is available to the settlor even though the charge on the settlor is under Part 5 of ITTOIA ('Miscellaneous Income').

The INT Manual considers the position where a beneficiary is taxed in the UK and a settlor is taxed in some other country under a foreign equivalent of s.624:

> **161040. Same income** [January 2011]
> The credit Article in an agreement and the corresponding provision for unilateral relief in s.9 TIOPA 2010 are concerned with relief from double taxation on income or gains. For credit to be allowed, it is not a requirement that the foreign tax on income or gains has to be borne by

28 See 27.2.7 (Settlor's deductions and reliefs).

> the same person who is liable to UK tax on the same income or gains. For example, if the foreign country taxes a settlor on the income of a UK resident beneficiary, who is chargeable to UK tax on that income, credit may be given to the beneficiary for the foreign tax paid by the settlor. However, it must be the same income which is being taxed in both countries. ...

59.4.2 *Trustees treaty-resident outside UK*

This section considers whether DT exemptions are available where:

(1) income accrues to a settlor-interested trust whose trustees are treaty-resident in a foreign state.

(2) the settlor is not treaty-resident in a foreign state.

The settlor is subject to tax under s.624. It is considered that the settlor can claim indirect DT exemption.

Section 619 and 624 ITTOIA must be read together:

> **619(1)** Income tax is charged on ... (a) income which is treated as income of a settlor as a result of section 624 (income where settlor retains an interest) ...
>
> **624(1)** Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone...

Section 624 imposes a deeming which changes the recipient, that is, the income which actually arises to the trustees is deemed to accrue to the settlor. The character of the income is not altered. That is, the income which is "treated as the income of the settlor" is the actual income of the trustees, and not different (notional) income.[29]

It follows that the settlor can in principle claim indirect DT exemption provided that the income is of a type which qualifies for DT relief.

Why in fact is there a charge to tax under s.619? If the settlor is treated as receiving (say) interest income, the income would be chargeable to tax under the charging provisions relating to interest. No separate charge to tax is needed. The drafter is in my view slightly muddled as to whether the income of the settlor is the settlement income or notional income. The confusion is understandable, for it is not rational to try to draw a distinction between the two, they amount to exactly the same thing.

It might be argued that since the income is deemed to be the income of the settlor and of the settlor alone, it is deemed not to be the income of the

---

29 See 59.1.1 (Third party claiming DT exemption).

trustees, so the deeming disapplies the DT exemption. But that construction would put the UK in breach of the treaty, so it should not be regarded as correct. In any case, in the HMRC view, s.624 is not a defence to trustees from an assessment.

59.4.3 *Settlor treaty-resident outside UK*

This section considers whether DT exemptions are available where:

(1) income accrues to a settlor-interested trust whose trustees are not treaty-resident in a foreign state (so the settlor cannot claim indirect treaty relief).

(2) The settlor is treaty-resident in a foreign state.

The settlor is in principle subject to tax under s.624. It is considered that the settlor can claim DT exemption directly.

In some cases, DT exemption only applies if the income is "beneficially owned" by the settlor. In the case of a common form settlor-interested discretionary trust, the income is not "beneficially owned" by the settlor as a matter of English property/trust law. But since for tax purposes it is deemed to be the income of the settlor, this requirement is deemed to be satisfied. The OECD Commentary is helpful here:

> 12 ... The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.[30]

In the US/UK DTA, this is expressly dealt with: see 59.16.1 (Section 624, 720 income; s.13, 86 gains).

59.4.4 *HMRC view*

The TSE Manual provides:

> **3665. Relief for overseas tax: trust income deemed not to be the beneficiary's** [February 2006]
> For tax purposes, income may be deemed to be that of someone other than a beneficiary. For example, the anti-avoidance provisions may treat trust income as that of the settlor. The trustees can claim tax credit relief on the income.
> If the trustees do not claim relief, the overseas income chargeable is the net amount after deduction of overseas tax.

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30 See 25.12.2 (Discretionary trusts: beneficial owners for DTA purposes).

The International Manual raises some of these questions but does not tell us what HMRC regard as the answers:

> **339550 - DT applications and claims: Applicants/claimants - Trusts** [December 2011]
>
> ***Claims by non-resident trustees of discretionary trusts***
>
> You may receive a claim or application from non-resident trustees of a discretionary trust. For specific information about claims by non-resident trustees see the country specific pages. If the trust's entitlement to claim is not clear from previous papers, you will need to ask for details of the trust to establish whether relief is due. The necessary information is requested on the form 4467(trustee)/FD.
>
> ***What to do if the settlor of a discretionary trust is not excluded from benefit under the trust***
>
> Where the settlor of a non-resident discretionary trust is not excluded from benefit under the trust, the trust may be subject to the provisions of ICTA88/S660. In this situation the trust may be described as a 'caught settlement'. The settlor will be chargeable on the income of the trust as their own personal income, regardless of whether the income is accumulated or distributed.
>
> Where we have a claim or application from trustees of a discretionary trust from which the settlor is not excluded from benefiting, Specialist Personal Tax, PT International Advisory will need to refer the papers to Specialist PT, Trusts & Estates for advice. They will also consider whether the settlor or the trustees need to make a UK tax return.
>
> If the settlement is caught, a claim by the trustees will not be valid.
>
> (This text has been withheld because of exemptions in the Freedom of Information Act 2000)

59.5 DT reliefs: s.720 ITA

59.5.1 *Foreign tax credit relief*

Where income of the person abroad is subject to foreign tax, foreign tax credit relief in principle applies for the benefit of the transferor. That follows from first principles but if authority were needed, see s.746 ITA.[31]

Helpsheet 262 (income and benefits from transfers of assets abroad) 2013/2014 provides:

> **What if tax has been paid on the income?**

31 See 27.2.7 (Settlor's deductions and reliefs); 29.10.4 (Transferor's deductions and reliefs).

If the amounts included in boxes 11 and 13[32] of the Foreign pages include tax credits or other tax paid on the income of the person abroad, then you may be able to claim a deduction against your liability for that tax. You will only be entitled to relief for the tax paid by the person abroad if it is in effect tax on 'the same' income, and only to the extent that the tax has actually been paid by, and not refunded to, the person abroad. You should include the amount of tax for which you can claim relief in Column C and you should also include it in box 2 of the Foreign pages. You should note Column E of your claim. In addition, you should send a schedule with the Foreign pages, showing the amount of each item of income, and tax credit/tax paid on that income, which has been included in boxes 11 and/or 13, and Column C.

If the tax for which you are claiming relief is foreign tax, for which you wish to claim Foreign Tax Credit Relief (see page FN 3 of the Foreign notes) the details you enter on the schedule should include:

Column A – Country or territory code

Column B – Amount of income arising or received before any tax taken off

Column C – Foreign Tax taken off or paid

Column E – That you wish to claim Foreign Tax Credit Relief and the rate of tax allowed (see page FN 3 of the Foreign notes)

Column F – Amount included in box 11 and/or box 13 which should be the amount arising before any tax taken off.

In the event that you do not wish to claim Foreign Tax Credit Relief for foreign tax, you should not make an entry should be made in Column E and the amount you include in box 11 and/or box 13 should be the income after foreign tax. ... If you do not yet know the final amount of tax paid by the person abroad, you should estimate the amount of credit available and amend your tax return when the final details are known. You must draw attention to the estimate and explain the circumstances in the 'Any other information' box, box 19, of your tax return. If any additional tax becomes payable as a result of using an estimate the usual provisions for charging interest on tax paid late will apply.

If the income on which you are liable to tax under these provisions is a 'foreign dividend', then you may be entitled to a non-payable UK tax credit (see page FN 7 of the Foreign notes).

59.5.2 *Person abroad treaty-resident outside UK*

This section considers whether DT exemptions are available where:

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32 The boxes in which s.720 income is entered.

(1) Income accrues to a person abroad who is treaty-resident in a foreign state.
(2) The transferor is domestic-law UK resident and not treaty-resident in a foreign state.
(3) The transferor is in principle subject to tax under s.720.[33]

Under the pre-ITA wording, the s.739 ICTA deemed income of the transferor was the same as the income of the person abroad.[34] It follows that the transferor could in principle claim DT exemptions provided that the income qualified for the relief.[35]

The same applied to under ITA in its pre-2013 form, though that was not the official HMRC view.[36]

The changes in the FA 2013 were intended to disassociate the s.720 income of the transferor from the income of the person abroad. Now that the income of the person abroad is distinct from the (deemed) s.720 income of the individual, treaty relief has ceased to be available.

EN FB 2013 provides:

> 57. Finally there is a change that clarifies how the transfer of assets rules operate in relation to reliefs under double taxation agreements. This will make it clear that neither a treaty provision nor the transfer of assets legislation can allow a relief that would not otherwise be due.

The word "clarify" (like "modernise") is a convenient cloak to disguise changes. If a reform is said to be a clarification, there is unlikely to be much debate. Who could object to clarification? In fact there was a change of law, and the substantial rewriting of the TAA rules required to achieve it has left the statutory wording more complicated, and difficult to follow. Since the object was simply to deny DT relief where the person

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33 Similar points apply to s.727; see 29.11.1 (Nature of s.727 charge).

34 This was view for which *HMRC* argued, and which was accepted by the Special Commissioners, in *Carvill v IRC* [2000] STC (SCD) 143, 75 TC 477 at [100] - [102].

35 See the quote from 29.10.1 (Power to enjoy part of income of person abroad). Goy agrees: "Double Tax Treaties and ss.739 and 740 ICTA 1988", GITC Vol. V no.2, accessible *http://www.taxbar.com*. See too Venables, "Double Taxation Treaties: the Antidote to Anti-avoidance Provisions" (1996) OTPR Vol. 6 p.151, accessible *http://www.khpplc.co.uk/reviews*
It appears in *R oao Huitson v HMRC* [2010] STC 715 at [61] that HMRC tacitly accepted this and I think *Huitson* was broadly supportive. The issue was not considered in the Court of Appeal.

36 See the 2012/13 edition of this work.

abroad was treaty non-resident, why did the drafter not just say so? The reasons were, perhaps, first, to disguise a treaty breach; and second, to support the facade that that was the position before 2013.

59.5.3 *Transferor treaty-resident outside UK*

This section considers whether DT reliefs are available where:

(1) income accrues to a person abroad who is not treaty-resident in a foreign state
(2) the transferor is domestic-law resident in the UK but treaty-resident in a foreign state
(3) the individual is in principle subject to tax under s.720.

As the person abroad is not treaty-resident in a foreign state the transferor cannot claim indirect treaty relief. Can the transferor claim DT exemptions directly? Assuming it is correct that s.720 income is distinct from the income of the person abroad, the transferor may do so under the "other income" article, regardless of the type of income which accrued to the person abroad; even if, say, the income of the person abroad is of a type which would not normally qualify for DT exemption.[37] If that were not correct, the DT exemption is available if the type of income of the person abroad qualifies for the exemption.

In some cases DT exemption only applies if the income is "beneficially owned" by the transferor. The point is the same as for s.624.[38] In a s.720 case the income is not "beneficially owned" by the transferor as a matter of property law. But since for tax purposes it is deemed to be the income of the transferor, this requirement is deemed to be satisfied.

In the US/UK DTA, this is expressly dealt with: see 59.16.1 (Section 624, 720 income; s.13, 86 gains).

59.6 DT reliefs: s.731 ITA

59.6.1 *Person abroad treaty-resident outside UK*

This section considers whether DT reliefs are available where:

(1) income accrues to a person abroad who is treaty-resident in a foreign state
(2) an individual (not the transferor) is domestic-law resident in the UK and not treaty-resident in a foreign state

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37 See 59.6.2 (Individual treaty-resident outside UK).

38 See 59.4.3 (Settlor treaty-resident outside UK).

(3) the individual is in principle subject to tax under s.731.

DT exemption is not applicable for s.731 ITA. ITA EN provides:

> 2170. The method statement [s.733 ITA 2007] makes it clear that "relevant income" in relation to an individual is not actually taxable income of the individual, but is an element in the calculation of taxable income. "Relevant income" is actual income arising to a person abroad; the income charged under section 731 is income treated as arising to the individual in question. This deemed income may be more or less than "the relevant income of the tax year" in relation to the individual and the tax year identified at Step 3.

The ToA draft guidance makes the same point:

> **INTM601700 The measure of the benefits charge**
> The benefits charge is a charge on 'income treated as arising' to the individual and it is a charge by reference to the amount treated as arising. Whether income is treated as arising and if so the amount of it is determined by application of a formulaic approach which, in effect, compares benefits received by the individual with the income of a person abroad that can be used for providing a benefit (the relevant income of the tax year). This is not a charge on the actual income of the person abroad nor on the benefits received rather an amount determined by comparison of both elements over time.

Section 731 may be regarded as a charge on a benefit, or a charge on fictional income, but it is not a charge on the income arising to the person abroad.

There is no foreign tax credit relief. However, income used to pay foreign tax is not relevant income as it cannot be used to benefit a beneficiary.

59.6.2 *Individual treaty-resident outside UK*

This section considers whether DT reliefs are available where:

(1) an individual (not the transferor) is domestic-law UK resident and treaty-resident in a foreign state

(2) the individual is in principle subject to tax under s.731.

Can the individual claim treaty relief directly? It is considered that exemption is available under OECD Model Art.21(1) (other income):

> Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be

taxable only in that State.[39]

Most UK treaties restrict this relief by adding: *other than income paid out of trusts or the estates of deceased persons in the course of administration*. That exclusion does not prevent relief for s.731 income. It has an entirely different purpose.[40] S.731 income is fictional income and not "paid out of trusts" even if relevant income accrues to a trust.

Some DTAs restrict this relief to income *beneficially owned* by a resident of a Contracting State.[41] That restriction does not prevent relief for s.731 income for one of two reasons:

(1) As a matter of property law, s.731 deemed income is not "beneficially owned" by the individual or anyone else: it is fictional income which does not exist. But since for tax purposes it is deemed to be the income of the individual, this requirement is deemed to be satisfied.[42]
(2) Section 731 deemed income is "beneficially owned" by the individual because s.731 is a tax by reference to a benefit which is beneficially owned by the individual.[43]

Suppose s.731 income arises where a beneficiary enjoys the benefit of occupying land in the UK. Article 6 OECD Model provides (so far as relevant):

> 1. Income derived by a resident of a Contracting State from immovable property ... situated in the other Contracting State may be taxed in that other State...
> 3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property

It is considered that s.731 income is not "income derived from immovable property" even if the charge is by reference to the occupation of UK land.

59.7 DT relief: s.13 TCGA

In the following discussion I use the following terms to distinguish

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39 See Wattel & Marres, "Characterization of Fictitious Income under OECD-Patterned Tax Treaties", 43 European Taxation 3 (2003), p.66.

40 See 25.11.2 (DTAs with restrictions on "other income" article).

41 Eg art.22 US/UK DTA.

42 See 30.12.1 (Benefit giving rise to s.731 charge in year of receipt).

43 This point is the same as for s.624. See 59.4.3 (Settlor treaty-resident outside UK).

between types of company residence:[44]

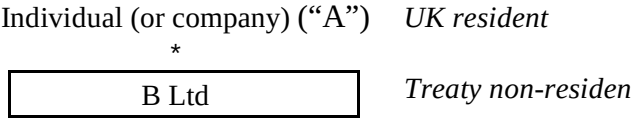
Type of residence	**Domestic-law UK resident**	**Treaty-resident in State with DTA with CG article**
Treaty non-resident	No	Yes
Simple non-resident	No	No
UK resident	Yes	No

In this terminology, for instance, a Jersey resident company is *simple* non-resident (the Jersey/UK DTA has no CG article) but a Luxembourg resident company is *treaty* non-resident.

I assume the company is close and so in principle within s.13 TCGA.

59.7.1 *Company treaty non-resident*

Suppose an individual (or a company) owns a treaty non-resident company which realises a gain:



Section 13(2) TCGA provides that A:

> shall be treated for the purposes of this Act as if a part of the chargeable gain had accrued to him.

The sidenote to s.13 calls this "attribution" of gains. The text of s.13 refers to gains "apportioned" to participators. Section 13(10A) TCGA (repealed) used the words "treated as".[45] It all comes to the same thing. This is a deeming which changes the recipient, and the s.13 gain treated as received by A is the same gain as the gain actually received by B Ltd. A can claim DT relief for gains accruing to B Ltd (deemed to accrue to A) under s.13 TCGA.

HMRC agree. The CG Manual provides:

> **57380 Double taxation agreements** [April 2011]
> You should always check whether there is a double taxation agreement

44 A treaty non-resident company must be domestic law non-UK resident so it is not necessary to consider the position of a company which is UK resident but treaty-resident outside the UK.

45 Section 13(10A) provided: *A gain which is treated as accruing to any person by virtue of this section shall not be eligible for taper relief.*

> between the UK and the country in which the company making the gain is resident. If there is no double taxation agreement any TCGA 1992, s.13 charge is unaffected. Similarly if the agreement does not refer to capital gains or CGT the charge under TCGA 1992, s.13 is unaffected. But, if the agreement provides that gains of the type realised by the non-resident company are only taxable in that company's country of residence TCGA 1992, s.13 cannot apply. For example, Article 15(4) of the Kenya/UK Double Taxation Agreement[46] would prevent TCGA 1992, s.13 applying to the disposal of stocks and shares by a company resident in Kenya. Agreements will often treat gains on the disposal of particular types of asset differently.[47]

The FA 2008 introduced new terminology. Section 14A(2) TCGA provides:

> The part of the chargeable gain treated as accruing to the individual *("the deemed chargeable gain")* is a foreign chargeable gain within the meaning of section 12 if (and only if) the asset is situated outside the UK.

This does not alter the DTA position: the expression "deemed chargeable gain" does not show that the gain changes its character. The wording reflects the deeming which changes the recipient and in that sense the s.13 gain accruing to the participator can be called a deemed gain. The

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46 The Kenya/UK DTA follows the OECD Model, so what is stated here of Kenya is generally true for DTAs which have a capital gains article.

47 Likewise INT Manual provides:

> **169060 Resident shareholders in non-resident companies - Section 13 TCGA 1992** [September 2011]
>
> This Section enables the UK, in certain circumstances, to tax a UK resident in respect of gains made by a non-resident company in which he is a shareholder (participator where the gains accrue on or after 28 November 1995 - Section 174 FA 1996)(see CG57200 onwards). However the Capital Gains Articles in double taxation agreements may override it.
>
> If the non-resident company disposes of immovable property; for example, land, buildings etc, in the UK, double taxation agreements normally provide that any gain can be taxed in UK. Although UK domestic law may prevent a capital gains tax charge on the non-resident company (see Section 10 TCGA 1992), Section 13 TCGA 1992 can be applied to tax the UK resident shareholder.
>
> If the asset disposed of is not immovable property in the UK; for example, immovable property situated outside the UK, shares etc, then the Capital Gains Article will normally prevent a charge to tax under Section 13 TCGA 1992 being made on the shareholder...

character of the gain is not altered. That is, the gain deemed to accrue to the participator is the actual gain accruing to the company, and not a different (notional) gain.

The wording does perhaps suggest that the drafter was not conscious of the distinction between the actual gain and an equivalent notional gain, but that is understandable since it is a distinction without a difference.

59.7.2 *Non-standard form DTAs excluding s.13 relief*

The INT Manual correctly states:

> **169060 Resident shareholders in non-resident companies - Section 13 TCGA 1992** [September 2011]
> ... The text of the Capital Gains Article in the agreement with the country concerned will need to be examined to see whether there are any variations from the general principles outlined above...

For instance, article 14(6) France/UK DTA qualifies the CG article:

> The provisions of paragraph 5 shall not affect the right of a Contracting State to levy according to its law a tax chargeable in respect of gains from the alienation of any property
> [a] on a person who is, and has been at any time during the previous six fiscal years, a resident of that Contracting State or
> [b] on a person who is a resident of that Contracting State at any time during the fiscal year in which the property is alienated.

This would preclude DT relief for a participator in a company resident in France (though the EU law defence would usually fill that gap).
This is found in many modern DTAs.[48]

If the current policy is to exclude s.13 gains from new treaties, it is misguided. It is illogical for a treaty to provide CGT exemption but not s.13 exemption. If the foreign state does not tax chargeable gains, there should be no CG exemption at all. If it does, exemption should extend to s.13. But there it is.

59.7.3 *Participator treaty non-resident*

Suppose an individual who is domestic-law UK resident but treaty non-resident owns a simple non-resident company which realises a gain:

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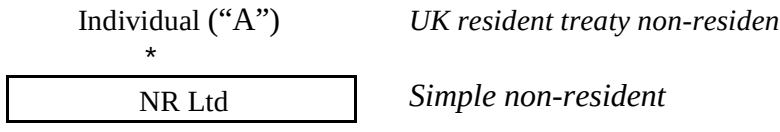
48 Australia, Botswana, Canada, Chile, Faroes, Georgia, Japan, Libya, Macedonia, Mauritius, Moldova, Netherlands, New Zealand, Poland, Saudi Arabia, Slovenia, Switzerland.



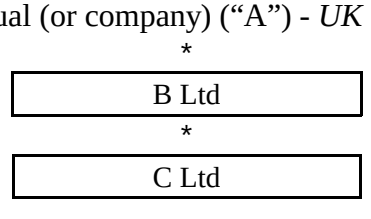
The gain treated as received by A is the same gain as the gain received by NR Ltd. But art.13(5) OECD Model provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the *alienator* is [treaty-resident].

On a literal reading, A does not qualify for treaty relief on a gain accruing to NR Ltd. A (though treaty non-resident) is not the alienator. NR Ltd is the alienator but (on the facts of this example) NR Ltd is not treaty resident in the foreign state which confers DT reliefs. So the terms of art.13(5) are not satisfied. The US treaty is wider and DT exemption applies to individuals who are treaty-resident in the US.[49] Even under the OECD Model, the same result is arguable on the grounds that the gain is treated as accruing to A, so A should be deemed to be the alienator; or the word "alienator" does not require that one must alienate property, only that the gain on the alienation accrues to the person.

59.7.4 *Chain of companies*

Suppose there is a chain of companies:



Suppose a gain accrues to C ("C's gain"). We have the following possibilities:

	Case 1	**Case 2**	**Case 3**
B Ltd	UK resident	simple non-resident	treaty non-resident
C Ltd	treaty non-resident	treaty non-resident	simple non-resident

Case 1: If B Ltd is UK resident, and C Ltd is treaty non-resident:

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49 See 59.16.1 (Section 624, 720 income; s.13, 86 gains).

(1) C's gain is deemed to accrue to B Ltd; B Ltd may claim DT relief, as noted above.
(2) A does not need to claim relief, as
  (a) C's gain is not deemed to accrue to A under s.13(9) and
  (b) apparently C's gain is not deemed to accrue to A under s.13(2) (but if it did, DT relief would be available.)

Case 2: If B Ltd is simple non-resident and C Ltd is treaty non-resident, C's gain in principle accrues to A. Section 13(9) TCGA provides:

> [a] If a person who is a participator in the company at the time when the chargeable gain accrues to the company is itself a company which
> [i] is not resident in the UK but which
> [ii] would be a close company if it were resident in the UK,
> [b] [i] *an amount equal* to the amount apportioned under subsection (3) above out of the chargeable gain to the participating company's interest as a participator in the company to which the gain accrues
> [ii] shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators, and
> [c] subsection (2) above shall apply to them accordingly in relation to the amounts further apportioned,
> [d] and so on through any number of companies.

HMRC accept that A can claim DT relief. This is so even though s.13(9) refers to "an amount equal to" the gain. The words do not show there is a change in the character of the gain (though they do perhaps show some confusion on the point).

Case 3: If C Ltd is simple non-resident, but B Ltd is treaty non-resident, C's gain is deemed to accrue to A, but A cannot claim DT relief.

59.7.5 *The future*

HMRC say:

> 2.21. Some double taxation agreements already provide that section 13 may apply to gains of an overseas company, but others make no specific provision. Where no such provision is present, current HMRC policy is to accept that section 13 is disapplied by any treaty that contains a provision similar to article 13(5) of the OECD Model convention. In those cases gains of the type realised by the non UK-resident company

are taxable only in that company's country of residence.

2.22. This practice will be reviewed alongside the amendments outlined in this Chapter and any further changes introduced as a result of this consultation.[50]

59.8 Disallowance of DT relief for trust participator

Section 79B TCGA provides:

> (1) This section applies where the trustees of a settlement are participators[51]—
>
> (a) in a close company, or
>
> (b) in a company that is not resident in the UK but would be a close company if it were resident in the UK...
>
> (2) Where this section applies, nothing in any double taxation relief arrangements shall be read as preventing a charge to tax arising by virtue of the attribution to the trustees under s.13, by reason of their participation in the company mentioned in subsection (1) above, of any part of a chargeable gain accruing to a company that is not resident in the UK.

Suppose a UK trust owns a treaty non-resident company which realises a gain:

Trust	*UK resident*
*	
TNR Ltd	*Treaty non-resident*

DT relief is disallowed under s.79B(1)(b) and the trustees are taxable.

Similarly if a non-resident trust within s.86 owns a treaty non-resident company which realises a gain: DT relief is disallowed under s.79B(1)(b) and the settlor is taxable.

I am unable to see the point of s.79B(1)(a). If the trustees are participators in a *close* company, gains accrue to that company and are not attributed to the trustees. I would be grateful if any reader could offer an explanation.

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50 HMRC Consultation Document *Reform of two anti-avoidance provisions* (July 2012) accessible *http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_032219*

51 Section 79B(1) provides: "For this purpose 'participator' has the same meaning as in section 13".

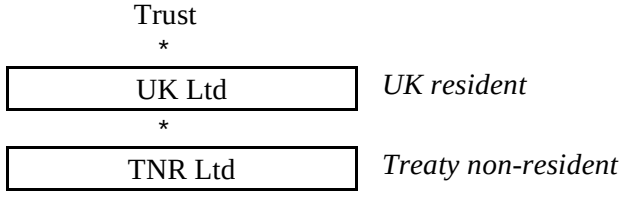
Section 79B(3) TCGA provides:

> Where this section applies and—
>
> (a) a chargeable gain accrues to a company that is not resident in the UK but would be a close company if it were resident in the UK, and
>
> (b) all or part of the chargeable gain is treated under section 13(2) as accruing to a close company which is not chargeable to corporation tax in respect of the gain by reason of double taxation arrangements, and
>
> (c) had the company mentioned in para (b) (and any other relevant[52] company) not been resident in the UK, all or part of the chargeable gain would have been attributed to the trustees by reason of their participation in the company mentioned in subsection (1) above,
>
> section 13(9) shall apply as if the company mentioned in para (b) above (and any other relevant company) were not resident in the UK.

Section 79B(3) addresses the more challenging case where:

(1) a trust owns a holding company ("UK Ltd") which is UK resident;

(2) UK Ltd holds a treaty non-resident subsidiary ("TNR Ltd"):



UK Ltd is not taxed under s.13 on TNR's gain as UK Ltd can claim DT relief. In the absence of s.79B(3), TNR's gain apparently cannot be apportioned to the trust under s.13(9) or s.13(2). The trust does not need DT relief. Section 79B(3) treats UK Ltd as non-resident, so that the gain accruing to TNR can be attributed to the trust under s.13(9).

59.8.1 *Critique of s.79B*

There are two objections to s.79B.

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52 Section 79B(4) TCGA provides:

> "The references in subsection (3) above to 'any other relevant company' are to any other company which if it were not resident in the UK would be a company in relation to which section 13(9) applied with the result that all or part of the chargeable gain was attributed to the trustees as mentioned in that subsection."

One is the constitutional point that the UK is in breach of its DTAs. It might pragmatically be said that if the foreign state does not care enough to complain, that does not matter.

It is certainly anomalous that s.79B adversely singles out trustee participators, ignoring individual and company participators.[53] Section 79B could have no part to play in a coherent and logical system of taxing offshore company gains.

59.9 Foreign tax credit: s.13 TCGA

SP D23 provides:

> **Non-resident company: TCGA 1992 s 13**
> [1] Where a UK participator in a non-resident company which would be a close company if resident in the UK is chargeable to CGT on a proportion of a capital gain accruing to that company, tax credit relief may be given against UK CGT for the appropriate proportion of any overseas tax payable by the company in the country where it is resident in respect of its gain [s.9(2) TIOPA];
> [2] alternatively, under [s.113 TIOPA], the appropriate proportion of the overseas tax may be deductible in computing the shareholder's gains to the extent that the overseas tax has not qualified for relief under [s.9(2) TIOPA].

This relates to two reliefs:
(1) Foreign tax credits
(2) CGT computation deduction
The CG Manual summarises these two reliefs and gives a worked example:

> **57381. Overseas tax payable by NR SP D23** [April 2011]
> The non-resident company may have to pay tax on the gain in its country of residence. UK residents to whom the gain is apportioned will get relief for this tax. The two methods of giving relief are set out in SP D23.
> - Either the UK resident can claim tax credit relief, see CG57382 or
> - a proportionate part of the tax can be claimed in computing the apportioned gain, see CG57383.

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53 CIOT make this point: "Reform of two anti-avoidance provisions" (October 2012) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2012/10/121002_s13_trans_assets_CIOT.pdf*

57382. Tax credit relief [April 2011]
The UK resident can claim tax credit relief under [s.9(2) TIOPA]. Relief is given on a proportion of the foreign tax equal to the proportion of the total gain attributable to the UK resident. This amount is set-off against the charge to CGT or Corporation Tax on the relevant chargeable gains. See the example at CG57384. If tax credit relief is allowed no deduction under [s.113 TIOPA] can be allowed in computing the chargeable gain. See CG57383.

57383. Tax deducted in computing gain [April 2011]
If the UK resident does not want to claim tax credit relief, the tax can be deducted in computing the gain, [s.113 TIOPA]. The foreign tax paid does not qualify for indexation allowance. Although it is an allowable deduction in computing the gain it is not a deduction within TCGA 1992, s.38(1)(a) or TCGA 1992, s.38(1)(b). This means it is not relevant allowable expenditure for indexation allowance purposes, see CG17240. In all other respects you compute and apportion the gain in the usual way allowing the foreign tax paid as a deduction. See the example in CG57384. For further guidance on [s.113 TIOPA] see CG14410+.

The Manual gives a worked example:

57384. Foreign tax paid by a NR company [April 2011]
This example illustrates the differences between allowing any foreign tax paid by the non-resident company as tax credit relief or as a deduction in computing the gain.
Facts
- The non-resident company realises a gain of £20,000 computed under the normal CGT rules.
- It has to pay £5,000 tax on this gain in its country of residence.
- 75% of the gain is attributable to a UK resident.

CGT treatment
A TCGA 1992, s.13 [gain][54] of £20,000 @ 75% = £15,000 is apportioned to the UK resident. Relief for the tax paid can be claimed in two ways.
- TAX CREDIT RELIEF, SEE CG57382.

Suppose the UK resident is liable to CGT at 40%. The tax payable would be £6,000. The UK resident can claim tax credit relief on the foreign tax of £5,000 paid by the company in the same proportion as the gain is apportioned. £5,000 @ 75% = £3,750. The total tax payable by the UK resident becomes £2,250.

54 The original erroneously says: charge.

- DEDUCTION IN COMPUTING THE GAIN, SEE CG57383.
The foreign tax paid of £5,000 can be deducted in computing the gain. No indexation allowance is due on this deduction. The gain to be apportioned becomes £20,000 – £5,000 = £15,000. The taxpayer's share is £15,000 @ 75% = £11,250. At a rate of 40% the tax payable would be £11,250 @ 40% = £4,500.
In this example you would expect the taxpayer to claim tax credit relief.

59.10 DT reliefs: s.86 TCGA

59.10.1 *Trustees within s.86 treaty-resident outside UK*

Assume the fundamental conditions in s.86(1) TCGA are satisfied. Section 86(4) TCGA provides:

> Where this section applies—
> (a) chargeable gains of an amount equal to that referred to in subsection (1)(e) above shall be treated as accruing to the settlor in the year ...

In the HMRC view, the fact that the trustees are treaty-resident in a foreign state with standard form DTA CGT relief does not allow the settlor to claim relief from s.86. HMRC raise two arguments in the Manuals. The first is a categorisation, *Bricom*-type argument. The CG Manual provides:

> **38208 Double taxation relief** [November 2012]
> The gain which is chargeable on the settlor is not the same gain as that which accrues to the trustees, but only an amount equivalent to that gain.
> Therefore articles in particular Double Taxation agreements, under which chargeable gains from the alienation of particular property are exempt from UK tax, will not operate to exempt the settlor from liability under TCGA Section 86.

I think this argument is doubtful. However HMRC have a better argument, at which the CG Manual provides a hint. The Manual first explains why DT relief did apply to the former s.77 TCGA when trustees were treaty-resident in a foreign state with a capital gains article

> **34912. Double taxation relief** [April 2010]
> A settlor may be able to claim exemption [from s.77 TCGA] on some or all of the attributed trust gains, but this depends on the terms of the particular double taxation agreement. The gain which is chargeable on the settlor is not the same as the gain which accrues to the trustees.

> Therefore Articles which exempt trustees from UK tax on gains accruing on the disposal of particular property do not necessarily operate to exempt the settlor from liability under Section 77. However section 77(1)(b) requires there to be an amount on which the trustees would have been chargeable for the year in respect of the gains in question. So if the correct interpretation of the Double Taxation Agreement by reference to the relevant acts is that the trustees would be exempt if they were chargeable then there is no liability.[55]

HMRC say this argument does not run for s.86 because the legislation is differently worded:

> This is by way of contrast with section 86 where there is a hypothesis in subsections (1)(e)(i) and (3) that the trustees are in fact resident in determining whether the section applies[56] and therefore one cannot take into account the actual non-residence. Compare *Bricom Holdings v CIR* 70 TC 272.

But this is not necessarily right; see 59.12.1 (Trustees within s. 87 treaty-resident outside UK) for the discussion on s.87.

Another argument is that s.86(3) envisages a charge in a case where trustees are dual resident in the sense of being domestic-law UK resident but treaty-resident in a foreign state. In that case the treaty is intended to be overridden. By implication the same should apply where the trustees are treaty-resident in a foreign state and not UK resident at all.

HMRC accept that foreign tax credit relief is available. The CG Manual provides:

> **38208 Double taxation relief** [November 2012]
> ... Where, however, the particular article provides for the allowance, as a credit, of overseas tax payable on gains, that tax can be allowed as a

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55 Section 77(1) TCGA (now repealed) provided, so far as relevant:
(1) Where in a year of assessment—
(a) chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property,
(b) after making any deduction provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would be chargeable to tax for the year in respect of those gains ... , and
(c) at any time during the year the settlor has an interest in the settlement,
[i] the trustees shall not be chargeable to tax in respect of those gains but
[ii] instead chargeable gains of an amount equal to that referred to in para (b) shall be treated as accruing to the settlor in that year.

56 See 50.10 (Section 86 trust gains condition).

> credit. This is because UK tax is computed by reference to the same chargeable gains in respect of which the overseas tax is computed. If there is no Double Taxation agreement, then unilateral relief is available on the same basis.

59.10.2 *Settlor treaty-resident outside UK*

Suppose the settlor is domestic-law UK resident but treaty-resident in a foreign state. Can the settlor claim direct relief? The point is the same as for s.13 gains. Art.13(5) OECD Model provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the *alienator* is [treaty-resident].

On a literal reading, the settlor does not qualify for treaty relief because (though treaty non-resident) the settlor is not the alienator. The trustees are the alienator but (on the facts of this example) the trustees are not treaty non-resident. So the terms of art.13(5) are not satisfied. The US treaty is wider and DT exemption applies to a settlor who is treaty-resident in the US.[57] Even under the OECD model, the same result is arguable on the grounds that the gain is treated as accruing to the settlor, they should be deemed to be the alienator; or the word "alienator" does not require that one must alienate property, only that the gain on the alienation accrues to the person.

59.10.3 *Trust owns company which is treaty-resident outside UK*

If a non-resident trust within s.86 owns a treaty non-resident company which realises a gain DT relief is disallowed and the settlor is taxable; see 59.8 (Disallowance of DT relief for trust participator).

59.11 Restriction on DTR for gains of trustees and settlors

It is easiest to understand the legislation if one bears in mind the tax avoidance schemes it was intended to block. Suppose a non-resident settlor-interested trust within s.86 TCGA. The trustees would take two steps:

(1) arrange to dispose of an asset at a time when they are treaty-resident in a foreign state with a DTA with a CGT article and
(2) become UK resident later in the same tax year.

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57 See 59.16.1 (Section 624, 720 income; s.13, 86 gains).

In the absence of an anti-avoidance rule, this works as s.86 does not apply and the trustees (although within the charge to CGT) claimed DTR.[58]

This arrangement is counteracted by s.83A TCGA.

> (1) This section applies if a chargeable gain accrues to the trustees of a settlement on the disposal by them of an asset in a year of assessment and the trustees—
>
> (a) are within the charge to capital gains tax[59] in that year of assessment, but
>
> (b) are non-UK resident at the time of the disposal.

The expression "non-UK resident" in (b) is defined in s.83A(4) TCGA:

> For the purposes of this section the trustees of a settlement are non-UK resident at a particular time if, at that time,—
>
> (a) they are not resident in the UK, or
>
> (b) they are resident in the UK but are Treaty non-resident.

This is a slightly artificial definition, but it is difficult to think of a better label.

If these conditions are satisfied, s.83A(2) TCGA overrides DT relief:

> Where this section applies, nothing in any double taxation relief arrangements shall be read as preventing the trustees from being chargeable to capital gains tax (or as preventing a charge to tax arising, whether or not on the trustees) by virtue of the accrual of that gain.

EN FA 2005 explains the words in brackets:

> 4. Subsection (2) of section 83A has effect to provide that where section 83A applies, nothing in the terms of any Double Taxation Agreement (DTA) can be read as preventing the trustees being chargeable to capital gains tax, or of preventing a charge to tax arising (whether on the trustees or another person), by virtue of the accrual of the gain.

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58 The reader may have considered a similar arrangement where the non-resident trust was not within s.86 but is within s.87. In the absence of an anti-avoidance provision, the same steps would be taken in order to avoid a s.2(2) amount. But this is caught by s.88 TCGA; see 51.17 (Dual resident trust: s.88 TCGA).

59 Section 83A(3) gives this expression a commonsense definition:

> "For the purposes of this section the trustees of a settlement are within the charge to capital gains tax in a year of assessment—
>
> (a) if, during any part of that year of assessment, they are resident in the UK and not Treaty non-resident".

> 5. The reason for the reference to "another person" in paragraph 4 above is that, in certain circumstances where the trustees of a settlement are within the charge to capital gains tax in a tax year, the rules in section 77 TCGA provide that the trustees do not actually suffer a tax charge in respect of chargeable gains which arise to them on the disposal of settled property which originates from a UK resident or ordinarily resident settlor who has an interest in the settlement at any time in the year. Chargeable gains are instead treated as arising to the settlor, who is then chargeable to tax in respect of them.

Now that s.77 has been repealed, the words in brackets in s.83A(2) should be repealed, as they can never apply, but they do no harm. Section 83A is still needed in order to deal with the s.86 scheme.

Section 83A is somewhat wider than it needed to be in order to deal with these two schemes, and considerable care is needed where trustees become or cease to be treaty non-resident, but in practice difficulties are fairly rare.

59.12 DT reliefs: s.87 TCGA

59.12.1 *Trustees within s. 87 treaty-resident outside UK*

This section considers whether DT reliefs are available where:

(1) Gains ("trust gains") accrue to a trust which is treaty-resident in a foreign state.
(2) A UK resident beneficiary receives a capital payment so a s.87 gain accrues to them.

At first sight, the DTA offers no defence to the charge on the beneficiary. The trust gains accruing to trustees meet the requirements for DTR but the s.87 gain accruing to the beneficiary under s.87 TCGA is not the same gain as the trust gains accruing to the trustees. Section 87 may be regarded as a charge on the capital payment, or a charge on fictional gains, but it is not a charge on the trust gains accruing to the trustees. That seems reasonably clear for several reasons:

(1) The wording of s.87(2) suggests that the s.87 gains and the trust gains are distinct.
(2) If the trust gains exceed the capital payment, it would not be clear which trusts gains were charged. Although there are matching rules, these rules only match capital payments to trust gains of a year; they do not match capital payments to specific gains within the year.
(3) In the case of a foreign domiciled beneficiary, the s.87 gain is a foreign chargeable gain, even though the trust gain accruing to the

trustees is a gain on the disposal of a UK situate asset.[60]

The absence of DT relief in this situation has always been a potential cause of injustice, but since the extension of s.87 to foreign domiciliaries in 2008 it has become a major cause of injustice.

There is however an argument that the gains accruing to the trustees are not s.2(2) amounts. The definition is:

> the amount upon which the trustees of the settlement would be chargeable to tax under s.2(2) for that year if they were resident in the UK in that year

The argument is that assuming the trustees were UK resident, they would still be treaty non-resident, so "the amount on which they would be chargeable to tax" would be nil![61] I refer to this as **"the DT argument"**. It is the old question of how far one carries through the deeming.[62]

Unfortunately an argument of this kind was put in a similar context in *Bricom v IRC* where it was rejected. This was a CFC case. One issue was to ascertain the chargeable profits of the CFC. "Chargeable profits" is defined in s.747(6) ICTA which provides (so far as relevant):

> In relation to a company resident outside the UK—
> (a) any reference in this Chapter to its chargeable profits for an accounting period is a reference to the amount which, on the assumptions in Schedule 24, would be the amount of the total profits of the company for that period on which ... corporation tax would be chargeable.

Para 1(1) sch.24 provides:

> The company shall be assumed to be resident in the UK.

The CFC was resident in the foreign state, and treaty-resident there, and it argued that although it was deemed to be UK resident, the deeming did not undo those facts. Accordingly, the CFC's chargeable profits should be ascertained on the assumption that the CFC was dual resident and entitled to the benefit of the DTA. The Court of Appeal rejected the argument:

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60 See 51.15 (Section 87 remittance basis).

61 This assumes that the trustees would claim treaty relief, but that is merely an administrative matter and should not be an obstacle.

62 See App 2.1 (Construction of Deeming Provisions).

> ... para 1(1) of Sch 24 is a statutory assumption, and is ambiguous. The question is: what is the nature of the assumption?...
> In the present case the purpose for which the assumptions are required is self-evident (!). A controlled foreign company is ex hypothesis resident outside the UK. As a non-resident, it will not normally be subject to UK corporation tax and will have made no claim to relief from such tax. The computation of the profits on which corporation tax is chargeable, therefore, involves ascertaining a hypothetical amount, that is to say the amount which would have represented the amount of such profits if the controlled foreign company had been resident in the UK and had made all necessary claims for relief. The assumptions which Sch 24 requires are not additional assumptions to be made in combination with the actual facts. In relation to the matters which they cover they are substituted for the actual facts. [The CFC] was resident outside the UK; this means that it had no profits actually chargeable to corporation tax; accordingly its chargeable profits are to be ascertained on the footing that it was resident in the UK instead. It is as simple as that. There is no question of dual residence.
> ... The chargeable profits referred to in s 747(4)(a) must be ascertained without reference to the double taxation agreement ....[63]

The reader may think this a particularly blatant case of assuming the answer and then "construing" the statute to yield that answer. However that may be, *Bricom* is not a general rule for the construction of provisions deeming UK residence, but a case on the construction of the CFC legislation. The point in the s.87 code must be considered independently.

If the DT argument were correct, there would be an anomaly between:

(1) trusts which were domestic-law non-resident and treaty non-resident, ie within the scope of a DTA; and
(2) trusts which were domestic-law UK resident and treaty non-resident, for these are caught by s.88 TCGA.[64]

If the DT argument is not correct, a CGT computation deduction is available so foreign tax paid by the trustee is deducted in computing the s.2(2) amount. This is because:

(1) The s.2(2) amount is the amount on which trustees would have been chargeable to tax if UK resident; and
(2) UK resident trustees would qualify for a CGT computation deduction, which reduces the amount on which trustees would be chargeable to

63 *Bricom v IRC* 70 TC 272 at p.289.

64 See 51.17 (Dual resident trust: s.88 TCGA).

tax.

59.12.2 *Beneficiary treaty-resident outside UK*

Suppose now the beneficiary is UK resident but treaty-resident in a foreign state, in a foreign state with a DTA with a common form CGT article. Can the beneficiary claim treaty relief directly? Art.13(5) OECD Model provides (with immaterial exceptions):

> Gains from the alienation of any property ... shall be taxable only in the Contracting State of which the alienator is a [treaty-resident].

It is suggested that the beneficiary cannot claim DT relief because:
(1) The beneficiary is not the alienator.[65]
(2) The gain is not "from the alienation of any property".
The contrary is arguable, but does require a very loose reading of the provision.

59.13 DT reliefs: Offshore income gains

59.13.1 *s.13 OIGs: Company treaty-resident outside UK*

Suppose OIGs accrue to a company which is treaty-resident in a foreign state and so are deemed to accrue to a UK resident participator under s.13 TCGA. In principle, DT reliefs apply to OIGs deemed to accrue under OIG s.13 just as they do for chargeable gains deemed to accrue under CGT s.13.[66]

I have considered reg. 24(6) OFTR which provides:

> If this regulation applies, the person to whom the offshore income gain arises is treated as the person making the disposal.

This does not disapply treaty relief, either because it has no application for the purposes of the treaty or because (while deeming the participator to be the disponor) it does not say that the non-resident company is not the alienator.[67]

59.13.2 *s.13 OIGs: Participator treaty-resident outside UK*

In the case of CGT s.13 gains, the participator has a difficulty in obtaining

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65 See 59.7.3 (Participator treaty non-resident).
66 For this terminology, see 35.14 (OIG s.13 charge).
67 For the reason for this provision, see 35.13.4 (Deemed disposal).

relief under a CG article, in that they are not at first sight the "alienator".[68] However it is considered that the other income article provides relief, in the case of OIGs. If the capital gains article is in point, it is arguable that reg. 24(6) OFTR deems the participator to be the alienator.

59.13.3 *s.87 OIGs: Beneficiary treaty-resident outside UK*

In the case of CGT s.87 gains, the beneficiary has a difficulty in obtaining relief, in that they are not at first sight the "alienator" and the gain is not "from the alienation of any property". See 59.12.2 (Beneficiary treaty-resident outside UK). However in the case of OIGs it is considered that the other income article provides relief. If the capital gains article were in point, it is arguable that reg.20(5) OFTR deems the beneficiary to be the alienator but the problem remains that the gain is not "from the alienation of any property".

59.14 DT reliefs: Policy held by trust or by company

If the policy is held by a trust, the position is similar to s.624; see 59.4 (DT reliefs: s.624 ITTOIA). If the policy is held by a company within s.720, s.720 issues arise: see 59.5 (DT reliefs: s.720 ITA).

59.15 US/UK DTA

The US/UK DTA follows the US model which differs significantly from the OECD model. A full discussion would require a book to itself.

For the US/UK DTA definition of treaty residence, see 6.19 (USA/UK DTA).

59.15.1 *US/UK DTA: Savings clause*

Article 1(4) US/UK DTA provides:

> Notwithstanding any provision of this Convention except paragraph 5 of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence), and by reason of citizenship may tax its citizens, as if this Convention had not come into effect.

This is called **"the savings clause"**.

So subject to the art 1(5) exceptions:

(1) US may tax US citizens and US treaty-residents ignoring treaty relief.

(2) UK may tax UK treaty-residents ignoring treaty-relief.

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68 See 59.7.3 (Participator treaty non-resident).

On the other hand, UK must allow treaty relief to US treaty-residents, and US must allow relief to UK treaty-residents who are not US citizens.

The US Department of the Treasury Technical Explanation of the Convention[69] provides:

> Paragraph 4 contains the traditional saving clause found in U.S. tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of the UK performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of the UK is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894(a)). However, subparagraph 5(a) of this Article preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in the UK. See paragraph 6 of Article 24 (Relief from Double Taxation).
>
> For purposes of the saving clause, "residence" is determined under Article 4 (Residence). Thus, an individual who is a U.S. resident under the Internal Revenue Code but who is deemed to be a resident of the UK under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. For example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, and is also a resident of the UK under its law, and that individual has a permanent home available to him in the UK and not in the United States, he would be treated as a resident of the UK under Article 4 and for purposes of the saving clause. The United States would not be permitted to apply its statutory rules to that person if they are inconsistent with the treaty.[70]

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69 Accessible *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

70 The treaty continues with a comment that UK treaty-residence does not preclude US domestic-law residence, a point only relevant to the US (though a comparable rule applies in the UK): "However, the person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be

59.15.2 *Article 1(5) exceptions*

The list of exceptions in art 1(5) is quite limited:

> The provisions of paragraph 4 of this Article shall not affect—
> (a) the benefits conferred by a Contracting State under
> [i] paragraph 2 of Article 9 (Associated Enterprises),
> [ii] sub-paragraph (b) of paragraph 1 and paragraphs 3 and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support),
> [iii] paragraphs 1 and 5 of Article 18 (Pension Schemes) and
> [iv] Articles 24 (Relief From Double Taxation),
> [v] [Art] 25 (Non-discrimination), and
> [vi] [Art] 26 (Mutual Agreement Procedure) of this Convention; ...

The US Department of the Treasury Technical Explanation of the Convention[71] summarises the exceptions:

> Some provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 sets forth certain exceptions to the saving clause that preserve these benefits for citizens and residents of the Contracting States.
> Subparagraph (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:
> (1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.
> (2) Subparagraph 1(b) and paragraphs 3 and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.
> (3) Paragraph 1 of Article 18 (Pension Scheme) provides an exemption for certain investment income of pension schemes located in the other State, while paragraph 5 provides benefits for certain contributions by

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considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See Treas. Reg. section 301.7701(b)-7(a)(3). The application of the saving clause to former citizens and long-term residents is addressed not in paragraph 4 but in paragraph 6."

71 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

> or on behalf of a U.S. citizen to certain pension schemes established in the UK.
> (4) Article 24 (Relief from Double Taxation) confirms the benefit of a credit to citizens and residents of one Contracting State for income taxes paid to the other, even if such a credit may not be available under the Code.
> (5) Article 25 (Non-Discrimination) requires one Contracting State to grant national treatment to nationals of the other Contracting State in certain circumstances. Excepting this Article from the saving clause requires, for example, that the United States give such benefits to a national of the UK even if that person is a citizen of the United States.
> (6) Article 26 (Mutual Agreement Procedure) may confer benefits on residents or nationals of the Contracting States. For example, the statute of limitations may be waived for refunds and the competent authorities are permitted to use a definition of a term that differs from the internal law definition. As with the foreign tax credit, these benefits are intended to be granted by a Contracting State to its citizens and residents.

The list of exceptions in art 1(5) continues:

> The provisions of paragraph 4 of this Article shall not affect ...
> (b) the benefits conferred by a Contracting State under
> [i] paragraph 2 of Article 18 (Pension Schemes) and
> [ii] Articles 19 (Government Service),
> [iii] Art 20 (Students),
> [iv] Art 20A (Teachers), and
> [v] Art 28 (Diplomatic Agents and Consular Officers)
> of this Convention, upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.

The US Department of the Treasury Technical Explanation of the Convention[72] provides:

> Subparagraph (b) of paragraph 5 provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent

72 *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

> residence status (i.e., in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with statutory rules. The benefits preserved by this paragraph are: the host country exemptions for the following items: government service salaries and pensions under Article 19 (Government Service); certain income of visiting students, trainees, teachers, professors, and researchers under Articles 20 (Students) and 20A (Teachers); the income of diplomatic agents and consular officers under Article 28 (Diplomatic Agents and Consular Officers); and the beneficial tax treatment of pension fund contributions under paragraph 2 of Article 18 (Pension Schemes).

Green card holders are at a disadvantage compared to US citizens since they pay US taxes but do not have the same benefits under the treaty. HMRC say:

> HMRC explained that the UK was not obliged to give credit where the US taxed a green card holder on a world wide basis and the taxpayer was not tax resident in the US, but where we see a recharge to the US for US workdays we will accept the US has the primary taxing rights in the same way as for US citizens and we will give credit for the US tax paid on those US workdays by green cardholders. In the US a green card holder is debarred from claiming relief under a treaty. HMRC suggested that an individual who is taxed in the US on their world wide income because he retains his green card and so is treated as a resident of the US for the purposes of Article 1(4) even though they would be treaty resident in the UK may not have taken all reasonable steps to minimise their US liability, as required by s.795A ICTA if he were to qualify for credit relief. As such, although strictly Article 24(6) may not apply to green card holders in these circumstances, the effect of the minimisation requirement is that the UK will limit relief given in the UK under the treaty to that which would be given if Article 24(6) did apply. Representatives pointed out that giving up the green card might trigger expatriation taxes in the US.
>
> The HMRC position is that we will not give relief in the UK for tax paid in the US as a result of Article 1(4). We believe that the US will give unilateral relief for the UK tax paid on their income at least to the extent it arises in the UK so as far as we know this should not lead to double taxation although it could lead to higher tax payable in the US as a result of the alternative minimum tax provisions.[73]

73 *http://www.hmrc.gov.uk/consultations/expat-mins-160409.htm*

59.16 US/UK DTA: Fiscally transparent bodies[74]

Article 1(8) of the US/UK DTA provides:

> An item of income, profit or gain derived through a person that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a Contracting State to the extent that the item is treated for the purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

It is essential to have in mind which state is which; the paragraph is easier to follow if it is expanded to read:

> An item of income/gain derived through a person that is fiscally transparent under the laws of either Contracting State shall be considered
> [i] to be derived by a resident of the UK to the extent that the item is treated for the purposes of the taxation law of the UK as the income/gain of a resident of the UK and
> [ii] to be derived by a resident of the US to the extent that the item is treated for the purposes of the taxation law of the US as the income/gain of a resident of the US.

This is not in the OECD Model Treaty but it is in the US Model Income Tax Convention from 1996 and is now standard in US treaties.

If both the UK and the USA regard an entity as transparent (eg a partnership) then this provision is not needed, for (say) partnership income would in any event be regarded as income of the partners. The provision is needed for a hybrid entity, ie an entity which is regarded as transparent in one state but not in the other. The IRS explain:[75]

> Paragraph 8 addresses special issues presented by fiscally transparent entities such as partnerships and certain estates and trusts. In general, paragraph 8 relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated system. This paragraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. Entities falling under this description in the United States include partnerships, common investment trusts

74 See Wheeler, *The Missing Keystone of Income Tax Treaties* (2012) para 2.4.5 (Concluded treaties).

75 US Department of the Treasury Technical Explanation of the Convention, accessible *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

under section 584 and grantor trusts. This paragraph also applies to US limited liability companies ("LLCs") that are treated as partnerships for US tax purposes.
Under paragraph 8, an item of income, profit or gain derived by such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income.

The IRS give some examples:

[1] For example, if a UK company pays interest to an entity that is treated as fiscally transparent for US tax purposes, the interest will be considered derived by a resident of the US only to the extent that the taxation laws of the United States treats one or more US residents (whose status as US residents is determined, for this purpose, under US tax law) as deriving the interest for US tax purposes. In the case of a partnership, the persons who are, under US tax laws, treated as partners of the entity would normally be the persons whom the US tax laws would treat as deriving the interest income through the partnership.
[2] Also, it follows that persons whom the United States treats as partners but who are not US residents for US tax purposes may not claim a benefit for the interest paid to the entity under the Convention, because they are not residents of the United States for purposes of claiming this treaty benefit. (If, however, the country in which they are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with the UK, they may be entitled to claim a benefit under that convention.)
[3] In contrast, if, for example, an entity is organized under US laws and is classified as a corporation for US tax purposes, interest paid by a UK company to the US entity will be considered derived by a resident of the United States since the US corporation is treated under US taxation laws as a resident of the United States and as deriving the income.
[4] The same result obtains even if the entity were viewed differently under the tax laws of the UK (e.g., as not fiscally transparent in the first example above where the entity is treated as a partnership for US tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for US tax purposes and as a corporation for UK tax purposes. These results also obtain regardless of where the entity is organized (i.e., in the United States, in the UK, or, as noted above, in a third country).

> [5] For example, income from US sources received by an entity organized under the laws of the United States, which is treated for UK tax purposes as a corporation and is owned by a UK shareholder who is a UK resident for UK tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the US entity.
> [6] These principles also apply to trusts to the extent that they are fiscally transparent in either Contracting State. For example, if X, a resident of the UK, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust, X would be treated under US law as the beneficial owner of income derived from the United States. In that case, the trust's income would be regarded as being derived by a resident of the UK only to the extent that the laws of the UK treat X as deriving the income for UK tax purposes by application of the UK "settlor trust" rules.

An Exchange of Notes between the Governments of the UK and USA discusses the relation of para 1(8) (transparency) and para 1(4) (savings clause):

> *With reference to paragraph 8 of Article 1 (General scope)—*
> [1] it is understood that where an item of income, profit or gain is derived through a person which is a resident of a Contracting State the provisions of the paragraph shall not prevent that Contracting State from taxing the item as the income, profit or gain of that person.

The IRS continue:[76]

> [7] Paragraph 8 is not an exception to the saving clause of paragraph 4.[77] Accordingly, the notes confirm that paragraph 8 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a US LLC with UK members elects to be taxed as a corporation for US tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether the UK views the LLC as fiscally transparent. The portion of the notes relating to Article 24 (Relief from Double Taxation) provides rules for determining which Contracting State has the primary right to tax and which State must provide a credit in such circumstances.

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76 US Department of the Treasury Technical Explanation of the Convention, accessible *http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf*

77 See 59.15.1 (US/UK DTA: Savings clause).

I do not find this easy to follow, but think one can draw out 6 examples from the 7 paragraphs of the IRS explanation (my numbering):

	Entity						**Resid. of person with interest in entity**			**For DT, item derived by:**		**IRS para**
eg no.	*Transparent*			*Resid, (if opaque)*		*example*	*UK*	*US*	*3rd state*	*person*	*entity*	
	in UK	in US	3rd state	in US								
1	n/r	y	n/r			p'ship		y		y		[1],[4]
2	n/r	y	n/r						y	n		[2],]4]
3	n/r	n	n/r	y		corp'n						[3],[4][78]
4	n					corp'n	y			n	y	[5]
5	y[79]					revoc. trust	y			y[80]		[6]
6	n[81]		n/r			revoc. trust	y			n[82]	n/r	[6]

The Exchange of Notes continues:

> [2] It is further understood that, where, by virtue of [para 1(8)],
> [a] an item of income, profit or gain is considered by a Contracting State to be derived by a person who is a resident of that Contracting State, and
> [b] the same item is considered by the other Contracting State to be derived [by that person or][83] by a person who is a resident of that other Contracting State,
>
> the paragraph shall not prevent either Contracting State from taxing the item as the income, profit or gain of the person considered by that State to have derived the item of income, profit or gain.

It is essential to have in mind which state is which; the paragraph is easier to follow if it is expanded to read:

> It is further understood that, where, by virtue of para 1(8),
> [a] an income/gain is considered by the UK to be derived by a person who is a resident of the UK, and

78 US will tax corporation under savings clause.
79 So far as s.624 applies.
80 So far as s.624 applies.
81 So far as s.624 applies.
82 So far as s.624 applies.
83 I do not understand the words in brackets and would be grateful to any reader who could explain.

[b] the same item is considered by the US to be derived by that person or by a person who is a resident of the US,

the paragraph shall not prevent

[i] the UK from taxing the item as the income/gain of the person considered by the UK to have derived the item;

[ii] the US from taxing the item as the income/gain of the person considered by the US to have derived the item.

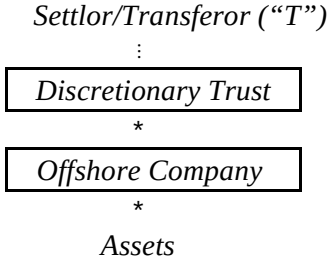
59.16.1 *Section 624, 720 income; s.13, 86 gains*

The Exchange of Notes continues:

> [3] It is further understood that, in applying [para 1(8)], the UK shall, exceptionally, regard an item of income, profit or gain arising to a person as falling within the paragraph where another person is charged to UK tax in respect of that item of income, profit or gain—
>
> (a) under [what is now s.624 ITTOIA & s.720 ITA]; or
>
> (b) under section [77][84] or 86, TCGA 1992.
>
> [4] It is further understood that, in applying the paragraph, a person shall be regarded as fiscally transparent under the laws of the UK in relation to an item of income, profit or gain where a charge is made on another person on that item either—
>
> (a) by virtue of section 13, TCGA 1992; or
>
> (b) because that other person has (or, under [what is now s.464 ITA[85]], is treated as having) an equitable right in possession in a trust.

Thus trusts within s.624 and companies within s.720 are regarded as fiscally transparent for IT; trusts within s.86 and companies within s.13 are regarded as fiscally transparent for CGT.

Take a standard structure:



84 [Author's note. Section 77 is now repealed.]

85 See 26.3.4 (Scots trusts).

Suppose:
(1) T is domestic-law UK resident but treaty-resident in the US.
(2) The entities are transparent for US tax so T regarded for US purposes as receiving OC's income.
(3) S.720 applies so T is taxed for UK tax purposes on OC's income
This is a straightforward case within example 1 of my table. For US/UK treaty purposes, T is treated as receiving OC's income.

59.16.2 *Relationship to art.24 (foreign tax credit)*

The Exchange of Notes continues:

> *With reference to Article 24 (Relief from double taxation)—*
> it is understood that, under paragraph 4 or 8 of Article 1 (General scope), the provisions of the Convention may permit the Contracting State of which a person is a resident (or, in the case of the United States, a citizen), to tax an item of income, profit or gain derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, and may permit the other Contracting State to tax
> (a) the same person;
> (b) the entity; or
> (c) a third person
> with respect to that item. Under such circumstances, the tax paid or accrued by the entity shall be treated as if it were paid or accrued by the first-mentioned person for the purposes of determining the relief from double taxation to be allowed by the State of which that first-mentioned person is a resident (or, in the case of the United States, a citizen), except that, in the case of an item of income from real property to which paragraph 1 of Article 6 (Income from real property) of the Convention applies, or a gain from the alienation of real property to which paragraph 1 of Article 13 (Gains) applies, the tax paid or accrued by the person who is a resident of the Contracting State in which the real property is situated shall be treated as if it were paid or accrued by the person who is a resident of the other Contracting State.
> In the case where the same item of income, profit or gain derived through a trust is treated by each Contracting State as derived by different persons resident in either State, and
> (a) the person taxed by one State is the settlor or grantor of a trust; and
> (b) the person taxed by the other State is a beneficiary of that trust,
> the tax paid or accrued by the beneficiary shall be treated as if it were paid or accrued by the settlor or grantor for the purposes of determining the relief from double taxation to be allowed by the State of which that

> settlor or grantor is a resident (or, in the case of the United States, a citizen), except that, in the case of an item of income from real property to which paragraph 1 of Article 6 (Income from real property) of the Convention applies, or a gain from the alienation of real property to which paragraph 1 of Article 13 (Gains) applies, the tax paid or accrued by the person who is a resident of the Contracting State in which the real property is situated shall be treated as if it were paid or accrued by the person who is a resident of the other Contracting State.
> It is further understood that paragraphs 2 and 5 of Article 24 shall apply to such an item of income, profit or gain to the extent necessary to provide relief from double taxation.

In *Anson* income arose to a LLC which was transparent for US purposes but not for UK purposes. The income was distributed to a UK resident shareholder. I would have thought that this was clearly a case where the exchange of notes should have applied. HMRC do not agree, arguing that the taxpayer should suffer US tax and UK tax without the benefit of any DT relief. Unfortunately the Court of Appeal refused to consider the point (on the grounds that the taxpayer failed to raise it soon enough[86]) so the law is at present unresolved.

59.16.3 *US partnerships and LLCs*

In the Double tax guidance note 3: Partnerships and LLCs claiming relief under the 2002 UK/USA DTC, HMRC say:

> **How the DTC treats US partnerships and LLCs**
> [HMRC set out Art.1(8) of the DTC and continue:] A transparent concern itself is therefore not given the right to found a claim for relief.

The reason that a transparent entity does not claim DT relief is that it is

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86 [2013] STC 557 at [92]:

> "There is clearly some dispute as to the mischief to which the exchange of notes is directed. There would have to be further evidence to resolve that dispute."

The view that a Court hears evidence to resolve a dispute about the scope of a DTA is unconventional. But perhaps it is better that the CA did not address the point, as they did not seem very sympathetic to the taxpayer, continuing:

> "Moreover, the words "with respect to that item", ... are, on the face of it, consistent with Mr Ewart's principal submission that no change is made in the requirement for the profits taxed in each jurisdiction to be the same profits in order to qualify for DTR. If an alteration to article 23 was intended, it is surprising that it was dealt with in this oblique way."

This will need to be reviewed when the case is final.

not "liable to tax" in a state which regards it as transparent, and so is not treaty-resident in that Contracting State.[87]

> Instead, that right is given individually to those 'qualifying persons' defined by the General Definitions Article [4][88]; and as further qualified by the Limitation on Benefits Article [23][89], who have derived their beneficial entitlement to income, profit or gain through their participation in the transparent concern.[90]

The text throughout erroneously refers to "qualifying persons"; the correct term is *qualified* persons. HMRC continue with a concession:

> **What this would mean for partners and LLC members**
> Strictly speaking, HMRC should accept claims only from those partners and members who themselves fall to be regarded as 'qualifying persons' in their own right.
> In practice, this would mean as many separate claims for one item of UK-source income paid to a transparent concern such as a partnership or LLC[91] as there are beneficial owners to whom it is then being paid on or distributed.
> HMRC recognises that applying the DTC provisions in such a literal way would be unwelcome to its customers and could possibly hamper the business interests of both countries. It would be a retrograde step in customer service terms, and would not be justified on either an assessment of risk to the UK Exchequer or on compliance grounds. HMRC wants to keep a proper balance between the ease with which US residents should be able to claim relief with the administrative procedures and paperwork that must be employed by the UK Revenue to verify and give effect to such a claim.
> **HMRC's approach to partnerships and LLCs**
> Accordingly, HMRC intends to continue its previous practice of taking claims in the names of both partnerships and LLCs.
> These concerns should use the form US/Company 2002, and should provide (as before) a list of the names and addresses of the partners or members, with details of their respective shares of income. This is covered by the second bullet of the form's own Guidance Note 2.
> This form is tailored for use by the majority of those non-individual businesses and concerns which are covered by detailed provisions of the DTC - most notably by the Limitations on Benefit Article 23, which lays down very specific

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87 See 6.15 (Treaty-residence: Partnerships); 84.25.3 (Treaty-residence of LLC and S-Corp).

88 The original erroneously refers to article 3.

89 The original erroneously refers to article 27.

90 HMRC add: "It will be noted that this is not so very different from the situation that obtained under Article 4(1)(b)(i) of the 'old' 1980 DTC." I am not sure about that, but the point does not now arise.

91 The Manual is considering a LLC which is transparent under US law.

tests for defining the 'qualified persons' who can benefit under the treaty. There is therefore no separate section for transparent concerns such as partnerships or LLCs.

What partnerships and LLCs are asked to do

HMRC Residency ask partnerships and LLCs to complete the US/Company 2002 as follows

* Parts A and B in full
* Part C in full, as appropriate
* Part D if repayment of UK tax is claimed
* Part E if appropriate
* Part F in full, with the general or managing partner/member signing the declaration
* With the additional details as requested in the US-Company 2002 Notes, which is part of the claim form.

Claimants are also free to attach any statement or schedule in support of the claim, as they believe would help explain their circumstances or the basis of the claim.

What HMRC will do

HMRC will consider the replies to all the above, and the information supplied. Consistent with previous practice, where the facts allow the reasonable conclusion that all beneficial owners of the income for whose shares relief is being claimed are 'qualifying persons' within the meaning of the DTC, then HMRC will process things in the normal way. This will more often than not involve a reference to the tax office for the UK payer, under normal internal liaison arrangements.

If the information given in with the claim form does not allow this conclusion, considering in particular the tests set out in Article 23, HMRC will probably have to contact claimants with further specific questions and requests for information before it can consider finalising processing of things.

HMRC do not want to add to the time taken to resolve matters. Where possible, it will start processing the claim, on a 'without prejudice' basis and pending satisfactory conclusion of any correspondence.

HMRC will be as quick as possible, with due consideration for customers' business needs, and with sympathy and understanding for any compliance difficulties that the process might cause them.

As with any claim, letting HMRC have an advance copy of the form US/Company 2002 (at the time it is submitted to the IRS for certification) may allow it to flag up any points of difficulty at an early stage, and opens up the possibility of anticipating what is needed or might be done before the certified form arrives.

No doubt some high level lobbying has taken place. In relation to claims for relief from deduction at source, HMRC say (inconsistently) that they adopt a strict approach.[92]

92 See 18.17.8 (Relief when borrower is a partnership).

59.17 "Subject to tax"

Some treaties provide exemption for income which is "subject to tax". This is not in the OECD Model, and only survives in a diminishing number of treaties, but for instance Art. VI (Interest) of the Greece/UK treaty provides:

> Any interest or royalty derived from sources within one of the territories by a resident of the other territory, *who is subject to tax in that other territory in respect thereof* and does not carry on a trade or business in the first territory through a permanent establishment situated therein, shall be exempt from tax in that first territory.

The issue may arise whether income is subject to UK tax in order to qualify for a foreign DT exemption; and the issue may arise whether income is subject to foreign tax in order to qualify for UK DT exemption.. The former issue would ultimately be decided by foreign tax authorities and courts, but the HMRC view of what counts as subject to UK tax may well represent an international consensus.

The INTM Manual provides:

> **INTM332210 - Double Taxation applications and claims - Subject to tax: Background** [January 2012]
> The expression "subject to tax" usually means that the person must actually pay tax on the income in their country of residence.
> However, a person is still regarded as "subject to tax" if, for example, he or she does not pay tax because their income is sufficiently small that it is covered by personal allowances that are available to set against liability to tax in the other country.
> A person is not regarded as "subject to tax" if the income in question is exempted from tax because the law of the other country provides for statutory exemption from tax. For example
> - the income is that of a charity
> - the income is that of an exempt approved superannuation scheme (pension fund).
>
> In such cases the "subject to tax" condition is not met and relief is not allowable.

In *Weiser v HMRC*[93] the tribunal agreed with this passage.

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93 [2012] UKFTT 501 (TC) at [38]. Similar points are made in INTM 162020. 'Subject to tax' [January 2014].

Similarly, in the context of the lower-paid employee exemption, the RDR Manual provides:

> **32070 - Remittance Basis: Accessing the remittance basis: Claiming the remittance basis: Calculation of income tax liability - exemption for non-domiciles with small amounts of foreign employment income** [June 2010]
> *...Subject to Foreign Tax*
> Although 'subject to a foreign tax' might in some circumstances mean that the individual has actually paid some tax on the foreign income to a foreign tax authority, actual payment is not a necessary requirement to take advantage of this exemption.
> For example, given the levels of foreign income involved there might be nothing due to be paid on part or all of the income, as a result perhaps of a foreign countries' own personal allowances systems, or similar tax provisions which are akin to such allowances, such as a tax rate band of 0 per cent. Such income would still be considered to be 'subject to a foreign tax' in the context of this exemption.

In *Weiser v HMRC* [2012] UKFTT 501 (TC) the appellant (not represented by counsel) claimed relief under Article XI(2) of the UK/Israel Treaty which provides:

> Any pension ... derived from sources within the United Kingdom by an individual who is a resident of Israel and subject to Israel tax in respect thereof, shall be exempt from United Kingdom tax.

The taxpayer was treaty-resident in Israel but unfortunately qualified for an Israel tax exemption which applied to foreign source income of new residents for a 10 year period. The pension income was held not "subject to tax" in Israel, so the DT exemption did not apply. The decision contains a helpful analysis of the relevant law:

> 22. ... There is, [Counsel for HMRC] submitted, an internationally recognised distinction ... which gives the expression "liable to tax" a broader meaning that the expression "subject to tax". She argued that "liable to tax" is understood to require only an abstract liability to taxation on income in the sense that a contracting state may exercise its right to tax the income in question (whether or not the exercise of that right actually results in an amount of tax becoming payable). "Subject to tax", on the other hand, requires income actually to be within the charge to tax in the sense that a contracting state must include the income in question in the computation of the individual's taxable income with the result that tax will ordinarily be payable subject to

deductions for allowances or reliefs, etc....

24. An Australian case, *Emanuel v Federal Commissioner of Taxation* [1968] HCA 57, concerned the Australia/UK double tax treaty. ... Under the treaty, [the rate of tax on dividends] was reduced to 15% in the case of such dividends to a UK resident "who is subject to United Kingdom tax in respect thereof". The UK resident recipient was not domiciled in the UK, and so, although generally within the scope of UK tax as a resident, was chargeable on income from non-UK sources only to the extent that the income was remitted to the UK. The dividends had not been so remitted.

25. In the High Court of Australia, Windeyer J held that the taxpayer was not entitled to the reduced rate of withholding tax. He said (at [15]):

> "The present case has, as I have said, proceeded on the basis that the taxpayer is not domiciled in the United Kingdom – and that he is treated as having satisfied the Commissioners of Inland Revenue of that fact. Therefore in respect of the dividends in question the 'remittance' basis would apply. Therefore, in my opinion, unless and until they be remitted and received by him in the United Kingdom he is not "subject to United Kingdom tax in respect thereof". These words I think describe a present liability of a person to tax, not the character of income in respect of which he will if it comes to him in the United Kingdom in the future incur then a liability to tax"

26. In *General Electric Pension Trust v Director of Income-tax (International Taxation)* Mumbai (2005) 8 ITLR 1053, the Indian Authority for Advance Rulings held that a pension fund which was exempt from tax in the US under US tax law was not "subject to tax" in the US and so could not fall within the meaning of "resident of a Contracting State" as that was defined for a trust under the US/India double tax treaty. After describing the relevant provision, under which in the case of income derived or paid by a trust the term 'resident of a Contracting State' applied only to the extent that the income derived by the trust (which would have to be liable to tax by reason of residence or another relevant criterion in the State in question) was in addition subject to tax in that State as the income of a resident either in its own hands or in the hands of the beneficiaries, Syed Shah Mohammed Quadri J said (at p 1061):

> "It is worth pointing out that the phrase 'liable to tax' in para (1) and the phrase 'subject to tax' in proviso (b) are not synonymous. If both were read to be synonymous, proviso (b) would become otiose. Whereas para (1) speaks of being in the tax net, proviso (b) speaks of actual taxation."

> [The judge considered various academic articles, and continued]
> 34. In my view, consist with what I regard as the purpose of the treaty in this regard, the ordinary meaning of Art XI(2) is that pension income derived from UK sources is only exempt from UK tax if that income is chargeable to Israel tax such that Israel tax will ordinarily be payable in respect of that income, subject to deductions for allowances and reliefs, etc. This follows from the distinction that must in my view be drawn between the use, in double tax treaties, of the expressions "liable to tax" and "subject to tax", and also by the requirement, under Art XI(2), that the individual concerned should not only be a resident of Israel (that is, resident in Israel for the purposes of Israel tax), but should be subject to tax in respect of the relevant income. The reference to that income in this context clearly distinguishes this provision from one which requires that the individual fall within the scope of a State's taxation generally. This provision is not concerned with the status of the individual, but with the chargeability to tax of the specific income. Income which is exempted from taxation cannot during the currency of that exemption be income in respect of which an individual can be said to be subject to tax.

Under the OECD model wording (lacking the words "subject to tax") treaty relief would apply.[94]

94 See 24.7 (Double Taxation relief for pension income).

CHAPTER SIXTY

EU LAW AND UK TAXATION

60.1 EU law and UK taxation: Introduction

This chapter considers the effect of EU law on UK tax law. A full discussion would volumes. Many such books have been written; as the issues are EU wide, we benefit in the UK from the work of scholars across the EU. This chapter focuses on matters closest to the themes of this work, but I begin with some more general comments which the more impatient reader may wish to skip.

Under the Lisbon Treaty (in force 2009), the Treaty Establishing the European Community is now named: the Treaty on the Functioning of the European Union (TFEU). The numbering of the treaty has changed twice, once following the Treaty of Amsterdam (1999) and again after the Treaty of Lisbon. It may be helpful to set out the former and present numbers of the articles discussed here:[1]

Subject	**Original version**	**Amsterdam version** (1999)	**TFEU** (2009)	**EEA agreement**
Freedom of establishment	52	43	49	31
– public policy exception	55	45	51	32
– for companies	58	48	54	34
Free movement of capital	73b	56	63	40
– standstill	73c	57	64	41
– justification	73d	58	65	42

1 For a table comparing all 3 numberings see *http://global.oup.com/uk/orc/law/eu/hartley7e/resources/table.*
For a comparison of the pre and post Lisbon numbering, see the FCO "A Comparative Table of the Current EC and EU Treaties as Amended by the Treaty of Lisbon" Cm7311.
http://www.official-documents.gov.uk/document/cm73/7311/7311.pdf.

Most of the EU rules discussed here also apply under the EEA agreement; in the interests of brevity, and comprehensibility, references in this chapter to TFEU include the EEA agreement; and references to a member state (MS) include EEA states.

60.1.1 *Cross references*

The following issues are discussed elsewhere:
8.9 (EU restriction on exit taxes)
28.15 (ToA EU law defence)
For further reading, see Terra & Wattel, *European Tax Law* (6th ed., 2012) and Mullan & Brown, *The Interaction of EU Treaty Freedoms and the UK Tax Code* (1st ed., 2011).

60.2 Relationship of EU law and UK law

The primacy of EU law over UK domestic law hardly needs to be stated, but to begin at the beginning: in *Thoburn v Sunderland City Council*, Laws LJ stated the fundamental proposition:

> All the specific rights and obligations which EU law creates are by the 1972 Act[2] incorporated into our domestic law and rank supreme: that is, anything in our substantive law inconsistent with any of these rights and obligations is abrogated or must be modified to avoid the inconsistency. This is true even where the inconsistent municipal provision is contained in primary legislation.[3]

Similarly:

> [24] ...it is a fundamental principle of the law of the EU, recognised in s 2(1) of the European Communities Act 1972, that if national legislation infringes directly enforceable Community rights, the national court is obliged to disapply the offending provision. The provision is not made void but it must be treated as being ... without prejudice to the directly enforceable Community rights of nationals of any member state of the EEC.

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2 The reference is to s.2 European Communities Act 1972 which provides:
"All such rights, powers, liabilities, obligations and restrictions from time to time created or arising by or under the Treaties, and all such remedies and procedures from time to time provided for by or under the Treaties, as in accordance with the Treaties are without further enactment to be given legal effect or used in the UK shall be recognised and available in law, and be enforced, allowed and followed accordingly."

3 [2003] QB 151 at [69].

> [25] Disapplication is called for only if there is an inconsistency between national law and EU law. In an attempt to avoid an inconsistency the national court will, if at all possible, interpret the national legislation so as to make it conform to the superior order of EU law ... Sometimes, however, a conforming construction is not possible, and disapplication cannot be avoided.[4]

60.2.1 *Relationship between UK tax law and EU law*

It follows that there is a "tension, if not an inconsistency between national jurisdiction over direct taxation and EC Treaty freedoms, once those freedoms are interpreted as prohibiting unjustified differential tax treatment of national and foreign EU companies."[5] This area of law raises important questions about the boundaries of market integration and state autonomy.

Settled case law puts it this way:

> although direct taxation falls within the competence of the Member States, the latter must none the less exercise that competence consistently with Community law.[6]

60.2.2 *CJEU case law*

CJEU case law is unlike case law in common law jurisdictions such as the UK.[7]

The CJEU gives one short, single judgment. Those who find these judgments sometimes difficult to follow may take comfort from the words of Lord Neuberger:

> One only has to look at some of the Judgments of the CJEU in Luxembourg to see how compulsory unanimity can result in decisions which (i) are incomprehensible, (ii) have internally inconsistent reasoning, (iii) do not answer the issue that has been referred, or (iv) manage to enjoy all these three regrettable characteristics. (And in these Euro-sensitive times, let me add that there are also some very good judgments emanating from Luxembourg, which are all the more impressive because of the straightjacket imposed by the requirement of

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4 *Fleming (trading as Bodycraft) v HMRC* [2008] STC 324.

5 *Thin Cap Claimants v HMRC* [2011] STC 738 at [7].

6 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439 at [15].

7 In this respect Scotland is like a common law jurisdiction.

compulsory unanimity).[8]

CJEU judgments contain a series of short, broad propositions, mostly repeated verbatim from earlier cases. Once repeated often enough, the propositions are described as "settled case-law." It is best to quote this verbatim. The selection of case(s) to cite as authority for these propositions is therefore somewhat arbitrary; one cannot cite them all.

Earlier cases are cited by name but never considered in detail.

The language of the TFEU is different from UK statutory drafting, and states broad principles with vague evaluative terms which give the CJEU freedom to develop its own principles. There is little consideration of the precise words of the TFEU. Decisions are based on policy considerations to a greater extent than is the case, or at least than is expressed to be the case, in common law:

> ... the Court adopted teleological methods of interpretation. These methods are much closer to those of constitutional courts than to those of international tribunals. Far from keeping to the real or supposed intention of the contracting parties - a compulsory point of reference in the interpretation of international agreements - the judges frequently drew inspiration from the ultimate objective of integration, outlined in broad terms in the preamble of the Treaty. ... The idea is to link each provision of EU law to the normative goals of integration, giving to these provisions the coherence of a complete system of law. Basically, all the interpretative work of the Court was to create a "European teleology" which protects EU law against the dangers of dissolution within the various national legal orders. In constitutionalising EU law, the Court was seeking to protect EU standards from the national legal constrains, the risks of political negotiations, and all the bureaucratic complexities that EU texts are likely to encounter when they enter the national arena. This case law greatly strengthened the authority of EU law, while at the same time giving the EU judge an absolute control of this new legal order.[9]

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8 Lord Neuberger, First Annual BAILII Lecture "No Judgment – No Justice" (2012) *http://www.supremecourt.uk/docs/speech-121120.pdf*. HMRC make the same point in the ToA draft guidance:

"**INTM603140 Genuine transactions exemption: EU law implications**

... Its judgments are in any case often hard for those familiar with UK law to follow, as they are collegiate and sparingly argued."

9 Jones, Menon and Weatherill (eds), *The Oxford Handbook of the European Union* (1st ed, 2012), para 25.2 (the Constitutionalization of the Treaties).

This is tempered with an element of political realism:

> Turning to national governments, it has been suggested that their overall acceptance of the European Court's jurisprudence could be viewed as a clue that judicial behavior was perhaps more concerned with political interests than it might seem at first sight. On this realist reading, because courts are concerned about the prospect of non-compliance or possible hostile reactions, they tend to calculate how far they can go without eliciting too costly a reaction from politicians. ... But there is no shortage of evidence that it is at times willing to challenge the dominant view amount governments. Its landmark rulings in *Van Gend and Loos*[10] and *Costa v ENEL*[11] were taken despite the declared opposition of a majority of states...

The EC maintain a useful updated list of CJEU cases relating to direct taxation.[12] New case law is constantly arriving, and almost all this chapter needs review from year to year.

60.2.3 *EU law terminology*

Judgments are translated into English, so the prose is unidiomatic. Since the usage is consistent, EU law has acquired its own vocabulary, which may be regarded as technical language, virtually a sub-dialect of legal English.[13] I refer to this usage as **"technical EU law terminology"**. It is

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10 Author's footnote: *van Gend en Loos NV v Nederlandse Belastingadministratie* C-26/62 [1963] ECR 1, [1963] CMLR 105 (direct effect of EU law in Member States).

11 Author's footnote; C-6/64 [1964] ECR 585 (EU law supreme and overrides domestic law of Member States).

12 *http://ec.europa.eu/taxation_customs/resources/documents/common/infringements/case_law/court_cases_direct_taxation_en.pdf*
There are also lists of outstanding infringement cases, by country:
http://ec.europa.eu/taxation_customs/common/infringements/infringement_cases/bycountry/index_en.htm
and by policy area:
http://ec.europa.eu/taxation_customs/common/infringements/infringement_cases/bypolicy/index_en.htm

13 Monoglot English readers should not carp. French was used by English lawyers until an Act of 1731, but by 1592 the pronunciation was such that it was impossible for a Frenchman to understand, and "even Englishmen were sometimes shocked by the barbarity of inns of court French"; see Baker, "The Three Languages of the Common Law" (1998) 43 McGill LJ 5
http://www.lawjournal.mcgill.ca/userfiles/other/5850855-43.Baker.pdf

not possible to analyse EU law without adopting this terminology.

There are occasional errors of translation, though the border between technical usage and erroneous usage can be difficult to draw. EU law terminology becomes second nature to those immersed in it, and it is then difficult to step back and notice how the usage has become detached from ordinary English.

The terminology used to describe European treaties and institutions can also be confusing. I follow the guidance in "The European Union: a guide to terminology, procedures and sources".[14]

60.3 The treaty freedoms

Article 26 TFEU provides:

> 1. The Union shall adopt measures with the aim of establishing or ensuring the functioning of the internal market, in accordance with the relevant provisions of the Treaties.
> 2. The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties.

The basic treaty provisions which facilitate the single market, the free movement of goods, services, persons and capital, are sometimes known as the four freedoms. The freedoms which most concern this chapter are freedom of establishment (FoE) and free movement of capital (FMC).

A case could generally be brought under more than one freedom, but it is settled law that CJEU picks the primary freedom and ignores the others. For instance, in *Geurts* (a FoE case) the Court dismissed arguments based on free movement of capital:

> The legislation at issue in the main proceedings primarily affects freedom of establishment and falls, in accordance with the case-law of the Court, within the scope only of the Treaty provisions concerning that freedom. If, as submitted by the applicants in the main proceedings, it were to be accepted that such a national measure has restrictive effects on the free movement of capital, such effects would have to be seen as

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Reading in translation, said Bialek, "is like kissing a woman through a veil".

14 House of Commons Library Standard Note SN/IA/3689. See *http://www.parliament.uk/briefing-papers/sn03689.pdf* *http://www.parliament.uk/business/publications/research/briefing-papers/SN03689/the-european-union-a-guide-to-terminology-procedures-and-sources-house-of-commons-background-paper*.

> an unavoidable consequence of any restriction on freedom of establishment and do not justify an independent examination of that measure in the light of Articles 56 EC to 58 EC [FMC].[15]

Similarly in *Cadbury Schweppes* (a FoE case) the Advocate General dismissed arguments based on freedom to provide services:

> 34 The applicants submit that the provisions of the Treaty on freedom to provide services also apply in this case. They claim that the legislation at issue makes the supply of financial services by [the CFCs] to their UK resident parent company more difficult. ...
> 35. I am not convinced by the applicants' argument....
> 36. Admittedly, if the legislation at issue has the result that a resident company is dissuaded from establishing a subsidiary in another Member State, it also has the result that the supply of services by such a subsidiary out of that Member State is prevented. However, that latter restriction is a consequence of the hindrance to establishment. In the present case, it is exactly the freedom to establish a subsidiary in that Member State which is at the core of the proceedings. I do not therefore see the relevance of reliance on the rules on freedom to provide services as well.[16]

This approach has the attraction of shortening the arguments.

60.3.1 *FoE or FMC: does it matter?*

It will generally make no difference which freedom is said to apply. The defences to different freedoms are differently worded, but being so policy based, they generally come to the same. In *Asscher*[17] after discussing whether a case should be categorised as FoE or FMC, the ECJ said:

> 29. ... a comparison of arts 48 and 52 of the Treaty shows that they are based on the same principles both as regards entry into and residence in the territory of the member states by persons covered by Community law and as regards the prohibition of all discrimination against them on grounds of nationality. The same applies to the pursuit of an economic activity in the territory of the member states by persons covered by Community law.[18]

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15 *Geurts v Administratie van de BTW* Case C-464/05 at [16].

16 *Cadbury Schweppes v IRC* [2006] STC 1908.

17 *Asscher v Staatssecretaris van Financiën* [1996] STC 1025.

18 The Court cited *Ramrath v Ministre de la Justice* (Case C-106/91) [1992] ECR I-3351 at 3381–3382, para 17.

Similarly the Advocate General in *Cadbury Schweppes*:

> In any event, I do not believe that examination of the legislation at issue in the light of that freedom, in addition to freedom of establishment, can change the result of my analysis.[19]

One important difference is that FoE applies only to Member States, but FMC extends to non-EU countries.

Scheunemann[20] concerned a German IHT business property relief. This relief applied to companies with a registered office or principal place of business in the EU. The testator died holding a shareholding of a Canadian company. It did not qualify for the relief as it did not have a registered office or principal place of business in the EU. This was held to be a FoE case, not a FMC case, so the taxpayer was not successful:

> 23 ... according to settled case-law,
> [1] national legislation which is intended to apply only to shareholdings enabling the holder to exert a definite influence over a company's decisions and determine its activities is covered by the Treaty provisions on freedom of establishment.
> [2] On the other hand, national provisions which apply to shareholdings acquired solely with the intention of making a financial investment, with no intention of influencing the management and control of the undertaking, must be examined[21] exclusively in the light of the free movement of capital.[22]

The question then is how large a shareholding is needed to confer a "definite influence". 25% is sufficient:

> 24 It follows that, in order to determine which freedom the national legislation at issue in the main proceedings falls under, it is necessary to examine whether the shareholding referred to in that legislation is sufficient to enable the shareholder to exert a definite influence over the company's decisions and to determine its activities.

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19 *Cadbury Schweppes v IRC* [2006] STC 1908 at[36].

20 *Scheunemann v Finanzamt Bremerhaven* Case C-31/11 (2012).

21 The Court refers to Case C-464/05 *Geurts v Administratie van de BTW* Case C-464/05 at [16].[2007] ECR I-9325, para 16.

22 The Court refers to *Haribo Lakritzen Hans Riegel and Österreichische Salinen,* para 35.

> 25 In the case under consideration, ... the possibility of receiving the tax advantages at issue is conditional upon having a direct holding of more than one quarter of the capital of the company....
> 29 It should accordingly be noted that, for the purposes of granting the tax advantages at issue in the main proceedings, the German legislature specified a shareholding threshold so high that the shareholder in the capital company is able to influence its management and control, and imposed conditions designed to ensure that the shareholder does not intervene solely with the intention of making a financial investment.
> 30 It should therefore be held that the legislation at issue in the main proceedings primarily affects freedom of establishment and that, in accordance with the case-law of the Court, it falls solely within the scope of the Treaty provisions concerning that freedom. If it were to be found that such a national measure has restrictive effects on the free movement of capital, those effects would have to be seen as an unavoidable consequence of a restriction on freedom of establishment and would not justify an independent examination of that measure in the light of the Treaty provisions on the free movement of capital.

In *Proceedings brought by Aberdeen Property Fininvest Alpha Oy*[23] a 20% threshold was regarded as sufficient.[24]

On the other hand, 10% is too low. The Advocate General said in *Columbus Container Services*:[25]

> 52. ... one of the facts giving rise to application [the relevant legislation] is the shareholding by a German taxpayer of at least 10% in the permanent establishment. In principle, it would seem that a holding of this size would preclude the possibility of exercising definite influence over the company's decisions and determining its activities.

Connected person rules are recognised which may aggregate small shareholdings into one conferring definite influence:

> 55. ...not only is Columbus controlled by at least six natural persons belonging to the same family, each of them having a 10% shareholding in the establishment concerned, but, in particular, those persons ... act together and are represented by a single person at the general meeting

23 [2009] STC 1945.

24 Also see *Thin Cap Group Litigation v IRC* [2007] STC 906 at [28] to [33] where UK thin capitalisation rules passed this test.

25 *Columbus Container Services v Finanzamt Bielefeld-Innenstadt* [2008] STC 2554.

> of the partners. Those eight partners therefore appear to be in a position to exercise, collectively, definite influence over Columbus's decisions. In that context, the possible infringement of the right of free movement of capital is merely a consequence of the alleged restriction on freedom of establishment.

This would only apply to well-targeted connected person rules, where the connected persons may be regarded as "acting together". Some aspects of the UK connected person rules are wildly extravagant[26] and would not meet this requirement.

60.4 Freedom of establishment

Article 49 TFEU provides:

> [1] Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited.

Article 49 contains two prohibitions:

(1) A MS cannot restrict a national of another MS (foreign nationals) from setting an establishment in the MS.
(2) A MS cannot restrict its *own* nationals from establishing themselves in another MS (a foreign MS).

The second is the more important in a tax context.

60.4.1 *What is "establishment"?*

Article 49 TFEU continues:

> [2] Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.
> [3] Freedom of establishment shall include
> [a] the right to take up and pursue activities as self-employed persons and
> [b] to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54,
> under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital.

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26 See 85.7.3 (Commentary: An excessively wide definition).

The CJEU said in *Columbus Container Services*:[27]

> 30. ... according to [settled] case law, the acquisition by one or more natural persons residing in a member state of all the shares in a company registered in another member state, conferring on those persons definite influence over the company's decisions and allowing them to determine its activities, is thus covered by the Treaty provisions on the freedom of establishment.[28]

As to whether a trust is an "undertaking" see Weber, *Tax Avoidance and the EC Treaty Freedoms, Kluwer Law International*, (2005), p.27. The enactment of the EU law defences to the ToA rules effectively concede that a trust is an undertaking.

In *Stauffer*[29] an Italian charity (tax exempt in Italy) received rent from an investment property in Germany. German law allowed charity tax exemption only for charities established in Germany. Accordingly the German Revenue sought to impose German tax on the rental income.

The ECJ held that there was no breach of freedom of establishment:

> 19 ... in order for the provisions relating to freedom of establishment to apply, it is generally necessary to have secured a permanent presence in the host Member State and, where immovable property is purchased and held, that property should be actively managed. It is clear from the account provided by the national court that the foundation does not have any premises in Germany for the purposes of pursuing its activities and that the services ancillary to the letting of the property are provided by a German property management agent.
> 20. It must therefore be concluded that the provisions governing freedom of establishment are not applicable in circumstances such as those in the dispute in the main proceedings.

The charity did not carry out any charitable work in Germany and did not actively manage its German investment property. The German property was not an agency, branch, subsidiary or undertaking. The charity did not

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27 *Columbus Container Services v Finanzamt Bielefeld-Innenstadt* [2008] STC 2554.

28 The AG cites *Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem* (Case C-251/98) [2000] ECR I-2787, paras 21 and 22, *Uberseering BV v Nordic Construction Co Baumanagement GmbH* (NCC) (Case C-208/00) [2005] 1 WLR 315, [2002] para 77.

29 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439.

have or seek to have an "establishment" in Germany so there was no restriction on the freedom to establish itself in Germany.[30]

Suppose the foundation had had an establishment in Germany – for instance if it ran a college there or provided services to its tenant rather than using a German property management agent. In that case it would have had an establishment in Germany. Assuming Germany would have denied the charity exemption, would it then have succeeded under this head? Since it succeeded under free movement of capital, the point seems somewhat academic.

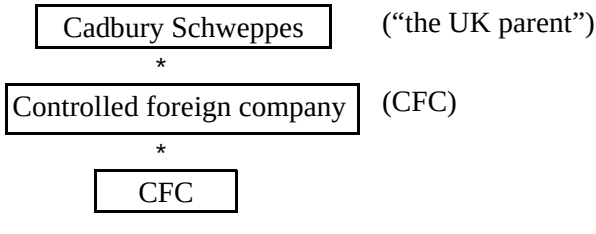
60.4.2 *The objective of FoE*

In *Cadbury Schweppes v IRC*[31] the ECJ say:

> 53. That objective [of FoE] is to allow a national of a member state to set up a secondary establishment in another member state to carry on his activities there and thus assist economic and social interpenetration within the Community in the sphere of activities as self-employed persons.[32] To that end, freedom of establishment is intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a member state other than his state of origin and to profit therefrom.[33]

60.4.3 *What is a restriction on freedom of establishment?*

Cadbury Schweppes v IRC [2006] STC 1908 concerned a simple corporate structure:



30 It seems to me that there was a restriction of the taxpayer's freedom to establish itself *outside* Germany. Because the taxpayer was established in Italy, it incurred a German tax burden which would not have been paid if it had been established in Germany. However the argument was not put on this basis and the ECJ did not consider it. Perhaps it could have responded that the main issue was FMC and not FoE.

31 *Cadbury Schweppes v IRC* [2006] STC 1908.

32 The ECJ cite *Reyners v Belgium* (Case 2/74) [1974] ECR 631, para 21.

33 The ECJ cite *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* (Case C-55/94) [1995] ECR I-4165, para 25.

The ECJ summarised the UK CFC legislation thus:

> 44 Where the resident company has incorporated a CFC in a Member State in which it is subject to a lower level of taxation within the meaning of the legislation on CFCs, the profits made by such a controlled company are, pursuant to that legislation, attributed to the resident company, which is taxed on those profits. Where, on the other hand, the controlled company has been incorporated and taxed
> [1] in the UK or
> [2] in a State in which it is not subject to a lower level of taxation within the meaning of that legislation,
> the latter is not applicable and, under the UK legislation on corporation tax, the resident [parent] company is not, in such circumstances, taxed on the profits of the controlled company.

The CFC legislation distinguished between UK and other EU companies, but it is not self-evident that it *restricted* the UK parent's FoE. However the ECJ held that it did:

> 45 That difference in treatment creates a tax disadvantage for the resident [parent] company to which the legislation on CFCs is applicable. Even taking into account ... the fact ... that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which would have been payable on those profits if they had been made by a subsidiary established in the UK, the fact remains that under such legislation the resident [parent] company is taxed on profits of another legal person. That is not the case for a resident company with
> [1] a subsidiary taxed in the UK or
> [2] a subsidiary established outside that Member State which is not subject to a lower level of taxation.
> 46 ... the separate tax treatment under the legislation on CFCs and the resulting disadvantage for resident companies which have a subsidiary subject, in another Member State, to a lower level of taxation are such as to hinder the exercise of freedom of establishment by such companies, dissuading them from establishing, acquiring or maintaining a subsidiary in a Member State in which the latter is subject to such a level of taxation. They therefore constitute a restriction on freedom of establishment within the meaning of Articles [49 & 54 TFEU].

The CFC rules only applied to companies in some member states, namely, those subject to a lower level of taxation (as defined). Because of this selective operation the CFC rules clearly restricted FoE, since given the

choice in siting a subsidiary in:
(1) a MS with a lower level of taxation or
(2) a MS with a higher level of taxation (but less than the UK)
one would in principle prefer the latter. But the point made at 44[1] and 45[1] shows that the CFC rules would restrict freedom of establishment even if they applied to every MS, regardless of the level of taxation just because they did not apply to a UK subsidiary. At first sight that seems surprising. The OECD express the same view:

> While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spillover effects in *source countries* because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.[34]

The income of the CFC is subject to foreign tax as well as UK tax. Although UK tax allows a credit for the foreign tax, the burden of dealing with two tax systems is a significant one.[35] That might be a deterrent against a UK parent establishing a CFC in any other MS. But that is not the basis of the court's decision.

60.4.4 *Generalising from CFCs to other anti-avoidance rules*

The CFC legislation attributes income of a non-resident to a UK resident. The attribution of income or gains of a non-resident to a UK resident is a feature of many UK anti-avoidance rules.

60.4.5 *Who is entitled to freedom of establishment?*

Article 49 confers FoE on"nationals of a Member State" ie non-nationals do not have FoE. If authority is needed, see *Scheunemann*:

> 33 As regards the Treaty chapter on freedom of establishment, it does not contain any provision which extends the scope of that chapter to cover situations concerning a shareholding in a company which has its registered office in a third country[36] and, as it is, the case before the referring court concerns a shareholding in a capital company which has its registered office in Canada.

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34 OECD, "Action Plan on Base Erosion and Profit shifting" (2013) p.16 *http://www.oecd.org/ctp/BEPSActionPlan.pdf*

35 DT relief was (unfairly) denied: see 59.2.2 (*Bricom*).

36 The Court cites: Case C-102/05 *A and B* [2007] ECR I-3871, para 29, and Case C-157/05 *Holböck* [2007] ECR I-4051, para 28.

> 34 Accordingly, Article 49 TFEU et seq. [FoE] does not apply in a situation such as that at issue in the case before the referring court.[37]

Article 54 TFEU extends the freedom to companies and firms:

> [1] Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

Article 54 goes on to define "companies or firms":

> "Companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.

What about trustees? The right to FoE is a right of nationals of a MS (extended to companies and firms). What is the nationality of a trust? One might look to the nationality of the trustees in their private capacities, or treat the trust as an entity with a nationality.

60.5 Public policy exemption to restriction on FoE

Article 52 TFEU provides an exception for public policy:

> The provisions of this Chapter and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health.

We are concerned with public policy.

60.5.1 *Abuse and justification compared*

In *Cadbury Schweppes* the ECJ considered separately (1) whether there was abuse of EU law and (2) whether the CFC legislation was justified. I would have thought that the two questions were linked, for provisions to prevent abuse would necessarily be justified.

Perhaps the distinction is:

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37 *Scheunemann v Finanzamt Bremerhaven* Case C-31/11 (2012).

(1) in cases of abuse, the EU law defence fails (even if UK provisions are unlawful in EU law);
(2) in the absence of abuse, the EU law defence succeeds (assuming the UK's provisions are contrary to EU law).

60.5.2 *Abuse*

Cadbury Schweppes dealt with abuse quite shortly:

> 35 It is true that nationals of a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation. They must not improperly or fraudulently take advantage of provisions of Community law.

Here of course everything depends on the meaning of the elastic term "improperly". ("Fraudulently" adds nothing since anything which is fraudulent must be improper.)

> 37 As to freedom of establishment, the Court has already held that the fact that the company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom ...
> 38 ... it follows that the fact that in this case Cadbury Schweppes decided to establish [its CFCs] in [Ireland] for the avowed purpose of benefiting from the favourable tax regime which that establishment enjoys does not in itself constitute abuse.

We do not know what abuse is, but we know what it is not, and if this is not abuse then use of a MS company (ie a company established in any MS) for tax avoidance is never an abuse.

The Advocate General explained the reasoning in *Columbus Container Services*:[38]

> ...in the absence of Community harmonisation, it must be accepted that there is competition between the tax regimes of the various member states.[39] It may be a matter for regret that such competition operates without restriction. That question ... calls, however, for an answer of a political nature and therefore has no effect on the rights and obligations of member states under the Treaty.

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38 *Columbus Container Services v Finanzamt Bielefeld-Innenstadt* [2008] STC 2554.
39 The AG refers to the opinion of the AG in *Cadbury Schweppes* at [55].

60.5.3 *Justification*

The ECJ next considered whether there was a justification for the CFC legislation:

> 55 ... in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent
> [1] conduct involving the creation of wholly artificial arrangements which do not reflect economic reality,
> [2] with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.

There are two requirements for justification: [1] is a conduct requirement and [2] is an intention requirement. Both must be present but the conduct requirement is the more important because if there are "wholly artificial arrangements which do not reflect reality" then the intention requirement is likely to be satisfied.

"Artificial" is of course vague[40] and the adjective "wholly" does not add anything except some emphasis. The ToA draft guidance muses on this without taking matters much further:

> *Wholly artificial arrangements*
> 'Wholly artificial arrangements' is a phrase first employed in the ICI case mentioned above. The authoritative text was English, but in the French working language the phrase was *montages purement artificiels*, which no doubt explains why it is sometimes in ECJ cases expressed as 'purely artificial arrangements', as for example in Case C-231/05 *Oy AA*.
> The *ICI* case concerned the UK group relief legislation then at ICTA70/S258 (5)(b) and the definition of holding company as a company whose business consists wholly or mainly in holding interests in UK resident subsidiaries; the court held that this type of rule was clearly not effective in focusing on artificiality. The phrase could be translated (and arguably makes more sense in context) as 'artificial arrangements only' rather than arrangements that in some sense are 'wholly artificial'. In English law ‹wholly artificial' arrangements might well be taken to mean sham arrangements (those fraudulently misleading, which very plainly was not in the mind of the court).
> The EU Commission (in its communication mentioned above) takes the view that ‹the detection of a wholly artificial arrangement … amounts in effect to a substance over form analysis'. That is a more effective approach than attempting to understand in what sense an arrangement can be 'wholly artificial'.
> A scheme may thus be regarded as artificial if it lacks genuine economic

40 See 32.17.2 ("Artificial" transactions and devices).

substance born of commercial purpose ('devoid of economic reality', as expressed at paragraph 63 of *Oy AA*) but is inserted to gain an advantage not within the aims of the Treaty. These aims are, for freedom of establishment 'economic interpenetration', a phrase taken from Cadbury Schweppes; and for freedom of movement of capital the efficient allocation of capital.

Paragraph 63 of *Oy AA* reads as follows:

> 'Even if the legislation at issue in the main proceedings is not specifically designed to exclude from the tax advantage it confers purely artificial arrangements, devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory, such legislation may nevertheless be regarded as proportionate to the objectives pursued, taken as a whole.'

The ECJ's decision in that case was based on the application of both the 'prevention of tax avoidance' and 'balanced allocation of taxing rights' justifications. It demonstrates that counteraction may be applied by an authority where there are gratuitous transfers of income from one tax jurisdiction to another within a group of companies. This 'profit shifting' is a common theme. It is easier to justify counteraction where there are transfers of assets or income without commercial exchange, threatening the balanced allocation of taxing rights.

What is the conduct requirement?

> ... objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment, as set out in paras 54 and 55 of this judgment,[41] has not been achieved.

When is the objective of FoE not achieved?

> 54. Having regard to that objective of integration in the host member state, the concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that state for an indefinite period ... Consequently, it presupposes actual establishment of the company concerned in the host member state and the pursuit of genuine economic activity there.
>
> 65 In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.

What is economic reality?

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41 For para 54, see 60.4.2 (The objective of FoE).

> 66 That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State, as is apparent from the case-law recalled in paras 52 to 54 of this judgment.

The expression "genuine economic activities" does not take us much further.

> 67 ... that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.

"Premises, staff and equipment" are easily understood. The question is: how large a premises, how many staff and how much equipment is needed?

> 68 If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a "letterbox" or "front" subsidiary.

The metaphors of "letterbox" and "front" and the epithet "fictitious" and "artificial" are conclusions rather than useful tests or even indications of what is "economic reality". The use of the words "genuine", "real" and "artificial" is normally a sign of conceptual desperation.[42] The ECJ offers a comment on "artificial":

> 69 On the other hand, as pointed out by the Advocate General in point 103 of his Opinion, the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement.

My conclusion is that what constitutes "genuine economic activities" is still at present a fairly open question.[43] The answer should become clearer

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42 See Appendix 3 (What Do We Mean by "Real"?).

43 For HMRC views see "Taxation of the foreign profits of companies: a discussion document" (June 2007) *http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=H*

in time.

60.5.4 *EC guidance*

In 2007 the EC issued a Communication "The application of anti-abuse measures in the area of direct taxation" (**"the 2007 EC anti-abuse statement"**).[44] This focusses on CFC and thin capitalisation rules, but the analysis is also relevant to other issues, such as the ToA EU law exemption.

2. DEFINITIONS AND KEY PRINCIPLES FROM ECJ CASE LAW

Avoidance and abuse

The ECJ has held that a person who would otherwise be in a situation covered by Community law may forfeit his Community law rights where he seeks to abuse them. Such cases are exceptional: an abuse occurs only where, despite formal observance of the conditions laid down in the relevant Community rules, their purpose is not achieved and there is an intention to obtain an advantage by artificially creating the conditions for obtaining it[45]. The ECJ has in particular applied the doctrine to the Community legislation on export refunds and VAT.

In its case law on direct taxation the ECJ has, in addition, held that the need to prevent tax avoidance or abuse can constitute an overriding reason in the public interest capable of

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MCE_PROD1_027592:

"In *Cadbury Schweppes*, the ECJ confirmed that there is a legitimate role for CFC rules under the Treaty, so long as the rules do not tax the profits of genuine economic activities in overseas subsidiaries.

The Government considers that, in making this judgment, the Court intended to draw a meaningful distinction between profits from a genuine commercial activity and profits that have been artificially divorced from the activity that creates them. So CFC rules should not be protectionist: but at the same time they may permit the fair allocation of taxing rights between Member States, so respecting the Treaty.

Commentators who have criticised the changes the Government has made in [s.751A ICTA] claim that in the light of Cadbury Schweppes only highly artificial transfers may be targeted by CFC rules. Subsequent rulings from the Court (e.g. on the thin capitalisation case) support the Government's wider reading – but full certainty on this point is unlikely to be achieved in the short term."

But the EC did not agree with HMRC: Reference: IP/11/606, 19 May 2011:

"Despite the corrective measures taken by the UK, the Commission considers that the UK is still not fulfilling its obligations under Articles 49 and 63 (freedom of establishment and free movement of capital) of the Treaty on the Functioning of the EU .... Indeed, UK provisions may lead, in certain cases, to an additional taxation of profits made by subsidiaries engaged in genuine economic activities in other EU Member States or EEA countries."

44 COM(2007) 785 final
http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52007DC0785

45 *Emsland-Stärke* C-110/99, #52-53; Halifax C-255/02, #74-75.

justifying a restriction on fundamental freedoms[46] . The notion of tax avoidance is however limited to "wholly artificial arrangements aimed at circumventing the application of the legislation of the MS concerned". In order to be lawful national tax rules must be proportionate and serve the specific purpose of preventing *wholly artificial arrangements*.

Wholly artificial arrangements

Prompted by arguments raised by MSs the ECJ has identified several factors which do not of themselves suffice to constitute abusive, i.e. wholly artificial arrangements. It has held, for instance, that the mere fact that a subsidiary is established in another MS cannot, of itself, be treated as giving rise to tax avoidance[47] and that the fact that the activities carried out by a secondary establishment in another MS could just as well be pursued by the taxpayer from within the territory of its home MS does not warrant the conclusion that there is a wholly artificial arrangement[48]. The ECJ has also expressly confirmed that it is quite legitimate for tax considerations to play a role in the decision on where to establish a subsidiary[49] . The objective of minimising one's tax burden is in itself a valid commercial consideration as long as the arrangements entered into with a view to achieving it do not amount to artificial transfers of profits. In so far as taxpayers have not entered into abusive practices, MSs cannot hinder the exercise of the rights of freedom of movement simply because of lower levels of taxation in other MSs[50] . This is the case even in respect of special favourable regimes in the other MSs' tax systems[51]. Distortions to the location of business activities due to state aid that is incompatible with the EC Treaty and to harmful tax competition do not entitle MSs to take unilateral measures intended to counter their effects by limiting freedom of movement[52]; rather they need to be resolved at source through the appropriate judicial or political procedures. Obviously, anti-abuse measures must themselves, too, comply with the EC treaty provisions on state aid[53]. ...

In order for anti-abuse rules to be justified, they must be confined to situations in which there is a further element of abuse. In its recent case law the ECJ has given more explicit guidance on the criteria for detecting abusive practices, i.e. wholly artificial arrangements. In Cadbury, the ECJ held that an establishment is to be regarded as genuine where, based on an evaluation of objective factors which are ascertainable by third parties, in particular evidence of physical existence in terms of premises, staff and equipment, it reflects economic reality, i.e. an actual establishment carrying on genuine economic activities and not a mere "letterbox" or "front" subsidiary[54]. In *Thin Cap*[55] the issue was not whether the establishment of the taxpayers concerned was genuine but whether the MS concerned could impose tax restrictions on financing arrangements between related companies. The ECJ confirmed that the fact that the terms and conditions of financial transactions between

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46 Eg. *Lankhorst*, C-324/00, #37.
47 *ICI*, C-264/96, #26.
48 C-196/04, #69.
49 *Cadbury*, #37.
50 *Eurowings*, C-294/97, #44.
51 *Cadbury*, #36-38.
52 Eg. AG Léger in *Cadbury*, #55-60.
53 See, Commission Notice of 11 November 1998, OJ C 384/98, in particular #13.
54 #67-68.
55 C-524/04.

related companies resident in different MSs deviate from those that would have been agreed upon between unrelated parties constitutes an objective and independently verifiable element for the purpose of determining whether the transaction in question represents, in whole or in part, a purely artificial arrangement. Legislation framed on that basis was proportionate on condition that the taxpayer was given the opportunity to provide evidence of any commercial justification for the arrangement.

The detection of a wholly artificial arrangement thus amounts in effect to a substance-over-form analysis. Application of the relevant tests in the context of EC Treaty freedoms and corporate tax directives necessitates an evaluation of their objectives and purposes against those underlying the arrangements entered into by their prospective beneficiaries (taxpayers). In the context of corporate establishment there are inevitably difficulties in determining the level of economic presence and commerciality of arrangements. Objective factors for determining whether there is adequate substance include such verifiable criteria as the effective place of management and tangible presence of the establishment as well as the real commercial risk assumed by it. However, it is not altogether certain how those criteria may apply in respect of, for example, intra-group financial services and holding companies, whose activities generally do not require significant physical presence...

Proportionality

It follows from *Cadbury* and *Thin Cap* that, for the purposes of determining whether a transaction represents a purely artificial arrangement, national anti-abuse rules may comprise 'safe harbour' criteria to target situations in which the probability of abuse is highest. Indeed, the Commission shares the view of Advocate General (AG) Geelhoed who, in *Thin Cap*, opined that the setting out of reasonable presumptive criteria contributes to a balanced application of national anti-abuse measures as it is in the interest of both legal certainty for the taxpayers, and workability for tax authorities[56].

... Moreover, the adjustments to the taxable income as a result of the application of the anti-abuse rules should be limited to the extent that is attributable to the purely artificial arrangement. With regard to intra-group transactions that means adherence to the arm's length principle, i.e. the commercial terms as would have been agreed upon between unrelated parties. However, this, in the Commission's view should not prevent MSs from imposing penalties on taxpayers who have made use of abusive schemes to avoid tax.

3. APPLICATION OF ANTI-ABUSE RULES WITHIN THE EU/EEA

General

MSs need to be able to operate effective tax systems and prevent their tax bases from being unduly eroded because of inadvertent non-taxation and abuse. At the same time, it is important to ensure that there are no undue obstacles to the exercise of the rights conferred upon individuals and economic operators by Community law provisions. Anti-abuse measures must therefore be accurately targeted at wholly artificial arrangements designed to circumvent national legislation (or Community rules as transposed into national legislation). This is also the case with regard to the application of anti-abuse rules in relation to EEA States (except for situations where there is no adequate information exchange relationship with the EEA State concerned). In order to ensure that such rules are not disproportionate to the objective of curbing abuse and to guarantee legal certainty,

56 #66.

adequate safeguards must be provided so that taxpayers have the opportunity to provide evidence of any commercial justifications that there may be for their arrangements...

60.5.5 *ToA Guidance*

The ToA draft guidance provides:

> **INTM603140 Genuine transactions exemption: EU law implications**
> In practice, the EU Commission (in its communication COM (2007)0785)[57] has indicated that national anti-abuse rules may incorporate 'safe harbour' criteria aimed at situations where the probability of abuse is highest. These may set out reasonable presumptive criteria which contribute to a balanced application of domestic anti-abuse measures in the interests of legal certainty for taxpayers and workability for tax authorities (AG Geelhoed in Case C-524/04 *Thin Cap*).
> • Abuse of the freedoms
> The ECJ has held that a person who would otherwise be in a situation covered by EU law may forfeit the rights under it where there is an attempt to abuse them. The criteria were set out in a case involving the Common Agricultural Policy, Case C-110/99 *Emsland-Stärke*, paragraphs 52 and 53:
>
> > 'A finding of abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by Community [EU] rules, the purpose of those rules has not been achieved. It requires, second, a subjective element consisting in the intention to obtain an advantage from the Community rules by creating artificially the conditions for obtaining it.'
>
> The principle has been applied to VAT (Case C-255/02 *Halifax Bank*, and more recently to direct tax in Case C-196/04 *Cadbury Schweppes*. Paragraph 51 of the court's decision in *Cadbury Schweppes* is as follows:
>
> > 'On the other hand, a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned ...
>
> It is an established principle that loss of tax is not in itself an abuse (see, for instance, Case C-294/97 *EUROWINGS*). And the importance of market freedoms is illustrated by company law cases such as Case C-212/97 *Centros* and Case C167/01 *Inspire Art*. These suggest that the circumvention of national rules by exercising the freedoms does not itself amount to abuse. But those cases involved companies and creditor protection. There is a clear application of market principles in a company choosing lighter regulation in a particular territory. Similarly, there is an exercise of market freedoms where a commercial entity chooses to take advantage of a reduced rate of taxation in another member state. This is illustrated by *Cadbury Schweppes*. A fiscal authority, however, may continue to tax without breaching those freedoms where there is no real application and serving of the Treaty freedoms (see below) but rather tax driven artificial arrangements designed to exploit the freedoms rather than to serve them.

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57 "The application of anti-abuse measures in the area of direct taxation"; see above.

60.6 Free movement of capital

Article 63 TFEU provides:

> 1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.
> 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

In this book I refer to third countries as **"non-EU countries**" as that seems clearer.

60.6.1 *Meaning of "movement of capital"*

The TFEU does not define "movement of capital" or "payments between member states". In practice the CJEU has regard to the list in annex 1 directive 88/361/EEC.[58] The technical EU law terminology is **"the nomenclature"**.

In *Test Claimants in the FII Group Litigation v IRC*[59] the ECJ said:

> 179. It is settled case law that, ... art 1 of Directive 88/361... retains the same indicative value, for the purposes of defining the term ‹movement of capital', ... subject to the qualification, contained in the introduction to the nomenclature, that the list set out therein is not exhaustive.[60]

The list – too long to set out here – includes gifts and inheritance. In *Scheunemann* the CJEU states:

> 22... Inheritances consisting in the transfer to one or more persons of assets left by a deceased person, ... are movements of capital for the purposes of Article 63 TFEU.[61]

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58 Directive for the implementation of Article 67 of the Treaty, 24 June 1988 (now repealed).

59 [2007] STC 326.

60 The Court cites: *Trummer* (Case C-222/97) [1999] ECR I-1661, para 21; *van Hilten-van der Heijden v Inspecteur van de Belastingdienst/Particulieren. Ondernemingen buitenland te Heerlen* (Case C-513/03) [2006] ECR I-1957, para 39.

61 The Court cites: Case C-11/07 *Eckelkamp* [2008] ECR I-6845, para 39; Case C-43/07 *Arens-Sikken* [2008] ECR I-6887, para 30; Case C-35/08 *Busley and Cibrian Fernandez* [2009] ECR I-9807, para 18; and Case C-25/10 *Missionswerk Werner Heukelbach* [2011] ECR I-0000, page 497, para 16).

It is not necessary that the donor or donee engage in cross-border economic activity for the applicability to inheritances of the free movement of capital provisions, so free movement of capital is important for IHT.

60.6.2 *What is a "restriction" on movement of capital?*

In *Test Claimants in the FII Group Litigation v IRC*[62] the ECJ say:

> 184. It is clear from case law that any less favourable treatment of foreign-sourced dividends in comparison with nationally-sourced dividends must be regarded as a restriction on the free movement of capital in so far as it is liable to make the acquisition of holdings in companies established in other member states less attractive.[63]

In *Stauffer*[64] the ECJ held that a charity tax relief applying only to income of charities established in Germany constituted a restriction on free movement of capital.

Similarly in *Persche*[65], an income tax relief for donors to German charities only constituted a restriction on free movement of capital. This was just a rerun of the arguments in *Stauffer* and the conclusion was inevitable.

The point was followed again in *Missionswerk*[66] at [24]–[26] where a Belgian succession duty relief restricted to Belgian non-profit organisations was held to be a restriction on free movement of capital.

A similar approach applies to determine what is a restriction on FoE.

There are interesting cases forthcoming: *EC v Spain*[67] and *EC v Germany*[68] concerning domestic IHT rules discriminating against non-residents.

60.7 Movement of capital to non-EU countries

Free movement of capital applies not just between member states but also between member states and non-EU countries (the technical EU law terminology is **"third countries"**). It is the only one of the four freedoms

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62 [2007] STC 326.

63 The ECJ cite: *Verkooijen*, para 35, *Lenz*, para 21, and *Manninen*, para 23.

64 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439.

65 *Persche v Finanzamt Lüdenscheid* [2009] STC 586.

66 *Missionswerk Werner Heukelbach eV v 'État belge* Case C-25/10.

67 Case C-127/12.

68 Case C-211/13.

which applies to non-EU countries.

60.7.1 *The standstill derogation*

There is a transitional relief in the case of non-EU countries. Article 64 TFEU provides:

> 1. The provisions of Article 63 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Union law adopted in respect of the movement of capital to or from third countries involving
> [a] direct investment — including in real estate —
> [b] establishment,
> [c] the provision of financial services or
> [d] the admission of securities to capital markets. ...

This is known as the **"standstill"** derogation.

The TFEU does not define "direct investment". In practice the CJEU has regard to the list in annex 1 directive 88/361/EEC[69] which provides:

> I - DIRECT INVESTMENTS
> 1. Establishment and extension of branches or new undertakings belonging solely to the person providing the capital, and the acquisition in full of existing undertakings.
> 2. Participation in new or existing undertaking with a view to establishing or maintaining lasting economic links.
> 3. Long-term loans with a view to establishing or maintaining lasting economic links.
> 4. Reinvestment of profits with a view to maintaining lasting economic links.
> A - Direct investments on national territory by non-residents
> B - Direct investments abroad by residents...
> EXPLANATORY NOTES
> For the purposes of this Nomenclature and the Directive only, the following expressions have the meanings assigned to them respectively:
> **Direct investments**
> Investments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or to maintain lasting and direct links between the person providing the capital and the entrepreneur to whom or the undertaking to which the capital is made

69 Directive for the implementation of Article 67 of the Treaty, 24 June 1988 (now repealed).

> available in order to carry on an economic activity. This concept must therefore be understood in its widest sense.
> The undertakings mentioned under I-1 of the Nomenclature include legally independent undertakings (wholly-owned subsidiaries) and branches.
> As regards those undertakings mentioned under I-2 of the Nomenclature which have the status of companies limited by shares, there is participation in the nature of direct investment where the block of shares held by a natural person of another undertaking or any other holder enables the shareholder, either pursuant to the provisions of national laws relating to companies limited by shares or otherwise, to participate effectively in the management of the company or in its control.
> Long-term loans of a participating nature, mentioned under I-3 of the Nomenclature, means loans for a period of more than five years which are made for the purpose of establishing or maintaining lasting economic links. The main examples which may be cited are loans granted by a company to its subsidiaries or to companies in which it has a share and loans linked with a profit-sharing arrangement. Loans granted by financial institutions with a view to establishing or maintaining lasting economic links are also included under this heading.

Thus "direct investment" is a somewhat technical term.

In *Test Claimants in the FII Group Litigation v IRC*[70] the ECJ comment on "direct investment":

> 180. The same indicative value must be given to that nomenclature [ie art 1 of Directive 88/361] in interpreting the concept of direct investment. The first section of that nomenclature, entitled "Direct investments" includes the establishment and extension of branches or new undertakings belonging solely to the person providing the capital and the acquisition in full of existing undertakings, participation in new or existing undertakings with a view to establishing or maintaining lasting economic links, long-term loans with a view to establishing or maintaining lasting economic links, and reinvestment of profits with a view to maintaining lasting economic links.
> 181. As that list and the relative explanatory notes show, the concept of direct investments concerns investments of any kind undertaken by natural or legal persons and which serve to establish or maintain lasting and direct links between the persons providing the capital and the undertakings to which that capital is made available in order to carry out

70 [2007] STC 326.

> an economic activity.
> 182. As regards shareholdings in new or existing undertakings, as the explanatory notes confirm, the objective of establishing or maintaining lasting economic links presupposes that the shares held by the shareholder enable him, either pursuant to the provisions of the national laws relating to companies limited by shares or otherwise, to participate effectively in the management of that company or in its control...
> 196. ... Holdings in a company which are not acquired with a view to the establishment or maintenance of lasting and direct economic links between the shareholder and that company and do not allow the shareholder to participate effectively in the management of that company or in its control cannot, in this connection, be regarded as direct investments..

The ECJ also comment on "existing legislation":

> 195. ... the FID regime cannot be categorised as an existing restriction merely on the basis that, because it is optional, the companies concerned can always elect to be taxed under the system previously in place, with the restrictive effects to which it gave rise. As mentioned in para 162 of this judgment, a system which restricts the freedoms of movement still remains incompatible with Community law, even though its application may be optional.
> 196. ... art 57(1) EC is to be interpreted as meaning that where, before 31 December 1993, a member state has adopted legislation which contains restrictions on capital movements to or from non-member countries which are prohibited by art 56 EC and, after that date, adopts measures which, while also constituting a restriction on such movements, are essentially identical to the previous legislation or do no more than restrict or abolish an obstacle to the exercise of the Community rights and freedoms arising under that previous legislation, art 56 EC does not preclude the application of those measures to non-member countries when they apply to capital movements involving direct investment, including investment in real estate, establishment, the provision of financial services or the admission of securities to capital markets.[71]

Most important UK anti-avoidance legislation already existed in 1993, which could preclude EU law remedies based on FMC for a non-EU country; but post -1993 amendments have been so numerous, and so far reaching, that it is very doubtful whether the standstill derogation still

71 See *Skatteverket v A*, C-101/05 para 49.

applies. The ToA rules, for instance, have been extended to include transfers by non-residents, to apply to UK residents (as opposed to ordinarily residents), to restrict the motive defence, and to exclude DT relief. S.13 TCGA has been extended to foreign domiciliaries, and extended by restrictions on treaty relief in the case of trusts.

60.7.2 *EU Overseas Countries and Territories*

The extent to which the free movement of capital applies to EU Overseas Countries and Territories awaits clarification pending the decision of the ECJ in *Prunus* case (C-384/09). The Advocate General considered in his opinion that this freedom applies to OCTs and that the standstill derogation is not applicable to them.

60.8 Justification for restriction on free movement of capital

Article 65 TFEU provides an exception to the general principle of free movement of capital:

> 1. The provisions of Article 63 shall be without prejudice to the right of Member States
>
> (a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation
>
> [i] with regard to their place of residence or
>
> [ii] with regard to the place where their capital is invested.
>
> (b) [i] to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or
>
> [ii] to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or
>
> [iii] to take measures which are justified on grounds of public policy or public security.
>
> 2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.

One might have thought that article 65(1) overrides FMC in all tax cases, as UK and non-UK entities are not "in the same situation with regard to their place of residence." However the provision is limited by what follows:

> 3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised

> restriction on the free movement of capital and payments as defined in Article 63.

It is not the case that *any* discrimination on the ground of residence or location of property is permitted as restrictions must not be "arbitrary" or "disguised restrictions on free movement of capital".

It is settled law:

> 32 In so far as that provision of Article [65 TFEU] is a derogation from the fundamental principle of the free movement of capital, it must be interpreted strictly. It cannot therefore be interpreted as meaning that all tax legislation which draws a distinction between taxpayers on the basis of their place of residence or the Member State in which they invest their capital is automatically compatible with the Treaty...
> 33 The derogation in Article 58(1)(a) EC is itself limited by Article 58(3) EC, which provides that the national provisions referred to in paragraph 1 of that article 'shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56'.[72]

These principles leave the CJEU free to devise its own principles and that is what it has done.

60.8.1 *"Objectively comparable"*

The wording of the test is settled law, for instance, *Stauffer*:

> 32. According to the case law, for national tax legislation such as that at issue in the main proceedings, ... to be regarded as compatible with the Treaty provisions on the free movement of capital, the difference in treatment must concern situations which are not objectively comparable...[73]

The CJEU are fond of the word "objectively" but it seems to me that it adds rather little; perhaps the point is that the answer is decided by the CJEU and not by anyone else.

"Comparable" is the word always used in this context, but "substantially the same" would, I think, be more idiomatic English. That would highlight the fact that the formula poses, rather than answers, the question of what is required. In other words, "objectively comparable" is a vague and

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72 *Mattner v Finanzamt Velbert* C-510/08.

73 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439.

evaluative expression, which should be regarded as technical EU law terminology.[74]

60.8.2 *Proportionality*

Stauffer continues:

> ... or be justified by overriding reasons in the general interest, such as the need to safeguard the coherence of the tax system or effective fiscal supervision ... In order to be justified, moreover, the difference in treatment between charitable foundations with unlimited tax liability [ie subject to tax on worldwide income, though subject to charity tax exemption] in Germany and foundations of the same kind established in other member states must not go beyond what is necessary in order to attain the objective of the legislation in question.[75]

60.8.3 *Excessive tax cost of abolishing restriction on free movement of capital*

The CJEU does not think much of this argument. In *Thin Cap Claimants v HMRC:*

> It is settled law that reduction in tax revenue does not constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom.[76]

60.8.4 *Need to prevent tax avoidance*

The need to prevent avoidance is accepted as a reason for a restriction on EU freedoms only if the legislation is targeted so that it is limited to cases of tax avoidance. The idea that tax avoidance legislation should be limited in this way is something to which the UK government have paid lip-service but it has not been reflected in practice:

> ... at the moment [anti-avoidance] works like a drive-by shooting. You might hit your objective but you also hit a lot of other people.[77]

It will not surprise tax practitioners that when UK legislation is put to this

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74 Contrast the discussion of the view that people who are "relevantly equal" should pay the same amount of tax; see 1.3.1 (What is fairness?).

75 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439 at [32].

76 [2007] STC 326 at [36].

77 Ussher and Walford, *National Treasure* (Demos, 2011) *http://www.demos.co.uk/files/National_treasure_-_web.pdf?1299511925*.

test, it regularly fails. This is not an exclusively UK problem:

> 37. As regards more specifically the justification based on the risk of tax evasion,[78] it is important to note that the legislation at issue here does not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent German tax legislation, from attracting a tax benefit, but applies generally to any situation in which the parent company has its seat, for whatever reason, outside the Federal Republic of Germany. Such a situation does not, of itself, entail a risk of tax evasion, since such a company will in any event be subject to the tax legislation of the State in which it is established ....[79]

60.8.5 *Need for effective supervision of taxpayers/to prevent fraudulent evasion*

This has not helped national governments. The CJEU takes the view that the mutual assistance directive, now 2010/24/EU, allows national governments "to obtain all the information that may be necessary to effect a correct assessment of a taxpayer's liability to tax".[80]

60.8.6 *Counteracting tax advantages of non-residents*

Mattner concerned German gift tax which made an allowance where donor or donee was resident in Germany. If donor and donee were not resident in Germany, the allowance was not available but the taxpayers had the advantage that German gift tax applied only to property in Germany.

The CFEU did not regard this as justification:

> 40 In the first place, the Finanzamt submits that if the [German statute] provided in such a case for the application of the same allowance to gifts between non-residents and gifts involving a resident, Ms Mattner would be able, by making use of the same tax advantages in her Member State of residence, in which she has unlimited tax liability,[81] to benefit from multiple allowances.
>
> 41 On this point, the Court has already held, in its case-law on the free movement of capital and inheritance tax, that a national of a Member

78 The meaning is "avoidance": see 32.7.1 (Avoidance/evasion distinction).

79 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2003] STC 607.

80 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439 at [50].

81 "Unlimited tax liability" is technical EU law terminology meaning subject to tax on worldwide income, as opposed to a non-Germany resident, who is subject to tax only on German source income ("limited tax liability").

State cannot be deprived of the possibility of relying on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided for by the rules in force in a Member State other than his State of residence ....

42 In any event, the Member State in which the immovable property which is the subject of the gift is located cannot, in order to justify a restriction on the free movement of capital arising from its own legislation, rely on the possibility, beyond its control, of the donee benefiting from a similar allowance by another Member State, such as that in which the donor and the donee resided on the date of the gift, which might wholly or partly offset the loss incurred by the donee as a result of the smaller allowance when calculating the gift tax payable in the former Member State ...

43 A Member State cannot rely on the existence of an advantage granted unilaterally by another Member State – in this case the Member State in which the donor and the donee reside – to escape its obligations under the Treaty, in particular under the Treaty provisions on the free movement of capital ...

44 That is all the more the case if, as the German Government submitted at the hearing, the Member State in which the donor and the donee reside applies a smaller allowance than that granted by the Member State in which the immovable property which is the subject of the gift is situated, or sets the value of that property at a higher figure than that determined by the latter State.

45 Moreover, it appears from the case-file submitted to the Court that, in calculating the tax on gifts, the national legislation at issue in the main proceedings purely and simply excludes the full-rate allowance where the donor and donee are not resident in the Member State in which the property gifted is situated, without taking into consideration the possible grant of a similar allowance in another Member State, such as that in which the donor and the donee reside, or the method of determining the value of the property in the latter Member State.

60.8.7 *Ensuring a balanced allocation between members states of the power to tax*

This was recognised as a possible justification in the *Thin Cap* case [2011] STC 738 at [55].

60.8.8 *Cohesion*

In *Stauffer* the ECJ said:

> 52 In that regard, the Court has acknowledged that the need to safeguard the cohesion of a tax system may justify a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty.[82]

I am not sure what is meant by the terms "coherence" or "cohesion" of the tax system, if it is anything other than a general term for the more specific needs set out above: the need to collect enough tax, and to prevent avoidance and evasion. In OECD papers the word is used specifically to refer to the avoidance of double taxation and double non-taxation.[83] Whatever it means, the concept does not justify much. It did not help the German government in *Stauffer*. In *Thin Cap Claimants v HMRC* the Court of Appeal concluded:

> The permissible scope of the justification of the need to maintain the coherence of the tax system was held to be very narrow indeed, so narrow as to approach vanishing point.[84]

60.8.9 Discrimination on grounds of nationality

Article 18 TFEU provides:

> Within the scope of application of the Treaties, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited...

60.8.10 Overt and covert discrimination

It is settled case law that:

> the rules regarding equal treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result.[85]

Direct and indirect discrimination would be the more natural English expression.

In particular, discrimination by reason of non-residence may be indirect

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82 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2008] STC 1439.

83 Eg OECD, "Action Plan on Base Erosion and Profit shifting" (2013) *http://www.oecd.org/ctp/BEPSActionPlan.pdf*

84 [2011] STC 738 at 26. The point will need to be reviewed when the case is final.

85 *Gielen v Staatssecretaris van Financiën* [2010] STC 1053 at [37] citing *Finanzamt Köln-Altstadt v Schumacker* (Case C-279/93) [1995] STC 306, para 26.

(covert) discrimination by reason of nationality, as residence may serve as a proxy for nationality. But in these cases FoE or FMC is also likely to be in point; I am not sure what it adds to put the complaint under the banner of discrimination.

60.8.11 Comparable situations v different situations

In *Royal Bank of Scotland v Greek State*[86] the ECJ said:

> 26. ... It is settled case law that discrimination consists in the application of different rules to comparable situations or in the application of the same rule to different situations.[87]

Similarly, in *Gielen*[88] the ECJ said:

> 38. ... discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations.[89]

"Comparable" situations is best regarded as technical EU law terminology, meaning "effectively the same situations", ie not relevantly different.[90] Where situations are not "comparable" the EU law terminology is "objectively different" though I do not think that "objectively" adds much except emphasis.

The question is when situations are "comparable" and when are they different. In *Royal Bank of Scotland plc v Greek State*[91] the ECJ said:

> 27. As far as direct taxation is concerned, the court has held, in cases relating to the taxation of income of natural persons, that the situations of residents and non-residents in a given state are not generally comparable, since there are objective differences between them from the point of view of the source of the income and the possibility of taking

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86 [2000] STC 733.

87 The Court cites: *Finanzamt Köln-Altstadt v Schumacker* (Case C-279/93) [1995] STC 306 at 325 para 30, *Wielockx v Inspecteur der Directe Belastingen* (Case C-80/94) [1995] STC 876 at 887, para 17; *Asscher v Staatssecretaris van Financiën* (Case C-107/94) [1996] STC 1025 at 1045, para 40.

88 *Gielen v Staatssecretaris van Financiën* [2010] STC 1053.

89 The Court cites: *Schumacker* (para 30), and *Gschwind v Finanzamt Aachen-Außenstadt* (Case C-391/97) [2001] STC 331, para 21).

90 This nuance of the word "comparable" appears in the expression "closely comparable" (meaning "more or less the same").

91 [2000] STC 733.

> account of their ability to pay tax or their personal and family circumstances.[92] However, it has explained that, in the case of a tax advantage denied to non-residents, a difference in treatment between the two categories of taxpayer might constitute discrimination within the meaning of the EC Treaty where there is no objective difference such as to justify different treatment on this point as between the two categories of taxpayers.[93]

Similarly:

> 29. It is true that companies having their seat in Greece are taxed there on the basis of their worldwide income (unlimited tax liability) whereas foreign companies carrying on business in that state through a permanent establishment are subject to tax there only on the basis of profits which the permanent establishment earns there (limited tax liability). However, that circumstance, which arises from the limited fiscal sovereignty of the state in which the income arises in relation to that of the state in which the company has its seat is not such as to prevent the two categories of companies from being considered, all other things being equal, as being in a comparable situation as regards the method of determining the taxable base.
>
> 30. Consequently, national legislation, such as the Greek tax legislation, which, for the purposes of taxing income, does not establish, as between companies having their seat in Greece and companies which, having their seat in another member state, have a permanent establishment in Greece, any distinction such as to justify, in relation to the same taxation, a difference in treatment between the two categories of companies and which establishes a difference in treatment as regards the rate of income tax, introduces discrimination against companies having their seat in another member state in so far as it imposes on them, irrespective of their legal form and the nature of the shares which they issue, a rate of taxation of 40% whereas the rate of 35% applies only to companies whose seat is in Greece.

A MS may allow tax advantage for non-residents over residents. Of course

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92 The Court cites: *Finanzamt Köln-Altstadt v Schumacker* (Case C-279/93) [1995] STC 306 at 325, paras 31 to 32, *Wielockx v Inspecteur der Directe Belastingen* (Case C-80/94) [1995] STC 876 at 887, para 18; *Asscher v Staatssecretaris van Financiën* (Case C-107/94) [1996] STC 1025 at 1045, para 41.

93 The Court cites: *Finanzamt Köln-Altstadt v Schumacker* (Case C-279/93) [1995] STC 306 at 325, paras 36 to 38; *Asscher v Staatssecretaris van Financiën* (Case C-107/94) [1996] STC 1025 at 1045, para 42.

the rule could hardly be otherwise, given the basic structure of international tax, under which:

(1) residents are subject to tax on foreign income and non-residents are not;

(2) residents are often subject to tax at a higher rate than non-residents.

But a MS may not allow tax advantage for residents over non-residents. In the former case there are relevant "differences" and in the latter case there are no relevant "differences". The policy based nature of the distinction is evident.

60.8.12 *Discrimination against non-residents*

In RBS, the ECJ said:

> 28. As far as the method of determining the taxable base is concerned, the Greek tax legislation does not establish, as between companies having their seat in Greece and companies which, whilst having their seat in another member state, have a permanent establishment in Greece, any distinction such as to justify a difference of treatment between the two categories of companies. As the Commission points out ... tax is calculated, in the case of both Greek and foreign companies, on net income or profits after deduction of the part thereof corresponding to non-taxable receipts, this being determined according to that method both for Greek companies and for foreign companies.[94]

In *Gielen*[95] the ECJ said:

> 40. ... under the national legislation at issue in the main proceedings, a resident taxable business operator may include, for the purposes of calculation under the hours test which gives rise to the right to the self-employed person's deduction, both hours worked in another member state and those worked in the Netherlands, whereas a non-resident taxable business operator can include only hours worked in the Netherlands in that calculation.
>
> 41. ... the Netherlands government recognises in its written observations that this amounts to discrimination based on place of residence.
>
> 42. It must therefore be held that, with regard to satisfaction of the 'hours test' for the purposes of the self-employed person's deduction, the national legislation at issue in the main proceedings treats taxable persons differently depending on whether or not they are resident in the

94 *Royal Bank of Scotland plc v Greek State* [2000] STC 733.

95 *Gielen v Staatssecretaris van Financiën* [2010] STC 1053.

Netherlands....

43. More specifically, the court has indeed accepted, in cases relating to taxation of the income of natural persons, that the situation of residents and the situation of non-residents in a given member state are not generally comparable, since there are objective differences between them, both from the point of view of the source of the income and from the point of view of their ability to pay tax or the possibility of taking account of their personal and family circumstances.[96]

44. However, the court has made it clear that, in the case of a tax advantage which is not available to a non-resident, a difference in treatment as between the two categories of taxpayer may constitute discrimination for the purposes of the Treaty on the Functioning of the European Union where there is no objective difference between those categories such as to justify different treatment in that regard (Talotta (para 19) and the case law cited, and Renneberg (para 60)).

45. The Hoge Raad points out that the self-employed person's deduction is not related to the personal capacity of taxable persons but rather to the nature of their activity. That deduction is granted to business operators whose main activity is running their business, which is demonstrated, inter alia, by satisfying the ‹hours test'.

46. In so far as that deduction is granted to all taxable business operators who have satisfied that test, inter alia, it must be held that it is not relevant in that regard to make a distinction according to whether those business operators performed their work in the Netherlands or in another member state.

47. Consequently, as was stated by the Advocate General in point 39 of his opinion, for the purposes of the self-employed person's deduction, the situation of non-resident taxable persons is comparable to that of resident taxable persons.[97]

48. In those circumstances, it must be concluded that national legislation which, for the purposes of a tax advantage, such as the self-employed person's deduction at issue in the main proceedings, uses an ‹hours test' in such a way as to prevent non-resident taxable persons from including hours worked in another member state risks operating primarily to the detriment of those taxable persons. Consequently, such legislation

96 The CJEU cites: *Talotta v Belgium* (Case C-383/05) [2008] STC 3261, para 19; *Renneberg v Staatssecretaris van Financien* (Case C-527/06) [2008] ECR I-7735, para 59.

97 The CFEU cites: *Gerritse v Finanzamt Neukölln-Nord* (Case C-234/01) [2004] STC 1307, para 27; *Conijn v Finanzamt Hamburg-Mitte-Altstadt* (Case 346/04) [2006] ECR I-6137, para 20.

constitutes indirect discrimination on grounds of nationality for the purposes of art 49 TFEU.

60.8.13 *Option to be treated as resident*

In *Gielen*[98] the ECJ continued:

> 49. That conclusion is not called into question by the argument that the option to be treated as a resident taxable person is capable of remedying the discrimination at issue.
> 50. It should be noted, at the outset, that the option to be treated as a resident taxable person provides non-resident taxable persons, such as Mr Gielen, with a choice between a discriminatory tax regime and one which is ostensibly not discriminatory.
> 51. It has, however, to be pointed out in that regard that such a choice is not, in the present case, capable of remedying the discriminatory effects of the first of those two tax regimes.
> 52. As the Advocate General stated, in essence, in point 52 of his opinion, if such a choice were to be recognised as having the effect described, the consequence would be to validate a tax regime which, in itself, remains contrary to art 49 TFEU by reason of its discriminatory nature.
> 53. In addition, as the court has already had the opportunity to clarify, the fact that a national scheme which restricts the freedom of establishment is optional does not mean that it is not incompatible with European Union law.[99]
> 54. Consequently, the choice offered, in the dispute in the main proceedings, to non-resident taxable persons by means of the option to be treated as resident taxable persons does not serve to neutralise the discrimination established in para 48 above.
> 55. It follows from all of the foregoing that art 49 TFEU [FoE] precludes national legislation which, in relation to the granting of a tax advantage, such as the self-employed person's deduction at issue in the main proceedings, is discriminatory towards non-resident taxable persons, even though those taxable persons may opt for the regime applicable to resident taxable persons in order to benefit from that tax advantage.

Although the option did not remedy the defect in that case, it is possible that taxpayer options may do so in other cases.

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98 *Gielen v Staatssecretaris van Financiën* [2010] STC 1053.

99 The Court cites: *Test Claimants in the FII Group Litigation v IRC* [2007] STC 326, para 162).

60.9 State aid

State Aid rules constitute a significant restriction on the UK's freedom to impose tax rules.

There is an interesting interaction with Scottish devolution. The UK government cannot set a corporation tax rate that varies across the UK: this would be regarded as providing preferential treatment for different areas. Different rates can only therefore be achieved by devolving tax powers. To be EU law compliant the proposal would have to meet the criteria set out in *Portugal v Commission*, (the Azores case): institutional autonomy, procedural autonomy and fiscal autonomy.[100]

Gibraltar's proposed corporation tax regime was held to breach the rules in *Commission v Government of Gibraltar and United Kingdom*.[101]

State Aid may sometimes be convenient for the government in that it provides an excuse for actions which would otherwise be controversial.[102]

This only rarely concerns practitioners in the context of the issues discussed in this book.

60.10 Section 86 TCGA

Section 86 TCGA constitutes a restriction on FoE where the settlor is a MS national, provided the trust is an undertaking for the purposes of FoE.[103]

60.11 IHT and EU law

In December 2011 the EC stated:

> ... Some Member States apply a higher tax rate if the assets, the deceased and/or the heir are located outside their territory. In such cases, EU law is clear: Member States are obliged to respect the basic principles of non-discrimination and free movement set out in the Treaties...
>
> **Next steps**
>
> ... In 3 years time, the Commission will present an evaluation report showing how the situation has evolved, and decide on this basis whether further measures are necessary at national or EU level. Meanwhile, the Commission, as guardian of the Treaties, is continuing to take the necessary steps to act against discriminatory features of Member States

100 Case C-88/03

101 Cases C-106/09, C-107/09.

102 See 5.1 (Trustee residence: Introduction).

103 See 60.4.1 (What is "establishment"?).

taxation rules.[104]

IHT is gradually becoming EU law compliant, with recent changes including the extension of agricultural property relief to land in the EU (2009) and the extension of IHT relief to EU charities (2010 – 2011).[105]

The EC Working Paper provides a helpful summary of case law relevant to IHT as at December 2011.[106] The CJEU found a breach of EU law in 8 of the 10 reported cases. The EC's success rate is comparable to that of HMRC in the UK Courts.

60.11.1 *Discrimination against non-residents*

A number of cases involved more favourable rules given to residents of the domestic MS as against residents of other MS: these have regularly been held to breach FMC or FoE:

Barbier:[107] Domestic IHT law allowed a deduction from the value of an estate if the deceased lived in that Member State at the time of death but not if the deceased resided in another Member State. The rule breached FMC. The value of an obligation attached to the property should be taken into account for tax purposes irrespective of the Member State of residence of the deceased.

Eckelkamp:[108] Domestic IHT law disallowed a deduction for charges on immovable Belgium property owned by non-resident. The rule breached FMC.

Arens-Sikken:[109] Domestic IHT law allows an heir is to deduct debts relating to the property inherited only where the person whose estate is

104 Press release IP/11/1551. For the Communication, Recommendation and Staff Working Paper, see: *http://ec.europa.eu/taxation_customs/taxation/personal_tax/inheritance/index_en.htm*

105 See Kessler & Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013), para 2.4 (Tax definition of charity) online version *http://www.taxationofcharities.co.uk*.

106 Commission Staff Working Paper, "Non-discriminatory inheritance tax systems: principles drawn from EU case-law" *http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/inheritance/working_paper_en.pdf*

107 Case C-364/01.

108 Case C-11/07.

109 Case C-43/07.

being administered was residing, at the time of death, in the Member State in which the property is situated. The rule breached FMC. For the purposes of assessing the compatibility with EC law of domestic inheritance tax legislation, the existence of a tax advantage (ie tax credit) granted unilaterally by another Member State is not relevant.

Mattner:[110] A domestic gift tax relief applicable only where donor and donee are resident in Germany. The rule breached FMC.

Van Hilten-Van Der Heijden:[111] Domestic IHT law taxed the estate of a national who dies within 10 years of ceasing to be resident in that MS: rule compatible with FMC, particularly if the legislation in question allowed relief for inheritance taxes levied by other States. The important point was that the rule did not distinguish between residents and non-residents.

Thus UK s.267 IHT deemed domicile rules are EU law compliant.

60.11.2 *Discrimination against foreign property*

Jäger:[112] Domestic IHT law allowed relief comparable to IHT agricultural property relief for agricultural land in Germany. The rule breached FMC.

For practical implications, see 62.4.3 (Exemption for other MS government securities).

60.11.3 *Miscellaneous*

Geurts:[113] Domestic IHT law allowed an exemption for family undertakings which employed at least five workers in the same Member State. The rule breached FoE.

Halley:[114] Domestic IHT law provided a limitation period for the tax authority to challenge valuations in IHT returns. The period was usually 2 years. However, in the case of shares in a company resident outside Belgium, the period was 10 years. The rule breached FMC.

60.12 Pursuing EU law claims

As an alternative to pursuing points directly, a taxpayer may complain to

110 Case C-510/08.
111 Case C-513/03 [2008] STC 1245.
112 *Jäger v Finanzamt Kusel-Landstuhl* Case C-256/06 (2008).
113 Case C-464/05.
114 Case C-132/10.

the EC, leaving the Commission to take up the issue.[115]

The EC maintain a list of current complaints.[116]

115 For the procedure, see COM(2012) 154 final *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0154:FIN:EN:PDF*.

116 *http://ec.europa.eu/taxation_customs/common/infringements/infringement_cases/bycountry/index_en.htm#unitedkingdom*.

CHAPTER SIXTY ONE

DEEMED DOMICILE FOR IHT

61.1 IHT deemed domicile: Introduction

There are three types of domicile for IHT. We need terminology to describe them and I use the following terms:

(1) General law domicile ("**actual domicile**").[1]

(2) IHT deemed domicile:

(a) under s.267 IHTA ("**s.267 deemed domicile**")

(b) under s.267ZA IHTA ("**spouse election domicile**")

This chapter considers the two types of deemed domicile (**"IHT deemed domicile").** A person who is deemed domiciled in the UK for IHT purposes under these rules is described as **"IHT deemed domiciled"**.

61.1.1 *Scope of IHT deemed domicile*

IHT deemed domicile applies for (almost) all IHT purposes but not for other taxes. For example, it does not affect eligibility for the IT/CGT remittance basis.

The two exceptional situations where IHT deemed domicile does not apply for IHT are discussed elsewhere:

(1) FOTRA securities and qualifying certificates of Islanders[2]

(2) Estate Duty double tax treaties[3]

61.2 S.267 deemed UK domicile

A foreign domiciliary can often live almost indefinitely in the UK without acquiring a UK domicile of choice and so (more or less) exempt from inheritance tax. The s.267 deemed domicile rule seeks to identify foreign

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1 See 3.1 (Domicile: Introduction).

2 See 62.5.1 (Disapplication of IHT deemed domicile rule). For these exemptions generally, see 62.4 (Non-settled property: FOTRA securities); 62.12 (Trusts: FOTRA Securities); 62.8 (Individual domiciled in Channel Islands or Isle of Man).

3 See 69.5 (Domicile requirements of treaty IHT exemption).

domiciliaries who have close UK connections and provides that for IHT purposes, such individuals are generally treated as if they were UK domiciliaries, and so (more or less) within the full scope of IHT.

Section 267(1) IHTA provides:

> A person not domiciled in the UK at any time (in this section referred to as "the relevant time") shall be treated for the purposes of this Act as domiciled in the UK (and not elsewhere) at the relevant time if—
>
> (a) he was domiciled in the UK within the three years immediately preceding the relevant time, or
>
> (b) he was resident in the UK in not less than seventeen of the twenty years of assessment ending with the year of assessment in which the relevant time falls.

"S.267 deemed domicile" is not an altogether helpful label, but no short label could do justice to the rather complicated rules.

In this book:

"The 3-year domicile rule" is the rule in para (a)

"The 17-year residence rule" is the rule in (b)

61.2.1 *3-year domicile rule*

The 3-year domicile rule concerns the person who is actually UK domiciled and who loses their UK domicile. Such a person is IHT deemed domiciled for three years from the date of their change of domicile.

The IHT Manual gives a straightforward example:

> **Example 1** (Paula)
>
> P has an English domicile and lives in England. She retires from work and decides that she wants to live for the rest of her life in Spain. She goes to Spain and takes a Spanish domicile of choice on 31 January 2007. She dies on 1 January 2010 still in Spain.
>
> Because of the deemed domicile 'three year rule' she is deemed domiciled in the UK at her death and her world wide estate is chargeable to IHT. Her estate can, of course, claim tax relief for any Inheritance Tax paid in another country.

Unlike the 17-year residence rule, the three year period is not related to years of assessment.

Section 267(5) IHTA provides:

> In determining for the purposes of this section whether a person is, or at any time was, domiciled in the UK, sections 267ZA and 267ZB are to be

ignored.

Thus spouse election domicile and s.267 deemed domicile operate independently: the loss of spouse election domicile does not give rise to s.267 deemed domicile under the 3-year domicile rule.

61.2.2 *17-year residence rule: Time of acquisition of IHT deemed domicile*

The 17-year residence rule concerns the person who is not actually UK domiciled but who becomes resident here. Once they have been resident in the UK for 17 out of the last 20 years of assessment they become IHT deemed domiciled. In the discussion below I abbreviate "years of assessment" to "tax years".

A person may meet this condition before they have been present in the UK for 17 complete years. In theory, fifteen years and a few days may suffice:

(1) An individual who arrives in the UK on 5 April 2003 may arguably be resident in the UK in the tax year 2002/03. (Although this seems surprising, this was the HMRC view of the pre-SRT residence rules, if the individual came to the UK to live here permanently or intending to stay for three years or more.)

(2) If they are still resident in 2018/19 they may be resident in the tax year 2018/19. The 17-year residence condition would then be satisfied.

Under the SRT, one may not know whether one is resident in a tax year until well into the year, or even until some time after the year. So during the 17th year of residence one may not know whether or not one is IHT deemed domiciled. The taxpayer must guess as best they can, and if that proves to be wrong, then puts in a return or tax reclaim later if needed.

The 17-year residence rule does not apply to visiting forces.[4]

It may be useful to set out an aide memoire of when the 17-year residence rule begins to apply. Assuming a continual period of UK residence:

UK res: s.267 deemed dom	**UK res: s.267 deemed dom**
1997/98: 6 April 2013	2002/03: 6 April 2018
1998/99: 6 April 2014	2003/04: 6 April 2019
1999/20: 6 April 2015	2004/05: 6 April 2020
2000/01: 6 April 2016	2005/06: 6 April 2021
2001/02: 6 April 2017	2006/07: 6 April 2022

4 See App 5.4.2 (IHT deemed domicile).

2007/08: 6 April 2023
2008/09: 6 April 2024
2009/10: 6 April 2025
2010/11: 6 April 2026
2011/12: 6 April 2027
2012/13: 6 April 2028
2013/14: 6 April 2029
2014/15: 6 April 2030

61.2.3 *17-year residence rule: Time of loss of IHT deemed domicile*

If an individual has been UK resident continuously for a block of 17 tax years, IHT deemed domicile under the 17-year residence rule ceases to have effect at the start of the 4th year of non-residence. The matter is best illustrated by a table:

Year	**Resident Years**	**20 years ending year:**				
		2009/10	2010/11	2011/12	2012/13	2013/14
1990/91	*Not relevant*	1				
1991/92	*Not relevant*	2	1			
1992/93	*Not relevant*	3	2	1		
1993/94	Resident 1	4	3	2	1	
1994/95	Resident 2	5	4	3	2	1
1995/96	Resident 3	6	5	4	3	2
1996/97	Resident 4	7	6	5	4	3
1997/98	Resident 5	8	7	6	5	4
1998/99	Resident 6	9	8	7	6	5
1999/00	Resident 7	10	9	8	7	6
2000/01	Resident 8	11	10	9	8	7
2001/02	Resident 9	12	11	10	9	8
2002/03	Resident 10	13	12	11	10	9
2003/04	Resident 11	14	13	12	11	10
2004/05	Resident 12	15	14	13	12	11
2005/06	Resident 13	16	15	14	13	12
2006/07	Resident 14	17	16	15	14	13
2007/08	Resident 15	18	17	16	15	14
2008/99	Resident 16	19	18	17	16	15
2009/10	Resident 17	**20**	19	18	17	16
2010/11	Non-resident 1		**20**	19	18	17
2011/12	Non-resident 2			**20**	19	18
2012/13	Non-resident 3				**20**	19
2013/14	Non-resident 4					**20**
Deemed domicile in 2013/14		**Yes**	**Yes**	**Yes**	**Yes**	**No**

Suppose an individual is resident in the UK throughout the block of 17 tax years from 1993/94 to 2009/10. We have to identify a relevant time. We then have to identify the tax year in which the relevant time falls. The table considers transfers of value in each of the 5 years 2009/10 to 2013/14.

We then have to identify "the twenty years of assessment ending with the year of assessment in which the relevant time falls". For each of the years 2009/10 to 2013/14 those 20 years include the 17-year block (shaded in the table), so the individual is IHT deemed domiciled.

The IHT Manual gives an example:

> **Example 3** (Humberto)
> H is 70 - he has a Portuguese domicile but has been tax resident in England since he was 20. He decides that he wants to move back to Portugal and he leaves the UK for good on 1 January 2007. On 2 January 2007 he makes a gift of £400,000 to a Gibraltar discretionary settlement from his Jersey Bank account. Without the deemed domicile provisions this would be a gift of excluded property.
> However the '17 out of 20' year rule will apply to this transfer as H was tax resident in the UK for part of the tax before he left the UK. There is no provision in the Income Tax Acts for splitting a Tax year in relation to residence, H is assessed and charged Income Tax as if he was UK Tax resident for the whole year. As a result he was non-resident in 2007/08. 2008/09 and 2010/11 only and the transfer is caught by the 17/20 rule.

H should have made a gift of FOTRA securities, which would not have been taxable.

61.2.4 *Comparison of 3- year domicile and 17-year residence rules*

It is easy to envisage cases where a person is caught by one rule and not by the other.

For instance, a person who has always been UK resident and domiciled and who ceases to be UK domiciled on 1 August 2008 and leave the UK a that time. They cease to be caught by the 3-year domicile rule on 1 August 2011. However, as they were UK resident in 2008/09, they will still be IHT deemed domiciled under the 17-year residence rule until 6 April 2012 (the start of the year 2012/13).

Again, a UK domiciled person may reside outside the UK for twenty years, and subsequently acquire an actual foreign domicile. Such a person is not affected by the 17-year residence rule. But three more years must pass before they cease to be UK domiciled under the 3-year domicile rule.

61.2.5 *Meaning of "residence" for 17-year residence rule*

Section 267(4) IHTA provides:

> For the purposes of this section the question whether a person was resident in the UK in any year of assessment shall be determined as for

the purposes of income tax.

Thus in this context "residence" has its normal income tax meaning. From 2013/14, the statutory residence test applies.

For years prior to 1993/94 s.267(4) IHTA provided:

> For the purposes of this section the question whether a person was resident in the UK in any year of assessment shall be determined as for the purposes of income tax *without regard to any dwelling house available in the UK for his use*.

This excluded the (supposed) available accommodation rule but it went further and disregarded available accommodation for all residence purposes.[5] This remained significant when determining residence for the years up to 1992/93 which ceased to feature as part of the 17-year calculation in 2010. The issue might still arise in determining whether trust property is excluded property, as that depends on the domicile of the settlor at the time the trust was made.

IHT Manual provides:

> **10685. D31- Domicile outside the UK** [July 2011]
> Trusts & Estates, Inheritance Tax follow any advice given by PTI Advisory with one qualification. For the tax years before 6 April 1993, someone was considered to be resident in the UK if they visited the UK during the year and had a dwelling house in the UK, which was available for their use. However, availability of a dwelling house was ignored for the purposes of our 17/20 rule (IHTA84/S267 (4)). In the absence of any information, you should assume that advice given by PTI Advisory for the purpose of Income Tax made before 93/94 was **not** made on the basis of this rule alone.

Split years count as full years of residence for s.267 deemed domicile purposes. The pre-2013 split year concession did not apply and from 2013 the position is statutory.[6]

61.3 IHT deemed domiciled individual leaving the UK

Suppose:

(1) A person who is not actually UK domiciled becomes IHT deemed domiciled, having spent 17 tax years resident here.

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5 See the 2012/13 edition of this work para 3.6 (Accommodation in the UK).

6 See 7.1 (Year of arrival and departure).

(2) They then cease to be resident in the UK. In the fourth tax year after departure, they cease to satisfy the 17-year residence rule.

Is the person still treated as domiciled here for three years under the 3-year domicile rule? In other words, does the 3-year domicile rule apply to a person who was only a deemed domiciled under the 17-year residence rule? The answer is, no. If that were wrong, then the following absurdity arises. Suppose T, non-resident for many years, ceases to be actually UK domiciled. In years 1-3 T is still IHT deemed domiciled. In year 4 T ceases to be deemed domiciled. HMRC could argue that since T was (deemed) domiciled in year 3, T must wait three more years before T can cease to be deemed domiciled. Then, of course, three years later T is still deemed domiciled. T can never throw off the deemed domicile. This shows that "domicile" in s.267(1)(a) means actual domicile and not IHT deemed domicile. The word should have the same meaning throughout the section.[7]

61.4 Domicile of child of a IHT deemed domiciled parent

A child in principle acquires the domicile of their father at the time of their birth as a domicile of origin; and if the father's domicile changes while the child is under 16, the child in principle acquires the father's new domicile as a domicile of dependency. Does IHT deemed domicile count for this purpose? Suppose:

(1) A father ("F") is actually foreign domiciled but IHT deemed domiciled when his child ("C") is born; or

(2) F is not IHT deemed domiciled when C is born but becomes IHT deemed domiciled while C is under 16.

It is the old question of how far one carries the deeming. It is suggested that the deemed domicile of F does not affect the domicile of C. The question may not arise directly in that form, as the domicile of children and young persons only rarely needs to be ascertained. When C is adult, it is suggested that his domicile for IHT purposes is determined on the basis of his actual foreign domicile of origin; one does not deem C to have a fictional UK domicile of origin. For s.267 only requires F to be treated as UK domiciled. The section is not needed for C, as C will himself become IHT deemed domiciled once he has been UK resident for 17 tax years.

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7 This is consistent with *Russell v IRC* [1988] STC 195.

61.5 1974 transitional rules

Section 267(3) IHTA contains five transitional rules:

> Para (a) of subsection (1) above shall not apply in relation to a person who (apart from this section) has not been domiciled in the UK at any time since 9th December 1974 ...

This disapplies the 3-year domicile rule only. It would only apply in a relatively rare case of someone who was actually UK domiciled and ceased to be so before 9 December 1974.

> and para (b) of that subsection shall not apply in relation to a person who has not been resident there at any time since that date ...

This disapplies the 17-year residence rule only. It would only apply to someone who had been UK resident for 17-years and ceased to be so before 9 December 1974.

> and that subsection shall be disregarded—
> (a) in determining whether settled property which became comprised in the settlement on or before that date is excluded property,

This applies to pre-9 December 1974 settlements.

> that subsection shall be disregarded— ...
> (b) in determining the settlor's domicile for the purposes of section 65(8) above in relation to settled property which became comprised in the settlement on or before that date, and
> (c) in determining for the purpose of section 65(8) above whether the condition in section 82(3) above is satisfied in relation to such settled property.

This applies to the exemption for FOTRA securities.

61.6 Spouse election domicile

Section 267ZA IHTA provides:

> (1) A person may, if condition A or B is met, elect to be treated for the purposes of this Act as domiciled in the UK (and not elsewhere).
> (2) A person's personal representatives may, if condition B is met, elect for the person to be treated for the purposes of this Act as domiciled in the UK (and not elsewhere).

In the discussion below:

An election under s.267A is a **"spouse**[8] **election**"

IHT deemed domicile under s.267ZA(1) is **"spouse election domicile"**

The conditions in s.267ZA are **"spouse election conditions A and B"**.

The point of making a spouse election is to qualify for the unrestricted IHT spouse exemption: see 73.2 (Restricted IHT spouse exemption for foreign domiciled spouse).

The development of the provisions can be traced through an HMRC Technical Note[9] but that is now of historic interest only.

61.6.1 *Spouse election condition A*

Section 267ZA(3) IHTA provides:

> Condition A is that, at any time
> [a] on or after 6 April 2013 and
> [b] during the period of 7 years ending with the date on which the election is made,
> the person had a spouse or civil partner who was domiciled in the UK.

It is necessary to consider two individuals, which statute calls
- "the person" and
- "the spouse".

To avoid confusion, I refer to them as:

"**W (the electing person)**" and

"**H (the donor spouse)**"

My terminology embodies certain assumptions. The first assumption is that H makes a gift to W. The terminology embodies a gender assumption, which the drafter of the statute rightly avoids, namely that *H* makes a gift to *W*. But it does make discussion of the provisions slightly easier to follow than if the spouses were called X and Y, and in this rather confusing area of law, the reader may grasp at any aid to navigation.

In the usual course of events, W will survive H, but of course H may die first.

Spouse election condition A is just that H (the donor spouse) was UK domiciled or deemed domiciled. But in practice W (the electing person)

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8 I use the word "spouse" to include a civil partner.

9 HMRC, "IHT: spouses and civil partners domiciled outside the UK" (December 2012) accessible *http://www.hmrc.gov.uk/budget-updates/11dec12/784.pdf*.

will only[10] consider a spouse election if:

(1) H makes (or intends to make) a gift to W.
(2) H is UK domiciled or IHT deemed domiciled at the date of the gift.
(3) W is not UK domiciled or IHT deemed domiciled at the date of the gift.
(4) The gift would or might otherwise be chargeable being:
    (a) made on the death of H or
    (b) a failed PET (H has died within 7 years of the gift) or
    (c) a PET anticipated to become a failed PET (H still living but may not survive 7 years from the gift).

In the following discussion, it is assumed that
- H is UK domiciled (at the time of the gift)
- W is not UK domiciled (at the time of the gift), and
- the gift from H to W is a PET.[11]

That is the scenario where the IHT spouse election is important.

61.6.2 *Spouse election condition B*

Section 267ZA(4) IHTA provides:

> Condition B is that
> [A] a person ("the deceased") dies and,
> [B] at any time
> [i] on or after 6 April 2013 and
> [ii] within the period of 7 years ending with the date of death,
> the deceased was—
> (a) domiciled in the UK, and
> (b) the spouse or civil partner of the person who would, by virtue of the election, be treated as domiciled in the UK.

It is necessary to consider two individuals, which statute calls:
- "the deceased" and
- "the spouse who will by virtue of the spouse election be treated as UK domiciled".

To avoid confusion, I refer to them as:
"**H (the deceased donor spouse)**" and
"**W (the electing person)**"

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10 There may, exceptionally, be a case where an election may be made to qualify for relief under a DTA even in the absence of a gift, but I doubt if that would ever happen.

11 See 73.2 (Restricted IHT spouse exemption for foreign domiciled spouse).

Spouse election condition B is just that H (the deceased donor spouse) was UK domiciled or deemed domiciled. But in practice W (the electing person) will only consider a spouse election if:

(1) H makes a gift to W.
(2) H is UK domiciled or IHT deemed domiciled at the date of the gift.
(3) W is not UK domiciled or IHT deemed domiciled at the date of the gift.
(4) The gift would otherwise be chargeable being:
    (a) made on the death of H or
    (b) a failed PET (H has died within 7 years of the gift).

"Lifetime election" and "death election"

Section 267ZB(1) IHTA defines these terms:

> For the purposes of this section–
>
> (a) references to a lifetime election are to an election made by virtue of section 267ZA(3) [condition A], and
>
> (b) references to a death election are to an election made by virtue of section 267ZA(4) [condition B].

The terminology is slightly confusing:

A *lifetime* election (condition A) is made by W (the electing spouse) so W must be alive at the time of the election. But H (the donor spouse) may be alive or dead at the time of the election.

A *death* election (condition B) can only be made after H has died. But W (the electing person) may be alive, or else she may have died (in which case the election is made by W's PRs).

It might have been clearer to refer to a "condition A election" and a "condition B election". I will use the terms

"lifetime election (condition A)" and

"death election (condition B)"

Summarising in a table:

W	**H**	**Election by W**
Alive	Alive	Lifetime election (condition A)
Alive	Dead	Lifetime election or death election (conditions A or B)
Dead	Alive	No election possible until H dies
Dead	Dead	Death election (condition B)

61.6.3 "The 7 year period" and conditions A and B compared

Spouse election conditions A and B refer to distinct periods, thus:

Condition	**Period**
Condition A	7 years ending with the date on which the election is made
Condition B	7 years ending with the date of death H (the deceased donor spouse)

I refer to these as **"the 7 year periods"**.

Condition B is not so different from condition A, except that:

(1) H (the deceased donor spouse) must have died.
(2) The 7 year periods are different:
    (a) Condition A: the 7 year period runs up to the date of the election.
    (b) Condition B: the 7 year period runs up to the date of the death of H (the deceased donor spouse).
(3) If W has died, her PRs may make an election (a death election) under condition B. The PRs cannot make a lifetime election under condition S: if W has not made a lifetime election during her life, the opportunity is lost.

61.6.4 *Date from which spouse election domicile takes effect*

It is necessary to distinguish:

(1) The date that the spouse election is *made*
(2) The date that the spouse election *takes effect*; this is earlier, and will be the date from which spouse election domicile starts.

The starting point is that W (the electing person) can choose the date from which the spouse election takes effect. Section 267ZB(3) IHTA provides:

> A lifetime or death election is treated as having taken effect on a date specified, in accordance with subsection (4), in the notice.

Then s.267ZB(4) IHTA goes on to impose a number restrictions on that freedom of choice. Firstly:

> (4) The date specified in a notice under subsection (3) must—
> (a) be 6 April 2013 or a later date

The earliest date that a spouse election can take effect is 6 April 2013. That is the effective commencement date of the spouse election regime. EU law may provide a remedy for transfers of value before 6 April 2013.[12] The EU law remedy will continue to be important until 6 April 2020 (at which point PETs made before 6 April 2013 must become exempt). The

12 See 73.2.3 (EU law aspects).

EU law remedy will continue to be important even after 2020 where:
(1) H makes a gift to W before 2013.
(2) The gift is a gift with reservation of benefit.
(3) H dies and there is a charge under the GWR rules.
In practice that may not happen often (and if it does, the GWR may often be overlooked).

Section 267B(4) IHTA continues:

> (4) The date specified in a notice under subsection (3) must ...
> (b) be within the period of 7 years ending with—
> (i) in the case of a lifetime election [condition A], the date on which the election is made, or
> (ii) in the case of a death election [condition B], the date of the deceased's death ...

In the case of a lifetime election (condition A), the election must take effect (and spouse election domicile begins) within 7 years of the election. If H (UK domiciled) makes a gift to W (foreign domiciled), and the gift is a PET, there is a choice:
(1) W could elect immediately.
(2) W could wait and see. If H died (or was expected to die) then an election could be made later:
(a) If H survived 7 years then an election should not be needed.[13]
(b) If H died within the 7 year period, W could make an election after the death. This allows W to consider the trade-off between the advantages and disadvantages of the election in the light of the circumstances at the time. For instance, if H survived more than 3 years from H's gift, then W's election decision could take into account IHT taper relief.
(c) There would be a risk that H might die just at the end of the 7 year period, in which case W may be unable to elect in time. But if an election is signed, and ready to dispatch if needed:
(i) The risk is small.
(ii) If W does not elect, there would at least be 80% taper relief on H's gift.[14]

If W has died, without electing, we move to the death election (condition

13 Unless there is a GWR.
14 There is also perhaps a chance that HMRC may allow a late election but one could not expect that.

B). Here the PRs of W (the electing spouse) can only make the election
(1) if H has died, or
(2) if H survives W, but dies within 2 years of W's death.

Section 267ZB IHTA provides:

> (4) The date specified in a notice under subsection (3) must—
> (c) meet the condition in subsection (5).

So we turn to s.267ZB(5) IHTA:

> The condition in this subsection is met by a date if, on the date—
> (a) in the case of a lifetime election—
> (i) the person making the election was married to, or in a civil partnership with, the spouse or civil partner, and
> (ii) the spouse or civil partner was domiciled in the UK, or
> (b) in the case of a death election—
> (i) the person who is, by virtue of the election, to be treated as domiciled in the UK was married to, or in a civil partnership with, the deceased, and
> (ii) the deceased was domiciled in the UK.

In short, the donor spouse must be UK domiciled when the spouse election takes effect, but that does not matter as in practice the election is only wanted in those circumstances.

If H (the donor spouse) has become UK domiciled, W may still make an election to cover an earlier period when H was non-UK domiciled.

The IHT Manual correctly provides:

> **IHTM13046 - Domicile: election by non-UK domiciled spouse or civil partner: the date the election takes effect** [Nov 2013]
> The person making the election does not need to be married or in a civil partnership when the election is made

Individuals who divorce may make an election to cover the period they were married.

61.6.5 *Cessation of spouse election domicile*

IHT deemed domicile is good from the point of view of allowing the unrestricted IHT spouse exemption; but of course it has the drawback that IHT may be due on the death of W (the electing spouse) and on gifts made by her. How much that matters depends of course on all the facts of the case. It may be a serious drawback; it may not. The point of the election is to allow the electing spouse to weigh the advantages and disadvantages.

Section 267ZB(9) IHTA provides:

> A lifetime or death election cannot be revoked.

There is one get-out from spouse election domicile: non-residence. Section 267ZB(10) IHTA provides:

> If a person who made an election under section 267ZA(1) [spouse election] is not resident in the UK for the purposes of income tax for a period of four successive tax years beginning at any time after the election is made, the election ceases to have effect at the end of that period.

So an electing person will cease to be IHT deemed domiciled, and so cease to be liable to IHT on foreign situate assets, after 3 non-resident tax years;[15] that effectively breaks their connection with the UK.

The IHT Manual provides:

> **IHTM13049 - Domicile: election by non-UK domiciled spouse or civil partner: election ceasing to have effect** [Nov 2013]
> ...This approach is in line with the position where a taxpayer is deemed domiciled in the UK under IHTA84/S267(1)(b). To shake off that deemed domicile, they need to be resident outside the UK for four years.

In fact the rules are not aligned. The requirement to lose spouse exemption domicile is to be non-UK resident for four *successive* tax years and deemed domicile is lost at the end of the 4th year of non-residence. The requirement to lose s.267 deemed IHT domicile under the 17-year residence rule is to be non-resident for four tax years, but the non-resident years need not be successive and deemed domicile is lost at the start of the fourth year of non-residence.[16]

61.6.6 *Time limit for death election*

There is no express time limit as such for a lifetime election. However since the election can only take effect within the 7 year period up to the election, there is effectively a time limit of 7 years from the death of H (the deceased donor spouse).[17]

Section 267ZB(6) IHTA provides:

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15 Assuming they are not then deemed IHT domiciled under s.267 IHTA, or actually UK domiciled.

16 See 61.2.3 (17-year residence rule: Time of loss of IHT deemed domicile).

17 See 61.6.2 (Spouse Election Condition B).

> A death election may only be made within 2 years of the death of the deceased or such longer period as an officer of Revenue and Customs may in the particular case allow.

Suppose the sequence of events is:
(1) H makes a gift to W (a PET).
(2) W dies (leaving H surviving).
(3) H dies more than 2 years later (but within 7 years of the gift).
W's PRs may want to elect to make H's gift exempt. They would depend on HMRC allowing a time extension. A refusal to allow extra time may breach EU law, as it penalises the foreign domiciled spouse. But W could have avoided the problem if she had make a lifetime election before she died.

61.6.7 *EU law compliance*

The CIOT say:

> **3 Non-compliance with EU law**
> 3.1 The proposed changes to do not appear to us to be compliant with EU law. It is disappointing that the Technical Note fails to address this aspect at all.
> 3.2 Although, from an EU perspective, the availability of an election, which allows a non-domiciled spouse to elect to be UK-domiciled for IHT purposes, appears to level the playing field, this is a disproportionate response to the perceived problem of assets escaping the inheritance tax net because an election will have the effect of bringing all of the non-domiciled spouse's assets within the UK IHT net.
> 3.3 The European Court has held (Case C-440/08 *F. Gielen v Staatssecretaris van Financiën*) that discrimination cannot be countered by the availability of an election to be treated in particular way if the making of the election, while alleviating the specific issue causing the discrimination, puts the taxpayer in a worse position in some other respect.[18]
> 3.4 In our view a more proportionate response to the discrimination faced by non-domiciled spouses would be to provide for an election which, if made, would apply only to the assets being transferred, that is there would be no inheritance tax on the transfer of value to the spouse, but that the assets would then be caught by UK inheritance tax on a subsequent transfer of value by the non-domiciled spouse regardless of

18 See 60.8.14 (Option to be treated as resident).

where they are situated.[19]

HMRC have not responded, at least publically, and the CIOT have followed this up with a complaint to the EC. It will be interesting to watch how the battle proceeds.

61.6.8 *Planning*

The IHT Manual provides some IHT planning advice:

> **IHTM13047 - Domicile: election by non-UK domiciled spouse or civil partner: consequences of making an election** [Nov 2013]
> When an election is made, the person making the election will be treated as domiciled in the UK for all IHT purposes from the date stated in the election. Consequently, any transfers between spouses or civil partners made after that date qualify for full spouse or civil partner exemption.
> Whether to make an election and the date it is take effect from will require careful consideration as it could mean that a transfer that did not give rise to a charge at the time is was made, proves to be chargeable.
> **Example** (David and Birgit) ("H" and "W")
> H, who is domiciled in the UK transfers property worth £1m in 2014 to his spouse, W who is not domiciled in the UK.
> Subsequently, in 2016, W transfers some German shares to the trustees of an offshore[20] trust.
> H dies in 2019.

The HMRC analysis is as follows:

> At the time of H's transfer, the value transferred is exempt to the extent of £325,000 and a PET to the extent of £675,000.[21] Following his death, the failed PET is chargeable and after deducting the nil-rate band, £350,000 is subject to tax.
> B's transfer was a transfer of excluded property, IHTA84/S6(1). Following D's death, W has the choice of electing to be treated as domiciled in the UK. If she does so, the gift from H in 2014 will become fully exempt as a transfer where both spouses are domiciled in the UK.

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19 CIOT, "IHT Spouses and Civil Partners domiciled outside the UK" (February 2013) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2013/02/130204%20IHT%20and%20NDS%20-%20CIOT%20comments.pdf*.

20 [Author's footnote] The residence of the trust is not relevant to the example.

21 [Author's footnote] It is assumed that H has not made earlier gifts which would reduce the IHT spouse exemption.

> However, W will then be treated as domiciled in the UK from 2014 for all IHT purposes. This means that her transfer to the trustees is no longer one of excluded property and will be subject to IHT. As a transfer to a trust, it will be immediately chargeable to tax.
> W will need to consider all the consequences of making an election...

W (or her advisors) will indeed have much to consider. Firstly, if she elects and falls within the scope of IHT, what will be the IHT on her death? Is she, or will she become non-resident for four years, so as to lose IHT spouse election domicile? Will the current law be held to be invalid under EU law and does she have to take the point now, or can she make the election and take it later?

The example assumes that W did not have to consider the position until the death of H in 2019. But if she is non-resident, she should consider the issue in 2016 when the gift was made. If she had made an election then, and was non-resident, her spouse election domicile would expire in 2020; by waiting until 2019, she extends the period during which she is at risk of IHT.

In fact, if W is non-resident, she should consider the position before H makes the gift. If W had made the spouse election in 2013, then the gift made in 2016 would be exempt, and spouse election domicile would expire in 2017. Even if W is in good health, insurance against the risk of death would be cheaper if the election is made sooner rather than later.

61.6.9 *Procedure for making election*

Section 267ZB(2) IHTA provides:

> A lifetime or death election is to be made by notice in writing to HMRC.

There is no prescribed form. The IHT Manual provides:

> **IHTM13043 - Domicile: election by non-UK domiciled spouse or civil partner: how to make an election** [Nov 2013]
> An election must be made by notice in writing and sent to HMRC. It must be made by the person who is not domiciled in the UK. There is no prescribed form of election, but for HMRC to keep meaningful records it must contain:
> - the full name and address of the person making the election, or for whom the personal representatives are making an election,
> - their date of birth and, if appropriate, their date of death,
> - the full name of their spouse or civil partner who is domiciled in the UK, and

- the date the election is to take effect from.

If you receive an election that does not contain all of the information we need you should write to the sender, using standard letter SL16, to ask for the missing information. The election should be sent to:
Trusts & Estates Risk Team (Elections), Inheritance Tax, Ferrers House, Castle Meadow Rd, Nottingham NG2 1BB.

61.6.10 *Due dates for payment of IHT and returns: Alteration of time limits*

A retrospective election could mean that gifts made by the electing spouse become retrospectively chargeable. This requires some tinkering with the rules relating to time limits and interest. Section 267ZB IHTA provides:

(7) Subsection (8) applies if—
(a) a lifetime or death election is made,
(b) a disposition is made, or another event occurs, during the period beginning with the time when the election is treated by virtue of subsection (3) as having taken effect and ending at the time when the election is made, and
(c) the effect of the election being treated as having taken effect at that time is that the disposition or event gives rise to a transfer of value.

(8) This Act applies with the following modifications in relation to the transfer of value—
(a) subsections (1) and (6)(c) of section 216 [date for payment of IHT] have effect as if the period specified in subsection (6)(c) of that section were the period of 12 months from the end of the month in which the election is made, and
(b) sections 226 and 233 [interest on unpaid tax] have effect as if the transfer were made at the time when the election is made.

61.6.11 *Informing PRs whether spouse election has been made*

The IHT Manual provides:

IHTM13045 - Domicile: election by non-UK domiciled spouse or civil partner: disclosure about elections [Nov 2013]
If a person who has made an election has died, it is possible that their personal representatives may want to know whether or not a lifetime election had been made. This is because it could have a significant impact on the tax liability that arises following their death. If they cannot trace any information amongst the deceased's papers, they may phone the Helpline to find out if we have any record of an election.

> You may not disclose any information about the existence of an election over the phone. Instead, you should ask the executors to make their request in writing and provide evidence that they are the people entitled to apply for a grant of representation.
> If the executors can demonstrate that they are appointed by sending us a copy of the Will, you can disclose whether or not the person has made an election and the date that the election took effect. You can also disclose this information to administrators, provided they can demonstrate that they are applying for letters of administration, or that they are entitled to apply. You should refer any case of doubt to Technical.

61.6.12 *Commentary*

I wonder if this was fully worked out at the time when the legislation was enacted. Probably not. One's confidence is slightly dented by s.267ZB(8) IHTA which provides:

> In determining for the purposes of this section whether a person making an election under this section is or was domiciled in the UK, section 267 is to be ignored.

This is otiose as the domicile of the person making the election (in my terminology, W, the electing person) is not relevant. The provision made sense under the original Finance Bill clauses, but lost its purpose when the provisions were amended at committee stage.

61.7 Tax planning for IHT deemed domiciled individual

An individual who is IHT deemed domiciled because of:
(1) a spouse election; or
(2) 17 years UK residence
will lose IHT deemed domicile status after three or four years non-residence. An individual who is IHT deemed domiciled because of a former actual UK domicile ceases to be UK domiciled 3 years after acquiring a foreign domicile.

For such individuals, a simple form of tax planning is to refrain from making any gifts until they have ceased to be IHT deemed domiciled.

A non-resident individual who is deemed IHT domicile may obtain exemption without waiting four years by purchasing FOTRA securities or some other property which qualifies as excluded property. This may be important for deathbed planning.

In the case of an individual who is IHT deemed domiciled but actually domiciled in the Isle of Man or in the Channel Islands there is scope for

acquiring excluded property in the form of exempt saving certificates.[22]

61.8 Domicile in Channel Islands or IoM

The law discussed in this section is of historic interest only, but there are some interesting territorial policy issues here which continue to resound.

Section 45(1)(c) FA 1975 formerly provided a person was deemed domiciled for IHT purposes if:

> he has, since 10th December 1974, become and has remained domiciled in the Islands[23] and, immediately before becoming domiciled there, he was domiciled in the UK.

This was unlike other types of deemed domicile in that it could continue without limit of time.

The rule was repealed by s.12 F(no.2)A 1983:

> (1) Section 45(1)(c) of the Finance Act 1975 (which treats certain persons who have become domiciled in the Channel Islands or in the Isle of Man as domiciled in the UK) shall cease to have effect.
> (2) This section has effect in relation to transfers of value made, and other events occurring, on or after 15th March 1983.

The repeal extends to the taxation (from 1983) of a settlement made by an Islander who was deemed domiciled under the former s.45(1)(c): the former deemed domicile of the settlor is now disregarded so the trust property may now be excluded property.

John Moore (then Economic Secretary to the Treasury) stated the reason for the repeal:

> The original justification for the [deemed domicile] rule applying to emigrants to the offshore islands was that they were thought to provide particularly convenient bases for those who wished to maintain some contact with the mainland. Morever, at the time when the rule was introduced the islands were within the exchange control area. It was thus easier to shift property there than elsewhere abroad. The rule has been strongly resented in the islands as being discriminatory. The removal of exchange control restrictions has deprived one of the main arguments in support of

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22 See 62.8 (Individual domiciled in Channel Islands or Isle of Man).

23 Section 45(3) FA 1975 provided: "In this section "the Islands" means the Channel Islands and the Isle of Man."

the special rule of its force.[24]

Although John Moore did not mention it, I wonder if enforcability issues also affected the decision.

24 Hansard HC Deb 14 July 1983 vol 45 cc1055-9, *http://hansard.millbanksystems.com/commons/1983/jul/14/domicile*

CHAPTER SIXTY TWO

EXCLUDED PROPERTY FOR IHT

62.1 Excluded property: Introduction

"Excluded property" is (more or less)[1] outside the scope of inheritance tax. There are ten classes of excluded property:

(1) Non-settled property:[2]
   (a) foreign situate property;
   (b) AUTs and OEICs;
   (c) FOTRA securities.
(2) Settled property:
   (a) foreign situate property;
   (b) AUTs and OEICs;
   (c) FOTRA securities.
(3) Qualifying certificates of Islanders (Channel Islands/Isle of Man domiciliaries).
(4) Property of visiting forces.[3]
(5) Reversionary interests in settled property.
(6) Decorations awarded for valour.[4]

Thus with an economy of language the exemptions for excluded property are used to serve several purposes:

(1) A territorial exemption
(2) Limiting the scope of IHT:
   (a) in order to encourage UK investment by foreigners (FOTRA securities, UK funds)

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1 See 62.18 (Excluded property exemptions: Lifetime gift and death charges).

2 A note on terminology. I use the term "non-settled property" to describe property which is not held in a settlement for IHT purposes. The term used in the IHT Manual is "unsettled property".

3 See App 4.4.1 (Excluded property).

4 Section 6(1B) IHTA; this is too specialist a topic to discuss further here.

(b) to fit the scheme of the Act, avoid double taxation (relief for reversionary property)
(c) other meritorious cases (visiting forces, etc)

This chapter considers:
(1) The definition(s) of excluded property
(2) The reliefs for excluded property
(3) The reliefs for works of art, foreign currency bank accounts and foreign pensions, which (though not excluded property) qualify for some similar exemptions

62.1.1 *Cross references*

The following topics are considered elsewhere, see:
64.1 (Transfers between trusts and adding to trusts: Introduction).

62.2 Non-settled property: Foreign situate property

Section 6(1) IHTA provides:

> Property situated outside the UK is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.

Excluded property status depends on the domicile of the individual at the time the disposition is made. Likewise, excluded property status depends on the location of assets at that time only. It is irrelevant that the assets may previously have been situate in the UK. If a foreign domiciled individual transfers their property out of the UK the moment before they die, or the moment before they make a gift of the property, they obtain the full benefit of excluded property status: see *Kwok Chi Leung Karl v Commissioner of Estate Duty* [1988] STC 728. On the situs of assets, see 82.1 (Concept(s) of situs).

62.3 Non-settled property: Authorised unit trusts and OEICs

Section 6(1A) IHTA provides:

> [a] A holding in an authorised unit trust[5] and

5 Defined in s.272 IHTA:
"'authorised unit trust' means a scheme which is a unit trust scheme for the purposes of the Income Tax Acts (see section 1007 of the ITA 2007) and in the case of which an order under section 243 of the Financial Services and Markets Act 2000 is in force."

> [b] a share in an open-ended investment company[6]
> is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.

AUTs and OEICs will generally be UK situate assets. I refer to them together as **"UK funds"**. These are excluded property for all IHT purposes.

The relief only applies to a *holding* in an AUT or a *share* in an OEIC so other interests in AUTs and OEICs (for instance, options) are not excluded property. Perhaps that does not arise in practice.

The exemption for UK funds uses the expression "beneficially entitled" and the exemption for FOTRA securities uses the expression "beneficial ownership" but it is considered that the meaning is the same; for a discussion see 62.6 ("Beneficial ownership" of FOTRA securities).

62.4 Non-settled property: FOTRA securities

The next category of excluded property consists of FOTRA securities[7] (certain UK government securities, sometimes called exempt gilts). FOTRA securities are UK situate assets. Section 6(2) IHTA provides:

> Where securities have been issued by the Treasury subject to a condition authorised by section 22 of the F(No.2)A 1931 (or section 47 of the F(No. 2)A 1915) for exemption from taxation so long as the securities are in the beneficial ownership of persons of a description specified in the condition, the securities are excluded property if they are in the beneficial ownership of such a person.

FOTRA securities issued from 1 April 2005 are titled "Treasury Gilts". Earlier securities have one of the following names:

- Treasury Loan/Stock
- Conversion Loan/Stock
- Exchequer Loan/Stock
- Consolidated Loan/Stock
- War Loan

These names have only historic significance.

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6 Defined in s.272 IHTA:
"'open-ended investment company' means an open-ended investment company within the meaning given by section 236 of the Financial Services and Markets Act 2000 which is incorporated in the UK."

7 "Free of Tax to Residents Abroad".

Products issued by National Savings and Investments are not FOTRA securities.

62.4.1 *Interest on FOTRA securities*

The IHT Manual provides:

> **27260 Exclusion of interest on exempt securities** [January 2014]
> The exclusion for exempt securities can also apply to certain payments of interest on the securities. Payments that qualify for the exclusion are:
> [1] warrants or coupons for interest already received but not encashed at the date of the relevant chargeable event
> [2] apportionment of interest due up to, but receivable after, the date of the chargeable event
> [3] in the case of a trust, any interest payments already encashed but held, at the date of the chargeable event, by the trustees before distribution in the administration of the trust. These payments will be excluded even if no separate moneys can be identified as relating directly to interest on exempt securities.
>
> The **exclusion for interest does not apply** to any warrants or coupons already encashed, or payments of interest already received by the beneficiary in their lifetime, in connection with a chargeable event that happened after they were encashed or received. This is the case whether the beneficiary is the absolute owner of the exempt securities or a beneficiary under a trust.

[1] and [2] are correct, but point [3] seems generous.[8]

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8 For completeness, the Manual continues:
"27261 Exclusion of repayment of IT on exempt securities [February 2006]
Repayment of income tax relating to interest on exempt securities also falls within the exclusion for such securities:
- if an existing warrant for repayment remains uncashed at the date of the relevant chargeable event
- in the case of a trust, if the proceeds of an encashed warrant are held – at the date of the chargeable event – by the trustees pending distribution in the administration of the trust or
- if the repayment due up to the date of the chargeable event is receivable after the date.

A repayment encashed – before a chargeable event – by the person beneficially entitled to the repayment is not eligible for the exclusion on that event."
Before 1998 interest was generally paid subject to deduction of tax. But now interest is paid without deduction of tax (unless the owner asks for tax to be deducted) so this

62.4.2 *Use of FOTRA securities for tax planning*

The exemption is useful for individuals who are:

(1) UK domiciled or IHT deemed domiciled, (so foreign property is not excluded property)

(2) not resident in the UK (so they can satisfy the conditions for exemption).

62.4.3 *Exemption for other MS government securities*

The EC say:

> The underlying [EU law] principles could equally prohibit, inter alia, inheritance tax treatment that ...
> c. is less favourable in the case of public debt securities issued by other Member States than in the case of similar securities issued by the taxing Member State.[9]

The EC is taking action over similar rules in Spain:

> The European Commission has officially requested Spain to amend the provisions of the Inheritance and Gift Tax legislation of the *Territorios Históricos de Alava y Bizkaia* as these do not respect the free movement of capital.
> Under these tax provisions public debt issued by the local administrations (*la Comunidad Autónoma del País Vasco, the Diputaciones Forales or the Entidades Locales Territoriales de los tres Territorios Históricos*) benefits from a preferential tax treatment. This means that titles of public debt from these administrations are less taxed than other similar titles after inheritance. This tax treatment discriminates against investments in public debt issued by other EU Member States or EEA States.
> The Commission's request takes the form of a reasoned opinion. If the legislation is not brought into compliance within two months, the Commission may refer the matter to the EU Court of Justice.[10]

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point will not arise.

9 Commission Staff Working Paper "Non-discriminatory inheritance tax systems: principles drawn from EU case-law" (December 2011) para 3 accessible *http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/inheritance/working_paper_en.pdf*

10 MEMO/13/122 Event Date: 21/02/2013 accessible *http://europa.eu/rapid/press-release_MEMO-13-122_en.htm*

It is considered that the exemption conferred on UK gilts is in breach of EU law: it is an unjustified restriction on free movement of capital.[11] Similar exemption ought to be allowed for national securities of other MS. This matters for two classes of individuals who are not UK resident:

(1) Those who are deemed UK domiciled but not actually domiciled. They would qualify for IHT exemption on all FOTRA securities, and under EU law qualify for exemption on equivalent foreign state securities.
(2) Those who are actually UK domiciled. They qualify for IHT exemption on FOTRA securities.

Of course, foreign securities are non-UK situate property so in the hands of individuals who are foreign domiciled and not deemed UK domiciled, the IHT treatment is the same and no EU law issues arise. Perhaps that is why the EC has taken on Spain on this point and not (or not yet) the UK.

62.5 Conditions for FOTRA exemption

FOTRA securities were first issued under s.47 F(No 2)A 1915. This was a temporary measure:

> The Treasury may, if they think fit, during the continuance of the present war and a period of twelve months thereafter, issue any securities which they have power to issue for the purpose of raising any money or any loan with a condition that neither the capital nor the interest thereof shall be liable to any taxation, present or future, so long as ... the securities are in the beneficial ownership of persons who are neither domiciled nor ordinarily resident in the UK...

This section was repealed in 1927, but the repeal did not affect tax exemptions for securities previously issued and one such security (War Loan 1952 Or After) is still in existence.

Section 22(1) F(No.2)A 1931 provides:

> Any securities issued by the Treasury under any Act may be issued with the condition that -
>
> (a) so long as the securities are in the beneficial ownership of persons who are not [ordinarily][12] resident in the UK, the interest thereon shall be exempt from income tax; and
> (b) so long as the securities are in the beneficial ownership of

11 See 60.11.1 (Discrimination against foreign property).

12 See 62.5.2 (Abolition of ordinary residence).

> persons who are neither domiciled nor [ordinarily] resident in the UK, neither the capital thereof nor the interest thereon shall be liable to any taxation present or future.

Subsequent statutory provisions do not specify the condition for exemption: they give the Treasury a discretion to specify the condition in the terms of the issue. Section 60 FA 1940 provides:

> The power of the Treasury under s.22 F(No.2)A 1931 to issue securities with the condition as to exemption from taxation specified in that section shall extend to the issuing of securities with that condition so modified, whether as to the extent of the exemption or the cases in which the exemption is to operate, as the Treasury may specify in the terms of the issue.

So the details must be found in the prospectus for each gilt concerned.[13] Section 154(1) FA 1996 provides:

> The modifications which, under s.60 of the FA 1940, may be made for the purposes of any issue of securities to the conditions about tax exemption specified in s.22 of the F(No.2)A 1931 shall include a modification by virtue of which the tax exemption contained in any condition of the issue applies, as respects capital, irrespective of where the person with the beneficial ownership of the securities is domiciled.

It is hard to see the need for this, but it does no harm.

Before 6 April 1998 some gilts were issued without FOTRA conditions. These have now been given the benefit of FOTRA conditions by s.161 FA 1998:

> (1) Subject to the following provisions of this section, any gilt-edged security[14] issued before 6 April 1998 without FOTRA conditions shall be treated in relation to times on or after that date as if—
>
> (a) it were a security issued with the post-1996 Act conditions; and
>
> (b) those conditions had been authorised in relation to the issue of that security by virtue of s.22 of the F(No. 2)A 1931...
>
> (4) In this section "FOTRA conditions" means any such conditions about exemption from taxation as are authorised in relation to the issue of a gilt-edged security by virtue of section 22 of the Finance (No 2) Act

13 Prospectuses can be found on *http://www.dmo.gov.uk/rpt_parameters.aspx?rptCode=D8E&page=Prospectuses*

14 "Gilt-edged securities" has the CGT definition: see s.161(6) FA 1998.

> 1931...
> (5) In this section "the post-1996 Act conditions" means the FOTRA conditions with which 7.25% Treasury Stock 2007 was first issued by virtue of s.22 of the F(No. 2)A 1931.[15]
> (7) This section does not apply to any 3½% War Loan 1952 Or After which was issued with a condition authorised by virtue of s.47 of the F(No. 2)A 1915.

So all UK government securities have FOTRA status, irrespective of the original terms of issue but there are two classes of FOTRA securities with different conditions attached. The IHT manual provides:

> **IHTM04291 - Government securities in foreign ownership: introduction** [October 2010]
> ...Prior to 6 April 1998, FOTRA securities or gilts were issued with the additional requirement that the beneficial owner (IHTM04031) had to be domiciled (IHTM27000) as well as ordinarily resident outside the UK. The domicile requirement continues to apply to FOTRA securities that were issued before 29 April 1996.
> Under FA1940/S60(1), The Treasury has powers to modify the operation of the general exemption from taxation specified in the terms of issue of the security concerned. This power was exercised so that with effect from 6 April 1998 all gilts were deemed to be FOTRA gilts. So, for deaths and other chargeable events on or after 6 April 1998, all government securities are excluded property (IHTM04251) for IHT purposes by reference only to the ordinary residence of the beneficial owner.
> The only exception is 3½% War Loan, where the additional domicile condition continues to apply to deaths or other chargeable events on or after 6 April 1998.
> So, in summary,
> - FOTRA securities issued before 29 April 1996 will be exempt provided the beneficial owner is both domiciled and ordinarily resident outside the UK.[16]
> - 3½% War Loan 1952 or after will be only be exempt if the

15 This was one of the first gilts issued in 1996/97. The condition provided: "the Stock will be exempt from all UK taxation, present or future, so long as it is shown that the Stock is in the beneficial ownership of persons who are not [ordinarily] resident in the UK".

16 [Author's note] There are not many gilts left which were issued before 29 April 1996. IHTM 04306 has a list.

beneficial owner is both domiciled and ordinarily resident outside the UK, even if the chargeable event is after 6 April 1998.

- All other government securities issued before 6 April 1998 without FOTRA conditions will be exempt from that date provided the beneficial owner is ordinarily resident outside the UK. Domicile is no longer relevant.
- All other government securities issued after 29 April 1996 will be exempt provided the beneficial owner is ordinarily resident outside the UK. Domicile is no longer relevant.

It would be simpler if all gilts could be governed by the same rules.

62.5.1 *Disapplication of IHT deemed domicile rules*

Section 267(2) IHTA provides:

> Subsection (1) above [s.267 deemed domicile for IHT] shall not apply for the purposes of section 6(2) or (3) or 48(4) above ...

Similarly, s.267ZA(5) IHTA provides:

> An election under this section does not affect a person's domicile for the purposes of section 6(2) or (3) or 48(4).

That is, the IHT deemed domicile rules do not apply for the purposes of the exemptions conferring excluded property status on FOTRA securities and qualifying certificates of Islanders.[17]

The reason is historical. The concept of deemed domicile was introduced with CTT in 1974. At that time gilts had been issued with a promise that they would be free from taxation (including Estate Duty, now IHT) if the owner was not (actually) UK domiciled. The deemed domicile rule could not have been applied to those gilts. All that the drafter needed to do was to disapply the deemed domicile rule to FOTRA securities in issue at the time of the introduction of CTT (now IHT). It was not necessary to disapply the deemed domicile rule to gilts issued later. But that is the rule. Presumably the intention was to avoid having two classes of FOTRA securities governed by different rules; or to encourage foreigners to continue to invest in FOTRA securities issued after 1974.

No doubt the same reasoning applied to qualifying certificates of Islanders.

The practical importance of this rule is diminished by the fact that it is

17 See 62.8 (Individual domiciled in Channel Islands or Isle of Man).

only relevant to those FOTRA securities where IHT FOTRA exemption requires the owner to be domiciled outside the UK; in (I think) almost all cases, except 3½% War Loan 1952 Or After, the exemption only requires the owner to be non resident, and domicile (deemed or actual) is irrelevant.

62.5.2 *Abolition of ordinary residence*

Para 114 Sch 46 FA 2013 provides:

> (4) Sub-paragraph (5) applies to a person who becomes the beneficial owner of a pre-commencement security (or an interest in such a security) on or after 6 April 2013.
> (5) If obtaining the relevant exemption is conditional on being not ordinarily resident in the United Kingdom, any enactment conferring the exemption is to have effect (in relation to a person to whom this sub-paragraph applies) as if obtaining the exemption were conditional instead on being not resident in the United Kingdom.
> (6) In this paragraph—
> "pre-commencement security" means a FOTRA security (as defined in section 713 of ITTOIA 2005) issued before the day on which this Act is passed;
> "the relevant exemption", in relation to a pre-commencement security, means the exemption for which provision is made in the exemption condition (as defined in that section).

Para 114(1) Sch 46 FA 2013 deletes the word "ordinarily" in s.22 F(No.2)A 1931 and para 114(3) provides a similar rule:

> (3) Subject to sub-paragraph (5), the amendment made by sub-paragraph (1) does not affect a pre-commencement security (nor the availability of the relevant exemption).

62.6 "Beneficial ownership" of FOTRA securities

The gilts must be in the "beneficial ownership" of the individual. The expression here has its English law/trust law meaning:

> Although I might not, with Lord Diplock, have gone so far as to think that the expression "beneficial ownership" is a term of art, it is certainly one which has for several centuries had a very well-recognised meaning amongst property lawyers. And there can be no doubt that, in enacting a provision such as [what is now s.1154 CTA 2010], Parliament must have intended to adopt that meaning. It means ownership for your own benefit as opposed to ownership as trustee for another. It exists either

> where there is no division of legal and beneficial ownership or where legal ownership is vested in one person and beneficial ownership or, which is the same thing, the equitable interest in the property in another.[18]

In the following discussion I abbreviate the term to "ownership".

There have been many cases discussing "ownership" in the context of company groups, and the reader who wishes to research this area further should refer to the discussion on group relief in corporation tax and SD textbooks. Unfortunately the case law is in disarray and a number of contradictory dicta can be found. But two propositions seem reasonably clear. Gilts remain in the ownership of a person even if they are subject to a mortgage or charge.[19] Gilts are not in the ownership of a person if they are subject to a contract of sale, even a conditional contract.[20]

Gilts remain in the ownership of an individual even if they have granted put and call options, according to *Sainsbury v O'Connor* 64 TC 208.

Ownership is not a precise term in English law and is used with a variety of meanings. Its common meaning is to denote the sum of all the rights which a person has over an asset; that is, ownership is a bundle of rights, or if you prefer, ownership has a number of incidents.[21] In the case of gilts the bundle (or incidents) consists of the right to dividends, capital on redemption and rights of disposal.

One can make some dent in the usual array of rights or incidents and still be regarded as the owner. This explains why one remains beneficial owner after granting a charge or licence. Where does one draw the line? The courts answer to this question has been confused because they insist that ownership must (with limited exceptions) be regarded as vested in one person or another.

This causes artificial results when property is subject to a contract of sale and it is said that ownership must be vested in either the vendor or purchaser. There is no reason why that should be so, if one remembers that ownership is no more than a convenient term for a bundle of rights. The better analysis is that ownership rights are split between vendor and

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18 *Sainsbury v O'Connor* 64 TC 208 at p.250. For other meanings, see 25.12.1 (Meaning(s) of "beneficial ownership").

19 *English Sewing Cotton v IRC* [1947] 1 All ER 679.

20 *Wood Preservation v Prior* 45 TC 112.

21 See Turner, "Some Reflections on Ownership in English Law" (1941) 19 Can. Bar Review 342; Harris *Property and Justice* (1996) p.125.

purchaser. Neither need be regarded as "the" beneficial owner.[22] Likewise for property subject to an option. On this analysis, *Wood Preservation* was rightly decided but for the wrong reasons, and *Sainsbury* was wrongly decided. But however unconvincing the reasoning, the law on this point is settled below the Supreme Court.

The IHT Manual provides:

> **IHTM27264 Exempt securities as partnership assets** [Jan 2014]
> Very occasionally the assets of a partnership may include exempt securities which will normally constitute 'excepted assets' (see IHTA84/S112) so they will not qualify for Business Relief. In this situation a partner's transfer of their interest in the partnership will be excluded property:
> - to the extent that it is attributable to the exempt securities (IHTM27241)
> - and only if it satisfies the conditions specified for the security
>
> You should calculate the amount to be excluded as follows:
> (Value of exempt securities ÷ Total value of partnership) × Value of transferor's partnership interest

HMRC (rightly) accept that partners are beneficial owners of partnership assets.

62.6.1 *Beneficial ownership in Scotland*

The IHT Manual discusses the expression "beneficially entitled", in a passage which sheds a little light on beneficial ownership:

> **IHTM04031 what is meant by beneficially entitled?** [January 2008]
> The use of the words 'beneficially entitled' means broadly that the estate includes only property
> - to which a person is entitled, or
> - in which they have an interest for their own benefit.
>
> In England, Wales and Northern Ireland this includes property which a person owns either legally or beneficially (IHTM04441).

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22 Likewise the courts have come to reject the dogma that "where ownership is vested in a trustee, equitable ownership must necessarily be vested in someone else because it is an essential requirement of a trust that it confers upon individuals a complex of beneficial legal relations which may be called 'ownership'". See *CPT Custodian Pty v Commissioner of State Revenue* (2005) 221 ALR 196 at [25] accessible *http://www.austlii.org*. Of course, the context in which the expression "beneficial owner" is used should always be considered.

So far, the text is unexceptionable. The discussion then turns to Scotland:

> In Scotland, the term 'ownership' does not necessarily equate to beneficial entitlement, for example where the land that is being transferred is subject to missives of sale [or][23] there is an unrecorded disposition. This is because of the Scottish system of unitary ownership. Any case where the question is in point should be referred to TG for advice.

The text raises the interesting suggestion that the position in Scots law is not the same as in English law.[24] The passage concludes:

> A person is not beneficially entitled to property held
> - purely in a fiduciary capacity (for example as a trustee)
> - in a representative capacity (for example as an executor or a trustee in bankruptcy), or
> - by way of security (for example as a mortgagee prior to foreclosure).
>
> ...

This is clearly right.

62.6.2 *Registration*

The IHT Manual provides:

> **IHTM04294 - Government securities in foreign ownership: type of security and ownership** [October 2008]
> If a government security is a FOTRA gilt you will have to consider who is beneficially entitled to that security to work out whether it is excluded property for IHT purposes.
> If a worthwhile amount is at stake you should investigate the possibility of a last-minute purchase. Except where the available information (e.g. inclusion of sufficient income/interest) reasonably rules out that possibility, you should seek specific confirmation that the securities concerned were in fact registered in the transferor's, or the trustee's, name(s) at the date of the relevant transfer.
> (This text has been withheld because of exemptions in the Freedom of Information Act 2000)

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23 The original reads "of". The emendation to "or" makes sense, though it might be that some text is missing here.

24 I would be grateful to any Scots reader who could direct me to relevant authority. McDonald and Pagan, *Inheritance Tax in Scotland: Tax Annual* (Bloomsbury) may help here.

I do not think that the IHT Manual means to say that relief only applies if the securities are registered in the name of the individual or the trustees. The point is that no relief applies if the securities are purchased but not paid for. The purchaser is not the beneficial owner until payment, or even if they were, securities not paid for have no value because of the vendor's lien. So if the gilts are not registered in the name of the individual, further evidence may be needed to show that the individual actually is the beneficial owner.

In practice, register the gilts in the name of the individual or the trustees to avoid possible dispute. Perhaps the withheld text instructs Inspectors how to identify false claims for relief, or perhaps it identifies what is a "worthwhile amount" to investigate.

62.7 UK funds *v* foreign funds

As far as tax is concerned, which is better for the foreign domiciliary: UK funds or foreign funds?

(1) A remittance basis taxpayer will prefer a foreign fund to a UK one, so that income and gains from the fund will be taxed on the remittance basis.[25] Likewise a settlor-interested trust whose settlor is a remittance basis taxpayer will prefer a foreign fund to a UK one; similarly if the transfer of asset rules may apply, as UK source income from the fund will be taxed on an arising basis and foreign source income will qualify for the remittance basis.

(2) A non-resident non-domiciled individual will not mind (for IHT, CGT or IT) whether they purchase a UK or a foreign fund. However, taxation at fund level is another matter, and the additional burden on UK funds, particularly SDRT, has encouraged fund managers to set up new funds offshore.[26]

Thus the IHT exemption for UK funds represents a pragmatic decision by the Government, but, like so much in the tax system, falls short of

25 If the individual intends to remit income from the fund, it would be better to have a UK fund because higher rates of tax apply to remitted dividends. But that is a special case.

26 See "Taxation and the Competitiveness of UK Funds" (October 2006) *http://www.investmentuk.org/research/research/* (scroll down to 2006 and click on first link). The report also notes that the uncertainty and instability of the UK tax regime is regarded as making the UK an unsuitable location.

consistency or joined-up thinking.[27]

62.8 Individual domiciled in Channel Islands or Isle of Man

Section 6(3) IHTA provides:

> Where the person beneficially entitled to the rights conferred by any of the following, namely—
>
> (a) war savings certificates;
> (b) national savings certificates (including Ulster savings certificates);
> (c) premium savings bonds;
> (d) deposits with the National Savings Bank or with a trustee savings bank;
> (e) a certified SAYE savings arrangement within the meaning of section 703(1) ITTOIA;
>
> is domiciled in the Channel Islands or the Isle of Man, the rights are excluded property.

In the following discussion:

(1) "**Qualifying certificates**" are investments within (a) to (e).
(2) "**Islanders**" are persons domiciled in the Channel Islands or the Isle of Man.

The IHT deemed domicile rule does not apply for the purposes of this section: see s.267(2) IHTA.

The IHT Manual para 27270 [January 2014] correctly states:

> Other points to note are:
>
> [1] the exclusion applies not only to securities that are owned absolutely but also to any settled securities in which the owner has a beneficial interest in possession[28]
> [2] the exclusion does not extend to settled securities in which there is no interest in possession, (held on discretionary trusts
> [3] the relevant domicile is that of the transferor (and not the transferee) of the securities, at the time of the transfer
> [4] the deemed domicile provisions of IHTA84/S267 (2) do not apply. So the transferor's domicile has to be determined under general law.

Points [2] to [4] are straightforward, but point [1] is important.

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27 See 1.2.2 (Attitudes to tax competition arguments).

28 [Author's note] From 2006 this will only apply to an estate IIP.

The exemption could be particularly useful for an individual who is:
(1) domiciled in the Channel Islands or the Isle of Man, and
(2) deemed UK domiciled (so in principle within the scope of IHT), and
(3) resident in the UK (so the FOTRA securities exemption is not available).

The exemption is also useful for a trust with such a person as life tenant.

The exemption dates back to 1931[29] and was presumably an attempt to market the securities to Islanders, who would otherwise not find them an attractive choice. It seems surprising that the exemption is limited to Islanders; no doubt there were reasons.

62.9 Trusts: Foreign situate property

Section 48(3) IHTA provides:

> Where property comprised in a settlement is situated outside the UK—
>
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the UK at the time the settlement was made ...

This is the main category of settled excluded property, roughly corresponding to the rule that non-settled foreign situate property is excluded property.

A trust made by a foreign domiciled settlor is sometimes referred to as an **"excluded property trust"**. This label could mislead (property in a so-called excluded property trust may or may not be excluded property, depending on its situs and nature) but it may be a convenient shorthand.

Three important consequences arise from the definition.

First, the resident and domicile status of the beneficiaries is irrelevant for this purpose. The residence of the trustees is similarly irrelevant.

Secondly, excluded property status depends on the domicile of the settlor at the time the settlement was made. The domicile at the time of the transfer or chargeable event is ignored.[30] Contrast the IT and CGT

---

29 Section 41 FA 1931. The exemption for FOTRA securities was revived in the same year.

30 See 62.14 (Initial interest of settlor or spouse) for an exception where the settlor or their spouse has an initial interest in possession in the settled property.

position. The identity of the settlor is therefore crucial.[31]

Thirdly, the situs of the trust assets matters only at the moment a charge arises; provided the assets are then situated abroad, it is irrelevant that they may previously have been situated in the UK. So trustees could transfer the settled property out of the UK the moment before the death of a life tenant, or the occasion of a ten-year charge, and obtain the full benefit of excluded property status: see *Kwok Chi Leung Karl v Commissioner of Estate Duty* [1988] STC 728.

HMRC accept this. IHT Manual provides:

> **04274. Identifying settled property** [February 2006]
> The expression 'property comprised in a settlement' in Section 48(3) IHTA 1984 means the items of property (IHTM04030) held in the settlement (IHTM16000) at the time of the chargeable event that you are considering. In determining the locality (IHTM27071) of any particular property, therefore, you should consider the property in its current form and not its previous history.
> *Example*
> S, when domiciled in Germany, settles some German realty[32] and some securities then situated in the UK on X for life with remainder to Y. On X's death the life interest comes to an end and the settled fund consists of
> a. a villa in Spain, or
> b. land in the UK, or
> c. a house in Spain and some English securities.
> With a., the villa is excluded property even though it partly represents the proceeds of what was previously UK property (the securities). The land in b. is not excluded property although it is partly derived from the German realty. In c., the house is excluded property but the securities are not.

62.10 Income accrued but not paid at time of death of life tenant

Suppose:

(1) A trust for A for life remainder to B.
(2) On the death of A, income has accrued but not yet been paid ("the accrued income").
(3) After the death of A, the trustees receive that income.

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31 See 80.3.4 (IHT definition of settlor).

32 [Author's footnote] The question whether this is possible as a matter of German law is ignored for the purpose of the example.

62.10.1 *The trust law background*

The default trust law rule is that the trustees apportion the income they receive, and a part equal to the accrued income is paid to the executors of A.[33] I refer to this as **"the apportionment rule"**.

For instance, suppose A dies on 30 April 2012. In 2013 the trustees receive interest which accrued in the calendar year 2012:

(1) One-third of the income will be apportioned to the period before A's death (and so paid to A's estate).

(2) The remaining two-thirds is apportioned to the period after A's death and so paid to B.

There are however two exceptions so wide that the apportionment rule does not often apply:

(1) The rule may be reversed by the terms of the trust, and it usually is.[34]

(2) The Trusts (Capital and Income) Act 2013 abolished this rule for trusts created after 1 October 2013, when the Act took effect, including a trust created under a power conferred by an old trust. Any entitlement to income under a new trust is an entitlement to income as it arises.

The amounts involved are usually small, in which case no-one takes any notice of the apportionment rule even if it does apply; but that is not always the case.

62.10.2 *IHT position*

Dymond's Capital Taxes para 23.673 provides:

> [1] When a life-tenant dies, any apportionment of dividends or interest payable to his personal representatives may be excluded from the account of the property passing under the settlement and should be included in the Inland Revenue account of his free estate.
>
> [2] If any dividend or apportionment does not come within the charge to Inheritance Tax because, for instance, the life-tenant had a foreign domicile and the apportionment is payable by foreign trustees, it seems that in strictness deduction of the dividend could be refused on the ground that the value for tax is the market price of the security at the date of death, but in practice the deduction is permitted.

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33 Apportionment Act 1870.

34 See Kessler & Sartin *Drafting Trusts & Will Trusts* (11th ed 2012) para 21.61 (statutory and equitable apportionment rules).

Point [1] is looking at the position where:
(1) Trust property is held on trust for A for life, remainder to B.
(2) A dies and there is income (dividends or interest) which accrued during the lifetime of A ("the accrued income").
(3) The apportionment rule applies, so the accrued income is payable to the executors of A.

Dymond states that the accrued income is subject to IHT as part of A's free estate. The accrued income is not subject to IHT as part of the trust fund. In such a case, clearly, one would not expect the accrued income to be subject to IHT twice, once as part of A's free estate and also as part of the trust fund. It should be one or the other. Of the two, it can be said to make sense to treat it as part of A's free estate and not as part of the trust fund because that is where it belongs, and then IHT is paid by the executors, and borne by the residuary beneficiaries of A's free estate who receive it; the burden of IHT should not be paid by the trustees of the trust who do not receive it.

Point [2] is looking at the same position but the accrued income is not subject to IHT in A's free estate. The example is where the accrued income is excluded property (on the basis that A is not UK domiciled and the accrued interest is not UK situate property). Dymond says that in practice in such cases the trustees are still not subject to IHT on the accrued income. Here it is suggested that the trustees have a deduction for the accrued income.

The practice is long standing, as the same point is made in Dymond's Death Duties[35] in a passage from which the current text of Dymond is derived.

There are two possible bases for this practice. It might be said that the trust holds two assets, the loan and the accrued income; but that seems difficult to sustain (even more so if the trust asset is shares and the accrued income is an unpaid dividend). The correct basis is that the trustees have a liability in respect of the accrued income, which is deductible in computing the value of the trust fund for IHT purposes, just like any other trustee liability.

Sometimes the practice will favour HMRC. For instance, if A is UK domiciled but the settlor of the trust was not UK domiciled when the trust was made then the trust property (including the accrued income) would be

35 (15th ed., 1973), p.819.

excluded property but the right to the A's free estate is chargeable property.

Does the same practice apply where the apportionment rule is excluded? If the practice is that the liability to pay accrued income is a deductible trustee liability, it should be deductible in this case also. The liability remains; the exclusion of the apportionment rule only alters the person to whom the liability is due.

For the special case of accrued income on FOTRA securities, see 62.4.1 (Interest on FOTRA securities).

62.11 Trusts: Authorised unit trusts and OEICs

Section 48(3A) IHTA provides:

> Where property comprised in a settlement is a holding in an authorised unit trust or a share in an open-ended investment company—
>
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the UK at the time the settlement was made, and
>
> (b) section 6(1A) above applies to a reversionary interest in the property but does not otherwise apply in relation to the property;[36]
>
> but this subsection is subject to subsection (3B) below.[37]

62.12 Trusts: FOTRA securities

FOTRA securities held by trustees may be excluded property. Under this exemption the domicile of the settlor is irrelevant; one must look at the residence of the relevant beneficiary or beneficiaries and, if appropriate, their domicile.

For the interaction with s.44(2) IHTA, see 64.3.1 (When separate settlements fiction does not apply).

62.12.1 *Estate IIP trust*

Section 48(4) IHTA provides:

> Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; but the securities are

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36 For a discussion of s.48(3A)(b), see 62.13.2 (Foreign situate property and UK funds in estate IIP trust).

37 For the subsection 3B exception, see 62.17.3 (Purchased equitable interests).

excluded property if—

(a) a person of a description specified in the condition in question is entitled to a qualifying interest in possession in them.

Qualifying IIP is defined in s.59(1) IHTA:

(1) In this Chapter "qualifying interest in possession" means—

(a) an interest in possession—

(i) to which an individual is beneficially entitled, and

(ii) which, if the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, is an immediate post-death interest, a disabled person's interest or a transitional serial interest, or

(b) an interest in possession to which, where subsection (2) below applies, a company is beneficially entitled.[38]

That is, a qualifying IIP is what this book describes as an estate IIP. The 2006 reforms have (inadvertently?) restricted the scope of the exemption for FOTRA securities in settlements.

62.12.2 *Other trusts*

Section 48(4) IHTA provides:

Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; but the securities are excluded property if—

...

(b) no qualifying interest in possession subsists in them but it is shown that all known persons

[i] for whose benefit the settled property or income from it has been or might be applied, or

[ii] who are or might become beneficially entitled to an interest in possession in it,

are persons of a description specified in the condition in question.

The IHT Manual correctly states:

27248 - Unknown persons [January 2014]

The legislation refers to ‹known persons'. So, when considering the

38 The position for companies entitled to IIPs is not considered here.

> question of domicile and ordinary residence you should not consider the possibility that some (currently) unknown person (for example an unborn child or future spouse or civil partner of an existing beneficiary) might become a beneficiary in the future.
>
> **27249 - UK charities** [January 2014]
>
> In the case of *Von Ernst and Cie S.A. v IRC* [1980] 1 WLR 468 the Court ruled **that any payment or potential payment** from the settled property to an incorporated UK charity – to be used by the charity for its charitable purposes – would not be an application for the 'benefit' of the charity. So, you should not deny the exclusion for exempt securities just because a qualifying charity (whether incorporated or not) has received or might receive any of the settled property or income from it.

For relief for the exit charge on acquisition of FOTRA securities, see 62.19.3 (Exit charge).

62.13 Estate IIP trust

62.13.1 *The question*

As we have seen, there are two sets of definitions of excluded property:

(1) Section 6 IHTA defines categories of excluded property for non-settled property to which a person is beneficially entitled.

(2) Section 48 IHTA defines corresponding categories of excluded property for trust property.

Property is either settled or not, so at first sight the definitions appear to be mutually exclusive. However, a settlement under which a beneficiary has an estate interest in possession raises a doubt. Property held in a settlement with an estate IIP is certainly settled property (so *prima facie* the s.48 rules apply). However, s.49(1) IHTA provides (for an estate IIP):

> A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as beneficially entitled to the property in which the interest subsists.

Since the person is treated as beneficially entitled, should the s.6 IHTA rules apply to settled property?

62.13.2 *Foreign situate property and UK funds in estate IIP trust*

The answer is provided by s.48(3)(b) IHTA:

> Where property comprised in a settlement is situated outside the UK...
>
> (b) section 6(1) above applies to a reversionary interest in the property *but does not otherwise apply in relation to the*

property;

Thus for settled foreign-situate property the s.48 definition applies and the s.6(1) definition is disapplied. The operation of these rules can be illustrated by two examples:

(1) Suppose a foreign domiciled beneficiary has an estate IIP in a settlement made by a UK domiciled settlor. The trust property is situated outside the UK.

The trust property is not excluded property as it does not meet the requirements of s.45(3)(a). It would meet the requirements of s.6(1) but s.48(3)(b) disapplies s.6(1).

(2) Suppose the reverse situation – a UK domiciled beneficiary has an estate IIP in a settlement created by a foreign domiciled settlor. The trust property is again situated outside the UK.

The tax position is now reversed. The trust property would not qualify as excluded property under s.6(1) but it does qualify under s.48(3)(a). Section 48(3)(b) disapplies s.6(1) but that is irrelevant: the trust property is excluded property.

For UK funds, the same answer is provided by s.48(3A)(b) IHTA:

> Where property comprised in a settlement is a holding in an authorised unit trust or a share in an open-ended investment company ...
>
> (b) section 6(1A) above applies to a reversionary interest in the property *but does not otherwise apply in relation to the property;*

Thus for settled AUTs and OEICs, the s.48 definition applies and the s.6(3A) definition is disapplied.

62.13.3 *FOTRA securities in estate IIP trust*

Section 48(4) IHTA provides:

> Where securities issued by the Treasury subject to a condition of the kind mentioned in subsection (2) of section 6 above are comprised in a settlement, that subsection shall not apply to them; ...

Again, the s.48(4) definition of excluded property applies and the s.6(2) definition is disapplied. This is not actually necessary because s.6(2) and s.48(4)(a) lead to the same result, but it does no harm.

62.13.4 *Qualifying certificates in estate IIP trust*

Qualifying certificates of an individual domiciled in the Channel Islands

or the Isle of Man ("**an Islander**") are excluded property.[39] If an Islander is entitled to an estate IIP in qualifying certificates, the certificates are not excluded property under s.48(3) or s.48(4). But it is considered that the property does qualify as excluded property under s.6(3) since the individual is to be treated as if they were beneficially entitled. In this case there is no express provision that s.48 overrides s.6. Section 48 and s.6 do not contradict each other: they offer two alternative routes to attain excluded property status. Such settled property is therefore excluded property. HMRC agree with this view.

62.14 Initial interest of settlor or spouse

62.14.1 *The s.80 fictions*

Special rules apply where the settlor or spouse have an estate interest in possession in a trust when it is made ("**an initial IIP**"). The basic rule is set out in s.80(1) IHTA:

> Where a settlor or his spouse or civil partner is beneficially entitled to an interest in possession in property immediately after it becomes comprised in the settlement,
> [a] the property shall for the purposes of this Chapter[40] be treated as not having become comprised in the settlement on that occasion;
> [b] but when the property or any part of it becomes held on trusts under which neither of those persons is beneficially entitled to an interest in possession, the property or part shall for those purposes be treated as
> [i] becoming comprised in a separate settlement
> [ii] made by that one of them who ceased (or last ceased) to be beneficially entitled to an interest in possession in it.

Thus where the settlor or spouse has an initial IIP, s.80 imposes three fictions ("**the s.80 fictions**"):

(1) Property which is actually held in one settlement (**"the actual settlement"**):

(a) is treated as non-settled property (so long as the settlor/spouse have an interest in possession); and subsequently:

(v) is treated as being held in a separate settlement (**"the notional settlement"**).

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39 See 62.8 (Individual domiciled in Channel Islands or Isle of Man).

40 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

(2) The notional settlement is treated as having the following qualities:
   (a) The person who is treated as the settlor of the notional settlement may be the spouse, ie different from the real settlor of the actual settlement.
   (b) The time at which trust property is treated as becoming held in the notional settlement is when the settlor/spouse IIP ceases, which is different from the time that property actually became held in the actual settlement.

62.14.2 *Transitional rules: Trusts before 1974 and after 2006*

Section 80(3) IHTA provides:

> This section shall not apply if the occasion first referred to in subsection (1) above occurred before 27 March 1974.

"The occasion first mentioned in subsection (1)" is the date that the property becomes held in the actual settlement, ie the date that the settlement is made. So:

(1) Section 80 does not apply to property settled before 27 March 1974.
(2) Section 80 can apply to property settled between 27 March 1974 and 22 March 2006.

The position for property settled after 22 March 2006 is governed by s.80(4) IHTA:

> Where the occasion first referred to in subsection (1) above occurs on or after 22 March 2006, this section applies—
>
> (a) as though for "an interest in possession" in each place where that appears in subsection (1) above there were substituted "a postponing interest", and
>
> (b) as though, for the purposes of that subsection, each of the following were a "postponing interest"—
>
> (i) an immediate post-death interest;
>
> (ii) a disabled person's interest.

Amended as s.80(4) IHTA directs, s.80(1) provides for settlements made from 22 March 2006:

> Where a settlor or his spouse or civil partner is beneficially entitled to ~~an interest in possession~~
>
> (i) an immediate post-death interest; [or]
>
> (ii) a disabled person's interest.
>
> in property immediately after it becomes comprised in the settlement,

[a] the property shall for the purposes of this Chapter[41] be treated as not having become comprised in the settlement on that occasion;
[b] but when the property or any part of it becomes held on trusts under which neither of those persons is beneficially entitled to ~~an interest in possession~~
(i) an immediate post-death interest; [or]
(ii) a disabled person's interest.
the property or part shall for those purposes be treated as
[i] becoming comprised in a separate settlement
[ii] made by that one of them who ceased (or last ceased) to be beneficially entitled to an interest in possession in it.

Section 80 can apply to trusts from 22 March 2006 if:
(1) the trust confers an IPDI (which applies to will trusts) or
(2) a disabled person's interest (which will be rare).
What is the position if:
(1) A trust is made before 22 March 2006 and confers an initial IIP on the settlor ("H").
(2) That IIP comes to an end during the lifetime of H and the spouse ("W") acquires an IIP which is not an estate IIP.

The drafter of the 2006 reforms failed to address this case. A purposive construction is called for, or the provisions are nonsensical. It is suggested that the reference to an "interest in possession" in s.80 means an interest in possession to which s.49 IHTA applies. The non-estate IIP of W does not count as an interest in possession. So the trust property is treated as becoming comprised in a notional settlement on the death of H.

62.14.3 *Time of 10-year anniversary when s.80 applies*

The date of the 10-year anniversaries is normally ascertained in a straightforward manner. First there is a commonsense definition of the commencement date of a settlement. Section 60 IHTA provides:

> In this Chapter references to the commencement of a settlement are references to the time when property first becomes comprised in it.

Then s.61(1) IHTA provides:

> In this Chapter "ten-year anniversary" in relation to a settlement means the tenth anniversary of the date on which the settlement commenced and subsequent anniversaries at ten-yearly intervals, but subject to

41 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

subsections (2) to (4) below.

However, s.61(2) provides a special rule for the s.80 notional settlement:

> The ten-year anniversaries of a settlement treated as made under section 80 below shall be the dates that are (or would but for that section be) the ten-year anniversaries of the settlement first mentioned in that section.

The section 80 fictions do not apply for the purposes of ascertaining the ten-year anniversary date of the notional trust: that is fixed by reference to the date of the actual settlement. I cannot see the reason for that rule.

62.14.4 *Trusts with only some property within s.80 fictions*

It is possible that one trust may hold some property which is within the scope of s.80 and some property which is not. This could happen in various ways, but the common example will be a trust conferring an interest in possession on the settlor where:

(1) Property ("pre-2006 property") was settled before 22 March 2006
(2) Other property ("post-2006 property") was added after 22 March 2006.

In that case:

(1) The pre-2006 property is treated as held in a separate notional settlement governed by the s.80 fictions.
(2) The post-2006 property is treated as held in the actual settlement.

The actual commencement date of the actual settlement is the date that property was first comprised in it. However pre-2006 property is "treated as not having become comprised in the settlement" at that date. The first time that property that is held by the actual settlement is when post-2006 property is added. That date is treated as its commencement date, and anniversaries of that date are treated as its 10-year anniversaries.

62.14.5 *Spouse with initial IIP: Excluded property rule*

Suppose:

(1) In Year 1, H creates a trust under which W has an initial IIP.
(2) In Year 2, W dies (so her IIP comes to an end). H does not become entitled to an estate IIP at the time that W dies.

In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as held in a notional trust, which is treated as made in Year 2 and W is treated as the settlor.

If that were all, it would follow that the trust property could be treated as

excluded property if W was foreign domiciled at the time of her death in Year 2. The domicile of H would be irrelevant. This would benefit the taxpayer if (for instance) H was UK domiciled and W was not, and could sometimes be used for tax avoidance.

Therefore where s.80 applies, s.82 IHTA imposes a further condition relating to excluded property.[42] This provides:

> (1) For the purposes of this Chapter[43] ... property to which section 80 ... applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the UK and that the settlor was not domiciled there when the settlement was made).
>
> ...
>
> (3) The condition referred to in subsection (1) ... is—
>
> (a) in the case of property to which section 80 above applies, that the person who is the settlor in relation to the settlement first mentioned in that section ...
>
> was not domiciled in the UK when that settlement was made.

The "settlement first mentioned" in s.80 is the actual settlement made by H. (The notional settlement treated as made by W is the second settlement mentioned in s.80.)

In relation to foreign situate trust property, s.82 prevents the s.80 fictions from benefiting the taxpayer. The fictions may however benefit HMRC. Suppose:

(1) H is the settlor.
(2) W has an initial IIP.
(3) Subsequently the settled property is held on trusts where neither H nor W has an interest in possession.[44]

It is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the domicile of W at the time her interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded

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42 With an economy of drafting, s.82 is also used for the purposes of the same settlement fiction but although there is some overlap, it is easiest to discuss that aspect separately. See 64.8.1 (Section 81 excluded property rule).

43 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

44 Whether an estate IIP or not. This is anomalous, but the drafter of the 2006 rules did not think through the consequences for s.80.

property. Both must be domiciled outside the UK (at the right time) in order for foreign situate property to qualify securely for excluded property status.

62.14.6 *Settlor with initial IIP: Excluded property rule*

In practice, in lifetime trusts it is rare for the settlor's spouse to have an initial IIP but it is common for the settlor to have an initial IIP. Suppose first that:

(1) Year 1: H has an initial IIP; and
(2) Year 2: that IIP comes to an end (without W becoming entitled to an estate IIP).

In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as held in a notional trust, which is treated as made in Year 2 though H is still treated as the settlor.

If that were all, it would follow that the trust property could be treated as excluded property if H was foreign domiciled in Year 2. The domicile of H at the time the trust was made would be irrelevant. This could not be used for tax avoidance, but s.82 IHTA nonetheless imposes its further condition relating to excluded property. It is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the time their interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded property. H must be domiciled out of the UK at both times in order for foreign situate property to qualify securely for excluded property status.

Suppose:

(1) In Year 1, H creates a trust under which H has an estate IIP.
(2) In Year 2, H dies and W becomes entitled to an estate IIP.
(3) In year 3, W's interest comes to an end (H not at that time becoming entitled to an estate IIP).

In this example H is the settlor of the actual trust and Year 1 is the date of commencement of the actual trust. However, applying the s.80 fictions, the property is treated as held in a notional trust, which is treated as made in Year 3 and W is treated as the settlor.

If that were all, it would follow that the trust property could be treated as excluded property if W was foreign domiciled at the time of her death in Year 3. The domicile of H would be irrelevant. Once again, s.82 IHTA imposes a further condition relating to excluded property. In relation to

foreign situate trust property, s.82 prevents the s.80 fictions from benefiting the taxpayer. It may however benefit HMRC. It is necessary to look at the domicile of H at the time when the actual settlement was actually made *and* at the domicile of W at the time her interest in possession came to an end in order to determine whether foreign situate trust property (in the notional settlement) is excluded property. Both must be domiciled out of the UK (at the right time) in order for foreign situate property to qualify for excluded property status.

62.14.7 *Planning for partly excluded property trust*

I use the term **"partly excluded property trust"** to refer to a trust where:

(1) the trust property in the actual settlement is excluded property on ordinary principles; but

(2) it is not excluded property in the notional settlement under s.80/82 rules.

The s.80/82 rules apply only for the purposes of "this chapter": the relevant property trust regime. They have no wider application. So foreign property of a partly excluded property trust:

(1) is not excluded property for the purposes of the relevant property trust taxation; but

(2) is excluded property for all other IHT purposes (eg GWR and the estate IIP trust regime).

Before 2006, s.80 did not much matter as a partly excluded property trust could remain IIP in form throughout its life. So in practice it qualified as excluded property. Now it cannot do so. So the tax position of these trusts has been seriously affected as an accidental result of the 2006 reforms.

62.14.8 *Avoiding s.80/82 problems: Trusts made on or after 22 March 2006*

No difficulty arises for lifetime trusts from 22 March 2006, unless the trust confers a disabled person's interest (which will be rare).

Section 80 still poses a trap for will trusts, where the testator is not UK domiciled and the spouse is (or later becomes) UK domiciled. One needs to avoid an IPDI.

A simple solution is to arrange that the will trust is discretionary at the outset, ie the widow does not have an initial interest in possession. A two-year discretionary period will in principle be needed to avoid s.144 IHTA. This is easy to arrange if the property given to the trust is not UK situate.

62.14.9 *Avoiding s.80/82 problems: Trusts made before 22 March 2006*

In cases where an existing trust conferred an initial IIP on the settlor/spouse, it would be desirable to revoke the IIP before the settlor becomes deemed UK domiciled. It does not matter that the settlor/spouse may have an initial IIP provided that when it comes to an end[45] the life tenant is not UK domiciled or IHT deemed domiciled.

62.14.10 *Avoiding s.80/82 problems by FOTRA securities or UK funds*

Section 80 provides that property shall not be taken to be excluded property *by virtue of s.48(3)* IHTA. So it prevents foreign situate property from being excluded property. It does not apply to FOTRA securities and AUTs.

62.14.11 *Section 80 fictions: Commentary*

What is the purpose of the three s.80 fictions? The standard IHT trust regime would not work well where the settlor or their spouse has an initial estate interest in possession under a settlement commencing after 26 March 1974. Dymond explains:

> In such a case there will be no chargeable transfer when the settlement was made and so no occasion to value the settled property for CTT or IHT at that time. If an exit charge arose nearly 10 years later, it might be difficult to ascertain the value at the commencement of the settlement, as required by s.68(5)(a) IHTA, because important evidence might have been lost or destroyed. It might also not be easy to ascertain the settlor's cumulative total at that time as required by s.68(4)(b) IHTA. The same difficulty with the settlor's cumulative total might occur at the time of the 10 yearly charge, because of s.66(5)(a).[46]

Section 80 solves this administrative problem but the reader may agree with the author that even before 2006 the cure was worse than the disease. This does explain why the s.80 fictions only apply for the purposes of the standard IHT trust regime.

Since 2006 the operation of the rules is bizarre, but (as is generally the case with bizarre law) careful planning can mitigate much of the unfairness.

It is suggested that the rules should be repealed.

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45 Not being followed by another IIP for the settlor/spouse.

46 *Dymond's Capital Taxes* (looseleaf 1986 onwards), para 19.700.

62.15 Settlor adds property to trust after change of domicile

Suppose:
(1) a settlor creates a trust when not UK domiciled; and
(2) the settlor[47] adds funds to the trust later when UK domiciled.
Can the added property be excluded property? The IHT Manual para 4272 provides:

> **04272. When the settlement was made** [January 2008]
> The legislation refers to the settlor's (IHTM16000) domicile (IHTM13000) 'at the time the settlement was made'. You should proceed on the basis that, for any given item of property (IHTM04030) held in a settlement, the settlement was made when that property was put in the settlement. Refer any case where this view is challenged to TG.
> *Example*
> S, when domiciled abroad, creates a settlement of Spanish realty. Later he acquires an UK domicile and then adds some Australian property to the settlement.
> The Spanish property is excluded property because of S's overseas domicile when he settled that property. However, the Australian property is not excluded property as S had a UK domicile when he added that property to the settlement.[48]

The relevant time in s.48(3) is not "the time when the property was settled"; it is "the time the settlement was made". HMRC seek to treat the transfer of an asset to an existing settlement as the making of a new settlement. It would follow that a person adding property to an existing settlement would be creating a second settlement or as many settlements as there are additions.

There is nothing conceptually impossible in HMRC's view that a separate settlement is deemed to be made where a person adds property to an existing settlement made by them.[49] But since adding property does not in fact create a new and separate settlement, two separate settlements do

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47 This section considers the position where the original settlor adds to a trust. For the position where others add to a trust, see 64.4 (B adds property to A's trust).

48 This view is repeated in RI 166 and IHTM27220 - Foreign Settled Property With Non-UK Domiciled Settlor.

49 This fiction is applied when there are two settlors, see 64.3 (The separate settlements fiction). The same fiction could in principle apply when the settlor adds property to an existing settlement.

not exist;[50] one needs something express or implied in the legislation to deem what is in fact one settlement to be treated as two. When new property is added to an existing settlement, the new property *becomes comprised* in the settlement at that time, but that is not the same as saying the settlement (or a new settlement) was made at that time. The HMRC view leads to a more sensible result. But the legislation is so clearly inconsistent with the HMRC view that even a purposive construction cannot assist.[51]

Section 43 IHTA provides:

> (1) The following provisions of this section apply for determining what is to be taken for the purposes of this Act to be a settlement, and what property is, accordingly, referred to as property comprised in a settlement or as settled property.
> (2) "Settlement" means any *disposition or dispositions* of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—
>
> (a) held in trust for persons in succession or for any person subject

50 This is self-evident but if authority is needed see *Truesdale v FCT* (1970) 120 CLR 353 at p.362 accessible *http://law.ato.gov.au*.

> "The words created a trust in s.102 are not, I think, apt to describe the payment of money to a trustee to hold under a trust already constituted. There is an obvious difference between creating a trust in respect of property, on the one hand, and, on the other, transferring property to a trustee to hold upon the terms of an established trust. To read the section as if it applied to such a transfer would be, in the absence of a context, to expand it. Such a reading would be tantamount to saying that the transfer to the trustee of property to be held as part of the assets of an already constituted trust would be to create a second trust, whereas, from the point of view of both the trustee and of the beneficiary, there would be but one trust and the property transferred would be nothing more than an addition to the property subject to the trust."

Contrast rule 64.4(2) Civil Procedure Rules 1998 which distinguishes (1) the person who created a trust and (2) a person who provided property for the purposes of the trust.

51 "It may be perfectly proper to adopt even a strained construction to enable the object and purpose of legislation to be fulfilled. But it cannot be taken to the length of applying unnatural meanings to familiar words or of so stretching the language that its former shape is transformed into something which is not only significantly different but has a name of its own. This must particularly be so where the language has no evident ambiguity or uncertainty about it." *Clarke v Kato* [1998] 1 WLR 1647 at p.1655.

to a contingency, or

(b) held by trustees on trust to accumulate the whole or part of any income of the property ... or

(c) charged ... with the payment of any annuity ...

(Emphasis added)

Perhaps the HMRC argument is that because a "settlement" means any disposition of property, each disposition constitutes a new and separate settlement. However, the words "any disposition or dispositions of property" indicate that more than one disposition can create a single settlement. One example would be where an original trust has been modified by a disposition by beneficiaries;[52] another would be where the settlor has made separate dispositions to the same trust. So these words do not help the HMRC argument.[53] See *Rysaffe v IRC* [2003] STC 536 at [13]:

> Section 43 does not specifically address a numerical question: what is the number of relevant settlements existing in a particular inheritance tax situation? In the absence of specific statutory provisions the answer to the numerical question is to be found in the general law of trusts.

Further, the HMRC view is incompatible with many provisions of the IHTA. If each addition to an existing trust is a new settlement it makes nonsense of the added property provisions in s.67 IHTA and the many references to added property in the surrounding sections. It also makes nonsense of the separate settlements fiction[54] which assumes (in the absence of s.44(2) IHTA) that one settlement may have two settlors.

The HMRC view is not consistent with s.49(5) FA 1977. This section clearly distinguished between:

(1) "the time when a settlement was made", and

(2) "the time when [added] property was settled".

It did so in the context of excluded property. That section is now repealed but the fact that the drafter took this view in 1977 remains relevant.

It is interesting to compare the transitional provisions for disabled beneficiary trusts in FA 2013. This makes amendments which have effect

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52 See 80.14.1 (General powers: The trust law background).

53 The drafter of the words "disposition or dispositions" almost certainly had in mind the reference to "instrument or instruments" and "compound settlement" in the earlier legislation and the comments in *Dymond's Death Duties* (15th ed., 1973), p.129.

54 See 64.3 (The separate settlements fiction).

in relation to property transferred into settlement on or after a specified date.[55] The legislation does not refer to the date that the settlement was made. One may infer that the drafter has taken the point, though that is a matter of speculation.[56] It does at least show that if the drafter had intended to define excluded property by reference to the date it was transferred into settlement (rather than by reference to the date the settlement was made) it would have been easy to say so.

On the other hand, the transitional relief for IHT deemed domicile appears to assume the HMRC view, that excluded property status depends on domicile of the settlor at the time the property was added.[57] But overall this factor is outweighed by all the others.

It might take litigation before HMRC amend their published stance on this issue but I think they would be advised not to fight. Until the point is clear, trustees should follow the advice in RI 166:

> **Trust records**
> ... the trustees of a settlement should keep adequate records to enable any necessary attribution of the settled property to be made if ...the settlor has added further assets to the settlement after it was made...

Suppose a settlor creates a trust when UK domiciled and adds property to it when foreign domiciled. On my view, none of the property is excluded property. However, HMRC must abide by their statement (at least until it is officially and publically withdrawn with appropriate transitional relief) and accept the added property may be excluded property! Thus, the consequence of their statement (if my view is right) is that HMRC have the worst of both worlds. Of course, a well advised settlor should not be in this situation, but it does arise from time to time by accident.

62.15.1 *Contract to transfer to trust*

It may be possible to avoid this problem if a foreign domiciled person contracts to assign property to a trust; provided that the contract is made while non-UK domiciled, domicile at the time of the transfer may not matter.

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55 Para 9(1), 10(3) sch 44 FA 2013.

56 It is conceivable that the drafter followed the precedent of s.103 FA 1977 without appreciating the issues involved.

57 See 61.5 (1974 transitional rules).

62.15.2 *Settlor adds property to company held by trust, after acquiring UK domicile*

Suppose:
(1) A settlor creates a trust while domiciled outside the UK;
(2) The settlor becomes UK domiciled; and
(3) The settlor gives property to a company owned by the trust.
Then HMRC's argument does not run at all. The shares in the company (if not UK situate) must be and remain excluded property. But watch out that the gift may be a gift with reservation and/or a chargeable transfer for IHT.

62.16 Transfer of value by close company

In this section I consider the position where a close company (UK resident or not) makes a transfer of value. In practice these issues only rarely need to be considered. A full discussion would need a chapter to itself, and I focus on the issues closest to the themes of this book. I do not consider the (even more) specialist topics of alterations of share capital or interests in possession held by companies.

62.16.1 *Individual participators*

Section 94(1) IHTA provides:

> [i] Subject to the following provisions of this Part of this Act, where a close company[58] makes a transfer of value, tax shall be charged as if each individual to whom an amount is apportioned under this section had made a transfer of value ...

Section 94 goes on to specify the amount of the transfer:

> [ii] of such amount as after deduction of tax (if any) would be equal to
> [a] the amount so apportioned, less
> [b] the amount (if any) by which the value of his estate is more than it would be but for[59] the company's transfer;

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58 Section 102(1) IHTA provides a referential definition of "close company":
"In this Part of this Act— 'close company' means a company within the meaning of the Corporation Tax Acts which is (or would be if resident in the UK) a close company for the purposes of those Acts."
For a note on this terminology, see 85.22.1 (Non-resident close company).

59 "But for" is a slip for "as a result of"! HMRC agree: see the example in IHTM16247 below.

> [iii] but for this purpose his estate shall be treated as not including any rights or interests in the company.

Section 94(2) IHTA explains how the transfer of value is apportioned:

> For the purposes of subsection (1) above the value transferred by the company's transfer of value shall be apportioned among the participators according to their respective rights and interests in the company immediately before the transfer, and any amount so apportioned to a close company shall be further apportioned among its participators, and so on;

The transfer of value if it arises is immediately chargeable, not a PET; the reason for this rule is unclear.

Section 94(2) sets out two exceptions where there is no apportionment. The first concerns company payments of an income nature.[60] The second exception concerns foreign domiciliaries:

> (b) if any amount which would otherwise be apportioned to an individual who is domiciled outside the UK is attributable to the value of any property outside the UK, that amount shall not be apportioned.

This exemption does not apply to FOTRA securities because they are UK situate. This was presumably an oversight and the IHT Manual extends the exemption to cover this:

> **14854. Foreign aspects** [January 2010]
> **[**The Manual summarises the statutory exemption and continues:]
> [1] A transfer of value by
> - a company incorporated abroad (hence domiciled abroad - *Gasque v IRC* [1940] 2 KB 80)... of
> - property situate abroad
>
> is **not** excluded property since s.6(1) IHTA only applies to individuals.
> [2] Nevertheless, if such a company
> - is resident abroad and
> - makes a transfer of exempt Government securities within s.6(2) IHTA,

60 "(a) so much of that value as is attributable to any payment or transfer of assets to any person which falls to be taken into account in computing that person's profits or gains or losses for the purposes of income tax or corporation tax (or would fall to be so taken into account but for section 1285 of the Corporation Tax Act 2009 (exemption for UK company distributions) shall not be apportioned..."

they **do** qualify as excluded property.[61]

There is no exemption for UK situate AUTs or OEICs. An HMRC concession would be sensibly consistent with the practice on FOTRA securities and it might be worth asking HMRC in an appropriate case.

62.16.2 *Trustee participators*

Section 94(1) IHTA only applies to individuals. Section 99 IHTA provides:

> (1) Subsection (1) of section 94 above shall not apply in relation to a person who is a participator in his capacity as trustee of a settlement, but—
>
> (a) the reference in subsection (2) of that section to subsection (1) shall have effect as including a reference to subsection (2) of this section, and
>
> (b) in relation to tax chargeable by virtue of subsection (2) of this section, sections 94(4) and 95 above shall apply with the necessary modifications.

Amended as s.99 directs, s.94(2) provides:

> For the purposes of ~~subsection (1) above~~ s.99(2) IHTA the value transferred by the company's transfer of value shall be apportioned among the participators according to their respective rights and interests in the company immediately before the transfer, and any amount so apportioned to a close company shall be further apportioned among its participators, and so on; but ...

Of the two exemptions which follow in s.94(2), para (a) still applies (exemption for payments of an income nature). However para (b) does not apply to a trustee, as it provides:

> (b) if any amount which would otherwise be apportioned to an *individual* who is domiciled outside the UK is attributable to the value of any property outside the UK, that amount shall not be apportioned.

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61 Sentence [1] is not technically accurate. It would be strictly correct to say that foreign situate *property* of a company incorporated abroad is not excluded property, because the definition of excluded property in s.6(1) only applies to property of individuals; however that is beside the point because (as the Manual has just noted) s.94(2) confers an equivalent exemption. But the important point here is that (however clumsily worded) sentence [2] extends the exemption to FOTRA securities.

This takes us to s.99(2) IHTA which incorporates the charge into the code of rules for IIP and non IIP trusts:

> Where any part of the value transferred by a close company's transfer of value is apportioned to a trustee of a settlement under section 94 above, then—
>
> (a) if a qualifying interest in possession subsists in the settled property, a part of that interest corresponding to such part of the property as is of a value equal to the part so apportioned less the amount specified in subsection (3) below shall be treated for the purposes of Chapter II of Part III of this Act as having come to an end on the making of the transfer,

This incorporates the rules in s.52 IHTA.

> (b) if no qualifying interest in possession subsists in the settled property, Chapter III of Part III of this Act shall have effect as if on the making of the transfer the trustee had made a disposition as a result of which the value of the settled property had been reduced by an amount equal to the part so apportioned less the amount specified in subsection (3) below;
>
> and where a qualifying interest in possession subsists in part only of the settled property paragraphs (a) and (b) above shall apply with the necessary adjustments of the values and amounts referred to there.
>
> (3) The amount referred to in paragraphs (a) and (b) of subsection (2) above is the amount (if any) by which the value of the settled property is more than it would be apart from the company's transfer, leaving out of account the value of any rights or interests in the company.

This incorporates the rules in s.65 IHTA, which can have some quirky results.

If the trust property is excluded property, there is no charge to IHT so the exemption in s.94(2)(b) is not needed.

Thus there is an interesting distinction between the rules for settled and non-settled companies. Where a company makes a transfer of value:

(1) Where a foreign domiciled individual is the participator, there is no IHT charge if the property which the company transfers is not UK situate; the situs of the shares in the company is not relevant.
(2) Where an excluded property trust is the participator, there is no IHT charge if the company's shares are not UK situate (the situs of the company's property is not relevant).

The IHT Manual provides:

> **IHTM16243 Close companies and settled property: the taxable amount** [Feb 2006]
> ... The provisions of IHTA84/Part IV do not provide any special charging section where settled property is concerned. Instead, the system for settled property provides a 'special' framework and then directs the notional transfers to their own existing taxing and rate sections, with the result that the claims produced by this legislation are the familiar IHTA84/S52 (1) for interests in possession ceasing. This basis of claim is artificial because in reality the interest does not cease.
> As a result such an event, occurring after 16 March 1987, can be a PET (IHTM04057) if it would have been so under a plain IHTA84/S52 (1) claim [i.e. if it was not then becoming held on non - interest in possession trusts]. This contrasts with the treatment of absolute gifts by close companies which, under IHTA84/S98 (3), are never PETs.
> In similar vein, annual and other exemptions (IHTM16082) available on a claim under IHTA84/S52 (1) are allowable.
> **IHTM16244 Close companies and settled property: foreign element** [Feb 2006]
> Bearing in mind that claims on settled property in the 'close company' (IHTM14851) regime under IHTA84/PartIV cases arise in their normal context and under normal charging sections it would seem that if the trusts identified above (IHTM16243) would in their own right, satisfy IHTA84/S48 (3), and the close company in question, being 'the property', is incorporated (and therefore domiciled) outside the UK, then an apportionment will not be made.
> So the trust property takes the benefit of excluded property treatment. IHTA84/S94 (2)(b) achieves this result for lifetime transfers.
> Where a company has the interest in possession as above, the position is more explicit -S48(4). If the trust property is invested in FOTRA securities (IHTM04306), and on looking through the company to the real beneficiaries, it can be seen that those individuals qualify under S48 (4), then exemption will be given...
> **IHTM16247 Close companies and settled property: example** [Feb 2006]
> Calculating the chargeable value of the property (or part):
> A close company has assets in excess of £3million. It transfers cash of £1million to A and B absolutely.
> The company has 1000 shares in issue.
> The 'participators' are identified under IHTA84/S94 (2). They are:
> A - who holds 500 shares

B - who holds 250 shares, and
C - who holds 250 shares in his capacity as a trustee of a settlement.
IHTA84/S99 (1)(a) causes S94 (2) to apply to him.
The transferred amount of £1,000,000 is apportioned so that A is deemed to have made a transfer of value of (500 ÷ 1,000) × £1,000,000 = £500,000.
From this figure we must deduct the amount of the transfer remaining in A's estate ('the amount by which his estate is more than it would be apart for the company's transfer' - S94(1)(a)). In this case he has accepted the money. His estate is 'more' by £500,000. So the taxable amount is £500,000 less £500,000 = nil.
As B is also an individual and has taken the money personally, his calculation follows the same lines.
But C is also a participator, and (250 / 1,000) × £1m is apportioned to him under S99 (1)(a) i.e. £250,000.
The amount to be taxed in relation to C under S99 (2) is £250,000 less the amount by which the settlement in question is 'more' as a result of the company's transfer - S99 (3).
Thus, as C and his settlement received nothing, the calculation is £250,000 less nil = £250,000 chargeable under S99 (2) above.
The last part of S99 (3) 'leaving out of account the value of any rights or interests in the company' means that the calculation stops here. S99 (3) prohibits the taking into account of the effects of these transactions by the company on the value of the shares (rights or interests).
E.g. the value of rights and interests still held by the shareholders as such could nullify the effect of all these provisions if that value were allowed into the above equation
also, if a company worth £3million gives away £1million as above, the thought might reasonably occur that the value of shares held by the shareholders personally has possibly dropped by about 1/3rd. You might then wonder about 'loss to the transferor'. You must put such thoughts out of your mind because such a claim does not exist.

62.17 Interests in trust property

An interest in trust property (an equitable interest) is itself an item of property which may be subject to IHT. That would lead to double taxation, eg in a trust for A for life, remainder to B, there might be

(1) tax on the death of A (if A has an estate IIP) or 10-year charges; and
(2) tax on the death of B (if the reversionary interest is an asset of B's estate).

62.17.1 *Reversionary interest*

Section 48(1) IHTA deals with this problem by providing that a reversionary interest is generally excluded property:

> (1) A reversionary interest is excluded property unless—
> (a) it has at any time been acquired (whether by the person entitled to it or by a person previously entitled to it) for a consideration in money or money's worth, or
> (b) it is one to which either the settlor or his spouse [or civil partner] is or has been beneficially entitled, or
> (c) it is the interest expectant on the determination of a lease treated as a settlement by virtue of section 43(3) above.

What about a reversionary interest within (a) to (c)? Section 48(3) IHTA provides:

> Where property comprised in a settlement is situated outside the UK—
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the UK at the time the settlement was made, and
> (b) section 6(1) above applies to a reversionary interest in the property *but does not otherwise apply in relation to the property* ...
> but this subsection is subject to subsection (3B) below

The words in italics make it clear that the non-settled property rules apply. An equitable interest which is a reversionary interest may be excluded property if it meets the conditions of s.48(1) or if it is not UK situate and owned by a foreign domiciliary.

62.17.2 *Interest in possession*

An equitable interest which is an estate IIP is excluded properly only if it is owned by a foreign domiciliary and is not UK situate. However, the disposal of the interest is not a transfer of value; s.51 IHTA. Tax is charged under s.52 only if the settled property is not excluded property.

62.17.3 *Purchased equitable interests*

Section 48(3) and (3A) IHTA both provide:

> but this subsection is subject to subsection (3B) below. ...

Section 48(3B) IHTA is an anti-avoidance provision which applies to two categories of settled excluded property: foreign situate property and UK

funds. It provides:

> Property is not excluded property by virtue of subsection (3) or (3A) above if—
>
> (a) a person is, or has been, beneficially entitled to an interest in possession in the property at any time,
>
> (b) the person is, or was, at that time an individual domiciled in the UK, and
>
> (c) the entitlement arose directly or indirectly as a result of a disposition made on or after 5th December 2005 for a consideration in money or money's worth.

EN FB 2006 explains:

> 8. ... By purchasing interests in existing trusts originally settled by a person domiciled outside the UK, UK-domiciled individuals have increasingly exploited this exemption to convert their wealth into IHT-free form.
>
> 9. This clause is aimed at blocking such avoidance by providing that property is not excluded property by virtue of section 48(3) or section 48(3A) IHTA if, at any time, a person domiciled in the UK has had an interest in possession in it, and their interest arose from a disposition for a consideration in money or money's worth. This applies whoever paid the money, and if the interest was acquired indirectly (for example, under a will or by intestacy) or has been passed on to someone else.

Section 48(3C) IHTA expands on this:

> For the purposes of subsection (3B) above—
>
> (a) it is immaterial whether the consideration was given by the person or by anyone else, and
>
> (b) the cases in which an entitlement arose indirectly as a result of a disposition include any case where the entitlement arose under a will or the law relating to intestacy.

Section 48(3C)(a) confirms (what would have been clear) that the provision can apply if an interest is purchased by A and then given by A to B. I am unable to see the point of s.48(3C)(b).

62.17.4 *F(No.1) A 2010 and FA 2012 rules*

Consideration is also needed for the anti-avoidance rules introduced in 2010 and 2012: ss.52, 53 F(No.1)A 2010 s.48(3D)-(3F) IHTA and s.74A, 74B IHTA. This topic will require many pages to discuss. It is some way from the themes of this book but I hope to address it in a future edition.

62.18 Excluded property exemptions: Lifetime gift and death charges

In this section I set out the various exemptions for excluded property. Each IHT charging provision has a separate exemption.

62.18.1 *Lifetime gifts*

The IHT charge on lifetime gifts is a charge on a transfer of value. The excluded property exemption for lifetime gifts is in the definition of transfer of value. One needs to read s.3(1)(2) together to follow the sense:

> (1) ... a transfer of value is a disposition made by a person ... as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition; ...
> (2) For the purposes of subsection (1) above no account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of a disposition.

"Ceases to form part of a person's estate" is not to be construed too literally. Suppose an individual makes a disposition which reduces the value of excluded property but the property itself is retained. That must come within the exemption.

62.18.2 *Gift from foreign bank account to donee's UK account*

What is the position if a foreign domiciled donor makes a gift from their foreign bank account (ie, not a UK situate asset) to a *UK situate* bank account of the donee? The gift is not a transfer of value for IHT purposes. When funds are held in the donor's account, the donor has an asset (a debt). When funds are transferred to the donee's account, the donor's asset comes to an end and the donee acquires a new asset (a debt). The donor is at no time entitled to the funds in the UK account.[62]

As a matter of banking law, the donor's cheque or other instruction to the bank to transfer funds from the donor's account to another account is in principle revocable until it is carried out[63] but that does not alter the analysis, because when the donee receives the credit to his account, the

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62 For the banking law analysis, see 11.12.8 (Gift to non-relevant person).

63 For completeness: in any particular case it would be relevant to consider the documentation and proper law concerned; but that is not going to affect the IHT analysis because it makes no difference if the instruction to the bank is revocable or not.

instructions have been carried out and the instruction has become irrevocable.

I stress this because the contrary has been suggested, but the position is perfectly clear.

62.18.3 *Charge on death*

The IHT charge on death is in s.4 IHTA. The charge is on the value of the deceased's estate. The IHT excluded property exemption for the charge on death comes in the definition of "estate" in s.5 IHTA; one needs to read sections 4 and 5 together to follow the sense:

> **4 Transfers on death**
> (1) On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death.
> **5 Meaning of estate**
> (1) For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that ...
> (b) the estate of a person immediately before his death does not include excluded property...

For interaction of the spouse exemption and excluded property on death, see 67.1 (IHT spouse exemption).

62.19 Excluded property exemptions: 10-year and exit charges

IHT operates a system of 10-year and exit charges on trusts. A full discussion would need a long chapter. I focus on the reliefs for excluded property.

62.19.1 *"Relevant property"*

The key term is "relevant property". Section 58 IHTA provides (so far as relevant):

> (1) In this Chapter "relevant property" means settled property in which no qualifying interest in possession subsists, other than ...
> (f) excluded property

"Relevant property" is not a particularly helpful term, but it is not easy to find one which encapsulates the complex definition; and in any event it is easier to adopt the statutory term here.

62.19.2 *10-year charge*

The 10-year charge on trusts is in 64(1) IHTA:

> Where immediately before a ten-year anniversary all or any part of the property comprised in a settlement is relevant property, tax shall be charged at the rate applicable under sections 66 and 67 below on the value of the property or part at that time.

The IHT excluded property exemption for the 10-year charge comes in the definition of relevant property. If trust property is excluded property on the 10-year anniversary, there is no charge.

If trust property was excluded property formerly but is not excluded at the time of the 10-year anniversary, s.66(2) IHTA provides a partial relief:

> Where the whole or part of the value mentioned in section 64 above is attributable to property which was not relevant property, or was not comprised in the settlement, throughout the period of ten years ending immediately before the ten-year anniversary concerned, the rate at which tax is charged on that value or part shall be reduced by one-fortieth for each of the successive quarters in that period which expired before the property became, or last became, relevant property comprised in the settlement.

62.19.3 *Exit charge*

The exit charge on trusts is in s.65 IHTA which provides:

> (1) There shall be a charge to tax under this section—
> (a) where the property comprised in a settlement or any part of that property ceases to be relevant property (whether because it ceases to be comprised in the settlement or otherwise); and
> (b) in a case in which paragraph (a) above does not apply, where the trustees of the settlement make a disposition as a result of which the value of relevant property comprised in the settlement is less than it would be but for the disposition.

If excluded property ceases to be comprised in a settlement, there is no charge because excluded property is not relevant property, so it does not "cease to be relevant property".

Under s.65(1) there would be a charge if trust property which is relevant property becomes excluded property (as it then ceases to be relevant property.) There are three exemptions which usually prevent this charge.

Section 65(7) IHTA provides relief if trust property becomes non-UK

situate excluded property:

> Tax shall not be charged under this section by reason only that property comprised in a settlement ceases to be situated in the United Kingdom and thereby becomes excluded property by virtue of section 48(3)(a) above.

Section 65(7A) IHTA provides relief if trust property becomes UK fund excluded property:

> Tax shall not be charged under this section by reason only that property comprised in a settlement becomes excluded property by virtue of section 48(3A)(a) (holding in an authorised unit trust or a share in an open-ended investment company is excluded property unless settlor domiciled in UK when settlement made).[64]

Section 65(8) IHTA provides some relief if trust property becomes FOTRA security excluded property:

> If the settlor of a settlement was not domiciled in the United Kingdom when the settlement was made, tax shall not be charged under this section by reason only that property comprised in the settlement is invested in securities issued by the Treasury subject to a condition of the kind mentioned in section 6(2) above and thereby becomes excluded property by virtue of section 48(4)(b) above.

This is not a complete FOTRA exemption: there is an exit charge if trust property becomes FOTRA security excluded property under s.48(4)(a) or if the settlor was UK domiciled.[65]

There could also be an exit charge if trust property becomes excluded property under other categories, but in practice that would be rare.

There is an exit charge if trust property ceases to be relevant property even if the property was excluded property at some earlier time. However there is some relief for this situation. If the charge arises before the first 10-year anniversary, section 68(3) IHTA allows a relief where trust property was excluded property at an earlier time:

> Where the whole or part of the amount on which tax is charged is attributable to property which was not relevant property, or was not comprised in the settlement, throughout the period referred to in subsection (2) above, then in determining the appropriate fraction in

64 This subsection was inserted in 2013, but with effect from 2002

65 See 62.12 (Trusts: FOTRA securities).

relation to that amount or part—

(a) no quarter which expired before the day on which the property became, or last became, relevant property comprised in the settlement shall be counted, but

(b) if that day fell in the same quarter as that in which the period ends, that quarter shall be counted whether complete or not.

There is no equivalent relief for exit charges after the first 10-year anniversary. That is perhaps not needed, as the exit charge depends on the 10-year anniversary charge, which may itself qualify for relief for excluded property.

62.19.4 *Occasions where excluded property is relevant for IHT*

RI 166 states:

> However, an "excluded" asset is not always completely irrelevant for the purposes of IHT. So—
>
> [1] an "excluded" asset in a person's estate may still affect the valuation of another asset in the estate, for example, an "excluded" holding of shares in an unquoted company may affect the value of a similar holding in the estate which is not "excluded";

This is correct, but point [1] does not arise in practice. RI166 continues:

> [2] the value of an "excluded" asset at the time the asset becomes comprised in a settlement may be relevant in determining the rate of any tax charge arising in respect of the settlement under the IHT rules concerning trusts without [estate] interests in possession—ss 68(5), 66(4) and 69(3).

This will sometimes be significant. For instance, suppose:

(1) Excluded property (say, foreign situate money) is transferred to a trust.

(2) The trust invests that money in UK situate (chargeable) property.

(3) The property is transferred out of the trust before the 10 year anniversary.

It may be better for the settlor to lend the funds to the trust.

62.20 Non-residents foreign currency bank accounts

62.20.1 *Individual's account*

Section 157(1)(a) IHTA provides a limited relief for non-residents foreign currency bank accounts:

(1) In determining for the purposes of this Act the value of the estate immediately before his death of a person to whom this section applies there shall be left out of account the balance on—

(a) any qualifying foreign currency account of his ...

(5) In this section "qualifying foreign currency account" means a foreign currency account with a bank[66]; and for this purpose—

(a) "foreign currency account" means any account other than one denominated in sterling.

Section 157(2) IHTA explains who qualifies for the relief:

This section applies to a person who is not domiciled and not resident[67] in the UK immediately before his death.

62.20.2 *Trustees bank account*

Section 157(1)(b) IHTA provides a similar restricted relief for trustees foreign currency bank accounts:

(1) In determining for the purposes of this Act the value of the estate immediately before his death of a person to whom this section applies there shall be left out of account the balance on ...

(b) subject to subsection (3) below, any qualifying foreign currency account of the trustees of settled property in which he is beneficially entitled to an interest in possession.

...

(3) Subsection (1)(b) above does not apply in relation to settled property

[a] if the settlor was domiciled in the UK when he made the settlement, or

[b] if the trustees are domiciled or resident in the UK immediately before the beneficiary's death.

For the definition of trust residence see 5.18 (Trustee residence for IHT). Domicile presumably depends on the domicile of the trustees in their personal capacity (the rule that trustee's domicile should be relevant is odd, and inconsistent with the general scheme of UK trust IHT or the

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66 Section 157(6) IHTA provides: "In this section 'bank' has the meaning given by section 991 of the Income Tax Act 2007."

67 Section 157(4) IHTA incorporates the income tax definition of residence:

"For the purposes of this section—

(a) the question whether a person is resident in the UK shall, subject to para (b) below, be determined as for the purposes of income tax;"

(Para (b) deals with trustee residence, discussed below).

taxation of trusts generally; but the relief is not important, so it does not much matter).

62.20.3 *Overdrawn account*

The IHT Manual provides at para 4380:

> **IHTM04380 - foreign currency bank accounts** [January 2008]
> Where the conditions are met, the balance on the account, whether in credit or in debit should be left out of account. You should refer any case of difficulty, especially if you are seeking to disallow a debit balance, to TG.

The second sentence suggests, perhaps, that HMRC are not entirely confident in this interpretation. It seems literally correct on a first reading, and provides an apparent symmetry of treatment with accounts with a positive balance; on the other hand it is a daft rule, a petty trap easily avoided by the well advised, and inconsistent with the general approach of deduction for debts.[68] I do not think it could have been the intention of Parliament.

See too 65.22 (Liability attributable to foreign currency bank account).

62.20.4 *Non-residents foreign currency bank accounts: Commentary*

This is a limited relief. The bank account is *not* excluded property for IHT purposes. It is only disregarded on the death of the owner or life tenant, so it is taken into account for lifetime gifts of individuals, and ten-year anniversary charges on trusts. The conditions for the relief are also stricter than for excluded property. It would in almost all cases be better to use a foreign bank account (which will be excluded property) rather than to rely on this exemption.

If the purpose of the relief is to encourage foreign domiciliaries to deposit funds with UK banks, these restrictions make no sense. It is suggested that foreign currency accounts (indeed all accounts) ought simply to qualify as excluded property in the same way as non-UK accounts. That change would also ensure the deductibility of overdrawn accounts. Otherwise the relief is just clutter in the system and if (as I expect) it is not much used it would be better to repeal it.

62.21 Works of art

The IHTA provides a pragmatic relief for works of art. Section 5(1) IHTA provides relief on death:

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68 See 65.8 (Against which property is the debt deductible?).

> For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that ...
> (b) the estate of a person immediately before his death does not include ... a foreign-owned work of art which is situated in the UK for one or more of the purposes of public display, cleaning and restoration (and for no other purpose).

Section 64(2) IHTA provides relief from 10-year charges:

> For the purposes of subsection (1) above, a foreign-owned work of art which is situated in the UK for one or more of the purposes of public display, cleaning and restoration (and for no other purpose) is not to be regarded as relevant property.

Section 272 IHTA defines these terms:

> "foreign-owned", in relation to property, means property in the case of which the person beneficially entitled to it is domiciled outside the UK or, if the property is comprised in a settlement, in the case of which the settlor was domiciled outside the UK when the property became comprised in the settlement;
> "public display" means display to which the public are admitted, on payment or not, but does not include display with a view to sale;

The reason is self-evident. Dawn Primarolo (then Financial Secretary to the Treasury) explained:

> the public interest would not be served if foreign owners of works of art were unwilling to send them to the UK for [purposes of public display, cleaning or restoration] for fear of a potential inheritance tax charge.[69]

This relief falls short of a complete exemption but in practice it is sufficient, and the gaps are not sufficiently important to discuss further here. See too 12.28 (Public access rule).

62.22 Overseas Pensions

A full discussion of the IHT treatment of pensions needs a book to itself. This section focusses on the issues closest to the themes of this book. See too 82.35 (Situs of pension and death benefits).

Section 153 IHTA provides a narrow relief:

> (1) In determining for the purposes of this Act the value of a person's estate immediately before his death there shall be left out of account any

69 Ministerial Statement 25 February 2003 [2003] STI 303.

pension payable under the regulations or rules relating to

[a] any fund vested in Commissioners under section 273 of the Government of India Act 1935 or

[b] to any fund administered under a scheme made under section 2 of the Overseas Pensions Act 1973 which is certified by the Secretary of State for the purpose of this section to correspond to an Order in Council under subsection (1) of the said section 273....

(3) Subsection (1) above shall be construed as if contained in section 273 of the Government of India Act 1935 ...

(4) If, by reason of Her Majesty's Government in the UK having assumed responsibility for a pension, allowance or gratuity within the meaning of section 1 of the Overseas Pensions Act 1973 payments in respect of it are made under that section, this section shall apply in relation to the pension, allowance or gratuity, exclusive of so much (if any) of it as is paid by virtue of the application to it of any provisions of the Pensions (Increase) Act 1971 or any enactment repealed by that Act, as if it continued to be paid by the Government or other body or fund which had responsibility for it before that responsibility was assumed by Her Majesty's Government in the UK.

62.23 IHT planning for individual

A foreign domiciliary should endeavour to secure, as far as possible, that their assets are situated outside the UK so that they qualify as excluded property and fall outside the inheritance tax net. The foreign domiciliary's property becomes excluded property the moment that it becomes non-UK situate; there is no qualifying period such as is required for agricultural or business property reliefs. The same applies to trustees of a settlement made by a foreign domiciliary. The question is: how is the individual's property to be transferred abroad?

The transfer abroad of £ Sterling from a UK bank account poses no problem. The transfer of bearer instruments abroad raises no problem. The transfer abroad of foreign currency in a UK bank account abroad needs consideration as to CGT. Chattels could be physically moved abroad but that may not be practical.

It is possible to turn UK situate shares and securities into non-UK situate assets for IHT: see 82.8 (Bearer documents and negotiable instruments).

Any UK asset could be sold and the proceeds remitted abroad. This is simple and satisfactory for inheritance tax; however, a sale may be ruled out by CGT or commercial reasons.

If the foreign domiciliary does not wish assets to be sold, they might give them to a company owned wholly by them. The shares in the company

should not be UK situate.[70] The company should normally be non-resident. The gift would not be a transfer of value for IHT because the donor's estate would not be reduced in value. It is considered that it is not a disposal by way of gift, as there is no gratuitous intent. In *Shiu Wing v Commissioner of Estate Duty*[71] the Hong Kong Court of Final Appeal refused to apply the *Ramsay* doctrine to arrangements made by the taxpayer to create property situated abroad (in this case situated outside Hong Kong). The gift would, of course, be a disposal for CGT purposes and hold-over relief would not normally be available. Accordingly, this option will only be a satisfactory solution either if no capital gain arises or if hold-over relief is available.[72]

If the individual is in good health, there is a lot to be said for doing nothing and ignoring IHT planning. The only inheritance tax risk in this strategy is that the individual might die so suddenly that no steps to save tax can be taken. This risk is reduced (but not eliminated) if the spouse exemption is available. It might be possible to take out insurance. In principle it is clearly undesirable to allow a beneficiary in poor health to retain an interest in possession in non-excluded property.

62.24 IHT planning for non-estate IIP trusts

A discretionary trust (and a non-estate IIP trust) is subject to IHT on its ten- year anniversaries. If the settlor is not UK domiciled when they made the trust, all that matters for IHT is the situs of the trust fund on that date.[73] The trustees may safely invest in the UK for a number of years, provided that, by the deadline, they hold foreign situate assets.

In principle this short-term planning may be extended indefinitely:

(1) As each ten-year anniversary approaches the trustees could sell the UK trust property (or even mortgage it) and invest in excluded property.

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70 See 82.6 (Situs of registered shares) and 82.8 (Bearer documents and negotiable instruments).

71 2 ITELR 794.

72 A gift to the company by way of *donatio mortis causa* solves the CGT problem: s.62(5) TCGA. But such a gift is not effective for inheritance tax purposes. The donor retains the right of revocation which would not be excluded property on their death.

73 Note also the possible tax charge on the death of the settlor, under the gift with reservation rules, if the property is UK situate: see 63.14 (GWR death charge: excluded property rules for settled property) and following.

(2) Immediately after the anniversary they might sell and revert to UK investments.

In practice such a course might be subject to the GAAR but it depends on how it is done. Ideally the trustees should look for a different strategy such as holding the UK assets in a foreign registered company.

62.25 IHT planning for trustees of settlement with UK domiciled settlor

If the settlor is UK domiciled when the settlement was made, trust property is not normally excluded property even if the beneficiary is foreign domiciled.

62.25.1 *Beneficiaries not resident*

If the life tenant of an estate IIP trust is not resident in the UK, the trustees might invest in FOTRA securities. The trust property would then be excluded property. See 62.12 (Trusts: FOTRA securities).

Likewise if all the known beneficiaries of a discretionary trust are resident abroad. This option is not available if any of the beneficiaries are domiciled or resident in the UK. A deed of appointment might be needed to satisfy these conditions. This would give rise to an exit charge unless the settlor is foreign domiciled when the settlement was made: see s.65(8) IHTA. However, the amount of the charge may be moderate or small.

62.25.2 *UK settlor: Foreign domiciled beneficiary*

The best option – if circumstances allow – may be to bring the present settlement to an end by appointment to the foreign domiciled beneficiary absolutely. CGT needs consideration if the trust is UK resident and s.87 TCGA needs consideration if it is not. The beneficiary may after an appropriate period re-settle.[74] This may also be appropriate where the settlor has become foreign domiciled after making the settlement.

An alternative course may be to confer a general testamentary power on the foreign domiciled beneficiary. The beneficiary may on their death create a new trust with excluded property.

62.25.3 *Life tenant domiciled in Channel Islands or Isle of Man but deemed UK domiciled*

For this case, see 62.8 (Individual domiciled in Channel Islands or Isle of Man).

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74 See 80.36 (Planning to create trust with foreign domiciled settlor).

CHAPTER SIXTY THREE

RESERVATION OF BENEFIT

63.1 GWR: Introduction

Here is a rendezvous of questions and question marks! A full discussion needs a book to itself. I focus on matters closest to the themes of this book, but it is necessary to consider the provisions generally in order to see the issues in their context.

I do not consider the special rules for insurance policies and for agricultural and business property relief. The IHT Manual contains much fascinating material which cannot be set out here.

63.2 Policy of GWR rules

In the past it has been rare for the Courts to consider the policy behind tax provisions in any detail. (This will now change as a result of the GAAR).

In *Ingram v IRC* Lord Hoffmann did address this issue:

> I should say something about the more general considerations involved in the application of s.102. Its policy has puzzled people for a long time. For one thing, it is in one sense a penal section. Not only may you not have your cake and eat it, but if you eat more than a few de minimis crumbs of what was given, you are deemed for tax purposes to have eaten the lot. Secondly, a superficial reading of phrases like 'beneficial enjoyment of the property' and enjoyment of property 'to the entire exclusion . . . of the donor' has led to numerous occasions in the past century in which the Revenue has put forward the proposition that, as a matter of practical common sense, it simply must be contrary to the policy of the statute for a donor to be able to give away property such as a house and go on enjoying the benefit of the property by continuing to live there. This is the premise upon which the Revenue claim the high ground of substance and reality. [Counsel for the Revenue] said that for Lady Ingram to have made a potentially exempt transfer and retained the right to stay in the house was simply too good to be true and in the Court

> of Appeal, Evans LJ accepted this proposition. But this approach ignores the fact that 'property' in s.102 is not something which has physical existence like a house but a specific interest in that property, a legal construct, which can co-exist with other interests in the same physical object. Section 102 does not therefore prevent people from deriving benefit from the object in which they have given away an interest. It applies only when they derive the benefit from that interest.
>
> If Lady Ingram had been dealing with a fund of investments instead of a house, she would have had no difficulty in achieving the same result, in economic terms, as the transaction in this case. She could have used part of the fund to purchase an annuity which would have guaranteed her exactly the same income as she had been receiving from the fund and given away the rest. Unless she needed to resort to capital, her outward circumstances would have continued unchanged. Why should it make a difference that her asset happened to consist of land? The gift was a real gift of the capital value in the land after deduction of her leasehold interest in the same way as a gift of the capital value of a fund after deduction of an annuity.
>
> What, then, is the policy of s.102? It requires people to define precisely the interests which they are giving away and the interests, if any, which they are retaining. Once they have given away an interest they may not receive back any benefits from that interest. In *Lang v Webb* (1912) 13 CLR 503 Isaacs J suggested that the policy was to avoid the 'delay, expense and uncertainty' of requiring the Revenue to investigate whether a gift was genuine or pretended. It laid down a rule that if the donor continued to derive any benefit from the property in which an interest had been given, it would be treated as a pretended gift unless the benefit could be shown to be referable to a specific proprietary interest which he had retained. This is probably the most plausible explanation and accepting this as the policy, I think there can be no doubt that the interest retained by Lady Ingram was a proprietary interest defined with the necessary precision.[1]

I set this out at length because it illustrates several important points about tax policy.

The first point is that the Courts ascertained the policy by using the ordinary methods of statutory construction, ie just by reading the statute. On this approach (there are others), the concept of tax policy is like the concept of the intention of parliament; it is a construct:

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1 [1999] STC 37 at p.41; for other aspects of this case see 76.2.2 (*Ingram* schemes).

> The phrase is a shorthand reference to the intention which the court reasonably imputes to Parliament in respect of the language used. It is not the subjective intention of the minister or other persons who promoted the legislation. Nor is it the subjective intention of the draftsman, or of individual members or even of a majority of individual members of either House.[2]

The second point is that it was difficult to ascertain what is the policy of s.102: two wildly different policies were both plausibly arguable:

(1) that the policy was prevent *Ingram* style planning (known as shearing, or more tendentiously, "having one's cake and eating it").
(2) that the policy was to require donors to identify precisely the interests they give away and those (if any) they keep.

In this respect, s.102 is not unusual. It is often difficult (perhaps more often than not) to ascertain the policy of tax provisions and sometimes it is impossible:

> In reaching these conclusions I have not attempted any purposive construction of the detailed provisions of the Act, since I am not sure what their purpose is.[3]

This should not be a surprise. There are several powerful factors which lead to this result. The first is the difficulty of formulating a coherent tax policy: in many cases irreconcilable policy considerations yield no satisfactory solution. The second is the inadequate way in which tax policy and drafting has been, and often continues to be, formulated in the UK.[4] In some cases the "policy" is to prevent supposed avoidance arrangements which the HMRC (and the drafter) are unable (or unwilling) to cogently or clearly identify, or which may exist wholly or mainly in the imagination of the Revenue.[5]

Only judicial desire for comity with Parliament prevents statements of this kind being made more often.

Since there are strongly differing views on what the tax policy should be, there are inevitable differing views as to what the policy actually is. The wish may be father to the thought.

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2 *R v Secretary of State ex p. Spath Holme* [2001] 2 AC 349.

3 *BP Oil Development. v IRC* 64 TC 498, at p.532B.

4 See 1.9 (The tax consultation framework).

5 For examples, see 65.36 (Purpose of disallowance for liabilities not paid after death); or the the Tainted Donation Rules in the taxation of charities.

For all these reasons, debates about what is the policy behind tax provisions will rarely be settled. Authoritative decisions of the Courts ought to resolve the question for practical purposes, on the relatively rare occasions when they exist; but even then, the losing side may continue to chip away at the issue. The history of the GAAR guidance on the policy of the GWR provisions offers an example.

63.2.1 *GWR and the GAAR*

HMRC draft GAAR guidance provided:[6]

> **4.1.2 The scheme**
> J grants a long lease over his home to S for no consideration, to take effect in 20 years time. ... J is able to continue to occupy the property for the next 20 years as he continues to own the freehold.
> The result of the scheme is that J has divided his home into two different interests: the lease and the freehold.
> J has gifted the lease of his home to S. J has also retained the freehold, which diminishes in value over the following 20 years.

This is a slight variant of the *Ingram* arrangement[7] but for present purposes the conveyancing details make no difference.

> **4.1.4 The taxpayer's tax analysis**
> The interest given away (the lease to take effect in 20 years time) is a potentially exempt transfer under section 3A, IHTA 1984 and will be exempt from IHT provided J survives for 7 years after the gift.
> The interest retained (the freehold subject to the lease) is reducing in value as the time for the lease to take effect approaches, so reducing the value of J's estate that will be subject to IHT on death.
> As the time for the lease to take effect approaches, the value of the asset transferred to S increases, but without giving rise to a charge to IHT.
> **4.1.5 What is the GAAR analysis under clause 2(2)?**
> 4.1.5.1 Are the substantive results of the arrangements consistent with any principles on which the relevant tax provisions are based and the policy objectives of those provisions?
> In 1975 Capital Transfer Tax ("CTT") replaced Estate Duty with the aim of reducing avoidance[8] through giving property away before death.

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6 HMRC, "GAAR Guidance- Consultation Draft Part B Examples of How the GAAR Applies to Tax Arrangements" (December 2012).

7 See 76.2.2 (*Ingram* schemes).

8 This is tendentious: see 32.18 (Intention of Parliament *v* intention of Government).

Under CTT, all disposals of property, whether to individuals or into trust were immediately subject to tax. By 1986, CTT was seen as an inhibitor to the transfer of wealth, so transfers between individuals and to certain favoured[9] trusts were exempted from charge (provided the donor survived 7 years). Provisions were introduced to prevent the avoidance of the charge on death by gifts where the donor continues to benefit from the gift. And the tax was renamed. The purpose of these provisions was published in the Budget Press Release in March 1986.

The scheme allows the taxpayer to 'have their cake and eat it' since an interest in J's home is given away and will be free from IHT provided J survives 7 years; yet J is still able to live in and enjoy his home; the value of which is reducing as the commencement of the lease draws ever closer. This is not consistent with the principles or policy objectives of the reservation of benefit provisions.

4.1.5.2 Does the means of achieving the substantive tax results involve one or more contrived or abnormal steps?

Absent the arrangements, had J given his home to S and continued to live there rent-free, there would have been a clear reservation of benefit in the property. The property would have formed part of J's estate on death and the full value of the property at that time would have been subject to IHT. Simply making a gift of his home to S whilst continuing to live there might be considered a 'normal' step for J to take, as opposed to the "abnormal steps" which J did take.

The intermediate step taken by J in granting a long lease for no consideration, the commencement of which is deferred for a period of time, is contrived and is inserted purely to gain a tax advantage.

4.1.5.3 Are the arrangements intended to exploit any shortcomings in the relevant tax provisions?

The gifts with reservation rules in section 102, FA 1986 cover a situation where an individual disposes of property by way of gift, but does not fully give away the ability to enjoy that property. The rules do not cover a situation where an individual creates two different interests in that property, and gives one interest away and retains the other.

In both situations the non-tax result for the individual may be the same. However, in the first situation the reservation with benefit rules apply. In the second situation, the rules do not apply.

The failure of the rules to cover a situation where an individual creates two different interests in a property is a shortcoming that the scheme is

9 This adjective is tendentious; but that does not affect the policy issues discussed here, and any one paragraph summary of CTT must oversimplify.

intended to exploit.

4.1.5.4 Do the tax arrangements accord with established practice and has HMRC indicated its acceptance of that practice?

HMRC has not indicated that these arrangements give rise to the claimed tax result.[10]

4.1.6 Conclusion

On the facts given, the arrangements are abusive arrangements to which HMRC would seek to apply the GAAR.

In an early test of the views of the GAAR advisory panel, this passage was deleted from the GAAR guidance. The guidance now provides:

> D27.4.1 ... In [*Ingram*], the House of Lords held that the policy of the legislation was to identify precisely what property had been given away by the donor and what (if anything) was retained. They noted that there is nothing in principle behind the "gifts with reservation" provisions that stops the donor carefully dividing up his cake, giving away a slice and retaining the remaining cake. Continued enjoyment of the latter does not amount to a reservation in the former. Arrangements of the type adopted are known as "shearing" operations.
>
> Ss102A–102C FA 1986 were introduced to stop shearing arrangements in relation to certain carve out schemes over land. Hence the policy on such arrangements has clearly been altered by legislation and the effect of the GAAR in relation to such tax schemes must be considered in this light. However, this does not mean that all "carve out" arrangements have been stopped. The House of Lords has indicated that such arrangements are not necessarily[11] against the principles behind the legislation and no legislative action has been taken in relation to other types of assets to stop such arrangements. The discounted gift scheme can be seen as a classic shearing operation on property other than land.[12]

63.3 The basic conditions

Section 102(1) FA 1986 provides:

> ... this section applies where, on or after 18 March 1986, an individual disposes of any property by way of gift and either—

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10 I wonder about that. *Ingram* arrangements (*avant la lettre*) were used in the 1960's and never challenged. But that does not affect the policy issue discussed here.

11 This is a somewhat tendentious summary of the view expressed in *Ingram*; but perhaps it does not matter.

12 HMRC GAAR Guidance Part D (Examples) (April 2013) accessible *http://www.hmrc.gov.uk/avoidance/gaar-partd-examples.pdf*

> (a) possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period;[13] or
> (b) at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise ...

There are two sets of conditions:

(1) An individual (in this chapter "**the donor**") makes a disposal of property by way of gift. There are three separate elements here: a *disposal*, of *property*, which must be *by way of gift.*
(2) Condition (a) or (b) above must be satisfied (a reservation of benefit).

63.4 Terminology

Section 102(2) FA 1986 defines **"property subject to a reservation"**:

> If and so long as—
> (a) possession and enjoyment of any property is not bona fide assumed as mentioned in subsection (1)(a) above, or
> (b) any property is not enjoyed as mentioned in subsection (1)(b) above,
>
> the property is referred to (in relation to the gift and the donor) as property subject to a reservation.

In the following discussion:

(1) "**GWR property**" is property subject to a reservation.
(2) "**Settled GWR property**" is GWR property which becomes settled property by the gift (ie the gift is to a settlement).
(3) "**Non-settled GWR property**" is GWR property which does not become settled property by the gift (ie the gift is not to a settlement).
(4) "**The GWR death charge**" is the charge imposed by s.102(3) FA 1986.
(5) "**The GWR PET charge**" is the charge imposed by s.102(4) FA 1986.

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13 Section 102(1) provides:

> ..."in this section 'the relevant period' means a period ending on the date of the donor's death and beginning seven years before that date or, if it is later, on the date of the gift."

63.5 "Disposal by way of gift"

There is no definition of "disposal by way of gift".

The surrender of a lease or life interest is arguably not a "disposal".

It is considered that the giving of consent to an exercise of a power of advancement or appointment is not a disposal.

It is considered that a sale at an undervalue is not "by way of gift".[14]

It is considered that a transfer to a settlement in which the settlor has an estate interest in possession is a disposal by way of gift, but from 2006 this issue will not usually arise.

A sale at market value, where the purchase price is left outstanding as an interest-free loan, repayable on demand, is not a disposal "by way of gift".

An interest free loan is not a disposal by way of gift.[15]

63.6 Reservation of benefit

The words used in s.102(1)(a)(b) are notoriously vague. While in most cases the matter will be clear enough there are significant areas of uncertainty. Some doubtful areas have been resolved for practical purposes by HMRC guidance.

63.6.1 *Gift to discretionary trust, settlor a beneficiary*

IHT Manual provides:

> **14393 Settlement on discretionary trusts** [January 2010]
> If a donor makes a settlement and is one of the members of the discretionary class of beneficiaries, this is a GWR.
> - The donor's position as a member of the discretionary class of beneficiaries is not an equitable interest retained by them (and so not included in the gift) and
> - as the donor is a member of the class, they have not been excluded (IHTM14333), or virtually excluded, from enjoyment. The fact that they do not receive any tangible benefit during the relevant period is immaterial.

This is correct.[16] It is considered that the same applies where an individual

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14 This view is supported by the drafting of para 2(4) Sch 20 FA 1986: see 63.20.3 (Gift by donee).

15 This view is supported by the drafting of para 5(4) Sch 20 FA 1986: see 63.21.3 (Loan to trust).

16 *IRC v Eversden (Greenstock's Executors)* 75 TC 340 in the High Court; the Court of Appeal did not consider this point; *Lyon v HMRC* [2007] STC (SCD) 675.

makes a gift to a discretionary trust under which:
(1) the settlor is not included in the class of beneficiaries; but
(2) the trustees have an unrestricted power to add the settlor to the class of beneficiaries.[17]

63.6.2 *Gift from A to B followed by gift to trust by B*

The position is different where:
(1) A makes a gift to B.
(2) Later, by an independent transaction, B creates a discretionary trust under which A is a beneficiary (or where A can be added as a beneficiary).

In these circumstances A is *not* the settlor. It is considered that there is no reservation of benefit merely because A is a discretionary beneficiary. There will be a reservation of benefit if A actually receives a benefit.

63.6.3 *"Virtually" to the entire exclusion*

This concept matters for GWR and also for remittance conditions C and D.[18] With an economy of concepts, HMRC apply their guidance to the conceptually distinct issue of whether a person "occupies" land, ie a person who is "virtually" excluded from land is not an occupier.[19] "Occupy" is a concept which matters for many tax purposes. So I consider the topic in some detail.

RI 55 provides:

> The word "virtually" in the de minimis rule in FA 1986 s 102(1)(b) is not defined and the statute does not give any express guidance about its meaning. However, the shorter Oxford English Dictionary defines it as, amongst other things, "to all intents" and "as good as". Our interpretation of "virtually to the entire exclusion" is that it covers cases in which the benefit to the donor is insignificant in relation to the gifted property.

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17 In the HMRC view, however, the position is not so clear. The IHT Manual provides:
"**14393 Settlement on discretionary trusts** [January 2010]
Example 2
... The question of whether the possibility that A's name might be added to the class is a reservation is one which you can only determine on the particular facts. Refer any case where the point is material to the Litigation Section."

18 See 11.23.2 (Enjoyment disregards).

19 See 76.3.1 ("Occupation").

> It is not possible to reduce this test to a single crisp proposition. Each case turns on its own unique circumstances and the questions are likely to be ones of fact and degree. We do not operate s 102(1)(b) in such a way that donors are unreasonably prevented from having limited access to property they have given away and a measure of flexibility is adopted in applying the test.

These generalities do not take us far. RI 55 goes on to give some more concrete examples:

> Some examples of situations in which we consider that FA 1986 s 102(1)(b) permits limited benefit to the donor without bringing the GWR provisions into play are given below to illustrate how we apply the de minimis test—
>
> [1] a house which becomes the donee's residence but where the donor subsequently—
>
> – stays, in the absence of the donee, for not more than two weeks each year, or
> – stays with the donee for less than one month each year;
>
> [2] social visits, excluding overnight stays made by a donor as a guest of the donee, to a house which he had given away. The extent of the social visits should be no greater than the visits which the donor might be expected to make to the donee's house in the absence of any gift by the donor;
>
> [3] a temporary stay for some short term purpose in a house the donor had previously given away, for example—
>
> – while the donor convalesces after medical treatment;
> – while the donor looks after a donee convalescing after medical treatment;
> – while the donor's own home is being redecorated;
> – visits to a house for domestic reasons, for example baby-sitting by the donor for the donee's children;
>
> [4] a house together with a library of books which the donor visits less than five times in any year to consult or borrow a book;
>
> [5] a motor car which the donee uses to give occasional (ie less than three times a month) lifts to the donor;
>
> [6] land which the donor uses to walk his dogs or for horse riding provided this does not restrict the donee's use of the land.

There follow some examples of where there is a benefit:

> It follows, of course, that if the benefit to the donor is, or becomes, more significant, the GWR provisions are likely to apply. Examples of this include gifts of—

> [1] a house in which the donor then stays most weekends, or for a month or more each year;
> [2] a second home or holiday home which the donor and the donee both then use on an occasional basis;
> [3] a house with a library in which the donor continues to keep his own books, or which the donor uses on a regular basis, for example because it is necessary for his work;
> [4] a motor car which the donee uses every day to take the donor to work.[20]

63.7 Full consideration exemption

The concept of full consideration matters for so many tax purposes that it is not possible to write a full list; these include:

(1) GWR
(2) Remittance conditions C and D[21]
(3) POA rules[22]

So I consider it in some detail.

Para 6(1) Sch 20 FA 1986 provides:

> In determining whether any property which is disposed of by way of gift is enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise—
> (a) in the case of property which is an interest in land or a chattel, retention or assumption by the donor of actual occupation of the land or actual enjoyment of an incorporeal right over the land, or actual possession of the chattel shall be disregarded if it is for full consideration in money or money's worth;

RI 55 provides:

> The GWR provisions do not apply where an interest in land is given away and the donor pays full consideration for future use of the property (FA 1986 Sch 20 para 6(1)(a)). While we take the view that such full consideration is required throughout the relevant period—and therefore consider that the rent paid should be reviewed at appropriate intervals to reflect market changes—we do recognise that there is no single value at which consideration can be fixed as "full". Rather, we accept that

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20 The same passage is found in IHTM14333 (modernised in 2010 to gender inclusive language).

21 See 11.23.2 (Enjoyment disregards).

22 See 76.21 (Full consideration exemption).

what constitutes full consideration in any case lies within a range of values reflecting normal valuation tolerances, and that any amount within that range can be accepted as satisfying the para 6(1)(a) test.

For chattels, see the published IR letter of 18 May 1987. At present HMRC argue that the industry standard guideline for chattels (market rent = 1% of capital value) is too low.

63.8 IHT on the disposal by way of gift

A gift which is a chargeable transfer will give rise to a charge to IHT (assuming it exceeds the nil rate threshold) whether or not it is a gift with a reservation.[23] The reservation of benefit does not affect this charge; just on the death of the donor there may be a further charge to tax. The Inheritance Tax (Double Charges Relief) Regulations 1987 mitigate a double charge. This chapter does not consider the IHT which might arise on a disposal by way of gift; it considers only the GWR aspects.

63.9 Gift of excluded property

Section 102 FA 1986 applies when an individual disposes of any property by way of gift. A foreign domiciliary is certainly "an individual". A gift of UK situate property by a foreign domiciliary is clearly within the GWR rule.

What is the position where a foreign domiciliary disposes of excluded

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23 The IHT Manual seems to make this somewhat elementary error:

"**14316 Sales for less than full consideration** [January 2010]

Example 1

In 1989 the donor sold a house, then worth £100,000, to his son for £25,000. This is a disposition partly by way of sale and partly by way of gift. The donor dies in 1993.

- If the donor has been excluded from enjoyment of the property throughout the period, the gift is a PET chargeable on his death. The loss to his estate is the value of the entirety of the property less the consideration received (£100,000 less £25,000 = £75,000).

[The correct view is that the sale is a PET whether or not the donor is excluded]

- If the donor was not excluded from enjoyment of the property, for instance because he resided at the property following the disposition, the disposal by way of gift is a GWR. The value of the property disposed of by way of gift is 75% of the value of the whole property. Thus, if the property is still subject to a reservation immediately before the donor's death, 75% of its death value is treated as property to which the donor was beneficially entitled."

[This is very doubtful; no property is disposed of by way of gift]

property by way of gift? There is nothing which expressly takes the gift out of the scope of the GWR rules. However, it is suggested that s.3(2) IHTA does so obliquely. Section 3 IHTA provides:

> (1) Subject to the following provisions of this Part of this Act, a transfer of value is a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition; and the amount by which it is less is the value transferred by the transfer.
> (2) For the purposes of subsection (1) above no account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of a disposition.

On a literal approach to construction this makes no difference. The fact that no account is taken of the value of excluded property for the purposes of s.3(1) does not entail that the disposition is not a "disposal by way of gift". However, a purposive construction suggests otherwise. It is absurd that there should be a charge to tax in circumstances where:

(1) a foreign domiciliary with no UK connection makes a gift of excluded property to another person with no UK connection, and enjoys some benefit; and
(2) the foreign domiciliary dies many years later at a time when property representing the property given is situate in the UK.

Nobody would expect the foreign domiciled donor or their executors to comply or to be able to comply with an obligation to pay IHT in such circumstances. The purpose of s.3(2) IHTA is to take excluded property out of the scope of inheritance tax and a disposal of excluded property is by implication ignored. Since it is ignored it is not a disposal "by way of gift". This view is also supported by the use of the term "excluded property" – the property is regarded as excluded from IHT. This explains why an inter-spouse gift of excluded property is not within the GWR rule.[24]

HMRC do not appear to accept this view. They might object with a counter-anomaly: that if it were right, the trust was within the POA charge as the POA GWR exemption would not apply.[25] One answer is that even though the terms of s.102(1) are not met (there is no disposal by way of gift) the trust property is still "property subject to a reservation" as defined

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24 See 63.10.1 (Inter-spouse gift of excluded property).

25 See 76.19 (GWR exemptions).

in s.102(2), purposively construed, so long as the donor enjoys a benefit, so the POA GWR exemption does not apply. (Also the foreign domicile exemption will often apply in this case.)

63.10 GWR spouse exemption

This section considers the GWR position on inter-spouse gifts. For the IHT spouse exemption generally see 67.1 (IHT spouse exemption); see too 63.19 (IHT spouse exemption defence to GWR death charge).

Section 102(5) FA 1986 provides a relief which I call the "**GWR spouse exemption**":

> This section does not apply if or, as the case may be, to the extent that the disposal of property by way of gift is an exempt transfer by virtue of any of the following provisions of Part II of the [IHTA],—
>
> (a) section 18 (transfers between spouses or civil partners) ... ;

In short, the GWR rules do not apply on gifts between spouses if the IHT spouse exemption applies.[26]

Where a UK domiciled individual makes a gift to a foreign domiciled spouse, the IHT spouse exemption is restricted[27] and a gift over the limit will be within the scope of GWR, unless some other exemption[28] is in point. One solution to this problem is to sell assets at market value, so there is no disposal by way of gift. Watch the SDRT/SDLT implications.

One common situation is where one spouse gives an interest in the family home to the other spouse, but as long as the property is jointly occupied, there is in principle no GWR: see s.102B FA 1986.

63.10.1 *Inter-spouse gift of excluded property*

What is the position when a foreign domiciled individual makes a gift of excluded property to their spouse? On a literal construction, the gift will fall within the GWR rules. A gift of excluded property is not a transfer of value, so outside the scope of the IHT spouse exemption, so it is outside the scope of the GWR spouse exemption! But that is absurd and cannot be the correct construction, even if words must be strained to reach this

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26 I use the term "**IHT spouse exemption**" to refer to the exemption on inter-spouse transfers in s.18 IHTA.

27 See 73.2 (Restriction on IHT spouse exemption for foreign domiciled spouse).

28 Such as the family maintenance exemption: see 73.4 (Disposition for maintenance of spouse and other exemptions).

result. This consideration supports the view taken here that gifts of excluded property, and gifts within s.11 IHTA, are deemed not to be by way of gift.[29]

63.10.2 *Restriction on GWR spouse exemption*

Section 102 FA 1986 provides:

> (5A) Subsection (5)(a) above does not prevent this section from applying if or, as the case may be, to the extent that—
>
> (a) the property becomes settled property by virtue of the gift,
>
> (b) by reason of the donor's spouse or civil partner ("the relevant beneficiary") becoming beneficially entitled to an interest in possession in the settled property, the disposal is or, as the case may be, is to any extent an exempt transfer by virtue of section 18 of the 1984 Act in consequence of the operation of section 49 of that Act (treatment of interests in possession),
>
> (c) at some time after the disposal, but before the death of the donor, the relevant beneficiary's interest in possession comes to an end, and
>
> (d) on the occasion on which that interest comes to an end, the relevant beneficiary does not become beneficially entitled to the settled property or to another interest in possession in the settled property.
>
> (5B) If or, as the case may be, to the extent that this section applies by virtue of subsection (5A) above, it has effect as if the disposal by way of gift had been made immediately after the relevant beneficiary's interest in possession came to an end.
>
> (5C) For the purposes of subsections (5A) and (5B) above—
>
> (a) section 51(1)(b) of the 1984 Act (disposal of interest in possession treated as coming to end of interest) applies as it applies for the purposes of Chapter 2 of Part 3 of that Act; and
>
> (b) references to any property or to an interest in any property include references to part of any property or interest.

This stops *Eversden* schemes;[30] it is now unnecessary (because of s.102ZA and the POA rules) and should be repealed (ideally along with a

29 If my view were wrong the further anomaly would arise that gifts of qualifying investments to charity would fall within the scope of GWR because such gifts fall within s.12 IHTA and not s.102(5)(d) FA 1986; but it is not necessary to pursue that here.

30 See 76.2.1 (Eversden schemes).

replacement of the POA rules with something more targeted).

63.11 GWR death charge

Section 102(3) FA 1986 provides:

> If, immediately before the death of the donor, there is any property which, in relation to him, is property subject to a reservation then ... that property shall be treated for the purposes of the [IHTA] as property to which he was beneficially entitled immediately before his death.

I refer to this as "**the GWR death charge**". Section 102(3) is a deeming provision; the donor is not in fact beneficially entitled to the property subject to the reservation but the property is treated as if they were so entitled. To understand the significance of this, it is necessary to set out the short series of sections that impose an inheritance tax charge on property to which a person is beneficially entitled at death.

Section 4(1) IHTA imposes the IHT charge on death:

> On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death.

The key word here is "estate". Section 5(1) IHTA defines estate by reference to beneficial entitlement:

> .... a person's estate is the aggregate of all the property to which he is beneficially entitled, except that ...
>
> (b) the estate of a person immediately before his death does not include excluded property ...

So if there is a GWR until death and the property is *not* excluded property:

(1) the property is treated as property to which the donor was beneficially entitled (in all cases);
(2) the property is part of their estate.

If there is a GWR until death and the property *is* excluded property:

(1) the property is treated as property to which the donor was beneficially entitled (in all cases);
(2) the property is not part of their estate.

63.12 GWR over debt owed by the deceased

Suppose:

(1) S creates a discretionary settlement under which S is a beneficiary.

(2) The trustees lend to S.
(3) S dies.

The debt ("the GWR debt") is treated as being in the estate of S. However a person cannot owe a debt to himself. If the GWR debt is treated as property beneficially owned by the debtor, it must be treated as if it ceased to exist. For this reason there is no IHT charge on the debt under the GWR rules, on the death of S, even if the GWR debt is UK situate.[31]

63.13 GWR death charge: Non-settled property excluded property rules

Suppose:

(1) A gives property to B, an individual, outright.
(2) There is a reservation of benefit: A enjoys benefits at the time of A's death.
(3) The property is not UK situate at the time of A's death.

A is treated as if A were beneficially entitled to the property at the time of A's death. It forms part of their estate unless it is excluded property at that time. How do the excluded property rules work in these circumstances?

Here we are concerned with non-settled property. The relevant rule is that:

> Property situated outside the UK is excluded property if the person beneficially entitled to it is an individual domiciled outside the UK.[32]

In the example above, B is *in fact* beneficially entitled to the property. A is *treated* as beneficially entitled. Who is "beneficially entitled" for the purpose of applying the excluded property rule; is it A or is it B? This does not matter if A and B are both foreign domiciled, but it does if one is and the other is not. One common case is in a gift from a UK domiciled donor to their foreign domiciled spouse.[33] The answer is to be found by applying the general rule of construction which applies to deeming provisions.[34] Applying this principle it follows that the domicile of the donor A is what matters for excluded property status. Thus if A has a foreign domicile, the property (if not UK situated) is excluded property.

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31 If the debt is non-UK situate it may also be outside the scope of IHT because of the excluded property rules. On the question of a deduction for the GWR debt, see 65.9.3 (Debt owed by settlor to settlor-interested discretionary trust).

32 Section 6(1) IHTA.

33 See 63.10 (GWR spouse exemption).

34 See App 2.1 (Construction of Deeming Provisions).

The domicile of the donee B is irrelevant. This conclusion is confirmed by the context. It would be absurd if the taxation of A depended on the domicile of B. The taxation of A should depend on A's own domicile position.

For the purposes of the excluded property rule, therefore:

(1) The domicile of the donor at the time of gift is irrelevant (contrast the position where the gift is made in trust).[35]
(2) The situs of the property at the time of the gift is irrelevant to the operation of the excluded property rules on the death of the donor.

HMRC agree. The IHT Manual provides:

> **14318 The gift: exempt transfers which cannot be GWRs** [November 2013]
> ...
> *Excluded property*
> Under the charging provisions (IHTM04072), excluded property (IHTM04251) cannot be the subject of a GWR...
> *Example*[36]
> Example 3 (George)
> G is originally domiciled in the UK, but moves to New Zealand and acquires a domicile of choice there. He gives some New Zealand shares to his son, R, but continues to enjoy the dividends until his death ten years later. He dies domiciled in New Zealand.
> The property is subject to a reservation and is therefore deemed to be part of G's estate on death. However, the property is situated outside the UK and the donor, who is treated as beneficially entitled to it, was domiciled outside the UK at his death. The property is therefore excluded property within IHTA84/S6 (1) and escapes the GWR charge.

This is correct; the Manual continues:

> However, if G had returned to the UK and his domicile of origin had revived, there will be a GWR claim on his death, or if the reservation had ceased in his lifetime and within 7 years of his death, the ending of the reservation will be treated as a deemed PET. This is because at the time the GWR charge arises, G is domiciled in the UK so IHTA84/S6(1) does not apply...

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35 See 63.14 (GWR death charge: excluded property rules for settled property) below.

36 This example was reworded and improved in 2010, probably in response to criticisms of the former wording in the 2010/11 edition of this book.

While it is correct that s.6(1) does not apply on the facts of this version of the example, it is arguable that there is no GWR.[37]

The same applies to gifts to companies, including companies held by trusts.

63.14 GWR death charge: Excluded property rules for settled property

Suppose:
(1) S (not UK domiciled) gives property to a discretionary settlement.
(2) There is a reservation of benefit, eg S is a beneficiary.
(3) The property is not UK situate[38] at the time of the death of S.
S is treated as if S were beneficially entitled to the property at the time of S's death. It forms part of S's estate unless it is excluded property at that time. How do the excluded property rules work in these circumstances?

63.14.1 *The rival solutions*

There are two sets of excluded property rules, relating to settled and non-settled property. Which does one apply?

The Settled Property Solution The property subject to a reservation is in fact settled property, so on this view one applies the settled property rules set out in s.48(3) IHTA:

> Where property comprised in a settlement is situated outside the UK—
> (a) The property ... is excluded property unless the settlor was domiciled in the UK at the time the settlement was made. ...

So on this view, where an individual makes a gift to a settlement with reservation of benefit, and dies, the property is excluded property for the GWR rules if:
(1) the donor is domiciled outside the UK at the time the settlement was made. (The domicile of the donor at the time of death is irrelevant); and
(2) the property is not situated in the UK at the time of death.
I call this "**the Settled Property Solution**".

The Non-settled Property Solution The settled property GWR is to be treated as property to which the donor is "beneficially entitled". On this

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37 See 63.9 (Gift of excluded property).

38 The position is the same if the property consists of UK AUTs or OEICs, but for convenience I refer to non-UK situate property only.

view one applies the deeming provision to its logical conclusion: if a person is beneficially entitled to property, it is not settled property. So on this view, where an individual makes a gift to a settlement with reservation of benefit, and dies, the property is excluded property for the GWR rules if:

(1) the donor was domiciled outside the UK at the time of their death. (The domicile of the donor at the time the settlement was made is irrelevant for GWR, though it is relevant for other purposes); and
(2) the property is not situated in the UK at the time of death.

I call this "**the Non-settled Property Solution**".

63.14.2 *The correct solution*

The Non-settled Property Solution has supporters.[39] Nevertheless it is generally regarded as wrong. What about the deeming provision that the property is to be treated as if the donor were beneficially entitled to it? The answer is that the property must still be regarded as "settled property" for the application of the excluded property rules. One does not carry the implications of the deeming provisions as far as the Non-settled Property Solution suggests. One way to reach this conclusion is to note that the deeming provision does not deem the donor to be beneficially and *absolutely* entitled to the settled property. One can be beneficially entitled to property which is settled property. (Bear in mind that "settlement" has a wide definition for IHT. It includes property held subject to a contingency, property charged with the payment of an annuity, and a lease for life. A person entitled to such property may nevertheless be said to be "beneficially" entitled.)

This view is supported by s.49(1) IHTA which provides:

> A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as *beneficially entitled* to the property in which the interest subsists.
> [Emphasis added]

No-one suggests that property to which s.49(1) applies is to be treated as non-settled property for the purposes of the GWR rules. The wording of the deeming provision in s.102(3) is materially the same.

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39 Venables, "Excluded Property Trusts and GROBs" [2003] OITR Vol 11 p.75, accessible *http://www.khpplc.co.uk/reviews*; Akin, *GITC Review*, Vol 1 Issue 2, p.1, accessible *http://www.taxbar.com*.

Under the Non-settled Property Solution, the property is simultaneously excluded property (for general IHT purposes) and non-excluded property (for GWR purposes). While that is not impossible, it would be remarkable, even in as convoluted an area as this, and for this reason too the Settled Property Solution is to be preferred.

It has been said that a purposive construction favours the Non-settled Property Solution: the purpose of the GWR rules is to put the donor in the same position as if they had not made the gift. This is the general purpose in the case of gifts by UK domiciliaries. However, arguments on purposive construction only run when one knows the general purpose and is confident that the general purpose applies in the particular circumstances of the case. This argument *assumes* that that purpose necessarily extends to the foreign domiciliary – which begs the question. Perhaps Parliament intended there to be a difference between the two cases. One cannot apply a purposive construction unless the purpose is clear.[40]

Even adopting the Settled Property Solution, there will arguably[41] be a charge to IHT on the death of a settlor who enjoys a benefit over trust property if at the time of their death the trust property is UK situated (and not UK AUTs or OEICs). Though I doubt if much notice is taken of that in practice.

In short, if the settlor is a beneficiary it is safer not to invest directly in UK situate property during their life.

Note that the Non-settled Property Solution favours the taxpayer if a UK domiciliary makes a GWR settlement, and becomes non-UK domiciled before their death. However that won't often happen.

63.14.3 *HMRC view*

After a decade of dithering[42] HMRC now agree with the Settled Property Solution. The IHT Manual provides:

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40 In the battle of the anomalies HMRC might instance the case where a foreign domiciliary made a settlement shortly before becoming UK domiciled, and say that it is absurd that a settlement made in such circumstances should avoid IHT on the death of the settlor. But (1) this is certainly the case where the foreign domiciliary enjoys no benefit from the settlement; and (2) this was the case under estate duty; and (3) this was the case under HMRC practice in the first 15 years or so of IHT; in the circumstances it is wrong (if not absurd) to describe that result as absurd.

41 See 63.9 (Gift of excluded property).

42 See the 2010/11 edition of this work para 51.12.3.

14396 Settled property: Settlement created when the settlor is domiciled outside the UK [January 2011]

Where the settlor was domiciled outside the UK at the time a settlement was made, any foreign property in the settlement is excluded property and is not brought into charge for Inheritance Tax (IHT) purposes (IHTM27220). This rule applies where property is subject to a reservation of benefit even though the settlor may have acquired a domicile of choice in the UK, or be deemed to be domiciled in the UK, at the time the GWR charge arises (IHTM04071).

Reservation ceasing on death

At the material date FA86/S102(3) deems the donor to be beneficially entitled to property that is, at that time, settled property. As the property in which the reservation subsisted is 'property comprised in a settlement', it is the provisions of IHTA84/S48(3) that are in point. It is the domicile of the settlor at the time the settlement was made that is relevant in deciding whether foreign property in which the reservation subsisted is excluded property.

Example (Henry)

H, who is domiciled in New Zealand, puts foreign property into a discretionary trust under which he is a potential beneficiary (IHTM14393). He dies five years later having acquired a domicile of choice in the UK and without having released the reservation. The property is subject to a reservation on death but it remains excluded property and is outside the IHT charge.

The Manual continues by noting three exceptions:

Exceptions to the rule

There are, however, circumstances where this rule does not apply:

[1] If the trustees had sold the foreign assets so that at the date of death the settled property was invested in UK assets, the exclusion would not apply as the property comprised in the settlement was not situated outside the UK, so IHTA84/S48(3) cannot apply.

[2] If the donor has acquired a domicile of choice (or is deemed domiciled) in the UK and adds other property to the settlement (irrespective of the situs (IHTM27071) of the property), we regard the donor as creating a separate settlement (IHTM04272). All the trust assets will be property subject to a reservation, but the foreign assets settled when the donor was domiciled outside the UK will be excluded property, whereas the assets settled when the donor was domiciled in the UK will be subject to IHT

[3] And in the reverse situation, if a donor who is domiciled (or deemed domiciled) in the UK creates a settlement with foreign assets and the

> settled property remains subject to a reservation at death, the trust assets will be subject to IHT under FA86/S102(3) even if the settlor dies domiciled outside the UK as IHTA84/S48(3) does not apply - as well as being subject to relevant property trust charges (IHTM42000).

Point [1] is correct that s.48(3) does not apply but it is arguable that there is no GWR for other reasons.[43] Point [2] is very doubtful: see 62.15 (Settlor adds property to trust after change of domicile). Point [3] is correct, assuming the settled property solution is correct. The unfairness of the double charge (which does not seem to trouble HMRC) may be avoidable by winding up the trust.

63.15 Gift to foreign domiciled donee who creates a settlement

Suppose:
(1) A gives property outright to B.
(2) B gives that property to a settlement.
(3) A is a beneficiary of that settlement and enjoys benefits so that there is a reservation of a benefit in relation to A's gift.
(4) B (and not A) is the settlor of the settlement.[44]

Now which set of excluded property rules is applied? It is suggested that one must apply the rules applicable to settled property for the reasons given in 63.14 (GWR death charge: excluded property rules for settled property). FA 1986 Sch. 20 para 5 needs to be considered but, properly understood, nothing there deems A to be the settlor of the settlement. If that is right, there is no reservation of benefit problem if:
(a) B (the settlor) was not domiciled in the UK when the settlement is made; and
(b) the property is not situated in the UK at the time of the death of A.

Conversely, on this view, there is a GWR problem if B (the settlor) is UK domiciled (regardless of the domicile of A).

63.16 GWR PET charge

So far we have considered the position where the benefit continues until the death of the donor. Section 102(4) FA 1986 provides:

> If, at a time before the end of the relevant period, any property ceases to

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43 See 63.9 (Gift of excluded property).
44 See 80.4 (Gift from A to B followed by gift to trust by B).

> be property subject to a reservation, the donor shall be treated for the purposes of the 1984 Act as having at that time made a disposition of the property by a disposition which is a potentially exempt transfer.

I refer to this as "**the GWR PET charge"**. Section 102(4) is a deeming provision; it is a different deeming from s.102(3), the GWR death charge. In s.102(3) the donor is deemed to be beneficially entitled. Here, the donor is deemed to have made a PET. To understand the significance of this, it is necessary to set out the definition of a PET. A PET is a particular kind of transfer of value (s.3A IHTA) and s.3 IHTA provides:

> (1) [a] ... a transfer of value is a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition;
>
> [b] and the amount by which it is less is the value transferred by the transfer.
>
> (2) For the purposes of subsection (1) above no account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of a disposition.

Note that s.3(1) contains two definitions: s.3(1)[a] defines "transfer of value" and s.3(1)[b] defines "value transferred". For both purposes s.3(2) states that excluded property is (in short) disregarded.

63.16.1 *Non-settled GWR PET charge*

Suppose:

(1) a non-UK domiciliary makes a non-settled GWR of non-UK situate property; and

(2) the property ceases to be subject to a reservation (while the donor is still non-UK domiciled).

No-one could sensibly suggest that there is a possible IHT charge. The reason is in s.3(2): the donor is deemed to have made a disposition of excluded property. While one can (just) call that a PET, the value transferred is ignored and no charge to IHT can arise. Nothing in the deeming provision requires one to ignore the application of s.3(2) to s.3(1)[b]. What matters is the domicile of the donor (and the situs of the GWR property) at the time the reservation ceases. There would be a deemed PET if:

(1) F (a foreign domiciliary) makes a GWR.

(2) F becomes UK domiciled.

(3) The GWR is released.[45]

63.16.2 *Settled GWR PET charge*

Suppose settled property ceases to be subject to a reservation; eg a donor ceases to be a beneficiary of a trust they have created, and becomes excluded from all benefit. The issues are similar to the case of the GWR death charge: how far do you carry the implications of the deemed PET? Do you deem the GWR property which is actually settled property to be non-settled property? Although the deeming is marginally different, the context is the same as for GWR on death.

The answer must be decided consistently with the answer to the related issue for a GWR on death. If (as concluded above) the Settled Property Solution is correct on death then there is also no charge on a lifetime cessation of GWR. HMRC agree, and (having eventually come down in favour of the Settled Property Solution) accept the view that there is no charge. The IHT Manual provides:

> **14396 - Settled property: Settlement created when the settlor is domiciled outside the UK** [January 2011]
> *... Reservation ceasing during lifetime*
> Where the reservation is released during the donor's lifetime, FA86/S102(4) treats the donor as making a disposition of the property by a disposition which is a potentially exempt transfer (PET) (IHTM04072). This is different to the basis of the charge arising on death, but as property in which the reservation ceases is 'property comprised in a settlement' the provisions of IHTA84/S48(3) are again in point to decide whether any foreign property is excluded property.
> As FA86/S102(4) treats the donor as making a disposition, it is the treatment of excluded property when disposition is made that is relevant. IHTA84/S3(2) states that no account shall be taken of the value of excluded property which ceases to form part of a person's estate as a result of disposition.
> So as the donor is treated as making a disposition, property is treated as ceasing to form part of their estate. Provided that property is excluded property, IHTA84/S3(2) applies to exclude the assets in which the reservation ceased from charge.

This vindicates the view taken in the pre-2011 editions of this work. ("The taxpayer should conduct their affairs on the basis of the Settled Property

45 There is a hint of this in IHTM 14318, but the point is not addressed clearly.

Solution. ... One should not be deterred by the ghost of an argument rattling its chains in the IHT Manual.")

The Manual continues with three exceptions:

> The same exceptions to the above will apply as regards
> [1] foreign property which is replaced by UK situs property (IHTM27071),
> [2] property added to the settlement when the donor is domiciled in the UK, and
> [3] in the reverse situation outlined above, a charge will arise under FA86/S102(4) if the reservation ceases before the donor's death.

For these exceptions, see 63.14.3 (HMRC view).

63.17 GWR on termination of interest in possession

Before 22 March 2006, GWR did not in principle apply on the termination of an interest in possession, because the termination did not usually involve a disposal by way of gift. Now s.102ZA FA 1986 provides:

> (1) Subsection (2) below applies where—
> (a) an individual is beneficially entitled to an interest in possession in settled property,
> (b) either—
> (i) the individual became beneficially entitled to the interest in possession before 22nd March 2006, or
> (ii) the individual became beneficially entitled to the interest in possession on or after 22nd March 2006 and the interest is an immediate post-death interest, a disabled person's interest or a transitional serial interest, or falls within section 5(1B) of the 1984 Act and
> (c) the interest in possession comes to an end during the individual's life.
> (2) For the purposes of—
> (a) section 102 above, and
> (b) Schedule 20 to this Act,
> the individual shall be taken (if, or so far as, he would not otherwise be) to dispose, on the coming to an end of the interest in possession, of the no-longer-possessed property[46] by way of gift.

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46 "The no-longer-possessed property" is defined in s.102ZA(3):
"In subsection (2) above 'the no-longer-possessed property' means the property in which the interest in possession subsisted immediately before it came to an end,

On the termination of an interest in possession, the former life tenant is in the same position as the settlor of the trust. See 63.14 (GWR death charge: excluded property rules for settled property).

If the life tenant does not enjoy any GWR, no problem arises.

If the former life tenant does enjoy a benefit the position is thought to be as follows:

(1) The GWR rules do not apply if the GWR property is excluded property.

(2) The GWR property is excluded if:

  (a) the settlor was not UK domiciled when the settlement was made; and

  (b) the trust property is not UK situate (or UK funds excluded property) at the time of the GWR charge (the death of the former life tenant or the time of cessation of benefit).

63.18 GWR property subject to debt

A debt secured on an asset is in principle deductible in computing a GWR charge on the asset.[47]

If the GROB property is held in trust, trust debts are similarly deductible. HMRC accept this. IHT Manual provides:

> **14401. The property comprised in the gift** [January 2010]
> ... *Example*
> In 1990 the donor settles £1 on discretionary trusts of which he is, and remains until his death in 2000, an object. Shortly after the creation of the settlement he advances £50,000 to the trustees by way of loan, interest free and repayable on demand.
> At the time of his death, the settled property comprises £1 cash (representing the original £1 gift into settlement) and the proceeds of an insurance policy (purchased with the borrowed monies) on the donor's life amounting to £250,000.
> The loan of £50,000 has been repaid at the rate of £2,500 per annum by the trustees and £25,000 is outstanding at the date of death.

The HMRC analysis is as follows:

> The proceeds of £250,000, *less the loan of £25,000*, are derived from

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other than any of it to which the individual becomes absolutely and beneficially entitled in possession on the coming to an end of the interest in possession."

47 See 65.2.1 (Incumbrance-debts).

the original loan, and you can treat them as part of the death estate. (The balance outstanding under the loan – £25,000 – forms part of the free estate).

63.19 IHT spouse exemption defence to GWR death charge

This section considers whether the IHT spouse exemption can apply on the death of the donor so as to override the GWR death charge.[48]

Suppose:

(1) H makes a gift to S which is a GWR so the gifted property is GWR property.

(2) H dies and leaves H's entire estate to his spouse W (and the IHT spouse exemption applies to H's estate).

On the death of H the position for the GWR property is governed by s.102(3) FA 1986:

> ...that property shall be treated for the purposes of the [IHTA] as property to which [H] was beneficially entitled immediately before his death.

The GWR property is not excluded property (even if S is foreign domiciled).[49] So H will in principle be subject to inheritance tax on the GWR property on H's death.

The spouse exemption is not available on the death of H to avoid this GWR charge. The IHT spouse exemption provides that the transfer of value deemed to be made on the death of H:

> ... is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner or,
> [b] so far as the value transferred is not so attributable, to the extent that the estate is increased.

This exemption does not apply to the GWR property since it does not become comprised in the estate of W. HMRC agree. The IHT Manual provides:

> **14303 Devolution of GWR property** [July 2006]
> It is important to keep in mind that that the GWR rules are fictitious

48 For the IHT spouse exemption generally see 67.1 (IHT spouse exemption); see too 63.10 (GWR spouse exemption).

49 See 63.13 (GWR death charge: non-settled property excluded property rules).

> treatments created only for the purposes of preventing IHT avoidance. They do not affect the **actual** devolution of the property in real life, so the gifted property does not actually pass on death under the will or intestacy, neither was any gift actually made at the time the reservation ceased.
>
> The gifted property passed to the actual donee at the time it was actually made. Thus, any reliefs or exemptions (IHTM11001) that may be available on death, or that apply to PET's, such as spouse or civil partner relief (IHTM11032), charity relief or annual exemptions, will **not** apply to the transfer deemed to be made on death, or deemed to be made when the reservation ceases.

Suppose:

(1) H (UK domiciled) makes a gift to W (foreign domiciled at the time of the gift).[50]
(2) The gift does not qualify for the IHT spouse (or any other) exemption and H continues to enjoy benefits from the property until H's death so the gifted property is GWR property.
(3) W still owns the GWR property at the time of the death of H.
(4) W has become UK domiciled (or IHT deemed domiciled) at the time of the death of H.

At first glance it might seem that the IHT spouse exemption does not apply. On the facts of this example the conditions of the relief are not in reality satisfied. The GWR property does not "become" comprised in the estate of the spouse; and on the occasion of the death of H, the estate of the spouse has not "increased". However, one must remember that s.102(3) FA 1986 is a deeming provision. It is the old question of how far one carries the deeming.[51] If one deems, as s.102(3) requires, the GWR property to be property to which H was beneficially entitled, it would follow that one must deem the estate of W to be increased by reason of the death of H. The conclusion is supported by considering the object of the GWR rules. The object is to put the donor in the same position as if they had not made the gift. If H had not made H's gift then (on the facts of the above example) H would qualify for the spouse exemption.

The IHT spouse exemption would also apply to defeat a GWR death charge if H made a gift to a trust under which H's spouse acquired an

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50 The gift is a PET (but assume H survives seven years so no tax charge arises on the PET).

51 See App 2.1 (Construction of deeming provisions).

estate interest in possession on H's death.

The same would apply if A made a GWR gift to B and A was not married to B at the time of the gift but was married at the time of A's death.

63.19.1 *Remedial tax planning where there has been a GWR*

Where H has made a gift, and a reservation of benefit problem arises, the following solutions may be considered:

(1) H ceases to enjoy any benefit.
(2) The donee gives the property back to H.
(3) Arrange that the IHT spouse exemption applies on the death of H.
(4) The donee settles the property: see 73.9.2 (Gift to foreign domiciled spouse, followed by settlement by spouse).

63.20 Identifying the property disposed of by way of gift: Tracing

The identity of the property disposed of by way of gift matters for several reasons:

(1) To determine whether the donor has reserved a benefit over it.
(2) To apply the excluded property rules.
(3) To identify the property subject to the GWR charge.

Sch 20 FA 1986 contains some tracing rules.

63.20.1 *"The material date"*

The legislation uses the term "material date" which is (in short) the date on which the GWR charge occurs. Para 1 Sch 20 FA 1986 provides:

> "the material date", in relation to any property means,
> [a] in the case of property falling within subsection (3) of the principal section [s.102], the date of the donor's death and,
> [b] in the case of property falling within subsection (4) of that section, the date on which the property ceases to be property subject to a reservation;

63.20.2 *Property received in substitution for gifted property*

Para 2(1) Sch 20 FA 1986 provides the general rule:

> Where
> [a] there is a disposal by way of gift and,
> [b] at any time before the material date, the donee ceases to have the possession and enjoyment of any of the property comprised in the gift,

> then on and after that time the principal section [s.102] and the following provisions of this Schedule shall apply as if the property, if any, received by the donee in substitution for that property had been comprised in the gift instead of that property (but in addition to any other property comprised in the gift).

Para 2(3) Sch 20 FA 1986 provides a commonsense definition of "in substitution":

> In sub-paragraph (1) above the reference to property received by the donee in substitution for property comprised in the gift includes in particular—
>
> (a) in relation to property sold, exchanged or otherwise disposed of by the donee, any benefit received by him by way of consideration for the sale, exchange or other disposition; and
>
> (b) in relation to a debt or security, any benefit received by the donee in or towards the satisfaction or redemption thereof; and
>
> (c) in relation to any right to acquire property, any property acquired in pursuance of that right.

This is a straightforward tracing or derivation rule. Para 2(2) Sch 20 FA 1986 provides two exceptions. The first relates to settled property, which has a separate code.[52] The second is a puzzle:

> (2) This paragraph does not apply if the property disposed of by the gift ...
>
> (b) is a sum of money in sterling or any other currency.

Suppose:
(1) A gives money to B.
(2) B uses the money to buy an asset.
(3) A enjoys a benefit over the asset.
There is no GWR over the asset. The money no longer exists: does it follow that there is no GWR at all? Taken at face value, this suggests that if there is a non-settled gift of money which is then invested, GWR ceases to apply. Could that really be correct?

63.20.3 *Gift by donee*

Para 2(4) Sch 20 FA 1986 provides:

> Where, at a time before the material date, the donee

52 See 63.21 (Tracing rule for settled property).

[a] makes a gift of property comprised in the gift to him,
[b] or otherwise voluntarily divests himself of any such property otherwise than for a consideration in money or money's worth not less than the value of the property at that time,

then, unless he does so in favour of the donor, he shall be treated for the purposes of the principal section [s.102] and sub-paragraph (1) above as continuing to have the possession and enjoyment of that property.

Para 2(5) Sch 20 FA 1986 defines "voluntarily":

For the purposes of sub-paragraph (4) above—
(a) a disposition made by the donee by agreement shall not be deemed to be made voluntarily if it is made to any authority who, when the agreement is made, is authorised by, or is or can be authorised under, any enactment to acquire the property compulsorily; and
(b) a donee shall be treated as divesting himself, voluntarily and without consideration, of any interest in property which merges or is extinguished in another interest held or acquired by him in the same property.

63.20.4 *Tracing in cases of gift of shares*

Para 1 Sch 20 FA 1986 provides:

(6) Where
[a] any shares in or debentures of a body corporate are comprised in a gift and
[b] the donee is, as the holder of those shares or debentures, issued with shares in or debentures of the same or any other body corporate, or granted any right to acquire any such shares or debentures,

then, unless the issue or grant is made by way of exchange for the first-mentioned shares or debentures, the shares or debentures so issued, or the right granted, shall be treated for the purposes of the principal section [s.102] and this Schedule as having been comprised in the gift in addition to any other property so comprised.

(7) In sub-paragraph (6) above the reference to an issue being made or right being granted to the donee as the holder of shares or debentures shall be taken to include any case in which an issue or grant is made to him as having been the holder of those shares or debentures, or is made to him in pursuance of an offer or invitation made to him as being or having been the holder of those shares or debentures, or of an offer or invitation in connection with which any preference is given to him as

being or having been the holder thereof.

This is needed because a bonus issue is not "in substitution" and so not within para 2(1). If the drafter had used the modern term "derived from" it would not have been necessary, but the drafter has taken the language from the old estate duty provision in the FA 1957.

63.20.5 *Deduction for new consideration in tracing cases*

Para 3 Sch 20 FA 1986 provides:

> (1) Where either sub-paragraph (3)(c) or sub-paragraph (6) of paragraph 2 above applies to determine, for the purposes of the principal section [s.102], the property comprised in a gift made by a donor—
>
> (a) the value of any consideration in money or money's worth given by the donee for the acquisition in pursuance of the right referred to in the said sub-paragraph (3)(c) or for the issue or grant referred to in and said sub-paragraph (6), as the case may be, shall be allowed as a deduction in valuing the property comprised in the gift at any time after the consideration is given, but
>
> (b) if any part (not being a sum of money) of that consideration consists of property comprised in the same or another gift from the donor and treated for the purposes of the 1984 Act as forming part of the donor's estate immediately before his death or as being attributable to the value transferred by a potentially exempt transfer made by him, no deduction shall be made in respect of it under this sub-paragraph.
>
> (2) For the purposes of sub-paragraph (1) above, there shall be left out of account so much (if any) of the consideration for any shares in or debentures of a body corporate, or for the grant of any right to be issued with any such shares or debentures, as consists in the capitalisation of reserves of that body corporate, or in the retention by that body corporate, by way of set-off or otherwise, of any property distributable by it, or is otherwise provided directly or indirectly out of the assets or at the expense of that or any associated body corporate.
>
> (3) For the purposes of sub-paragraph (2) above, two bodies corporate shall be deemed to be associated if one has control of the other or if another person has control of both

63.20.6 *Donee dies before the material date*

Para 4 Sch 20 FA 1986 provides:

Where there is a disposal by way of gift and the donee dies before the date which is the material date in relation to any property comprised in the gift, paragraphs 2 and 3 above shall apply as if—

(a) he had not died and the acts of his personal representatives were his acts; and

(b) property taken by any person under his testamentary dispositions or his intestacy (or partial intestacy) were taken under a gift made by him at the time of his death.

63.20.7 *Tracing rule on termination of estate interest in possession*

Para 4A Sch 20 FA 1986 provides:

(1) This paragraph applies where—

(a) under section 102ZA of this Act, an individual ("D") is taken to dispose of property by way of gift, and

(b) the property continues to be settled property immediately after the disposal.

(2) Paragraphs 2 to 4 above shall not apply but, subject to the following provisions of this paragraph, the principal section [s.102] and the following provisions of this Schedule shall apply as if the property comprised in the gift consisted of the property comprised in the settlement on the material date, except in so far as that property neither is, nor represents, nor is derived from, property originally comprised in the gift.

(3) Any property which—

(a) on the material date is comprised in the settlement, and

(b) is derived, directly or indirectly, from a loan made by D to the trustees of the settlement,

shall be treated for the purposes of sub-paragraph (2) above as derived from property originally comprised in the gift.

(4) If the settlement comes to an end at some time before the material date as respects all or any of the property which, if D had died immediately before that time, would be treated as comprised in the gift,—

(a) the property in question, other than property to which D then becomes absolutely and beneficially entitled in possession, and

(b) any consideration (not consisting of rights under the settlement) given by D for any of the property to which D so becomes entitled,

shall be treated as comprised in the gift (in addition to any other property so comprised).

(5) Where, under any trust or power relating to settled property, income

arising from that property after the material date is accumulated, the accumulations shall not be treated for the purposes of sub-paragraph (2) above as derived from that property.

63.21 Tracing rules for settled property

Para 2(2) disapplies the usual GWR rule for non-settled property:[53]

> This paragraph does not apply if the property disposed of by the gift—
> (a) becomes settled property by virtue of the gift...

Instead, para 5(1) Sch 20 FA 1986 provides:

> Where there is a disposal by way of gift and the property comprised in the gift becomes settled property by virtue of the gift,
> [a] paragraphs 2 to 4 above shall not apply
> [b] but, subject to the following provisions of this paragraph, the principal section [s.102] and the following provisions of this Schedule shall apply as if the property comprised in the gift consisted of the property comprised in the settlement on the material date, except in so far as that property neither is, nor represents, nor is derived from, property originally comprised in the gift.

This is the same in effect as the rule for non-settled property, except that it also applies to money.

63.21.1 *Settlement comes to an end*

Para 5(2) Sch 20 FA 1986 provides:

> If the settlement comes to an end at some time before the material date as respects all or any of the property which, if the donor had died immediately before that time would be treated as comprised in the gift,—
> (a) the property in question, other than property to which the donor then becomes absolutely and beneficially entitled in possession, and
> (b) any consideration (not consisting of rights under the settlement) given by the donor for any of the property to which he so becomes entitled,
> shall be treated as comprised in the gift (in addition to any other property so comprised).

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53 See 63.20.2 (Property received in substitution for gifted property).

This would apply on a transfer between trusts.

63.21.2 *Donee creates settlement*

Para 5(3) Sch 20 FA 1986 provides:

> Where
>
> [a] property comprised in a gift does not become settled property by virtue of the gift,
>
> [b] but is before the material date settled by the donee,
>
> sub-paragraphs (1) and (2) above shall apply in relation to property comprised in the settlement as if the settlement had been made by the gift; and for this purpose property which becomes settled property under any testamentary disposition of the donee or on his intestacy (or partial intestacy) shall be treated as settled by him.

63.21.3 *Loan to trust*

Para 5(4) Sch 20 FA 1986 provides:

> Where property comprised in a gift becomes settled property either by virtue of the gift or as mentioned in sub-paragraph (3) above, any property which—
>
> (a) on the material date is comprised in the settlement, and
>
> (b) is derived, directly or indirectly, from a loan made by the donor to the trustees of the settlement,
>
> shall be treated for the purposes of sub-paragraph (1) above as derived from property originally comprised in the gift.

The drafter presumably considered that a loan is not a disposal by way of gift.

63.21.4 *Accumulated income*

Para 5(5) Sch 20 FA 1986 provides:

> Where, under any trust or power relating to settled property, income arising from that property after the material date is accumulated, the accumulations shall not be treated for the purposes of sub-paragraph (1) above as derived from that property.

63.22 1986 transitional relief

The GWR rules only apply to disposals on or after 18 March 1986. The IHT Manual states correctly:

14311 Initial requirements [January 2010]
A pre-18 March 1986 settlement which would have been caught by the GWR provisions had it been made after 17 March 1986 will therefore escape the GWR charge unless further gifts into settlement are made after that date. The GWR provisions will apply to the property settled by those further gifts. ...
Example
On 1 January 1985 the donor settled £100,000 on discretionary trusts under which he was a potential beneficiary. On 1 January 1989 he added a further £50,000 to the settlement. The donor dies 1 April 1992 having remained a potential beneficiary throughout.
The GWR provisions apply to the 1989 addition but not to the property originally settled. The GWR claim extends to the assets in the settled fund at 1 April 1992 representing that £50,000. The Double Charges Regulations (IHTM 14711) will be in point.

But GWR does apply to pre-1986 settlements on the termination of an estate IIP.[54]

54 See 63.17 (GWR on termination of interest in possession).

CHAPTER SIXTY FOUR

IHT CONSEQUENCES OF TRANSFERS BETWEEN TRUSTS

64.1 Transfers between trusts and adding to trusts: Introduction

This chapter considers the IHT consequences of transfers between trusts and adding property to trusts. There are three main tiers of rules:

(1) General principles of trust law and tax law which apply in the absence of specific IHT provisions.

(2) A specific IHT provision for trusts with two settlors.[1] This applies generally for IHT trust taxation, which I refer to as **"general IHT law"**.

(3) Specific IHT provisions for transfers between trusts, which apply only for the taxation of relevant property[2] which I call **"relevant property taxation"**.

The main significance of these rules relates to excluded property status, especially if there has been a change of domicile of the settlor. The rules can affect other matters such as the date and computation of a ten-year charge.

For completeness: a fourth tier of rules applies to employee trusts[3] and pension trusts.

64.1.1 *Cross references*

For the trust law background, see 80.7 (Transfers between trusts: the trust law background).

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1 See 64.3 (The separate settlements fiction).

2 That is, trust property which is relevant property as defined by s.58 IHTA. Before 2006 this meant discretionary trusts, but (from March 2006) it includes non-estate IIP trusts.

3 See s.86(4)(5) IHTA (not discussed here).

Transfers between trusts raise other issues not discussed in this chapter: For s.87 issues, see 80.9 (Transfers between trusts). For sch 4B issues, see 52.2 (Outline of flip-flop schemes). For s.731 issues, see 30.33 (Transfer between trusts).

Another issue (not discussed in this book) is that the transfer may be a transfer of value or may give rise to an exit charge under s.65 IHTA.

For IT and CGT aspects of trusts with two settlors, see 81.1 (Trusts with two settlors: Introduction).

For the rather special case of property added after March 2006 to a pre-2006 trust under which the settlor or spouse has an initial interest in possession, see 62.14.4 (Trusts with only some property within s.80 fictions).

64.2 General tax principles

The position is in short as follows:[4]

(1) If trustees exercise a power to transfer property from trust A to trust B, then, at least to the extent of the transferred property, the settlor of trust A is a settlor of trust B.[5]

(2) If a beneficiary with an equitable interest under trust A transfers this interest to trust B, then, at least to the extent of the interest transferred, the beneficiary is a settlor of trust B.

64.3 The separate settlements fiction

Section 44(2) IHTA provides:

> Where more than one person is a settlor in relation to a settlement and the circumstances so require, this Part of this Act (except s.48(4) to (6)) shall have effect in relation to it as if the settled property were comprised in separate settlements.

I refer to this as "**the separate settlements fiction**".

The fiction is needed because inheritance taxation of trusts depends on:

(1) the domicile of the settlor

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4 See 80.9 (Transfers between trusts by appointment: IHT rules).

5 That is:

(1) If all the property of trust B is derived from A, directly or indirectly, then A is the only settlor of trust B.

(2) If some of the property of trust B is derived from A and some from B, then A and B become joint settlors.

(2) the transfers made by the settlor in the 7 years before commencement of the trust (which affect the trust's nil-rate band for RP taxation).

The rules are drafted on the basis that every trust has one settlor and only properly work on that basis; instead of making provision for a trust with multiple settlors, the scheme is to regard such trusts as multiple trusts.

IHT Manual provides:

> **42253. More than one settlor** [February 2006]
> ... This separation has 3 main effects
> [1] Where more than one trust exists each will have its own nil-rate band for rate purposes.
> [2] The value of property may be affected. For example, holdings of unquoted shares in a single trust might amount to a control holding whereas the same parcels of shares would be minority holdings if taken separately.
> [3] The separate trust made by the second person will have its own starting date. (IHTM42221)

This is correct as far as it goes, but it ignores the settlor domicile aspects of the rule.

When the separate settlements fiction applies, the settled property is treated as being in separate settlements (which I call "**notional trusts**"). It is important to note that these are fictional or notional trusts. They do not exist in the sense that the trust with several settlors exists. Each notional trust must (for IHT purposes) be regarded as possessing three features: (1) notional trust property (2) a notional settlor and (3) a notional date on which it was made. These features are as notional or fictional as the notional trust itself. The statute does not expressly tell us what they are: context and common sense must fill that gap.

64.3.1 *When separate settlements fiction does not apply*

The separate settlements fiction is expressed to apply for the purposes of Part 3 IHTA (not generally), but all the important provisions which govern trust tax are in Part 3.[6]

There are two cases where the separate settlements fiction does not apply.

Firstly, the fiction does not apply unless "the circumstances so require".

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6 The separate settlements fiction has to be repeated in s.201(4) IHTA in order to apply it to s.201 (because that is not in Part 3).

Normally the circumstances do so require, but the drafter was aware that the separate settlements fiction might not always be appropriate. Most likely the drafter could identify any cases where the fiction should not be applied but thought there might be some such cases; another possibility is that the drafter identified some cases but thought they were too difficult or insufficiently important to set out in the statute. So that has been left to the courts to sort out.

Secondly, the fiction does not apply for the purposes of s.48(4) to (6), ie for the purposes of the exemption for FOTRA securities. The reason was that FOTRA exemption does not depend on the identity of the settlor, it depends on the identity of the beneficiaries.[7] It was therefore unnecessary to apply the separate settlements fiction. As far as I can see the fiction would not have done any harm, but it would not have had any effect: presumably the drafter thought it safer or simpler not to have to bother with the separate settlements fiction.

64.4 B adds property to A's trust

Suppose:
(1) an individual ("A") creates a trust ("the real trust"), and
(2) another[8] individual ("B") adds property to it.[9]

The real trust has two settlors, A and B. The separate settlements fiction applies, and one must imagine that the trust fund of the real trust is comprised in two notional trusts, "notional trust A" and "notional trust B". Common sense suggests:

(1) Notional trust A is regarded as if:
    (a) It holds the property given by A.
    (b) A is its sole settlor.
    (c) It was made at the time A made the real trust.
(2) Notional trust B is regarded as if:
    (a) It holds the property given by B.
    (b) B is its sole settlor.
    (c) It was made at the time B added property to the real trust.

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7 See 62.12 (Trusts: FOTRA securities).

8 For the position where the settlor adds to their *own* trust, see 62.15 (Settlor adds property to trust after change of domicile).

9 The same analysis applies if A and B together transfer funds to a new jointly made trust.

64.4.1 *More than one addition to a trust*

Suppose:
(1) An individual ("A") creates a trust ("the real trust").
(2) Another individual ("B") adds property to it ("the first addition").
(3) B later adds more property to the trust ("the second addition").
It is considered that there are still two notional trusts. Notional Trust A is as before. Notional trust B is regarded as if:
(a) It holds the property given by B.
(b) B is its sole settlor.
(c) It was made at the time of the first addition
(d) B added property to the notional trust at the time of the second addition.
It follows that trust property added by the second addition may be excluded property if B was not UK domiciled at the time of the first addition.[10]

64.4.2 *Adding value indirectly*

It is suggested that the same applies if B adds value indirectly to the real trust (eg by a gift to a company held by the real trust). The real trust has two settlors, A and B.[11] The circumstances require the real trust to be regarded as two separate notional trusts. A division of the trust property of the real trust into two parts representing the value given by A and the value given by B is still possible. It may not be easy but it is no harder than many apportionments required for tax.[12]

64.5 Direct settlor and indirect settlor

Suppose there is an arrangement under which:
(1) A gives property to B, and
(2) B gives the property to a trust ("the real trust").
It appears at first sight that there are then two settlors: an indirect settlor (A) and a direct settlor (B).[13] Both have provided the *same* property.
What is the IHT analysis? On one view the separate settlements fiction

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10 See 62.15 (Settlor adds property to trust after change of domicile).
11 See 80.17 (Provision of property for company held by trust).
12 For instance, apportionment of gains of non-resident companies to participators.
13 See 80.4 (Gift from A to B followed by gift to trust by B). This issue usually arises in the context of failed tax planning of the kind discussed at 80.36 (Planning to create trust with foreign domiciled settlor).

applies so that the settled property in the real trust is treated as being comprised in separate trusts (which I call "notional trust A" and "notional trust B"). On this view the consequence is said to be that:

(1) Notional trust A:
    (a) holds *all* the trust property of the real trust;
    (b) A is its sole settlor;
    (c) I do not know when proponents of this view would say that notional trust A was made. It would either be at the time A gave the property to B or the time that B settled it, and this poses perhaps another difficulty with this view.
(2) Notional trust B:
    (a) also holds *all* the trust property of the real trust;
    (b) B is its sole settlor;
    (c) was made at the time B created the real trust.

The difficulty with this view is that it leads to double taxation[14] and the separate settlements fiction which only applies "if the circumstances so require" should not be used to give that result. So the better view is that the circumstances do not "so require" and the separate settlements fiction does not apply.

We have therefore one real settlement with two settlors. What is the position for excluded property if A is foreign domiciled and B is not? It will be recalled that settled property is (in short) excluded property "unless *the settlor* was domiciled in the UK at the time the settlement was made". There are two possible solutions:

(1) One cannot say that "the settlor" was domiciled in the UK unless both settlors were domiciled here. In that case the trust property may be excluded property if either A or B are foreign domiciled.
(2) To read the word "the settlor" in this context as meaning "the settlor or one of the settlors".[15] In that case the trust property is only excluded property if A and B are both foreign domiciled.

Both solutions have anomalous results, though in one case the anomaly

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14 This view is supported by comments in *Hatton v IRC* [1992] STC 140 at pp.160–161. But (1) the comments are obiter (2) the judge did not have the benefit of counsel's arguments on the issue (3) the judge did not appreciate the double taxation difficulties which arise on their view; in the circumstances it is considered that these comments do not represent the law.

15 Applying (perhaps extending) the rule of construction that the singular includes the plural.

favours the taxpayer and in the other it favours HMRC.

The best solution to this conundrum is that one should identify A as the "real" settlor and infer that B should not be regarded as a settlor.[16] Then the anomalies do not arise.

64.5.1 *The HMRC view*

RI 166 provides:

> **Several persons contribute to a single settlement** [February 1997]
> ...
> [Section 44(2)] is similar in terms to FA 1975 Sch 5 para 1(8), which was considered by Chadwick J in *Hatton v IRC* [1992] STC 140. In the light of the decision in that case [HMRC] take the view
> [1] that the determination of the extent to which overseas assets in a settlement are excluded property by reason of the settlor's domicile is a relevant "required circumstance"; and that
> [2] where a clear, or reasonably sensible, attribution of settled property between the contributions made by several settlors is possible, there will be a separate settlement, with its own attributed assets, for each contributor for IHT purposes;
> [3] if such an attribution is not feasible, each separate settlement will comprise all the assets of the single, actual settlement.[17]
>
> **Trust records**
> It follows from the comments above that the trustees of a settlement should keep adequate records to enable any necessary attribution of the settled property to be made if ... two or more persons have contributed funds for the purposes of the settlement.

Point [2] is correct. Point [3] is difficult to apply and doubtful. It is difficult to apply because how does one know whether attribution is

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16 See 80.4.2 (If A is indirect settlor, is B also the settlor?).

17 In similar vein, IHT Manual provides:

> "**42253. More than one settlor** [February 2006]
> ... In practice, you can take the phrase 'and the circumstances so require' to mean, 'in a simple and straightforward case'.
> [1] You can accept the separateness of direct additions made by the settlor's favourite aunt,
> [2] but if for instance the added property is situate in Liechtenstein and transferred by a nominee in Liberia to a trust company in Jersey you would need to satisfy yourself as to what the circumstances were and whether they require treatment as separate trusts."

Para [2] unhelpfully ducks the issue.

"feasible"? I suggest it should always be feasible where two or more persons have contributed funds.[18] Point [3] is doubtful because it rests on a shaky obiter comment, discussed above, which was actually considering the different situation of *reciprocal* settlors. I do not wish to consider reciprocal settlors here because they are hardly ever found in practice, but if the Judge's comments are right at all, they should be restricted to the case of reciprocal settlors, where it might more plausibly be said that attribution between settlors is not feasible. RI 166[3] suggests that penal taxation may arise as a result of inadequate record keeping, but that cannot be right.

In practice it is perhaps better to avoid joint settlors (or for one person to add property to a settlement made by another). This avoids the complication of the separate settlements fiction. But in a straightforward case there should not be any difficulty as long as:

(1) all settlors are foreign domiciled or all are UK domiciled; or
(2) the settlors include both UK and foreign domiciliaries, but trust record keeping is adequate. (Ordinary trust accounts should suffice.)

It is likewise best to avoid indirect additions to a trust fund (eg a beneficiary using their own funds to improve trust property), where the original settlor is foreign domiciled and another person adding property is UK domiciled. If the settlor adds property to a trust of which they are the settlor, this problem does not arise.[19]

64.6 Transfer from trust made by A to trust made by B

This paragraph considers the general IHT position though if (as is usually the case) the trust property is relevant property, s.81 also needs consideration.[20]

Suppose:

(1) A gives property ("A's fund") to trust A ("real trust A").
(2) B gives property ("B's fund") to trust B ("real trust B").
(3) The trustees of real trust A transfer A's fund to real trust B.[21]

Real trust B has two settlors, A and B. The separate settlements fiction applies and one imagines that the settled property is comprised in two

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18 This is assumed in s.471 ITA; see 80.8.1 (IT and CGT rule).

19 See 62.15 (Settlor adds property to trust after change of domicile).

20 See 64.8 (The same settlement fiction: s.81).

21 The same analysis applies if the trustees of real trusts A and B each transfer their trust funds to a third real trust C.

notional trusts ("notional trust A" and "notional trust B").

Notional trust A is regarded as if:

(1) it holds the property provided by A;
(2) A is its sole settlor;
(3) The important question is: at what time is notional trust A regarded as being made? The choice is:
    (a) at the time that real trust A was made;
    (b) at the time of the transfer to real trust B.

The latter view cannot be right, for various anomalies would then arise.

(1) Suppose A died before the transfer to real trust B. One cannot then apply the rule that the excluded property status of the trust depends on the domicile of the settlor "at the time the settlement was made".[22]
(2) Suppose a transfer from trust A to trust B and A changes domicile after the date of trust A but before the transfer:
    (a) If A is UK domiciled when A made real trust A and foreign domiciled at the time of the transfer to real trust B, A's fund would become excluded property after the transfer. One would not expect HMRC to agree with that.
    (b) Conversely, if A is foreign domiciled when A made real trust A and UK domiciled at the time of the transfer to real trust B, the trust fund would cease to be excluded property.

    These are not equivalent or self cancelling anomalies, for in case (a) no transfers would usually take place, whereas in case (b) transfers would take place every time.

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22 It has been argued that if A is UK domiciled when A made real trust A and dead at the time of the transfer to real trust B, A's fund can be excluded property after the transfer. The argument is:

(1) Notional trust A is regarded as made at the time of the transfer to real trust B.

(2) A is regarded as not "domiciled in the UK" at that time (because a dead person has no domicile).

The view that notional trust A is regarded as made at the time real trust A was made avoids obvious anomalies and is to be preferred.

If (contrary to my view) notional trust A is regarded as made at the time of the transfer to real trust B, after the death of A, one might regard A as having at that time the domicile A had:

(1) at the time of A's death; or

(2) at the time A made real trust A.

Another view is that s.44(2) only applies if the circumstances so require, and they do not so require. However adopting my approach, s.44(2) gives a sensible result.

Under my analysis, there is in principle no IHT advantage or disadvantage from a transfer to another trust, regardless of changes in the settlor's domicile, or the settlor's death, which is logical and sensible. I see no difficulty in a rule that the notional trust is regarded as made before the transfer, for once one accepts that the notional trust is fictional, it can logically be regarded as being made on any date.

This view is also consistent with the principle in *Muir v Muir* [1943] AC 468.

64.7 Transfer from trust made by A to another trust made by A

This section considers the general IHT position though if (as is usually the case) the trust property is relevant property, s.81 also needs consideration.[23]

Suppose:

(1) A creates two separate trusts, trust A1 and A2.
(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.

Trust A2 has only one settlor, A, and the separate settlements fiction does not apply to it. The possibilities are as follows:

A is UK domiciled when A made trust A1 but not when A made trust A2. It is suggested that the transferred property in trust A2 may in principle qualify as excluded property. Trust A2 *does* satisfy the condition that the settlor was foreign domiciled at the time that *this* settlement was made.

A is foreign domiciled when A made trust A1 and UK domiciled when A made trust A2. The result is reversed. The transferred property in trust A2 is not excluded property. Trust A2 does not satisfy the condition that the settlor was foreign domiciled when this settlement was made.

Thus there is a distinction between:

(1) transfer from trust made by A to a trust made by B (change of A's domicile irrelevant); and
(2) transfer from trust made by A to another trust made by A (change of A's domicile significant).

This is anomalous but the anomaly naturally follows from the fact that the separate settlements fiction applies in case (1) and not in case (2).

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23 See 64.8 (The same settlement fiction: s.81).

64.7.1 *Transfer from trust made by A to empty trust*

It is tentatively suggested that the same applies where trustees of trust A1 transfer the trust fund to new trustees who hold on the terms of a new declaration of trust which is an "empty trust", there being no trust property before the transfer ("trust A2"). In this case too the separate settlements fiction does not apply.

The view that trust A2 is regarded as made at the time trust A1 was made, applying the principle of *Muir v Muir* [1943] AC 468, gives a sensible result but is hard to reconcile with s.60 IHTA which provides:

> In this Chapter references to the commencement of a settlement are references to the time when property first becomes comprised in it.

It is considered that the transferred property may in principle be excluded property if A is living and foreign domiciled at the time of the transfer, even though A was UK domiciled when A made trust A1.

What if A is dead at the time of the transfer? On a literal reading, one might argue that (regardless of the domicile of A during A's life) the settlor A was not UK domiciled when trust A2 was made, since a deceased person has no domicile. The scope for tax avoidance would make that result unacceptable to a court in a case where A was UK domiciled at the time A made trust A1 and at the time of A's death. A court is likely to regard A as retaining after A's death the domicile A had during A's life. This is not as much of a stretch as first appears. If a company can be regarded as having a domicile (by analogy to the domicile rules of a living individual) why not a deceased person? However, it is suggested that the trust property in trust A2 may be excluded property if A was not UK domiciled at the time of A death.

64.8 The same settlement fiction: section 81

Section 81(1) IHTA provides:

> Where property which ceases to be comprised in one settlement becomes comprised in another then, unless in the meantime any person becomes beneficially entitled to the property (and not merely to an interest in possession in the property), it shall for the purposes of this Chapter[24] be treated as remaining comprised in the first settlement.

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24 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

I call this "**the same settlement fiction**".

What is the purpose of the same settlement fiction? It must be intended to counter IHT avoidance based on moving property between settlements. Suppose a trust ("the old trust") is approaching its 10-year anniversary (on which a 10-year charge would arise). Simple examples of tax avoidance by transfer to a new trust (in the absence of s.81) are as follows:

(1) The trustees might transfer the trust property to a new trust (made by the same settlor), whose 10-year anniversary is 10 or nearly 10 years ahead.

(2) (a) The trustees might appoint a reversionary interest to a beneficiary.
(b) The beneficiary transfers that interest to a new trust.
(c) The new trust becomes entitled to the trust property before the ten year anniversary of the old trust.

These schemes would avoid the 10-year charge on the old trust.[25] Section 81 effectively counteracts both these schemes by deeming the trust property to remain in the old trust. This explains why the same settlement fiction applies only for the purpose of relevant property taxation.

IHT regards trust property as a continuing fund,[26] so s.81 does not apply on a sale between trusts at full value, for no property moves between settlements.

Section 81 does not apply to a loan from trust 1 to trust 2 on commercial terms. It does not apply to an interest free loan repayable on demand, because the promise to repay is full consideration.

The section only applies on a transfer of trust capital: if trustees of a discretionary trust distribute trust income to another trust, it is considered that s.81 does not apply, because the income is not "settled property".

What if property is transferred from trust A to trust B and the terms of the trusts are different? Although the property transferred from is deemed to be held in trust B, it is considered that it is not deemed to be held on the terms of trust A: it is regarded as held on the terms set out in trust B as if they had been incorporated in trust A. For instance, a transfer from a discretionary trust to an estate IIP trust gives rise to an exit charge: the

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25 For completeness: these schemes might also be advantageous if the settlor had made chargeable transfers in the 7 years before the creation of the old trust, as the second trust might have a better nil-rate band in the computation of its ten years charges.

26 Contrast SP E9 "Property is regarded, for the purposes of s.48(3) IHTA, as becoming comprised in a settlement when it, *or other property which it represents*, is introduced by the settlor."

property is deemed to remain held in the first trust but the trust property ceases to be relevant property.

64.8.1 *Section 81 excluded property rule*

Where s.81 applies, s.82 IHTA imposes an additional requirement for trust property to qualify as excluded property.[27] This provides:

> (1) For the purposes of this Chapter[28] ... property to which section ... 81 above applies shall not be taken to be excluded property by virtue of section 48(3)(a) above unless the condition in subsection (3) below is satisfied (in addition to the conditions in section 48(3) that the property is situated outside the UK and that the settlor was not domiciled there when the settlement was made).
> (2) [Transitional rules: see 64.8.7 (Section 81 transitional rules).]
> (3) The condition referred to in subsection (1) ... above is ...
> (b) in the case of property to which subsection (1) or (2) of section 81 above applies, that the person who is the settlor in relation to the second of the settlements mentioned in the subsection concerned,
> was not domiciled in the UK when that settlement was made.

I refer to the rule in s.82 (as it applies in a s.81 case) as **"the s.81 excluded property rule"**.

This rule only applies in determining whether foreign situate property is excluded property, so it does not apply for AUTs and OEICs.[29]

This rule only applies for the purposes of relevant property taxation, so one must distinguish:

(1) excluded property for the purposes of relevant property taxation (**"RP excluded property"**); and
(2) excluded property for other IHT purposes (but the scope of this has been greatly reduced by the 2006 reforms.)

The consequences of this rule depend on the circumstances of the inter-trust transfer.

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27 With an economy of drafting, s.82 is also used for the purposes of the s.80 fictions, but although there is some overlap, it is easiest to discuss that aspect separately. See 62.14 (Initial interest of settlor or spouse).

28 "This Chapter" is Chapter 3 Part 3 IHTA which deals with relevant property trusts.

29 See 62.11 (Trusts: authorised unit trusts and OEICs).

64.8.2 *Transfer from trust made by A to another trust made by A*

Suppose:
(1) A creates two separate trusts, trust A1 and trust A2.
(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.

The possibilities are as follows:

A is not UK domiciled when A made trust A1 but UK domiciled when A made trust A2. The transferred property in trust A2 is not excluded property under general IHT principles.[30]

A is UK domiciled when A made trust A1 but not UK domiciled when A made trust A2. The transferred property may be excluded property under general IHT principles. However, s.82 prevents foreign situate transferred property in trust A2 from qualifying as RP excluded property. (This is probably an accidental consequence of the wording, because if the drafter had had the point in mind they would have made s.82 IHTA apply for all IHT purposes and not only for the purposes of relevant property taxation.)

In short, for foreign situate transferred property to qualify as RP excluded property, A must be domiciled outside the UK at the time A made trust A1 and trust A2.

64.8.3 *Transfer on to third trust or back to first trust*

Suppose:
(1) A creates three separate trusts, A1, A2 and A3.
(2) The trustees of trust A1 transfer property ("the transferred property") to trust A2.
(3) The trustees of trust A2 transfer the transferred property to trust A3.

The transferred property is treated as remaining in trust A1. It is only excluded property if A was not UK domiciled when A made "the second of the settlements mentioned" in s.81(1), but that refers (it is considered) to trust 3. The domicile of A at the time A made trust A2 is not relevant.

Thus if trustees of an excluded property trust transfer property to a non-excluded property trust made by the same settlor, they have fallen into a trap: foreign situate transferred property ceases to be excluded property. But they can extricate themselves from the trap if the trustees of trust A2 transfer the property back to trust A1; or if they transfer it on to trust A3

30 See 64.8.5 (B transfers equitable interest to another settlement).

(if A3 is a trust made when the settlor is not UK domiciled).

64.8.4 *Transfer from trust made by A to trust made by B*

Suppose:
(1) A gives property ("A's fund") to a settlement ("real trust A").
(2) B gives property ("B's fund") to a separate settlement ("trust B").
(3) The trustees of real trust A transfer A's fund to trust B.

For general IHT purposes, A's fund is regarded as in a notional trust and may be excluded property if A was not UK domiciled when real trust A was made. At first sight the position for the purposes of RP trust tax seems to be different:
(1) A's fund is treated as remaining comprised in real trust A (applying the same settlement fiction); and
(2) foreign situate property in A's fund can only be excluded property if:
    (a) A is foreign domiciled at the time real trust A was made; and
    (b) B is foreign domiciled at the time trust B was made
    (applying the s.81 excluded property rule).

There is a better view. On these facts the separate settlements fiction of s.44(2) applies. A's fund is treated for IHT as if it were transferred to a separate notional trust. The same settlement fiction applies as if there is a transfer from real trust A to the separate notional trust deemed to be made by A at the time (I think) of real trust A. So, for RP trust tax purposes, A's fund may be excluded property if A is not UK domiciled at the time A made trust A. That is, the s.82 rule does not add anything to the general excluded property rule. The domicile of B is irrelevant. That gives a fair result and is consistent with what I take to be the purpose of s.82; see below.

A similar result applies if the trustees of trust A transfer A's fund to a company held by trust B.

64.8.5 *B transfers equitable interest to another settlement*

The position is different if:
(1) A gives property ("A's fund") to a settlement ("trust A").
(2) B has an equitable interest under trust A (perhaps a reversionary or contingent right to trust capital).
(3) B assigns B's equitable interest to a separate settlement ("trust B").
(4) Trust B becomes entitled to A's fund (perhaps because the reversionary interest falls into possession or the contingency is satisfied).

B is in principle the settlor of trust B for general tax purposes. The position for the purposes of RP trust taxation is that:

(1) A's fund is treated as remaining in trust A (applying the same settlement fiction); and

(2) A's fund can only be RP excluded property if:
   (a) A is foreign domiciled at the time that trust A was made, and
   (b) B is foreign domiciled at the time trust B was made
   (applying the s.82 rule).

It would be possible to avoid these consequences if the trustees of trust B sell the equitable interest before it falls into possession, or if they transfer it to a company.

64.8.6 *Purpose of section s.81 excluded property rule*

What is the purpose of the s.81 excluded property rule? It often happens that an artificial deeming rule which closes up one avoidance scheme can be exploited for another. The same settlement fiction is an example. Dymond explains what might be done in the absence of the s.81 excluded property rule. Suppose:

(1) A, who is domiciled outside the UK, settles foreign property on discretionary trusts for a short period with remainder to A absolutely.

(2) B, who is UK domiciled, buys A's reversion and settles it on discretionary trusts.[31]

Under general IHT law, B would in principle be the settlor of trust B, which would be within the scope of IHT in the ususal way. However applying the same settlement fiction, A would be the settlor and (because of A's domicile) B's trust would be an excluded property trust!

Section 82 counteracts this scheme. If my analysis is right,[32] then s.82 works, though it does not produce the fair result in every case. Suppose the facts were reversed:

(1) A, who is domiciled in the UK, settles foreign property on discretionary trusts for a short period with remainder to A absolutely.

(2) B, who is foreign domiciled, buys A's reversion and settles it on discretionary trusts.

There is no obvious fairness here in the rule that B's trust should be within the scope of IHT but the example is somewhat contrived and perhaps it

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31 *Dymond's Capital Taxes* (Looseleaf 1986 onwards), 19.810. These are the facts considered in 64.8.5 (B transfers equitable interest to another settlement).

32 See 64.8.4 (Transfer from trust made by A to trust made by B).

does not much matter.

An incidental result is to restrict or prevent tax advantages on a transfer from trust A1 to A2 where A was UK domiciled when A made trust A1 but foreign domiciled at the time A made trust A2.[33]

64.8.7 *Section 81 transitional rules*

Section 81(2)(3) IHTA sets out three transitional rules:

> (2) Subsection (1) above shall not apply where the property ceased to be comprised in the first settlement before 10 December 1981; but where property ceased to be comprised in one settlement before 10 December 1981 and after 26 March 1974 and, by the same disposition, became comprised in another settlement, it shall for the purposes of this Chapter be treated as remaining comprised in the first settlement.
> (3) Subsection (1) above shall not apply where a reversionary interest in the property expectant on the termination of a qualifying interest in possession subsisting under the first settlement was settled on the trusts of the other settlement before 10 December 1981.

64.9 Pension benefits

For completeness: there is a special rule for pension benefits. Section 151(5) IHTA provides:

> Where
> [a] a benefit has become payable under
> [i] a registered pension scheme
> [ii] a qualifying non-UK pension scheme or
> [iii] a section 615(3) scheme, and
> [b] the benefit becomes comprised in a settlement made by a person other than the person entitled to the benefit,
> the settlement shall for the purposes of this Act be treated as made by the person so entitled.

This is not discussed here.

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33 See 64.8.2 (Transfer from trust made by A to another trust made by A).

CHAPTER SIXTY FIVE

IHT DEDUCTION FOR DEBTS

65.1 IHT deduction for debts – Introduction

This chapter is concerned with IHT deductions for debts, or liabilities; the two words are used (more or less) synonymously. A full discussion would need a book to itself. I focus on matters closest to the themes of this work, but it is necessary to consider the basic principles to see the points in their context. There is some interesting material in the IHT Manual which is not discussed here.

65.1.1 *Cross references*

The following topics are considered elsewhere:[1]

62.10 (IHT on income accrued but not paid at time of death of life tenant)

69.10 (Deductions for purpose of IHT DTAs)

76.17 (Pre-owned assets - Excluded liability rule).

65.2 Basis of deduction for debts

The legislation distinguishes between:

(1) A debt which is an incumbrance[2] on an asset. I refer to this as an

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1 It may also be necessary to consider other issues:

(1) Whether the benefit of debt is a UK situate asset, relevant for CGT and IHT position of the owner of the debt; see 82.1 (Concept(s) of situs).

(2) Whether interest on the debt has a UK source, relevant for:

(a) the recipient of the interest who may suffer UK income tax; and

(b) the payor, who may be required to deduct tax.

See 18.1 (Interest: Introduction).

Consistent with the patchwork nature of UK tax law, different (though overlapping) considerations apply in these contexts.

2 I reluctantly use the spelling "incumbrance" as that is the spelling in the IHTA. Outside UK statutory drafting the word is generally spelt *encumbrance*.

"incumbrance-debt" and I refer to the property as **"the incumbered property"**.

(2) Other debts **("unsecured debts")**.

65.2.1 *Incumbrance-debts*

IHT is charged by reference to the market value of assets. In the case of incumbrance-debts, there are in theory two possible ways to approach the deduction for debts:

(1) *A net valuation approach*: One might say that the asset is the asset subject to the incumbrance; the market value of the asset is the value taking the incumbrance into account.

(2) *A deduction approach*: One might say that the market value is the value of the asset ignoring the debt and then a deduction is made as a separate step.

At the end of the day the two approaches will generally reach the same result. However occasionally the paths diverge. The question arose in a procedural context in *Alexander v IRC*, because a question as to the value of land in the UK is (in some cases) referred to a lands tribunal but other questions are not.[3] In *Alexander* the asset was a lease acquired at a discount under "right to buy" legislation. Under the lease the tenant covenanted to repay the discount if he sold the property within five years. The Court of Appeal adopted the net valuation approach:

> The liability to repay the discount, being charged on the leasehold premises, was in my judgment, an incumbrance on the property and should be taken into account in ascertaining the value of that property. I therefore agree that ... the question as to the value of the flat, taking into account the liability to repay discount, was a question as to the value of land for the Lands Tribunal ... . the issue as to the value of the property of the deceased in the flat was not correctly described by the Lands Tribunal, as a question of 'deciding liabilities between the vendor and a third party'. It was, in my judgment, a question of the value of the property in the hands of the deceased.[4]

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3 Section 222(4A) IHTA.

4 [1991] STC 112 at p.122. If further authority is needed, see *Henty v The Queen* [1896] AC 567 at p.573: "In any question as to probate duty, [an incumbrance-debt] is a burden which adheres to and tends to diminish, or it may be to extinguish, the value of the asset upon which it is charged."

65.2.2 *Unsecured debts of individual*

If an individual has unsecured debts, the net valuation approach is not possible, and the only approach is the deduction approach - one must value the assets and make a deduction as a separate step. In this case Section 5(3) IHTA authorises, or at least confirms,[5] the deduction for the debt:

> In determining the value of a person's estate at any time his liabilities at that time shall be taken into account, except as otherwise provided by this Act.

65.2.3 *Disallowed debts*

There are 12 cases where the deduction for a debt is disallowed:[6]

(1) Liabilities incurred for less than full consideration
(2) Rights of reimbursement
(3) A liability in connection with a policy of life insurance[7]
(4) A debt which is trust property in which the debtor has an estate interest in possession[8]
(5) A debt which the debtor is treated as entitled to under the GWR rules

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5 In *St Barbe Green v IRC* [2005] STC 288 the judge regarded s.5(3) IHTA as merely confirming a deduction, not authorising it:

> "... the property of the deceased ... is his personal estate net of his liabilities. In other words, it is at that stage that the liabilities are dealt with. It is not necessary for section 5(3) to provide for a second time that the debts are to be deducted in arriving at the value of the deceased's property (or estate) and in my view it is not really doing that. It is in part confirmatory, but in the main it is intended to provide a qualification or qualifications to the principle that debts are deductible– the meat of the subsection is in the closing words 'except as otherwise provided by this Act'. One finds provisions in the Act which qualify that right in sections 5(4), 5(5) and 162. Its confirmatory nature is supported by the use of the phrase 'taken into account', which is more general than 'shall be deducted'. I accept that the nature of section 5(3) would be clearer without the comma, but nevertheless it seems to me to be clear enough."

In relation to incumbrance-debts, that is right; in relation to unsecured debts, it seems an odd construction of the words; but it does not matter.

6 The GAAR is another exception; but the GAAR provides an exception to every rule of tax law.

7 See s.103(7) FA 1986.

8 See 65.12 (Debt owed by estate IIP trust to life tenant).

(6) Non-residents overdrawn foreign currency bank accounts[9]
(7) A personal debt of the life tenant cannot be set against property in which the life tenant has an estate interest in possession[10]
(8) Section 103 FA 1986
(9) Liabilities attributable to:
  (a) excluded property
  (b) business/agricultural/woodland property
  (c) non-residents foreign currency bank account
(10) Liabilities not discharged after death

The disallowances could lead to insolvency, as the liabilities are disallowed for IHT purposes nevertheless remain payable. Unsecured creditors may need to ask for security in order to have priority over HMRC IHT claims.

65.3 Unenforceable debts

In principle a deduction is only allowed for an enforceable debt. That is not an exception to the general rule of deductibility, as an unenforceable debt is not a debt in the proper sense or the value of the liability is nil.[11]

The IHT Manual provides:

> **IHTM28383 Debts must be legally enforceable** [November 2013]
> The general position is that no deductions can be allowed for debts that are not legally enforceable or capable of being legally enforced...
> Debts that may be disallowed because they are not legally enforceable include
> - debts paid under a moral obligation (these are likely to be debts that have either been incurred for no consideration or for past consideration)
> - liabilities that are unenforceable because there is no written evidence (for example, oral agreements for the sale of an interest in land)

65.3.1 *Statute-barred debts*

The IHT Manual provides:

> **IHTM28384 Statute-barred debts** [November 2013]
> If a lender allows time to pass without receiving any payment an action for recovery may become barred.

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9 See 62.20.3 (Overdrawn account).
10 See 65.11.2 (Debt of life tenant not set against trust fund).
11 See 65.7 (The amount of deduction for a debt).

> [The Manual summarises the rules in the Limitation Act 1980 (wrongly called the Limitations Act 1980) and continues:]
> Even though the lender may be barred from pursuing recovery, a debtor may decide to pay the debt after the expiry of the time limits. Because of this you should allow a debt which is otherwise statute-barred if the personal representatives pay the debt and you receive evidence that the payment has been made.

I find this practice rather surprising but taxpayers will not complain. A different rule applies in Scotland:

> These instructions do not apply to debts in Scotland. Under Scottish law, if a lender allows time to pass without receiving any payment an action for recovery may become barred under the Prescription and Limitation (Scotland) Act 1973 (For details of this Act see Gloag and Henderson's *The Law of Scotland* (13th ed., 2012) at Chapter 4.). These debts are completely extinguished and cannot be enforced. Once the prescriptive period expires the debt cannot be allowed as a deduction.

65.4 Liabilities incurred for less than full consideration

Section 5(5) IHTA provides:

> Except in the case of a liability imposed by law, a liability incurred by a transferor shall be taken into account only to the extent that it was incurred for a consideration in money or money's worth.

This does not often apply, because debts are normally incurred for full consideration.[12] In particular, if an individual borrows money, the liability to repay the lender is in principle outside the scope of s.5(5), because it is a debt incurred for full consideration. By contrast, if an individual gratuitously covenants to pay money to a person, the liability to pay under that covenant is not taken into account for IHT. It follows that there is a transfer of value when a payment is made under the covenant.

65.5 Right to reimbursement

Section 162(1) IHTA provides:

> A liability in respect of which there is a right to reimbursement shall be taken into account only to the extent (if any) that reimbursement cannot reasonably be expected to be obtained.

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12 For the meaning of "consideration" see 75.43.2 ("Chargeable consideration").

65.6 Section 103 FA 1986

A debt is in principle deductible even though it is owed to a connected person. But in this case s.103 FA 1986 needs consideration. This applies (in short) where an individual owes a debt to a person to whom they have previously made a gift.

The section was described in *McDougal v IRC* 31 ATC 153 as "intricate and involved in expression". The reader who studies this chapter will agree! But if one works patiently through it a few times the meaning becomes clearer; contrast the less convoluted but hopelessly vague wording of s.102.

The GAAR guidance describes s.103 as concerned with "self-generated liabilities" but it seems to me that that label is not very apt, and is best avoided as it may cause confusion.

Section 103 must be split up into separate parts in order to distil the sense:

> (1) Subject to subsection (2) below, if, in determining the value of a person's estate immediately before his death, account would be taken, apart from this subsection, of a liability consisting of
>
> [i] a debt incurred by him or
>
> [ii] an incumbrance created by a disposition made by him,
>
> that liability shall be subject to abatement to an extent ...

Thus, subject to certain defences, s.103(1) disallows the deduction for the debt to a certain extent. The section then goes on to specify the extent of the disallowance:

> ... to an extent proportionate to the value of any of the consideration given for the debt or incumbrance which consisted of—
>
> (a) property derived from the deceased; or
>
> (b) consideration (not being property derived from the deceased) given by any person who was at any time entitled to, or amongst whose resources there was at any time included, any property derived from the deceased.

Thus s.103(1) works like this:

(1) One needs to identify the consideration given for the debt.
(2) One asks to what extent the consideration consists of the type of consideration described in s.103(1)(a) and (b).
(3) To that extent the debt is in principle disallowed. (There are defences. I will come to those later.)

65.6.1 *Section 103(1)(a) disallowance*

One needs first of all to ascertain whether the consideration for the debt was "property derived from the deceased". If so, the debt is disallowed under s.103(1)(a). The debt is wholly disallowed if all the consideration is "property derived from the deceased" or partly disallowed if the consideration is partly "property derived from the deceased".

The expression "property derived from the deceased" is given a commonsense definition in s.103(3):

> In subsections (1) and (2) above "property derived from the deceased" means, subject to subsection (4) below,
> [a] any property which was the subject matter of a disposition made by the deceased, either by himself alone or in concert or by arrangement with any other person or
> [b] which represented any of the subject matter of such a disposition, whether directly or indirectly, and whether by virtue of one or more intermediate dispositions.

The IHT Manual gives this simple example:

> **28365 How Section 103 FA 1986 applies when the consideration is 'property derived from the deceased'?** [November 2013]
> *Example*
> On 19 March 1987 A gives his brother B £25,000.
> On 25 April 1987 A borrows back £25,000 from B .[13]
> On 7 April 1994 A dies.
> Without the legislation A's estate includes the original £25,000. But if the money was still owed when A died the debt might be claimed as a deduction against his estate. And the PET in 1987 is exempt as more than 7 years have elapsed.
> The legislation disallows the deduction for IHT purposes ...

The IHT Manual explains "property derived from the deceased":

> **28367 Definition of 'property derived from the deceased' for Section 103 FA 1986 purposes** [November 2013]
> ... In practice, income from property given absolutely by the deceased is treated as falling outside this definition. But where the deceased settled the property, the definition includes income payable under the

13 [Author's Note] It is assumed that this £25,000 is, or represents, the £25,000 given to B.

> disposition.
> You should treat money raised by the sale or mortgage of property derived from the deceased as though it was property derived from the deceased.

65.6.2 *Section 103(1)(b) disallowance*

Assuming one passes unscathed past the s.103(1)(a) disallowance, the journey takes us to s.103(1)(b). One must identify the person who gave the consideration for the debt. One then asks whether this is a person:

> who was at any time entitled to, or amongst whose resources there was at any time included, any property derived from the deceased.

If so, the debt is disallowed under s.103(1)(b). In principle the debt is wholly disallowed.[14] The IHT Manual gives this simple example:

> **28366 How Section 103 FA 1986 applies when there is 'consideration given by any person whose resources at any time included property derived from the deceased'?** [November 2013]
> ... *Example*
> On 19 March 1987 A gives his brother B a parcel of land worth £25,000.
> On 25 April 1987 A borrows £25,000 from B.
> On 7 April 1994 A dies, at which time B retains the land which is non-income producing.[15]

The HMRC analysis is as follows:

> The PET was made more than seven years before the death so that no claim arises on the death. As the consideration for the debt is not derived from the deceased s.103(1)(a) FA 1986 would not apply.[16] But this arrangement is caught by s.103(1)(b) FA 1986 and the liability is not an allowable deduction for Inheritance Tax purposes.

65.6.3 *Section 103(2) defences to section 103(1)(b)*

Section 103(2) offers defences to the s.103(1)(b) disallowance.[17] This

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14 Unless the consideration for the debt is given by more than one person (very unusual); but see below on defences to the s.103(1)(b) disallowance.

15 But whether the land is income producing is not directly relevant.

16 [Author's Note] It is assumed that the £25,000 which B lends to A does not represent the land.

17 Section 103(2) does not override the s.103(1)(a) disallowance.

provides:

> If, in a case where the whole or a part of the consideration given for a debt or incumbrance consisted of such consideration as is mentioned in subsection (1)(b) above, it is shown that
> [a] the value of the consideration given, or of that part thereof, as the case may be, exceeded
> [b] that which could have been rendered available by application of all the property derived from the deceased,
> [c] other than such (if any) of that property—
> (a) as is included in the consideration given, or
> (b) as to which it is shown that the disposition of which it, or the property which it represented, was the subject matter was not made with reference to, or with a view to enabling or facilitating, the giving of the consideration or the recoupment in any manner of the cost thereof,
> no abatement shall be made under subsection (1) above in respect of the excess.

It is helpful to consider this as three distinct defences.

65.6.4 *Section 103(2)[b] defence*

"The s.103(2)[b] defence" is my term for the defence given by the words of s.103(2) down to the end of s.103(2)[b], ie ignoring s.103(2)[c].

The IHT Manual gives a simple example:

> **28369 - Allowing part of a debt under s.103(2) FA 1986** [November 2013]
> Even if an arrangement (IHTM28366) is caught by FA86/S103 (1) (b), a deduction may still be allowed for part of the debt. If the value of the consideration given by the [lender][18] exceeded the amount that would have been available if the lender had applied all the property derived from the deceased, then the debt is reduced only to the extent of that lower amount.
> Example
> A gives his son B shares worth £20,000.
> B lends A £25,000, out of his separate resources, at a time when the shares were worth £17,000.
> A dies and a deduction of £25,000 is claimed.
> The amount of the deduction is the realisable value at the time the debt

18 The IHT Manual erroneously reads: "deceased".

> was created. So the liability is reduced by £17,000 - leaving £8,000 as a valid deduction.

The s.103(2)[b] defence allows a deduction (overriding the s.103(1)(b) disallowance) to the extent that the debt exceeds the value of the property derived from the deceased. That is obviously fair.

65.6.5 *Section 103(2)[c](a) defence*

The next defence is the extension of s.103(2)[b] by s.103(2)[c](a). This prevents double counting with the s.103(1)(a) disallowance. The IHT Manual gives an example at 28369:

> **28369 Allowing part of a debt under Section 103(2) FA 1986** [November 2013]
> ... *Example*
> A gives shares worth £15,000 to B
> 18 months later B sells half the shares back to A for £7,500 – which is not paid but left as a debt repayable on demand.
> B lends A £12,000 entirely from his own resources.
> A dies owing B £19,500 [ie both debts remain outstanding].

The £7,500 debt is disallowed under s.103(1)(a). The reason is that the consideration for the £7,500 debt (the shares) is property derived from the deceased. The Manual correctly makes this point:

> The debt of £7,500 is clearly derived from the earlier gift of shares – and falls within s.103(1)(a) FA 1986. This liability is not deductible.

The Manual then turns to the £12,000 debt:

> If it was not for the provisions of FA86/S103 (2)(a) it would be possible to take that £7,500 into account in considering the debt of £12,000. The result would be that the entire debt of £12,000 would be non-deductible, so the whole of the claimed £19,500 would be disallowed. But because under FA86/S103 (1)(b) half the value of the shares is included in the consideration given for the debt there remains an excess of £4,500. This figure of £4,500 for the allowable debt is arrived at by calculating the resources available to B against the second loan of £12,000 as £7,500, being the original gift of shares less the £7,500 disallowed. So the balance of £4,500 is deductible without restriction because under IHTA84/S103 (2)(a) this amount is the excess consideration.

65.6.6 *Section 103(2)[c](b) defence*

The s.103(2)[c](b) defence is the extension of s.103(2)[b] by sub-para

[c](b). The Manual does not give an example of a defence within s.103(2)[c](b); though this is perhaps the most important of the three. The result in the s.103(1)(b) examples in the IHT Manual would be different if the gift from A to B was not made (in short) with a view to enabling B to lend to A.

65.6.7 *Section 103(4) defence*

Section 103(4) provides an important defence to the s.103(1)(a) and (b) disallowances:

> If
> [a] the disposition first-mentioned in subsection (3) above[19] was not a transfer of value and
> [b] it is shown that the disposition was not part of associated operations which included—
> (a) a disposition by the deceased, either alone or in concert or by arrangement with any other person, otherwise than for full consideration in money or money's worth paid to the deceased for his own use or benefit; or
> (b) a disposition by any other person operating to reduce the value of the property of the deceased,
> that first-mentioned disposition shall be left out of account for the purposes of subsections (1) to (3) above.

Suppose:
(1) S (not UK domiciled) transfers excluded property (ie non-UK situate property) to a trust.
(2) S borrows from the trustees and retains or spends the sum borrowed.
At first sight, the debt is disallowed as the consideration is property derived from the deceased, S. However, the s.103(4) defence applies. The disposition to the trust is disregarded, because it is the disposition first-mentioned in s.103(3)[a] and:
[a] the disposition is not a transfer of value;
[b] the disposition is a simple gift. It is not part of associated operations within s.103(4)[b](a) or (b).
Thus a debt to an excluded property trust is not usually disallowed under s.103. The same applies if the gift is to a trust where the settlor has a

19 That is, the disposition made by the deceased. See 65.6.1 (Section 103(1)(a) disallowance).

estate IIP (eg a gift to an IIP trust before 22 March 2006) because such a gift is not a transfer of value.

Suppose:

(1) The trustees lend to the settlor, S.

(2) S gives the borrowed money to a trust.

In this case the deduction for the debt is disallowed. The s.103(4) defence does not apply. Condition [a] is satisfied but condition [b] is not, because the gift to the trust is an associated operation.

65.6.8 *Payment of disallowed debt: s.103(5) deemed PET*

Section 103(5) FA 1986 provides:

> If, before a person's death but on or after 18 March 1986, money or money's worth, is paid or applied by him—
>
> (a) in or towards the satisfaction or discharge of a debt or incumbrance in the case of which subsection (1) above would have effect on his death if the debt or incumbrance had not been satisfied or discharged, or
>
> (b) in reduction of a debt or incumbrance in the case of which that subsection has effect on his death,
>
> the [IHTA] shall have effect as if, at the time of the payment or application, the person concerned had made a transfer of value equal to the money or money's worth and that transfer were a potentially exempt transfer.

There is no express exemption for a foreign domiciliary. However, the principle of territorial limitation requires that some exemption is implied. The best solution is that the deemed PET should be regarded as not only "equal to the money or money's worth" but made out of the money or money's worth. Thus, if the individual is not UK domiciled at the time they repay the debt, *and* the debt is repaid out of excluded property, then no tax charge arises. This would be broadly consistent with the similar provision in section 102(4) FA 1986.[20]

65.6.9 *Assignment of debts*

Suppose:

(1) A borrows from a bank.

(2) B purchases the debt from the commercial lender for its market value.

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20 See 63.16 (GWR PET charge).

It is suggested that the purchase price paid by B to the bank is "consideration given for the debt". So A's debt is disallowed if the purchase price which B pays to the bank is property derived from A. Otherwise the section is easy to avoid.

Conversely if A's debt is disallowed because it is made in consideration of property derived from A, it continues to be disallowed even if the debt is sold to a third party. In other words, "consideration for the debt" means the consideration for the creation of the debt but also includes consideration for the assignment of the debt.

65.6.10 *Pre-1986 transitional rules*

Section 103(6) FA 1986 provides:

> Any reference in this section to a debt incurred is a reference to a debt incurred on or after 18 March 1986 and any reference to an incumbrance created by a disposition is a reference to an incumbrance created by a disposition made on or after that date …

This cannot often apply now.

65.7 The amount of deduction for a debt

Section 162(2) IHTA provides:

> Subject to subsection (3) below,[21] where a liability falls to be discharged after the time at which it is to be taken into account it shall be valued as at the time at which it is to be taken into account.

This only states expressly what one would have expected in any event.

65.8 Against which property is the debt deductible?

65.8.1 *Why does it matter?*

Suppose an individual dies and is subject to certain debts immediately before death. The debt is deducted in computing the value of the estate. If on the death all the estate is subject to IHT at the same rate (here called "chargeable property") it does not matter for IHT whether the debt is regarded as a deduction from any particular item of property. However it often happens that an estate includes chargeable and exempt property. In particular:

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21 The exception relates to IHT liabilities.

(1) A foreign domiciled individual may have excluded property and non-excluded (chargeable) property.
(2) A non-resident individual may have FOTRA securities which are excluded property.
(3) An individual may have some property which qualifies for some IHT relief, eg:
    (a) APR or BPR
    (b) DT relief
    (c) Instalment relief
(4) The property may be given to a spouse or charity and so qualify for the IHT spouse or charity exemptions.

In these cases one must ask whether the debt is deducted from the value of the chargeable or the exempt property.

65.8.2 *Incumbrance-debt*

Section 162(4) IHTA provides:

> A liability which is an incumbrance on any property shall, so far as possible and to the extent that it is not taken to reduce value in accordance with section 162B, be taken to reduce the value of that property.

That adopts or confirms what I call the net valuation approach.[22]

If the amount of the debt exceeds the value of the property, the value of the property is taken as nil and the excess is deductible from the estate like an unsecured debt.

If a debt is an incumbrance on several assets there must be an apportionment. HMRC agree. The IHT Manual provides:

> **IHTM28210 - Investigating liabilities: mortgages** [November 2013]
> ... when a debt is charged on several properties it should be apportioned between them.

If the incumbrance on some asset has priority, then the deduction should be against that asset first.

If it is desired to secure a debt on non-UK property (but to keep the IHT deduction against UK property), a back-to-back guarantee may be a solution. That is:

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22 See 65.2 (Basis of deduction for debts).

(1) T borrows from a third party ("the primary debt").
(2) T's primary debt is guaranteed by a bank.
(3) Under the terms of the guarantee, T is required to reimburse the bank if the guarantee is called upon ("the second debt"). This second debt is secured on foreign assets.

Section 162(4) will not apply to the primary debt, which can in principle be deducted from UK property. But the GAAR may need consideration.

Conversely, if on those facts the second debt is secured on UK property, but the primary debt is not secured on that property and the deduction is not set against that property.

Note the need to comply with the Bills of Sale Acts if securing loans on chattels.

65.8.3 *Unsecured debt*

Section 162(5) IHTA provides:

> Where a liability taken into account is a liability to a person resident outside the UK which neither—
>
> (a) falls to be discharged in the UK, nor
>
> (b) is an incumbrance on property in the UK,
>
> it shall, so far as possible and to the extent that it is not taken to reduce value in accordance with section 162B, be taken to reduce the value of property outside the UK.

This identifies three connecting factors. Where a debt is not an incumbrance on any property, there are two connecting factors and four possibilities:

Case No.	**1**	**2**	**3**	**4**
Liability to UK resident	No	No	Yes	Yes
Discharge out of the UK	No	Yes	No	Yes

Section 162(5) tells us the answer to Case 1: the debt is set against non-UK property. Which non-UK property if there is more than one item of property? IHT Manual provides:

> **IHTM28394 - Law relating to debts: deducting foreign debts** [November 2013]
>
> Debts that are owed to a person resident outside the UK and:
>
> • not charged on UK property, or
>
> • not contracted to be paid in the UK
>
> should be deducted primarily against foreign property, IHTA84/S162 (5).

> If there are debts in more than one country the debts in any one country should be set against the assets in that country, and any excess set proportionately against the assets in other foreign countries.

I do not see any good reason for that: an unsecured debt should be set against foreign property pro rata; but it will not often matter.

There is nothing about Cases 2 to 4. However, the implication is that in Cases 2 to 4 the debt reduces the value of the property in the UK.

What is the priority between s.162(4) and (5)? It is considered that (4) is applied first. An incumbrance-liability is so far as possible to be taken to reduce the value of the property. Only if it is not an incumbrance on any property, or if the amount of the debt exceeds the value of the property, does one apply the rules in s.162(5). The IHT Manual shows that HMRC accept this:

> **28395 Deducting liabilities where there is excluded property** [November 2013]
> You will see cases where there is excluded property in the estate and deductions may be properly payable out of both excluded and other property. In this situation, provided the debts are to UK creditors, you may allow a deduction in full against the non-excluded property.
> But, in view of s.162(4) IHTA 1984 this does not apply to debts that are charged on excluded property.

> **IHTM28396 - Law relating to debts: deducting UK debts when there is both UK and foreign property in the estate** [September 2011]
> If the deceased's estate includes both UK and foreign assets you should first deduct any UK debts against the UK assets and set the deficit, if any, against the foreign assets. Debts are UK debts if one of the following applies:
> • they are owed to creditors who are resident solely in the UK
> • they are charged on property in the UK, or
> • they are contracted to be paid in the UK.
> This practice should be applied, despite the decision in *Re Kloebe, Kannreuther v Geiselbrecht* [1884] 28 Ch D 175. This was that in the administration of the English estate of a deceased person domiciled abroad, foreign creditors are entitled to be paid, along with those who are resident in the UK, in shares proportionate to their respective claims.
> If our official practice is challenged you should refer the case to Technical.

The practice seems right; I do not see why the probate case should have any relevance to IHT.

65.8.4 *Where does a debt fall to be discharged?*

In outline, the place where a debt falls to be discharged is that specified in the contract, or (if not specified) the residence of the creditor.[23] The IHT Manual shows that HMRC broadly accept this:

> **28396 Deducting UK debts when there is both UK and foreign property in the estate** [November 2013]
> If the deceased's estate includes both UK and foreign assets you should first deduct any UK debts against the UK assets and set the deficit, if any, against the foreign assets. Debts are UK debts if one of the following applies
> • *they are owed to creditors resident solely in the UK*
> • they are charged on property in the UK, or
> • *they are contracted to be paid in the UK*. ...
> (Emphasis added)

A debt which is set against UK property (but which is not charged on specific property) will be set against UK property rateably. Some of the deduction will be wasted if the individual owns UK property outside the scope of IHT, in particular:

(1) property qualifying for APR or BPR
(2) For a foreign domiciliary: UK AUTs or OEICs
(3) For a non-resident: FOTRA securities

65.9 Debt owed by individual to trust

65.9.1 *Debt owed by non-settlor life tenant to estate IIP trust*

Suppose the life tenant (not the settlor) owes a debt to trustees of an estate IIP trust (as happens when a pre-2006 IIP trust lends money to the life tenant). At first sight, the position seems to be:

(1) The life tenant can claim a deduction for the burden of the debt on their death.
(2) The benefit of the debt is an asset of the trust fund, and therefore part of the estate of the life tenant.

These two factors, the deduction and the asset, normally cancel each other out and the position ends up at neutral.

There is however one exceptional case. If the benefit of the debt is

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23 See *Chitty on Contracts* (31st ed., 2012), para 21-055 (Place of payment). Further consideration is needed for a contract not governed by English law.

excluded property (ie foreign domiciled settlor at the time the settlement was made and the debt not UK situate) then at first sight the result is a mismatch which benefits the taxpayer:

(1) a deduction for the burden of the debt in the estate of the life tenant; and

(2) no IHT on the benefit of the debt, being excluded property.

Robert Venables QC takes the view that there is no deduction for the debt. He cites Lord Asquith's familiar comment on the construction of deeming provisions[24] and continues:

> If one applies Lord Asquith's dictum, what is deemed to happen when the settlor[25] in fact borrows money from the trustees? As he is deemed to own the money before it is borrowed [s.49 IHTA], he cannot borrow it from himself. The transfer of the money to himself is a non-event for inheritance tax purposes. His estate is subject to no debt, as a man cannot owe a debt to himself. The question of any such debt being treated as non-deductible in computing the value of his estate for inheritance tax purposes therefore does not arise. Conversely, however, the settled property does not include the right to sue the settlor for the money borrowed, as a man cannot have a right against himself.[26]

I agree. The effect of s.49(1) IHTA is therefore to disallow the deduction for the debt.

A practical solution may be to arrange that the debt is not due to the trustees, but to a company owned by the trustees. Alternatively, perhaps, arrange that the debtor beneficiary ceases to be life tenant.

65.9.2 *Debt owed by life tenant settlor to estate IIP trust*

Suppose the life tenant settlor owes a debt to trustees of an estate IIP trust (as happens when a pre-2006 IIP trust lends money to the life tenant settlor). At first sight, the general position seems to be:

(1) The settlor can claim a deduction for the burden of the debt on their death.

(2) The benefit of the debt is an asset of the trust fund, and therefore part of the estate of the life tenant.

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24 See App 2.1 (Construction of deeming provisions).

25 Venables is considering the position of a settlor life tenant, but the same applies to a non-settlor life tenant.

26 Venables, "An IHT Trap for Settlors of Non-UK Resident Trusts", OTPR, vol 4, issue 3, p.165, accessible *http://www.khpplc.co.uk/reviews*

These two factors, the deduction and the asset, normally cancel each other out and the position ends up at neutral. There are however two special cases.

If the benefit of the debt is excluded property, at first glance the result is a mismatch which could benefit the settlor (deduction for the burden of the debt, no charge on the benefit of the debt).[27]

If the deduction for the debt is disallowed (eg under s.103[28]) the result is a mismatch which would favour HMRC (no deduction for the burden of the debt, but a charge on the benefit of the debt, unless it is excluded property).

However on the view set out in para 65.9.1 (Debt owed by non-settlor life tenant to trust), the burden of the debt and the asset of the trust cancel each other out and both are ignored for IHT purposes. This is a sensible result, which fits the purpose of the legislation. In practice HMRC appear to accept this.

65.9.3 *Debt owed by settlor to settlor-interested discretionary trust*

Suppose:

(1) The settlor ("S") owes a debt to trustees of a discretionary trust (as happens when a discretionary trust lends money to the settlor).
(2) The trust is within the scope of the GWR rules.

At first sight, the position seems to be:

(1) The settlor can claim a deduction for the burden of the debt on their death.
(2) The benefit of the debt is an asset of the trust fund, and therefore part of the estate of the settlor under the GWR rules.

These two factors, the deduction and the asset, normally cancel each other out and the position ends up at neutral.

There is however one exceptional case. Where the benefit of the debt is excluded property (ie foreign domiciled settlor at the time the settlement was made and the debt not UK situate) then at first sight the result is a mismatch which benefits the taxpayer:

(1) a deduction for the burden of the debt in the estate of the settlor;[29] and

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27 This might happen if the settlor was not UK domiciled, but needed the deduction for the debt as their property was UK situate.

28 But this would not often apply to excluded property trusts or to trusts where the settlor has an initial estate IIP: see 65.6.7 (Section 103(4) defence).

29 Since s.103 does not usually apply: see 65.6.7 (Section 103(4) defence).

(2) no IHT on the benefit of the debt, being excluded property.

It is considered that the debt is disallowed under s.102(3) FA 1986. Under this section the benefit of the debt is treated as property to which the settlor was beneficially entitled on their death. The analysis is therefore the same as where the settlor is a life tenant, see above. This is so whether the GWR debt is UK situate or foreign situate.[30]

65.10 Debts to and from trusts

Do not confuse two situations:

(1) The situation where an individual owes money to trustees (eg the trustees have lent money to the individual). Here:
   (a) the individual may be entitled to an IHT deduction for the burden of the debt in their estate;
   (b) the trustees have an asset, the benefit of the debt (which may or may not be excluded property).

(2) The reverse situation, where trustees owe money to another person (eg an individual has lent to the trustees). Here:
   (a) the individual owns an asset in their estate, the benefit of the debt, which may or may not be excluded property;
   (b) the trustees or beneficiaries may be entitled to an IHT deduction for the burden of the debt on the trust property.

The issue of deduction for debts of trustees raises entirely different questions to which we now turn.

65.11 Deduction for trust debt

The position for a trust debt[31] which is an incumbrance on a specific trust asset is straightforward: under the net valuation approach, the asset is valued for IHT purposes at the net value (less the incumbrance)[32]; that rule applies for the Inheritance Taxation of trusts as for individuals.

It is clear that unsecured trust debts are also in principle deductible for IHT purposes, although there is no provision which states this expressly. (Section 5(3) IHTA does not apply here as trustees do not have an estate.) This apparent gap has caused some confusion.

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30 As to whether the GWR debt is subject to IHT under the GWR rules, see 63.12 (GWR over debt owed by the deceased).

31 Strictly one should refer to a trustee debt rather than a trust debt, but in practice the two terms may be used synonymously.

32 See 65.2.1 (Incumbrance-debts).

Let us consider first the position where the trustees have borrowed funds and an estate interest in possession terminates during the lifetime of the life tenant. There is of course a transfer of value and the value transferred is:

> equal to the value of the property *in which his interest subsisted*.[33]

What is "the property in which their interest subsists"? In my view it is not the settled property; it is the property subject to the trustees' lien.[34] For the trustees' lien takes priority over the interest of the life tenant. The trustees' lien is a lien over both income and capital of the trust fund. The value of property is its market value. Market value of property subject to a lien will be the net value, the value after deducting the value of the lien. In this valuation exercise we are not strictly claiming a "deduction" for the lien. We are simply ascertaining what property will fetch in the market.

For the same reason, trustees debts are deductible when an estate IIP terminates on the death of the life tenant and in computing ten-year and exit charges.[35]

This is the correct reason why unsecured trust debts are deductible.[36]

Section 103(1) FA 1986 provides:

> ... if, in determining the value of a person's estate immediately before his death, account would be taken, apart from this subsection, of a liability consisting of a debt *incurred by him* or an incumbrance created

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33 Section 52(1) IHTA, emphasis added.

34 Where a trustee has incurred a liability as trustee, they may in principle reimburse himself out of the trust fund. For this purpose the trustee has a lien over the trust fund. One exception is where the trustee has committed a breach of trust. In the discussion here, it is assumed that is not the case.

35 Section 65(5) IHTA assumes debts are deductible, though it is not necessary to rely on this.

36 In *St Barbe Green v IRC* [2005] STC 288 at [12] the judge took a short cut to reach the same destination:

> "... s.49 IHTA [deems] the deceased to be beneficially entitled to 'the property' in which his life interest subsists. It does not say 'net property' (i.e. the value of the property net of trust liabilities) but that is what it must mean, and the parties to this appeal both agree that in practice that is the effect the Revenue gives to the section."

The point is discussed in detail in the 3rd ed of this book para 27.9, but it is not necessary to set this out now that *St Barbe Green* has confirmed the principle that trustee debts are deductible for IHT.

On HMRC practice see for instance IHT Manual 10541 [July 2011] (deduction for trustees' costs).

by a disposition *made by him*, that liability shall be subject to abatement.

This does not apply to debts of trustees as we are not concerned with a debt or disposition made by the individual.

65.11.1 *Against which trust property is deduction set?*

It matters in various cases whether a deduction for a trust debt is set against one item of trust property or another.[37] In particular, it matters where a trust with a foreign domiciled settlor has UK and excluded property.

The principles are as follows:

(1) If the debt is an incumbrance on specific trust property, the deduction is set against that property. This follows from the net valuation approach and is confirmed by s.162(4) IHTA.[38]

(2) If the debt is not an incumbrance on specific trust property, it is under general trust law principles an incumbrance on the trust fund as a whole and deducted from the trust assets *pro rata*. The place of payment and residence of creditor are not relevant, and s.162(5) IHTA does not apply.

65.11.2 *Debt of life tenant not set against trust fund*

The IHT manual provides:

> **IHTM28397 - Liabilities: law relating to debts: dealing with deficits** [Nov 2013]
> We take the view that a liability at any title may only be deducted against the assets at that title. This means that if there is an overall deficit on the free estate you cannot set this against the value of settled property. This is derived from the judgements of Lawrence J and the Court of Appeal in *Re Barnes (deceased)* [1938] 2 KB 684 in the first instance and [1939] 1 KB 316 CA. It is considered that these decisions, based on the relevant estate duty provisions in the 1894 Finance Act apply equally to the corresponding provisions in the Inheritance Tax legislation. But a contrary view is possible in view of IHTA84/S5(1) and IHTA84/S49(1). If the official view is contested and the tax involved is substantial you should refer the matter to Technical. **(This text has been withheld because of exemptions in the Freedom of**

37 See 65.8.1 (Why does it matter?).

38 If under the terms of the trust a debt is payable out of certain property it is for this purpose a incumbrance on that property.

Information Act 2000)

It is in fact clear that a personal debt of the life tenant cannot be set against property in which the life tenant has an estate interest in possession.[39] The Manual continues:

> You should treat a deficit on joint survivorship property in a similar way. The deficit cannot be set against the assets at another title. But a deficit on joint property that passes under the Will can be set against free estate assets.

I find this hard to follow; the passage was not written by someone familiar with legal terminology. But perhaps it does not matter. The Manual continues:

> You may generally allow a deficit in the deceased's estate that does not qualify for the instalment option to be set against the property that qualifies for the instalment option. If the value of the instalment option assets is insufficient to cover the liabilities, then the balance can be carried forward and set against any foreign property that the deceased owns. You may also allow any excess liabilities on the instalment option property against the non-instalment option property with any balance being carried forward against any foreign property, if any.

65.12 Debt owed by estate IIP trust to life tenant

Suppose trustees of an estate IIP trust owe a debt to the life tenant (as happens when a life tenant lends to a pre-2006 IIP trust). At first sight, the position seems to be:

(1) The trust can claim a deduction for the burden of the debt on the death.

(2) The benefit of the debt is part of the estate of the life tenant.

These two factors, the deduction and the asset, normally cancel each other out and the position ends up at neutral.

There is however one exceptional case. Where the benefit of the debt is excluded property (ie foreign domiciled life tenant and the debt not UK situate) then at first sight the result is a mismatch which benefits the taxpayer:

(1) a deduction for the burden of the debt in the trust;[40] and

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39 *St Barbe Green v IRC* [2005] STC 288.

40 Of course in most cases the trust property is excluded property so there is no need for the deduction, but that is not necessarily the case: the trust may hold UK property.

(2) no IHT on the benefit of the debt, being excluded property.

It is considered that s.49 IHTA does not disallow the debt.

65.13 Deduction for foreign taxes

65.13.1 *IHT payable on death*

Foreign inheritance taxes and similar taxes may be available as a credit to set against IHT: see 72.1 (Foreign IHT credit relief). Such taxes are not deductible for IHT purposes on general principles as they arise on the death and IHT is charged immediately before the death.

65.13.2 *Lifetime taxes*

Unpaid foreign taxes which accrue during a person's lifetime are in principle deductible. They are liabilities imposed by law.

The IHT Manual provides:

> **28100 Overseas taxes** [November 2013]
> Special rules (IHTM27181) apply to overseas taxes that are similar in nature to Inheritance Tax (IHT). These may in some cases be set against the IHT liability.
> For other types of overseas taxes the general rule is that they can normally only be deducted from the value of property in the country that imposes the tax. This is because the taxes are unenforceable in other countries, *Government of India v Taylor* [1955] AC 491.
> There are three exceptions to this rule:
> - tax debts in the Republic of Ireland (IHTM28101)
> - Canadian income tax on a deemed disposal on death (IHTM28102)
> - foreign tax on shares situated in the UK (IHTM27201).

The proposition that foreign taxes are unenforceable in other countries now needs to be qualified because under international treaties foreign taxes often are enforceable in other countries. So far as foreign taxes are unenforceable and unpaid it seems right in principle that there should be no deduction and a court would be expected to reach that conclusion even though there is no express provision to that effect. But it is difficult to see why the deduction should be against property in the country concerned: it should be against non UK property generally, under s.162(5) IHTA, unless the foreign tax legislation imposes an incumbrance (which does not seem likely).

65.13.3 *Irish tax debts*

The IHT Manual provides:

> **28101 Deduction for tax debts in the Republic of Ireland** [November 2013]
> If the deceased died owing tax in the Republic of Ireland, you should allow a deduction against the free estate for any tax that has actually been paid to the Irish authorities provided the deceased
> - was domiciled in the United Kingdom, and
> - had no assets in the Republic of Ireland.
>
> Where, in these circumstances, the deceased also has assets in a third country, you should apportion the tax debts.
> If a deduction is claimed for any 'Probate Tax' paid in the Republic of Ireland, you must refer the matter to Technical for advice. This tax, which is paid by the executors or administrators of an estate, is not covered by our Double Taxation Convention with the Republic of Ireland.

65.13.4 *Canadian income tax debts deducted for IHT*

The IHT Manual explains the Canadian tax background:

> **28102. Canadian income tax** [November 2013]
> Under Canadian law, the estate of an individual is deemed to have been disposed of immediately before their death. Income tax is charged on any resulting gains. If, under the (Income Tax) Double Taxation Agreement the deceased was resident in Canada, the charge applies to all property wherever it is situated. But if the deceased was resident in the UK the charge applies only to immovable property in Canadian and to certain business property. ...

(There was a similar charge to CGT in the UK between 1965 and 1971. The UK abolished the CGT charge on death; Canada abolished its Estate Duty instead, a wiser decision). ESC F18 provides:

> 1. Under IHTA 1984 s 5(3) a person's liabilities at the time of death are taken into account in arriving at the value of their estate for the purposes of IHT. The Board of Inland Revenue will by concession regard this provision as applying to income tax in Canada charged on a deemed disposal immediately before death, even though the liability may not in strictness have arisen until the person had died.
> 2. Where there is an IHT charge on a deceased person's world-wide estate, and income tax in Canada is charged on deemed gains which are attributable to assets forming part of that estate, the Canadian tax will

> rank as a deduction in arriving at the value of the estate for IHT purposes. The Canadian tax will normally be treated as reducing the value of assets outside the UK whether those assets are liable to IHT or not; but if the Canadian tax exceeds the value of those assets, the excess will be set off against the value of the UK assets.

HMRC say:

> This treatment relies on interpretation of the law and so does not amount to a concession. The concession will be withdrawn and HMRC's interpretation of the law will be set out in guidance.[41]

65.13.5 *Foreign tax on UK situate shares*

The IHT Manual provides:

> **27201. Procedure for relief by concession on shares** [January 2014] Occasionally shares in a company situated in some part of the UK by UK law, are also treated as liable to tax in a foreign country on the grounds, for example, that the company carries on business there. In this circumstance, by concession, the amount of foreign tax is allowed as a deduction against the value of the shares. This concession operates whether the company is incorporated in the UK or elsewhere.
> The concession applies in the same way where the obligation to pay foreign tax on death falls upon the company and the company has the right to be reimbursed by the personal representatives of the deceased shareholder before it registers a transfer of the shares.
> The concession does not apply to cases covered by the statutory reliefs provided for by s.158 IHTA 1984 and s.159 IHTA 1984. Nor does it apply to shares that become liable to the foreign tax by reason of the operation of a double taxation convention to which the UK is not a party.

I would have thought in this situation s.158 or 159 relief would normally apply, and in other cases relief would be available by law and not by concession. I would be interested if any reader can identify the foreign taxes to which this paragraph is applicable.

65.14 Liability attributable to excluded property

Section 162A IHTA provides:

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41 HMRC, "Withdrawal of extra statutory concessions: Technical note and call for evidence" (January 2014).

> (1) To the extent that a liability is attributable to financing (directly or indirectly)—
>
> (a) the acquisition of any excluded property, or
>
> (b) the maintenance, or an enhancement, of the value of any such property,
>
> it may only be taken into account so far as permitted by subsections (2) to (4).

I refer to this as **"the excluded property disallowance"**.

The disallowance can apply to individuals and to trustees, on death and on other occasions of charge.

65.14.1 *Commencement of excluded property disallowance*

Para 5 Sch 36 FA 2013 provides:

> (1) Subject to sub-paragraph (2),[42] the amendments made by this Schedule have effect in relation to transfers of value made, or treated as made, on or after the day on which this Act is passed [17th July 2013].

So the new rules applies to pre-2013 debts, if the transfer of value is after enactment. This is an unfair commencement rule as in many cases, including those without any tax avoidance, existing liabilities will have been incurred in reliance of the pre-2013 rules. But there it is.

65.15 "Financing" the acquisition of excluded property

What is meant by the expression "financing" an acquisition? It is suggested that it should be widely construed.

Suppose T enters into a contract to purchase excluded property and the purchase price remains outstanding. The liability is attributable to financing the acquisition of the excluded property. It appears that HMRC agree. The IHT Manual provides:

> **IHTM28018 Restricted deductions: meaning of 'indirectly' where money has been borrowed to acquire excluded property** {November 2013]
>
> ...
>
> *Example 2* (Emilio)
>
> E, who is domiciled outside the UK, borrows £800,000 and invests it in diamonds, which he keeps in the UK. He moves the diamonds abroad

42 This relates to the business/agricultural property disallowance: see 65.24.4 (Commencement of BPR/APR disallowance).

> just before he dies. On his death, the diamonds are still worth the same amount but interest has accumulated on the loan so that Emilio now owes £850,000.
>
> As the assets acquired with the loan have not been disposed of but have become excluded property, only the excess value of the loan over the asset can be allowed as a deduction against any chargeable estate. However, as the liability has increased due to accrued interest, none of the liability may be allowed as a deduction.

What about borrowing to pay the incidental costs of acquiring excluded property, such as foreign stamp duty? It is suggested that this is not disallowed.

If a person borrows to pay for services, the debt is not disallowed (unless the services relate to maintenance/improvement of excluded property).

Suppose:

(1) T borrows to acquire excluded property ("debt 1").

(2) T borrows to pay interest on debt 1 ("debt 2").

It is tentatively suggested that debt 2 is not incurred in financing the acquisition.

More commonly, the interest will be added to the acquisition debt, ie there will be one single debt; it is arguable that the debt is disallowed to the extent it reflects the acquisition cost, but not to the extent it reflects interest. However the drafter seems to have assumed that an increase in the debt due to interest is in principle caught: see 65.21.5 (Disallowable reason 2: increase in liability).

65.16 Maintenance/enhancement of value of excluded property

The IHT Manual provides:

> **IHTM28012 Restricted deductions: meaning of 'maintain' and 'enhance'** [November 2013]
>
> The words 'maintain' and 'enhance' extend the scope of the provisions beyond simply buying either excluded property (IHTM28014) or assets that qualify for relief (IHTM28019).
>
> Both words have their normal meaning. 'Maintain' means to keep in good or proper order, and 'enhance' means to improve or augment. These words are most likely to apply in connection with borrowing money to maintain or enhance buildings.
>
> Where a person borrows money instead of using their own money to acquire assets, it could be said that they have 'maintained' the value of their other assets. So if they were not domiciled in the UK and held

most of their assets abroad, borrowing against UK assets could be said to be 'maintaining' the value of excluded property. Individuals are free to choose how to use and invest their assets and whether to borrow money. So you should not normally disallow the deduction of a liability in these circumstances.

But, any case where the borrowing against UK assets appears to be part of arrangements that are primarily designed to avoid these provisions and obtain a tax advantage should be referred to Technical.

65.17 "Indirectly" financing

The IHT Manual provides:

> **IHTM28013 - Liabilities: restricted deductions: meaning of "indirectly"**
>
> The word 'indirectly' at IHTA/S162A(1), IHTA/S162B(1)(b) & (5)(c) significantly broadens the scope of the provisions. It reduces the possibility of avoiding the restrictions by inserting a step or steps in the process of acquiring excluded or relievable property with the borrowed funds.
>
> As with the pre-owned assets charge (IHTM44005),[43] it is not necessary to show any intention that the funds should eventually be converted into excluded or relievable property when a loan was taken out. Inserting steps in an attempt to disguise the true nature of a transaction will be a strong indicator of indirect financing. And the acquisition of assets of any nature as part of a sequence of transactions that ends with the acquisition of excluded or relievable property will not necessarily be sufficient to prevent the deduction being disallowed.

"Not necessarily" is not exactly guidance. HMRC go on to cite a case:

> In *IRC v Stype Investments (Jersey) Ltd* (1983) Unreported, but see Capital Taxes News & Reports, March 1987 Vol 7, No.17; Vinelott J observed that the word 'indirectly' was used to make it clear that the (Inland Revenue) charge extended not only to the proceeds of sale of property subject to the charge and to property purchased with those proceeds (which may be said to represent that property 'directly') but also to any property into which the property subject to the charge or the proceeds of sale can be traced. Whilst this view may (?) have been

43 This relates to different wording: "the chargeable person has directly or indirectly provided ... any of the consideration given by another person for the acquisition of ... an interest in the relevant land "; See 76.6 ("Provide"). That does not shed much light on the issue discussed here.

> expressed in connection with an administrative process, it shows the potentially broad scope of the word. There is no number of steps or a timescale beyond which borrowing money can be regarded as safe from being attributed to the acquisition of excluded property. And there is no statutory let-out where the taxpayer can show that at the time the loan was taken out; there was no intention to convert the borrowed funds into excluded property. But although the word 'indirectly' has a broad meaning, in the context of this provision, it must be possible to reasonably attribute the acquisition of the excluded property to the borrowed funds before the deduction of the loan is disallowed. Each case will turn on its own facts.

This is an important question. Suppose:

(1) T borrows to acquire an asset ("asset 1").
(2) T sells asset 1 and uses the proceeds to acquire another asset ("asset 2").

Is it the case that the liability is "attributable to financing indirectly the acquisition of asset 2? I would have thought that was the case if the steps formed part of an arrangement, but not otherwise.

The case cited does not shed any light on our issue. The article in Capital Taxes News and Reports provides:

> The fourth case, which was decided on 15 November 1983 but was not immediately reported, is *CIR v Stype Investments (Jersey) Ltd*, CTTL 26. This was an application by the defendant company ('Stype Investments') to vary a Mareva injunction freezing its assets in the United Kingdom. The company wished to use its assets to discharge a judgment debt in favour of the Official Solicitor.... The Inland Revenue opposed the application, on the ground that the company's UK assets were insufficient to meet the claims for CTT, so that the company ought to pay the Official Solicitor out of its other assets. The case is primarily concerned with enforcement procedure, an arcane subject well outside the mainstream of CTT law; but it contains some interesting points, particularly with reference to the Inland Revenue charge under IHTA 1984, s 237. ...

Section 237 IHTA provides:

> (1) Except as otherwise provided, where any tax charged on the value transferred by a chargeable transfer, or any interest on it, is for the time being unpaid a charge for the amount unpaid (to be known as an Inland Revenue charge) is by virtue of this section imposed in favour of the Board on—

> (a) any property to the value of which the value transferred is wholly or partly attributable...
>
> (2) References in subsection (1) above to any property include references to *any property directly or indirectly representing it*.

The passage continues:

> The Inland Revenue had a charge under s 237(1) on the company's shares which Sir Charles had settled on himself for life, and under s 237(2) on 'any property directly or indirectly representing' those shares. [The Revenue] argued that s 237(2) must be read as extending the charge to the underlying assets of the company.

This was a hopeless argument and met with no success:

> Vinelott J was not persuaded that this was a tenable construction. In his judgment subs (2) was not intended and was not apt to create a double charge in such circumstances.

Then Vinelott J makes the comment on which HMRC rely:

> The word 'indirectly' was used in subs (2) to make it clear that the charge extends not only to the proceeds of sale of property purchased with those proceeds (which may be said to represent that property 'directly') but also to any property into which the property subject to the charge or the proceeds of sale can be traced.

This is quite right, but the passage sheds no light on the meaning of "indirectly financing"; "indirectly" is a word which is very context dependent.

65.17.1 *Tracing borrowed money mixed in bank account*

The first set of examples concern borrowed money mixed in an account with non-borrowed money:

> **IHTM28025 Liabilities: restricted deductions: examples where money has been borrowed to 'indirectly' acquire excluded or relievable property** [November 2013]
> *Example 1* (Marianne)
> M, who is domiciled outside the UK, owns a property in the UK.
> She borrows some money which she charges against her property and puts the money in her UK bank account.
> Some time later, she use some of the money in the account to buy some UK listed shares and some foreign shares.

> On her death, the liability is still charged against her property. The extent to which the liability may be disallowed will depend on the facts.

The scenario is far-fetched, as one normally draws down a loan facility when the funds are needed, not before. Impatient readers may skip to the next section.

HMRC consider three permutations of facts.

> [*Example 1(a)*]
> If M had borrowed £100,000 and added that to her UK account which already contained £50,000 (that had not been borrowed) and had then used that money to buy £75,000 worth of UK shares and £75,000 worth of foreign shares, it might be reasonable to say that one half of the liability was attributable to acquiring excluded property and disallow £50,000.

The author of the passage seems somewhat unsure. The moral is that M should not mix borrowed money and other money: she should:

(1) use her existing £50k to purchase foreign shares, and

(2) borrowed £100k to purchase £75k UK shares and £25k foreign shares.

Then only £25k would be disallowed. But of course before 2013, M was not in a position to have known that.

In the next example the bank account holds (more or less) only the borrowed money:

> [*Example 1(b)*]
> Had the account contained very little other money and £100,000 of foreign shares had been acquired, the whole liability should be disallowed.

That seems straightforward.

The next example is similar to example 1a, but the HMRC analysis is unknown:

> [*Example 1(c)*]
> On the other hand, had the account contained, say, £400,000 and £100,000 of foreign shares had been acquired the position will depend on circumstances. You should obtain details of the amount in the account before the borrowed funds were added and details of how the funds in the account were used afterwards.
> Where the funds were borrowed specifically to acquire the excluded property, then they should be treated as being used wholly for that purpose and the liability disallowed. But if the facts indicate that the funds in the account were mixed, it might be more appropriate to

> apportion the amounts used to purchase the excluded property. If the position is unclear, or if the taxpayer or agent disagrees with your apportionment of the liability, refer the case to Technical.

This is not exactly "guidance".

65.17.2 *Tracing borrowed money through a series of purchases and sales*

It is convenient to coin some terminology. In the following discussion:
"A debt-financed asset" is one purchased out of borrowed funds.
"A partly debt-financed asset" is one purchased partly out of borrowed funds and partly out of other funds.
"Chargeable property" is property which is not excluded property within the IHT definition.

The IHT Manual provides:

> **IHTM28025 Liabilities: restricted deductions: examples where money has been borrowed to 'indirectly' acquire excluded or relievable property** [November 2013]
> ... *Example 3*
> The trustees[44] of an excluded property trust borrow £1m which is charged against existing UK property worth £1.5m (property 1).
> They use the borrowed funds to purchase a second UK property for £1m (property 2).
> At this point, if the liability were to be taken into account in arriving at the value subject to tax, the £1m liability would be allowed as a deduction because the money has been used to acquire UK property. IHTA84/S162A does not apply, so the chargeable value would be £1.5m (£2.5m chargeable UK assets less £1m allowable liability).
> Property 2 is later sold for £1m and all the proceeds are transferred offshore to become excluded property.

This is therefore a case where:
(1) A debt-financed asset is chargeable property.
(2) The chargeable property is sold.
(3) Excluded property is purchased with the proceeds.
The HMRC analysis is as follows:

---

44 This set of examples concern trustees whereas the first set concerned an individual. Is there any difference between trustees and individuals? Trustees are more likely to keep good accounts and a trust has more of a unity of purpose. I wonder if HMRC intend to suggest that.

The liability would now be disallowed by IHTA84/S162A. This is because the liability has been incurred to indirectly acquire excluded property - the funds now held offshore. The chargeable value is still £1.5m (£1.5m of UK assets and no deduction for the liability).

In the next example:
(1) A debt-financed asset is chargeable property.
(2) The chargeable property is sold.
(3) Excluded property is purchased with part of the proceeds.

Example 4
The trustees of an excluded property trust borrow £1m which is charged against existing UK property worth £1.5m (property 1).
They use the borrowed funds to purchase a second UK property for £1m (property 2).
Property 2 is later sold for £1m,

So far the facts are the same as example 3, but the proceeds of sale are used in a different manner.

£400,000 of which is used to acquire UK listed shares and the £600,000 to acquire foreign shares.

The HMRC analysis is as follows:

£600,000 of the liability is disallowed by IHTA84/S162A(1) having been used to acquire indirectly the foreign shares which are excluded property, with the result that only £400,000 of the liability is allowed as a deduction.
The value of the UK assets is £1.9m (£1.5m, plus the additional £400,000 in shares) from which can be deducted the allowable part of the liability of £400,000, leaving £1.5m chargeable.

In the next example:
(1) A *partly* debt-financed asset is chargeable property.
(2) The chargeable property is sold
(3) All the proceeds are used to purchase excluded property.

Example 5
The trustees of an excluded property trust own £1.5m of UK listed shares.
They borrow £1m and use a further £600,000 from sale of some of the shares to purchase a UK property for £1.6m.
The property is subsequently sold for £2.5m and all the sale proceeds are invested in foreign shares.

The whole of the £1m liability has been used indirectly to acquire excluded property, so it is disallowed by IHTA84/S162A(1).
The chargeable value is £900,000 (the original £1.5m less the £600,000 worth of the shares used to purchase the property).

In the next example:
(1) A partly debt-financed asset is chargeable property.
(2) The chargeable property is sold.
(3) Part of the proceeds are used to purchase excluded property.

Example 6
The trustees of an excluded property trust own £1.5m of UK quoted shares.
They borrow £1m and use a further £600,000 from sale of some of the shares to purchase a UK property for £1.6m.
The property is subsequently sold for £2.5m.

So far the facts are as in example 5.

This time £750,000 of the sale proceeds are used to reinvest in UK quoted shares and £1.75m is used to acquire foreign shares.
IHTA84/S162A(1) disallows the liability to the extent that it has been used indirectly to acquire excluded property.
Part of the £1.75m of excluded property has been acquired indirectly from the £1m borrowed at the outset; this part is established as follows.
The £1m borrowed made up 62.5% of the purchase price of the £1.6m UK property purchased by the trustees.
When this property was sold, 70% of the sale proceeds (£1.75m out of £2.5m) were used to acquire the foreign shares. Of the original £1m borrowed therefore, £437,500 (£1m × 70% × 62.5%) is attributable indirectly to financing the acquisition of excluded property.
Only the remaining £562,500 of the liability can be taken into account.
The value of the UK assets is £1.65m (the original £1.5m less £600,000 used to buy the property plus the additional £750,000 reinvested in UK shares) from which can be deducted the allowable part of the liability of £562,500, leaving £1,087,500 chargeable.

65.17.3 *Borrowing to repay debt (refinancing)*

Suppose:
(1) T borrows to purchase excluded property ("debt 1").
(2) T borrows to repay debt 1 ("debt 2").
Is debt 2 indirectly attributable to financing the acquisition of excluded property? What if T borrows to purchase non-excluded property but later

sells that property and uses the proceeds to repay debt 1? It is suggested that debt 2 is attributable to financing excluded property if the steps form part of an arrangement, but not otherwise.

65.17.4 *Acquisition by third party*

The position becomes more complex if a second person is involved. Suppose:
(1) A (an individual) borrows.
(2) A gives the borrowed funds to B.
If A borrows and acquires *excluded* property, and gives it to B the debt is forever disallowed.

A may borrow and acquire *chargeable* property and give it to B; in the hands of B the property may (a) be excluded or (b) become excluded. A's gift may be a PET or qualify for the IHT spouse exemption or it may be a chargeable transfer.

In the expression "attributable to financing (directly or indirectly) the acquisition of any excluded property" does "acquisition" mean acquisition by the person who has the liability? or does it mean acquisition by anyone? It is tentatively suggested that A's liability is attributable to financing the acquisition by B, if the steps form part of an arrangement, but not if they are independent.

Similar issues arise if trustees borrow and appoint the borrowed funds to B.

65.18 Outline of excluded property disallowance reliefs

Statute provides the following reliefs (exceptions to disallowance of debts attributable to excluded property):
(1) Disposal of debt-financed excluded property (disposal relief)
(2) Property ceasing to be excluded property
(3) Liability exceeding value of excluded property

65.19 Disposal of debt-financed excluded property

Section 162A IHTA provides:

> (2) [1] Where the property mentioned in subsection (1) has been disposed of, in whole or in part, for full consideration in money or money's worth, the liability may be taken into account
> [2] up to an amount equal to so much of that consideration as—
> (a) is not excluded property, and
> (b) has not been used—

(i) to finance (directly or indirectly) the acquisition of excluded property or the maintenance, or an enhancement, of the value of such property, or
(ii) to discharge (directly or indirectly) any other liability that, by virtue of this section, would not be taken into account.

I refer to this as **"disposal relief"**.

"Dispose" is not defined so will bear its normal meaning, not the extended CGT meaning.

For the meaning of "consideration" see 75.43.2 ("Chargeable consideration"). Strictly speaking, the liquidation of a company does not give rise to a disposal for consideration but it appears that HMRC do not take this point. The IHT Manual provides:

> **IHTM28015 - Restricted deductions: disposal of acquired assets where money has been borrowed to acquire excluded property** [November 2013]
> ... Example 2 (Axel)
> A, who is not domiciled in the UK, owns shares in an overseas company, which owns a UK property.
> A acquired the company by borrowing £1m.
> The company is liquidated and the UK property is transferred to A.
> IHTA84/S162A(2) refers to the disposal of excluded property for consideration in money or money's worth. You may accept that liquidating the company and transferring the property to A meets that requirement so the liability may be allowed as a deduction against the UK property, although the allowable liability cannot exceed the value of the UK property that was transferred to the A.

Suppose:
(1) T borrows to acquire excluded property ("asset 1").
(2) Asset 1 is sold and other excluded property purchased instead ("asset 2").
(3) Asset 2 is sold and chargeable property is purchased.

Disposal relief can apply, as the debt is attributable to financing the acquisition of asset 2. HMRC agree. The IHT manual provides:

> **IHTM28015 Restricted deductions: disposal of acquired assets where money has been borrowed to acquire excluded property** [November 2013]
> Example 3 (Basha)
> B, who is not domiciled in the UK, borrows £1m which she uses to invest in an overseas company (Company A).

> Company A in turn owns another overseas company (Company B) which owns a UK property.
> Company A is liquidated so B receives the shares in Company B. Company B is then liquidated and B becomes the owner of the UK property.
> Here the liability is attributable to indirectly financing the acquisition the shares in Company B that owned the UK property. So excluded property was disposed of for full consideration in money's worth and as the consideration (the UK property) is not excluded, the liability may be allowed as a deduction against it.[45]

65.20 Debt-financed property ceases to be excluded property

An item of property may be excluded property at one time and subsequently become chargeable property, for instance:

(1) The owner of foreign property may become UK domiciled; or
(2) Foreign property (such as a chattel or a bearer security) may be brought to the UK.

Section 162A IHTA provides:

> (3) The liability may be taken into account up to an amount equal to the value of such of the property mentioned in subsection (1) as—
> (a) has not been disposed of, and
> (b) is no longer excluded property.

If T borrows to acquire excluded property but the property becomes chargeable, the debt becomes allowable under 162A(3) up to the value of the property.

The IHT Manual gives this example:

> **IHTM28016 - Restricted deductions: property is no longer excluded where money has been borrowed to acquire excluded property** [November 2013]
> ... Example (Chandra)
> C, who is not domiciled in the UK borrows £750,000 and buys a property abroad for £1m.
> The interest due on the loan is allowed to accumulate instead of being repaid.

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45 The example goes wrong at the end: The deduction (if allowable) is not set against the UK property (unless it is charged on the property, which the author of the example has perhaps assumed to be the case). But that does not affect the main point of the example.

> C subsequently becomes deemed domiciled in the UK so the property is now subject to tax. On C's death, the property is worth £1.2m and the sum owed under the liability is £1.3m.
> As the property is now subject to tax, the liability may be allowed; but only up to the value of £1.2m. The remaining £100,000 may not be deducted.

Had C bought property in the UK the £100k would not be disallowed. The breach of EU law seems clear, so in the case of property in the EU/EEA, C should not accept the disallowance.

It is open to question whether the interest part of the debt is disallowed.

65.21 Liability exceeds value of excluded property

65.21.1 *"Remaining liability"*

Statute uses the term "remaining liability" which is defined in s.162A(8) IHTA:

> "remaining liability" means the liability mentioned in subsection (1) so far as subsections (2) and (3) do not permit it to be taken into account;

The label is not entirely apt: "disallowed liability" might have been clearer.

65.21.2 *Liability exceeds value of original excluded property*

Section 162A IHTA provides:

> (4) To the extent that any remaining liability is greater than the value of such of the property mentioned in subsection (1) as—
> (a) has not been disposed of, and
> (b) is still excluded property,
> it may be taken into account, but only so far as the remaining liability is not greater than that value for any of the reasons mentioned in subsection (7).

The IHT Manual gives a straightforward example:

> **IHTM28017 Restricted deductions: Excess liability over value of excluded property where money has been borrowed to acquire excluded property** [November 2013]
> **Example 1** (Dominique)
> D, who is not domiciled in the UK, borrows £800,000 which is charged on UK assets worth £1.5m.
> She uses the £800,000 to acquire a villa in Spain, which is excluded

property.
The open market value of the Spanish villa falls to £500,000 by the date of her death.
The £800,000 liability has been incurred to directly acquire excluded property, so would normally be disallowed by IHTA84/S162A(1). However, the reason for the liability being greater than the value of the excluded asset is not due to:

- it being part of an arrangement to secure a tax advantage, or
- an increase in the value of the liability, or
- a disposal of the whole or part of the excluded asset.

So £300,000 of the liability (£800,000 liability less the £500,000 value of the excluded asset) is allowed and reduces the chargeable value of the UK assets to £1.2m.

Example 2

If, in the example above:

- the money had been borrowed from abroad,
- it had not been charged on UK property, and
- the deceased had also owned assets in France,

the £300,000 should first be set against the French assets[46] before any balance is then set against UK assets.

65.21.3 *Liability exceeds value of property which becomes excluded*

Section 162A IHTA provides:

(5) Subsection (6) applies where—
  (a) a liability or any part of a liability is attributable to financing (directly or indirectly)—
    (i) the acquisition of property that was not excluded property, or
    (ii) the maintenance, or an enhancement, of the value of such property, and
  (b) the property or part of the property—
    (i) has not been disposed of, and
    (ii) has become excluded property.

(6) The liability or (as the case may be) the part may only be taken into account to the extent that it exceeds the value of the property, or the part of the property, that has become excluded property, but only so far as it does not exceed that value for any of the reasons mentioned in subsection (7).

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46 More accurately, the deduction is against D's *foreign* assets; but the author has perhaps assumed that D's French assets are her only foreign assets.

The IHT Manual provides a straightforward example:

> **IHTM28018 Restricted deductions: excess liability over property that has become excluded where money has been borrowed to acquire excluded property** [November 2013]
> ... Example (Roberto)
> R who is not domiciled in the UK borrows £500,000 which he uses to buy two paintings which he keeps in his London house.
> He subsequently takes one of the paintings, worth £300,000, to keep in his house in Florida. This painting is now excluded property.
> The £300,000 painting has not been disposed of but has become excluded property. The liability of £500,000 is therefore allowed to the extent that it exceeds the value of that painting. In other words, £200,000 of the liability is an allowable deduction (£500,000 less £300,000).

It was not necessary to have a separate relief for this case. Relief should have been available under s.162A(4).[47] But it does no harm.

65.21.4 *Disallowable reason 1: Tax avoidance purpose*

Section 162A(7) IHTA sets out three disallowable reasons. They override the reliefs in:

(1) s.162A(4): see 65.21.2 (Liability exceeds value of original excluded property).
(2) s.162A(5)(6): see 65.21.3 (Liability exceeds value of property which becomes excluded).

The first disallowable reason is set out in s.162A(7)(a):

> The reasons are—
> (a) arrangements[48] the main purpose, or one of the main purposes, of which is to secure a tax advantage ...

Section 162A(8) defines tax advantage:

> (8) In this section ...
> "tax advantage" means—

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47 See 65.21.2 (Liability exceeds value of original excluded property).

48 Section 162A(8) IHTA provides the standard (unnecessary) definition: "arrangements" includes any scheme, transaction or series of transactions, agreement or understanding, whether or not legally enforceable, and any associated operations.

(a) the avoidance or reduction of a charge to tax, or
(b) the avoidance of a possible determination in respect of tax.

"Tax" is not defined here, so it means IHT: see s.272 IHTA.

65.21.5 *Disallowable reason 2: Increase in liability*

The second disallowable reason is set out in s.162A(7)(b):

> The reasons are...
> (b) an increase in the amount of the liability (whether due to the accrual of interest or otherwise)...

An increase in the debt due to interest or index-linking is disallowed. So inflation will whittle away the value of the allowable debt over time.

In the case of a foreign currency debt the debt is valued at the time it is taken out and an increase in the value of the debt due to currency fluctuations is disallowed.

65.21.6 *Disallowable reason 3: Disposal*

The third disallowable reason is set out in s.162A(7)(c):

> The reasons are...
> (c) a disposal, in whole or in part, of the property.

I do not understand the purpose of (c): how can a liability be attributable to a disposal? Is this a reference to disallow borrowing to cover the incidental costs of disposal?

65.22 Liability attributable to foreign currency bank account

Foreign currency bank accounts of foreign domiciled non-residents qualify for IHT relief but they are not classified as excluded property.[49] It follows that a liability attributable to such an account is not disallowed under the excluded property disallowance. This was overlooked in the FA 2013 reforms, but a provision was introduced to deal with the matter in 2014. Section 126AA IHTA provides a set of rules based on the excluded property disallowance:

> (1) This section applies if—
> (a) in determining the value of a person's estate immediately before

49 See 62.20 (Non-residents foreign currency bank accounts).

death, a balance on any qualifying foreign currency account ("the relevant balance") is to be left out of account under section 157 (non-residents' bank accounts), and

(b) the person has a liability which is attributable, in whole or in part, to financing (directly or indirectly) the relevant balance.

(2) To the extent that the liability is attributable as mentioned in subsection (1)(b), it may only be taken into account in determining the value of the person's estate immediately before death so far as permitted by subsection (3).

(3) If the amount of the liability that is attributable as mentioned in subsection (1)(b) exceeds the value of the relevant balance, the excess may be taken into account, but only so far as the excess does not arise for either of the reasons mentioned in subsection (4).

(4) The reasons are—

(a) arrangements the main purpose, or one of the main purposes, of which is to secure a tax advantage, or

(b) an increase in the amount of the liability (whether due to the accrual of interest or otherwise).

(5) In subsection (4)(a)—

"arrangements" includes any scheme, transaction or series of transactions, agreement or understanding, whether or not legally enforceable, and any associated operations;

"tax advantage" means—

(a) the avoidance or reduction of a charge to tax, or

(b) the avoidance of a possible determination in respect of tax.

No consideration was given to alternative solutions to the problem. The better and simpler course would have been to classify foreign currency bank accounts as excluded property; or else to repeal the relief altogether.[50] Does it matter? It is just one more page of legislation, and one more straw on the camel's back.

65.23 Planning for excluded property disallowance

Planning is needed at the time of the acquisition of UK property. Suppose T owns £1m foreign property and wishes to purchase a UK home work £1m:

(1) If T borrows to purchase the UK home, the liability is deductible

(2) If T sells the foreign property to purchase the home, and subsequently

50 See 60.20.4 (Non-residents foreign currency bank accounts: Commentary).

borrows £1m to purchase foreign property, T is (more or less) in the same economic position. But in this case the liability is disallowed.

65.24 Debts and the GAAR

65.24.1 *Borrowing to reduce 10 year charge*

The GAAR guidance is confused; but it is worth studying as the confusion is itself revealing.

> **D28 Excluded property trust and debt**
> D28.2 ***The arrangements***
> D28.2.1 The trustees of an excluded property settlement buy a property in the UK and hold it directly. At the ten year anniversary, the UK property (in the absence of any other arrangements) will be subject to inheritance tax at a maximum of 6%.

The tax problem anticipated by the trustees is the 10-year charge. What do the trustees do?

> Shortly before the ten-year anniversary, the trustees borrow funds from a bank and secure the debt on the property.

At this stage - while the borrowed funds are still held by the trustees - there is no IHT saving, though the exact IHT analysis depends on whether the borrowed funds are excluded property or chargeable property.

If the borrowed funds are UK situate at the time of the 10-year charge, the debt is deductible but the borrowed funds are chargeable property: the IHT ten year charge is unchanged by the borrowing, as the net value of the trust fund is the same.

Before 2013, the trustees could have carried out the following arrangements:

(1) The trustees borrow charged on the property.
(2) The trustees hold the borrowed funds offshore on the ten year anniversary (so the funds would be excluded property),
(3) The trustees repaid the debt later.

This worked as the debt was then deductible but the borrowed funds were not chargeable. I refer to this as **"pre-2013 debt planning"**. But of course this planning no longer works from 2013.

My guess is that this is the scheme which the author of the example had in mind. But they realised that pre-2013 debt planning no longer worked, so they proposed a further step:

> The cash is paid out to the settlor[51] on the understanding[52] that the money will be returned.

The guidance does not specify the timing here, but it is envisaged that the payment to the settlor is made before the 10-year anniversary and the payment back from the settlor is made afterwards.[53] I refer to this as **"post-2013 debt planning"**.

The post-2013 debt planning does not save any IHT:

(1) If the trustees held the borrowed funds in the UK at the time the borrowed cash is paid to the settlor, there would be an IHT exit charge.

(2) If the borrowed cash was not UK situate at that time, the there would be no exit charge, but the trust debt would be disallowed under the excluded property disallowance; so there is a 10-year charge.

> Shortly after the ten-year anniversary, the settlor adds the funds back to the trust and the trustees use it to repay the loan, freeing the UK property from its charge...

The payment from the settlor to the trust has many tax implications, of which IHT in principle due on the payment is the most obvious.[54]

The guidance next considers the taxpayer's tax analysis. It does so in a paragraph of 3 sentences; it is convenient to consider the middle sentence first, as it makes a distinct point:

> D28.4 ***The taxpayer's tax analysis***
> D28.4.1 ...
> [2] The cash borrowed by the trustees is excluded property at the time of the ten-year charge and not subject to tax.

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51 [Author's footnote] Although the example specifies that funds are paid to the settlor, it does not matter for present purposes whether it is paid to the settlor or any other beneficiary.

52 [Author's footnote] It is envisaged that this is a non-binding understanding. If the arrangement involved a legally binding promise by the settlor to return the funds, then the promise is trust property

53 This is clear on first principles, but for completeness, it is confirmed later in the guidance ("... it is always intended to use the cash borrowed to repay the debt as soon as the anniversary has passed ...").

54 One can avoid this IHT problem if one is allowed to hypothesise that the settlor is not UK domiciled at the time of the transfer and the funds are not UK situate at that time, so the property is excluded property. The example does not specify that, but it not inconsistent with the given facts.

Sentence [2] is inconsistent with the given facts, which are that the borrowed cash has been paid out to the settlor before the 10-year anniversary. The borrowed cash is outside the scope of the 10 year charge because once it has been paid out to the settlor it is no longer settled property (in the statutory terminology, it is not relevant property). It is wrong to describe it as excluded property. I guess that what has gone wrong is that the author of the guidance here has in mind the pre-2013 planning (which does not involve any payment to the settlor) and has forgotten that the given example was altogether different.

The rest of the section "taxpayer's tax analysis" concerns deduction for the trustees debt:

> [1] The value of the UK property that will be subject to tax on the ten-year anniversary is reduced to nil as a result of the debt secured against it, so no tax will be payable in respect of the UK property...
> [3] The taxpayer claims that he has effected the scheme in such a way that the new anti-avoidance legislation in [Sch 36 FA 2013 introducing the excluded property disallowance] does not apply.

We move on to the HMRC analysis:

> D28.5 ***What is the GAAR analysis under s[207(2)] FA 2013?***
> D28.5.1 Are the substantive results of the arrangements consistent with any principles on which the relevant tax provisions are based (whether express or implied) and the policy objectives of those provisions?
> The relevant property regime applies to excluded property settlements only if UK property is owned by the trustees directly on the relevant date such as on the ten year anniversary.
> By charging the UK property with debt and paying the cash out to the settlor abroad, the trustees have tried to avoid the ten-year charge.
> Even if the taxpayer has found a way to circumvent the specific provisions of FB 2013 [the excluded property disallowance] it is clear that the policy intent expressed there is to prevent a deduction against UK property except where the loan was taken out to acquire the UK property. Using contrived borrowing that is not genuinely used to acquire UK property is clearly against the intent of the legislation.

Sentence [3] of the taxpayer's analysis, and the last paragraph of HMRC's analysis is lazy and inadequate. It is not satisfactory to say "*even if* the taxpayer has found a way to circumvent" the excluded property disallowance then the GAAR applies:

(1) If the taxpayer has *not* found a way to circumvent the excluded property disallowance, there is no tax saving and the GAAR does not apply.
(2) If the taxpayer *has* found a way to circumvent the excluded property disallowance, it is necessary to know how and why. One cannot carry out a satisfactory GAAR analysis unless one knows what is the technical tax analysis in the absence of the GAAR.[55]

The drafter of the guidance has not taken the trouble to identify and to answer these questions. It seems a safe inference that they reached the answer first, and the analysis (such as it is) came later. That is of course always a risk, particularly in policy-based adjudication such as the GAAR.

> D28.5.2 *Do the means of achieving the substantive tax results involve one or more contrived or abnormal steps?*
> Borrowing with the intention of removing the cash from charge and then repaying the loan shortly thereafter is not a normal transaction. Borrowing taken out simply to avoid tax may in this context be regarded as a contrived step.
> D28.5.3 *Are the arrangements intended to exploit any shortcomings in the relevant tax provisions?*
> The ten-year charge is based on a ‹snapshot' of the assets and liabilities of the settlement at the time of the charge. Until FB 2013 there was no specific provision dealing with the deduction of liabilities against settled property, nor could regard be had to the reasons behind borrowing the money. FB 2013 makes it clear that the general intention of the legislation is to grant inheritance tax deductions only in respect of borrowing taken out to acquire the particular property, with only limited exceptions, for example, where the value of the property acquired with the borrowings at the relevant time of charge is less than the amount borrowed (and not artificially devalued) in which case the excess may be set against other property.
> If the UK property was sold just before the ten year anniversary, HMRC accepts that the sale proceeds (if retained abroad) would not be subject to inheritance tax. Similarly, if the trustees had borrowed and lost the money on a poor investment the liability could be deducted against the house.

55 It is fair to point out that the excluded property disallowance was only published in the Finance Bill in March, so there was very little time to consider it, particularly as example D28 is minuscule in the context of the vast GAAR guidance, some 200 pages, which was published in April.

> However in this case the UK property continues to be owned before and after the ten year anniversary and one would therefore expect inheritance tax to be due on its value. The real economic value of the UK property has not been reduced; it is always intended to use the cash borrowed to repay the debt as soon as the anniversary has passed and the cash has been paid out of the trust in an attempt to circumvent the provisions but with the parties agreeing in advance that the monies will be resettled shortly thereafter. FB 2013 makes the regime for deduction of liabilities clear and attempts to circumvent this through insertion of more abnormal steps will be caught by the GAAR. In looking at the application of the GAAR it is appropriate to look at the wider context of the transaction before and after the ten year anniversary and in the light of FB 2013 to consider the context in which liabilities have been incurred.
>
> D28.5.4 *Do the tax arrangements accord with established practice and has HMRC indicated its acceptance of that practice?*
>
> HMRC has not indicated its acceptance of this practice and in the light of FB 2013 it is clear that liabilities may be deducted only if certain principles are satisfied.
>
> D28.6 ***Conclusion***
>
> D28.6.1 On the facts given, the arrangements are abusive arrangements to which HMRC would seek to apply the GAAR.
>
> D28.7 ***Proposed counteraction***
>
> D28.7.1 The liabilities would be ignored in calculating the tax due on the house and the transaction counteracted on this basis.[56]

Assuming for a moment that the post-2013 scheme could have worked, that is, ignoring the actual IHT legislation, a similar result could have been defended on *Furniss* grounds even without the GAAR. Though one point of the GAAR, I think, is that HMRC should no longer have to rely on *Furniss* which is (to say the least) a tool of uncertain application.

Perhaps a moral to draw is that HMRC dislike circular arrangements involving short term borrowing and repayment; the borrower should not return the borrowed money back to the trust to allow the trustees to repay the loan very shortly after the ten year anniversary.

It seems safe to predict that GAAR guidance example D28 will be withdrawn in due course.

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56 HMRC GAAR Guidance Part D (Examples) (April 2013) accessible *http://www.hmrc.gov.uk/avoidance/gaar-partd-examples.pdf*

65.24.2 *Borrowing set against UK residence: The GAAR*

The GAAR guidance provides:

> **D31 Lending to fund UK real estate by foreign domiciliary**
> *This example illustrates how standard tax planning may have increasing levels of abnormality attached to it. A number of the alternatives are, nonetheless, clearly on the non-abusive side of the GAAR boundary. However, the example aims to illustrate at approximately what point that boundary is crossed, although – given the condensed nature of the illustration – this will always be highly fact dependent. The example also aims to demonstrate a situation (option 7) where the arrangements might fail a single reasonableness test, but be saved by the double reasonableness test.* **...**
> **D31.2 The arrangements**
> D31.2.1 R is domiciled abroad and wishes to buy a valuable house in the UK for his occupation. He has a number of options:
> 1. [*Individual purchase*] R buys the house in his own name, using his own cash resources to fund the purchase.
> 2. [*Trust purchase*] R settles cash from his own resources into a trust that purchases the house. R is a beneficiary of the trust.
> The reasons for using a trust may be partially non-tax related and may include a desire for confidentiality, to avoid complex probate procedures, or to provide an automatic succession plan on R's death.
> [This does not say, but it does suggest, that the reasons may alternatively be wholly tax-driven.]
> 3. [*Individual borrows 70% from bank*] R even if he could have funded the purchase from his existing resources, chooses to borrow from a bank to fund a large part, say 70%, of the purchase price.
> 4. [*Trust borrows 70% from bank*] R (as in 2. above) partially funds the trust. The trustees (as in 3. above) then borrow the remainder of the purchase price from a bank.
> 5. [*Individual borrows 95% from bank*] R deposits foreign investments with a bank thereby enabling the bank to lend a greater amount (say 95%) to fund the purchase of the property. The borrowing is again secured on the property.
> 6. [*Trust borrows 95% from bank*] R having funded a trust to the value of, say, 5%, of the purchase price of the house, agrees to guarantee the trustees' borrowing. This enables R's trust to borrow the remainder of the purchase price from a bank. The borrowing is again secured on the property.
> 7. [*Existing trust borrows 100% from family offshore company*] R has

an existing substantive[57] discretionary trust which he settled many years ago. R is a beneficiary of the trust, but his adult children are also beneficiaries and they have all benefited from the trust over the years.
The trustees previously owned a UK house, but sold it a couple of years ago.[58]
The trustees have been looking around for a new UK property suitable for R and his children to use as each of them visit the UK for a few weeks a year.[59]
The trustees could afford to buy the new house using existing resources but instead they accept an offer from R to lend them the purchase price via an offshore company that is wholly owned by R. The loan is interest free and repayable on demand. The company owned by R secures the loan on the house.
8. [*Gift to trust and loan back to settlor*] R settles cash from his overseas resources into a newly established trust which then lends it back to him via an underlying company for the purchase of the house in his own name.
9. [*Loan trust lends to property trust*] R adds cash from his overseas resources to a trust, known as the Loan Trust, where he is settlor and beneficiary.
His spouse or other relative sets up another trust, known as the Property Trust, which is funded with, say, £1000 cash. R adds no funds to the Property Trust.
The Loan Trust forms an overseas company into which the cash is transferred and the company lends the cash to the Property Trustees who acquire the UK property that R wishes to occupy. The loan is repayable on demand and may be interest-free, interest-bearing or index-linked. The Property Trustees incur no personal liability as the lender may have recourse to the house only...

D31.4 ***The taxpayer's tax analysis***

D31.4.1 In options 1 and 2 [individual purchase and trust purchase] above there is no tax advantage and indeed additional ten year charges arise in relation to option 2. These options are included to illustrate the range of alternatives which R has and by way of contrast with the following options.

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57 Author's footnote: The term "substantive" is here used in a non-technical, layman's sense; see below.

58 Author's footnote: The ownership of a previous house should be irrelevant, but it does illustrate the existence of the trust over an earlier period.

59 Author's footnote: I think the facts in this sentence are irrelevant to the example.

> D31.4.2 In options 3 and 4 [70% bank borrowing] the borrowing provides a clear inheritance tax advantage compared to options 1 and 2. As R is not domiciled in the UK the cash he retains personally abroad is not subject to inheritance tax and the UK property is devalued by commercial borrowing.
> D31.4.3 The same tax advantage, albeit to a greater extent, is claimed to apply in options 5 to 9.
> D31.4.4 The reservation of benefit rules do not apply to options 1, 3, 5 and 8 because R owns the property.

More analytically, GWR does not apply in options 1, 3, and 5 because R does not make a disposal by way of gift. GWR does not apply in option 8 because the property in R's trust is excluded property.

> There is a reservation of benefit in options 2, 4, 6 and 7, but the taxpayer argues that [in cases 4, 6, & 7 where the trust borrows] this is only on the net value of the property.
> D31.4.5 In option 8, the liability is not, it is claimed, caught by s103 FA 1986 as a self-generated liability due to it being funded with excluded property (see s103(4) FA 1986).[60]
> D31.4.6 In option 9, there is no charge on the death of R because he has not gifted any property to the Property Trust (so the reservation of benefit provisions do not apply) and he is a beneficiary only of the Loan Trust that holds excluded property. As he has made no gift to the Property Trust, s102 and para 5(4) Sch 20 FA 1986 are not in point. If he has made such a gift then it is argued that the UK property is devalued by the loan taken out to acquire it.
> D31.4.7 Pre-owned assets charge does not apply to options 1, 3, 5 and 8 since R has made no disposal of the property and does not satisfy the contribution condition since the property has been acquired by him and not a third person. It does not apply to the other options on the basis that even if the contribution condition is satisfied, the loan in which R reserves a benefit (or in the case of option 2 the house itself) derives its value from the house and therefore protection under para 11(3) Sch 15 is available.[61]
> D31.4.8 The liabilities are incurred to buy the UK property and therefore on the face of it are not disallowed by [Sch 36 FA 2013].
> D31.4.9 HMRC does not accept R's analysis of the legislation and in particular the deductibility of loans against UK property in which he

60 The "claim" is correct: See 65.6.7 (Section 103(4) defence).

61 HMRC here accept the views set out in 76.16.2 (Derived property: benefit of loan).

> reserves a benefit under options 2, 4, 6 and 7. The GAAR analysis below should be read with this point in mind.

The reader may think it unsatisfactory that HMRC do not state what is their analysis or why the taxpayer's analysis is wrong. The GAAR analysis should only be carried out once one knows what is the general tax analysis. Of course the general tax analysis is a matter of considerable complexity, but HMRC are at least partly responsible for that.

> D31.5 ***What is the GAAR analysis under [s.207(2) FA 2013]?***
> D31.5.1 *Are the substantive results of the arrangements consistent with any principles on which the relevant tax provisions are based (whether express or implied) and the policy objectives of those provisions?*
> D31.5.2 *Do the means of achieving the substantive tax results involve one or more contrived or abnormal steps?*
> It is reasonable to conclude that the obtaining of a tax advantage was the main purpose or one of the main purposes of options 7 to 9.

This is correct for options 8 and 9 (Gift to trust and loan back to settlor; Loan trust lends to property trust). It is not correct for option 7 (Existing trust borrows 100% from family offshore company); this is in fact recognised in a passage which follows ("In the above example the loan may not be mainly tax motivated anyway...").

> This may not be so in relation to options 3 to 6. R might prefer to borrow from a bank to allow him more flexibility to make other investments with his cash or to preserve his liquidity.
> The intention behind the inheritance tax legislation is to tax UK assets and UK domiciliaries. The foreign assets of foreign domiciliaries are excluded property being outside the territorial scope of inheritance tax in the first place, whereas any UK assets they own are subject to tax.
> Options 3 and 4 [70% bank borrowing] are an application of the rules whereby IHT is chargeable on the net value of UK assets. The fact that R or his trustees could have funded the purchase using foreign investments is irrelevant: R is not compelled to turn assets which are outside the territorial scope of the tax into assets which are subject to tax, whatever his motivation for the borrowing. R's or the trustees' borrowing is a normal commercial transaction and is not contrived or abnormal. While reservation of benefit may be in point the GAAR is not thought to apply.
> Options 5 and 6, [95% bank borrowing] similarly, represent a commercial decision by R or his trustees. R or his trustees take the commercial risks associated with the additional borrowing and R takes

> the economic downsides of depositing funds in support of the borrowing/guarantee. Choosing to borrow a higher amount is similarly neither contrived nor abnormal. R takes the economic consequences of borrowing commercially. He may lose the cash he has chosen to place elsewhere. It can reasonably be regarded as a reasonable course of action.
>
> In option 7 [existing trust borrows 100% from family offshore company] loans to trusts do occur for all sorts of non-tax reasons and therefore cannot be considered in themselves to be necessarily abnormal or contrived. Even though the loan is tax-motivated and (in some senses) self-generated, it involves a single straightforward step.

The passage then goes on to consider variants of example 7:

> The position might well be different, however, if
>
> [1] the trust were not established for some time already or
>
> [2] [if the trust were not] substantive; for instance if R were the sole or principal beneficiary or able to direct the trustees or revoke the trust.
>
> A loan to such a newly created trust might be considered a contrivance.

There are two scenarios here; the last sentence only deals with the first. I do not see why it matters if R is the principal beneficiary or has a power of direction or revocation (though the latter would be unusual). It is not accurate to describe such a trust as "not substantive".[62] But in any case, a passage which provides "the position may well be different" is scarcely to be called guidance.

> In the above example the loan may not be mainly tax motivated anyway e.g. the trustees may wish to preserve cash for liquidity purposes, but even if it were the arrangement is still not necessarily abusive.

The guidance then turns to option 8 (Gift to trust and loan back to settlor):

> In option 8, the cash goes in a circle back to the settlor via a trust and loan arrangement. The position might be different under the GAAR if the trust had been in existence for some time so the gift was not made in contemplation of a loan back. The settlor sets up a trust as a vehicle to lend to himself. The setting up of the trust and company is done simply to enable a loan to be made back to the settlor and this is a contrived step. S103 FA 1986 was designed to stop assets being given

62 The author, who does not seem to have been a trust lawyer, may be thinking confusedly of the sham doctrine, or that the trust may be a nomineeship.

> away that are then lent back by the donee and it may be thought that option 8 is using a possible loophole in s103 to circumvent the intended policy.

It seems to me that s.103(4) is a sensible policy based exemption for foreign domiciliaries. The circularity of example 8 is certainly avoidance; whether it passes the test of *egregious* is more arguable.

The guidance then turns to option 9 (Loan trust lends to property trust):

> In option 9 the combination of a nominal-value settlement specifically set up to own the property coupled with the establishment of a separate loan trust and a corporate vehicle underlying it which is then used to make a loan which is on a non-recourse basis is on these facts set up only to achieve an artificial tax deduction. And, while taken individually, the steps may be considered normal, when taken in combination they may be considered abnormal. However, each case would be taken on its own facts and a situation where, for instance, both trusts were substantial and existing trusts or where the loan was on fully commercial terms or where the property trust was established for a different beneficiary apart from the settlor might be considered differently (see option 7 above).
>
> D31.5.3 *Do the tax arrangements accord with established practice and has HMRC indicated its acceptance of that practice?*
>
> Neither of the last two options accord with established practice and HMRC has not indicated acceptance of the interpretation that foreign domiciliaries are not caught by s103 as a matter of principle.

Section 207(5) FA 2013 provides:

> The fact that tax arrangements accord with established practice, and HMRC had, at the time the arrangements were entered into, indicated its acceptance of that practice, is an example of something which might indicate that the arrangements are not abusive.

This refers to "the fact" (in the singular) but it goes on to refer to *two* facts, namely (1) the fact that tax arrangements accord with established practice, and (2) the fact that HMRC indicated its acceptance of that practice.

If *both* facts are present, then that is obviously "something which might indicate that the arrangements are not abusive." (At first sight, that seems over-tentative. It is difficult to imagine anything that HMRC publically accept, but which is not reasonable tax planning: that could only arise if HMRC's acceptance of the planning is unreasonable. Perhaps HMRC

were concerned at the possibility of a maverick inspector, whose views HMRC later wanted to disavow.)

Contrary to the statement in the GAAR guidance, in option 9, my experience is that *one* of the facts is present, namely, the arrangement has been an established practice for a few years now. However it is not an arrangement about which HMRC has publically indicated any view. Is that solitary fact "something which might indicate that the arrangements are not abusive"? It is suggested that it should be taken as an indication to that effect (though not of course decisive).

> D31.6 ***Conclusion***
>
> D31.6.1 Options 1 and 2 do not result in a tax advantage and are included above merely to illustrate the tax advantage of the following options.
>
> D31.6.2 Options 3 and 4 are straightforward applications of the legislation and would not be caught by the GAAR. Similarly, options 5 and 6 involve commercial arrangements which are neither contrived nor abnormal and HMRC would not seek to invoke the GAAR against them.
>
> D31.6.3 With option 7, while economically the liability appears to be self-generated, the trust is of substance and the arrangements are not necessarily contrived or abnormal.
>
> D31.6.4 Options 8 and 9, on these particular facts, would be caught by GAAR. The liabilities would be ignored in calculating the tax due on the house and the transaction counteracted on this basis. However, as with option 7, each case would have to be considered on its full facts and it is not impossible that different scenarios might potentially be saved from the GAAR by the double-reasonableness test.

The passage is no doubt correct to say "it is not impossible that different scenarios might potentially be saved from the GAAR by the double-reasonableness test." But the reader may doubt whether a statement which is so qualified should be called "guidance".

One might of course set up the option 9 loan trust/property trust structure with a view to replacing the internal loan with bank borrowing at a later date.

If the loan is disregarded, the property trust will be insolvent after IHT falls due. If the trust loan is secured on the property, there will be no value left in the trust for IHT to be paid.

> D31.6.5 With all the options (but particularly options 7, 8 and 9) HMRC would consider whether other legislative means at their disposal

should be used to challenge the claimed tax treatment.[63]

65.25 Liability attributable to business/agricultural property

Section 162B effectively disallows three classes of liability, attributable to:

(1) business property
(2) agricultural property
(3) woodland

I do not consider the provisions relating to woodland. The IHT Manual uses the terms "relievable property" or "relievable assets"; but I think it is clearer to refer to business /agricultural property.

65.25.1 *Liability attributable to business property*

Section 162B(1) IHTA provides:

> (1) Subsection (2) applies if—
>
> (a) the whole or part of any value transferred by a transfer of value[64] is to be treated as reduced, under section 104, by virtue of it being attributable to the value of relevant business property, and
>
> (b) the transferor has a liability which is attributable, in whole or in part, to financing (directly or indirectly)—
>
> (i) the acquisition of that property, or
>
> (ii) the maintenance, or an enhancement, of its value.

The words in (b) are the same as the excluded property disallowance.[65]

Section 162B(2) IHTA provides:

> [a] The liability is, so far as possible, to be taken to reduce the value attributable to the value of the relevant business property, before it is treated as reduced under section 104 [BPR],
>
> [b] but only to the extent that the liability—
>
> (a) is attributable as mentioned in subsection (1)(b), and
>
> (b) does not reduce the value of the relevant business property by virtue of section 110(b).

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63 HMRC GAAR Guidance Part D (Examples) (April 2013) accessible *http://www.hmrc.gov.uk/avoidance/gaar-partd-examples.pdf*

64 Section 162B(9) IHTA provides a standard definition of "transfer of value" (repeating s.103(1) IHTA).

65 See 65.15 ("Financing" the acquisition of excluded property).

This is not strictly a disallowance of the liability; but in the (usual) case of property qualifying for 100% relief, it comes to the same thing. The wording is different from the excluded property disallowance as of course business property may not qualify for 100% relief.

The disallowance can apply to individuals and to trustees, on death and on other occasions of charge.

The IHT Manual gives a straightforward examples of a debt used to purchase shares qualifying for BPR:

> **IHTM28020 Restricted deductions: borrowed money used to acquire assets that qualify for business relief** [November 2013]
> ...
> *Example 2* (Habibah)
> H borrows £450,000, which is charged on her house, and uses the funds to acquire AIM shares. At the date of H's death the AIM shares are worth £575,000 and qualify for business relief. The rest of her estate is worth £1.5m.
> At the date of death the liability is taken to reduce the value of the AIM shares that can qualify for business relief under IHTA84/S162B(2) from £575,000 to £125,000. Business relief applies to that value.
> The total estate, including the AIM shares is £2,075,000 (£1.5m plus £575,000). This is reduced by business relief of £125,000 and, subject to it meeting the provisions of IHTA84/S175A, the liability of £450,000.
> The value of the chargeable estate is £1.5m. As the liability has been taken into account to reduce the value of the AIM shares sunder IHTA84/S162B, the liability cannot be deducted against the value of the house under IHTA84/S162(4).

65.25.2 *Interaction with spouse exemption*

The Manual then considers a more complex case involving the interaction with the spouse exemption:

> *Example 3* (Ian)
> I borrows £600,000, which is charged on his house and uses the money to buy shares in his son's company.
> At I's date of death,
> - the shares are worth £800,000,
> - the house £1m and
> - his personal estate is worth £500,000.
>
> Under his Will, I leaves his house to his spouse with the residue to his son.
> Assuming the liability meets the conditions of IHTA84/S175A, it is

taken to reduce the value of the company shares before business relief is applied. As the liability has been taken into account under IHTA84/S162B, it cannot be taken against the value of the house under IHTA/S162(4).
The value of shares is reduced to nil through a combination of deducting the liability (£600,000) and business relief (£200,000).
The liability has been taken into account against the shares, so the house passes to the spouse, free of the liability and qualifies for spouse or civil partner exemption.
This leaves a chargeable estate of £500,000 that passes to the son.

The house does *not* pass to the spouse free of the liability as a matter of succession law.[66] The author means that the spouse exemption applies as if the house were free of the liability. The value transferred on the death for IHT purposes is £1.5m, of which £1m is exempt under the IHT spouse exemption.

The IHT Manual does not address the more interesting question of whether the liability is disallowed on the death of I's spouse.

65.25.3 *Liability attributable to agricultural property*

Section 162B IHTA provides:

(3) Subsection (4) applies if—
(a) the whole or part of any value transferred by a transfer of value is to be treated as reduced, under section 116, by virtue of it being attributable to the agricultural value of agricultural property, and
(b) the transferor has a liability which is attributable, in whole or in part, to financing (directly or indirectly)—
(i) the acquisition of that property, or
(ii) the maintenance, or an enhancement, of its agricultural value.

(4) To the extent that the liability is attributable as mentioned in subsection (3)(b), it is, so far as possible, to be taken to reduce the value attributable to the agricultural value of the agricultural property, before it is treated as reduced under section 116.

This is exactly the same as the rule for BPR. The IHT Manual gives some examples. The first example is a straightforward loan to improve agricultural property:

66 Unless I's will so provides; see s.35 AEA 1925.

IHTM28021 Restricted deductions: borrowed money used to acquire assets that qualify for agricultural relief [November 2013]

... *Example 1* (Ken)

K borrows £200,000 which he uses to repair buildings on his farm which qualify for agricultural relief. The value of K's estate on death is £2m, of which £1,200,000 is agricultural property qualifying for relief at the date of death.

The £200,000 liability reduces the agricultural value of the agricultural property to £1,000,000 under IHTA84/S162B(4).

This £1,000,000 of agricultural value qualifies for agricultural relief.

The value of the estate is reduced by agricultural relief of £1,000,000 and, subject to it meeting the provisions of IHTA84/S175A, the liability of £200,000, leaving a chargeable estate on death of £800,000.

The next example involves a loan to acquire agricultural and non-agricultural property:

Example 2 (Jan)

J borrows £1m and invests it in a house[67] and some adjoining farmland. The house is worth £700,000 and the land £300,000. The farmland is let out to a neighbouring farmer.

At J's date of death, the value of the combined property has increased in value to £2m of which £1.2m is attributable to the house and £800,000 to the land.

The liability is to be taken against the agricultural property to the extent to which it can be attributed to paying for that property, IHTA84/S162B(4). When J acquired the property, £300,000 was attributable to the farmland and this is the amount of the liability to be taken against the agricultural value on death. So, subject to the liability meeting the provisions of IHTA84/S175A, the chargeable value of the house will be £500,000 (£1.2m less the £700,000 portion of the liability used to buy the house). The value of the land (£800,000) will be reduced to nil by a combination of the liability (£300,000) and agricultural relief (£500,000).

An alternative approach would be to apportion the liability by reference to the values at the date of death. The effect, in this example, would be that only £600,000 of the liability would have been attributable to the house (£1,200,000 ÷ £2,000,000 × £1,000,000) giving a chargeable value for the house of £600,000 and increasing the liability to tax.

If the combined value had been split differently between the house and the farmland, or if their values had increased in different proportions, apportioning the liability by reference to, say, date of death values may give a different result. But a consistent approach is necessary, and the liability should be apportioned using the values at the date of acquisition, even if an alternative approach would give rise to more tax.

As well as being consistent, using the values at the date of acquisition avoids difficulties that might arise if either part of the property is sold but the liability

67 It is assumed the house does not qualify for APR (though in practice it might do so).

> retained (how should the remaining liability then be apportioned?), or if there were a sale and part of the liability was repaid, which would trigger the provisions of IHTA84/S162C, (IHTM28026). Fixing the liability attributable to the different parts of the assets at the time they were acquired provides a certain basis going forward.

It would be better to take out two separate loans, one for the agricultural property and one for other property.

65.25.4 *Commencement of BPR/APR disallowance*

Para 5 Sch 36 FA 2013 provides:

> (2) Section 162B of IHTA 1984 (inserted by paragraph 3) only has effect in relation to liabilities incurred on or after 6 April 2013.
> (3) For the purposes of sub-paragraph (2), where a liability is incurred under an agreement-
> (a) if the agreement was varied so that the liability could be incurred under it, the liability is to be treated as having been incurred on the date of the variation, and
> (b) in any other case, the liability is to be treated as having been incurred on the date the agreement was made.

This is different from the commencement of the other FA 2013 IHT liability changes.

Care must be taken over refinancing pre-2013 loans relating to agricultural/business property, as that will have the effect of disallowing the liability.

Suppose:

(1) A pre-2013 liability is attributable to the acquisition of BPR/APR property which is not UK situate.
(2) The property is excluded property as it is owned by a foreign domiciliary or an excluded property trust.

The liability is not disallowed under the BPR/APR disallowance. However it is disallowed under the excluded property disallowance!

One solution if possible is to make the property UK situate.

If the property is EU situate, the breach of EU law seems clear, and it is considered that the disallowance does not apply.

65.25.5 *Effect on wills*

The new rules may have an effect on existing wills using formulae relating to valuation, or relating to agricultural or business property relief.

65.26 Debt of unincorporated business

Section 110 IHTA provides:

> For the purposes of this Chapter—
>
> (a) the value of a business or of an interest in a business shall be taken to be its net value;
>
> (b) the net value of a business is the value of the assets used in the business (including goodwill) reduced by the aggregate amount of any liabilities incurred for the purposes of the business;
>
> (c) in ascertaining the net value of an interest in a business, no regard shall be had to assets or liabilities other than those by reference to which the net value of the entire business would fall to be ascertained.

In the following discussion, **"business debt"** means a debt incurred for the purposes of an unincorporated business.

The IHT Manual gives an example involving an unsecured business debt:

> **IHTM28020 Restricted deductions: borrowed money used to acquire assets that qualify for business relief** [November 2013]
>
> ...
>
> *Example 1* (Gareth)
>
> G, who runs his own sole trader business, borrows £250,000 to buy property that is to be used in his business. The loan is unsecured and is shown in the accounts as a liability of the business. IHTA84/S162B(1)(b) applies as the liability has been incurred to acquire relevant business assets. Under IHTA84/S162B(2) the liability should be taken to reduce the value of the relevant business assets before that value is reduced by business relief. However in this case the liability has already been reflected in the net value of the business under IHTA84/S110(b), so IHTA84/S162B(2)(b) prevents the liability being deducted twice.

Charging a business debt on non-business assets did not reduce the IHT liability even before 2013. Now the position is reinforced by s.162B.

The IHT Manual provides:

> **IHTM25250 Partnership interests** [Jan 2008]
>
> ... One example of the operation of [s.110(c) concerns a partner's Income Tax liability on his share of the partnership profits. As the partner's tax is not a liability incurred for the purposes of the business, it should not be taken into account in determining the net value of the partnership for the purposes of business relief.

65.27 Property qualifying for BPR and APR

The IHT Manual provides:

> **IHTM28022 Restricted deductions: borrowed money used to acquire assets that qualify for both agricultural and business relief** [November 2013]
> Where an asset qualifies for both agricultural and business relief, IHTA84/S114 (IHTM24151) directs that agricultural relief applies to the agricultural value first, with business relief applying to any excess value over the agricultural value of the asset. So, where the liability exceeds the agricultural value of the asset, there will be no agricultural relief to be deducted against the estate. The balance of the liability should then be set against the non-agricultural value of the asset to arrive at the value of the asset which may qualify for business relief.
> If the liability is more than the open market value of the asset, any excess can be set against any other chargeable assets. If the other chargeable assets qualify for business relief, the balance of the liability must be set against those assets that qualify for business relief before being set against any other assets that are chargeable to tax, subject to the liability meeting the provisions of IHTA84/S175A (IHTM28027).
> *Example* (Leon)
> L borrows £800,000 which he uses to buy a farm which he then farms himself. On L's death the estate is worth £2m, of which the farm is worth £1m with an agricultural value of £750,000.
> The liability of £800,000 was incurred to finance the acquisition of assets that are both relevant business assets and agricultural assets. IHTA84/S114 provides that where both agricultural relief and business relief can apply to the same asset agricultural relief is given in priority to business relief.
> Under IHTA84/S162B(4) the agricultural value of the agricultural property is reduced from £750,000 to nil, leaving no value qualifying for agricultural relief.
> The remaining £50,000 liability is deducted from the £250,000 value of the relevant business property, leaving £200,000 which can qualify for business relief.
> So the value of the estate of £2m is reduced by business relief of £200,000 and, subject to it meeting the provisions of IHTA84/S175A, the liability of £800,000, leaving a chargeable value on death of £1m.

Why does it matter which relief applies?

65.28 Gift of debt-financed business/agricultural property

The IHT Manual provides:

> **IHTM28024 deductions: restricted deductions: transfer of relievable assets where borrowed money is used to acquire assets that qualify for relief** [January 2014]
> Where assets that qualify for relief have been acquired using borrowed funds and the liability has been secured against other chargeable assets, it would still be possible to obtain full relief and the deduction of the liability by:
> - giving away the relievable assets before death, but
> - retaining the liability within the estate.
>
> IHTA/S162B requires that the liability is set against the transfer of relievable assets at the time of the lifetime transfer, and any excess value over the value of the liability would qualify for relief. But at death, the estate would no longer include any relievable assets, so the provisions of IHTA/S162B would not apply and the liability could still be deducted against estate on death under IHTA84/S162(4).

Section 162B IHTA deals with this problem:

> (7) Subject to subsection (8), to the extent that a liability is, in accordance with this section, taken to reduce value in determining the value transferred by a chargeable transfer, that liability is not then to be taken into account in determining the value transferred by any subsequent transfer of value by the same transferor.

The IHT Manual provides:

> To prevent this, IHTA/S162B(7) stipulates that where a liability has already been taken into account to reduce the value transferred by a chargeable transfer, the liability cannot then be taken into account to reduce a subsequent transfer of value made by the same transferor.
> The wording used is important. The liability must reduce the value transferred by a chargeable transfer (a transfer that is immediately chargeable or a failed PET). If the lifetime transfer was a PET and the transferor survives 7 years, the transfer is an exempt transfer; so the liability may still be deducted from the estate on death as it will not have taken into account by an earlier chargeable transfer.
> ...
> *Example* (John)
> J, who has an estate of £3m borrows £1m and uses this to purchase farmland which he then farms for 3 years.
> He then gives the farmland, now worth £1.2m to his daughter who farms

> the land herself, but he retains the liability.
> The individual has made a transfer of value when he gives the farmland to his daughter. The value transferred is the loss to J's estate of £1.2m. IHTA84/S162B(4) has the effect of reducing the £1.2m agricultural value by the amount of the liability to £200,000. This £200,000 value then qualifies for agricultural relief, reducing the value transferred to nil.
> When J dies 2 years later, the £1m liability cannot be taken into account again due to IHTA84/S162B(7). Instead of the chargeable transfer on death being £2m (£3m less the £1m liability), it is £3m with no deduction for the liability.

Care is needed if a parent wishes to give different property to different children.

65.28.1 *Relevant property trusts*

Section 162B IHTA deals with this problem:

> (8) Subsection (7) does not prevent a liability from being taken into account by reason only that the liability has previously been taken into account in determining the amount on which tax is chargeable under section 64.

The IHT Manual provides:

> **IHTM28024 deductions: restricted deductions: transfer of relievable assets where borrowed money is used to acquire assets that qualify for relief** [January 2014]
> ...
> But this limitation does not apply to ten-year charges in view of IHTA84/S162B(8). So, whilst the assets acquired with the liability remain in the trust, the liability can be taken into account at each ten year charge. But once the assets cease to be relevant property, so that the liability is taken in account at the time of the exit charge, then if the liability remains in the trust, IHTA84/S162B(7) will prevent it from being taken into account against any further charges.

65.29 Part payment of liability for exempt & chargeable property

A single debt may be used to finance the acquisition of:
(1) excluded property
(2) UK business or agricultural property
(3) chargeable property
What if the debt is repaid in part? Is the part repaid:
(1) the allowable part (attributable to the chargeable property) or

(2) the non-allowable part (attributable to APR/BPR/excluded property)? Section 162C IHTA provides the answer in the manner most favourable to HMRC:

> (1) This section applies for the purposes of determining the extent to which a liability is attributable as mentioned in
>
> [a] section 162A(1) or (5) [excluded property disallowance]
>
> [b] 162AA(1) [foreign currency bank account disallowance]
>
> [c] or
>
> [b] 162B(1)(b), (3)(b) or (5)(c) [BPR/APR disallowances]
>
> (1A) In a case in which the value of a person's estate immediately before death is to be determined, where a liability was discharged in part before that time—
>
> (a) any part of the liability that, at the time of discharge, was not attributable as mentioned in subsection (1) is, so far as possible, to be taken to have been discharged first,
>
> (b) any part of the liability that, at the time of discharge, was attributable as mentioned in section 162B(1)(b), (3)(b) or (5)(c) is, so far as possible, only to be taken to have been discharged after any part of the liability within paragraph (a) was discharged,
>
> (c) any part of the liability that, at the time of discharge, was attributable as mentioned in section 162AA(1) is, so far as possible, only to be taken to have been discharged after any parts of the liability within paragraph (a) or (b) were discharged, and
>
> (d) any part of the liability that, at the time of discharge, was attributable as mentioned in section 162A(1) or (5) is, so far as possible, only to be taken to have been discharged after any parts of the liability within paragraphs (a) to (c) were discharged.
>
> (2) In any other case, where a liability was discharged in part before the time in relation to which the question as to whether or how to take it into account arises—
>
> (a) any part of the liability that, at the time of discharge, was not attributable as mentioned in section 162A(1) or (5) or 162B(1)(b), (3)(b) or (5)(c) is, so far as possible, to be taken to have been discharged first,
>
> (b) any part of the liability that, at the time of discharge, was attributable as mentioned in section 162B(1)(b), (3)(b) or (6)(c) is, so far as possible, only to be taken to have been discharged after any part of the liability within paragraph (a) was

discharged, and

(c) any part of the liability that, at the time of discharge, was attributable as mentioned in section 162A(1) or (5) is, so far as possible, only to be taken to have been discharged after any parts of the liability within paragraph (a) or (b) were discharged.[68]

The IHT Manual provides:

> **IHTM28025 - Restricted deductions: partial repayment of loan before tax charge arises** [November 2013]
> Where borrowed money has been used to acquire:
> - excluded property (IHTM28014), or
> - assets that have become excluded property (IHTM28018) or
> - relievable assets (IHTM28019)
>
> and the loan has been partially repaid before a charge to tax arises only the balance of the loan will be affected by the provisions of IHTA84/S162A or B, subject to the liability meeting the conditions of IHTA84/S175A (IHTM28027).
> Where borrowed money has been used to acquire both:
> - excluded property (IHTM28014), or
> - assets that have become excluded property (IHTM28018) and
> - relievable assets (IHTM28019)
>
> and the liability has been partially repaid before a charge to tax arises, IHTA84/S162C sets out the order in which the liability is treated as having been discharged. The provisions cover the situation where a single loan has been used to acquire other assets that would be subject to tax as well.
> Any part of the liability that is attributable to assets that are neither excluded nor relievable is treated as having been repaid first, IHTA84/S162C(2)(a). If the partial repayment was greater than that part of the liability, the part of the liability that is attributable to relievable assets is treated as having been repaid next, IHTA84/S162C(2)(b).
> And, if the partial repayment was greater than the part of the liability attributable to both of those two categories of asset, the remainder of the liability must be attributable to excluded property, or assets that have become excluded property, and is treated as being repaid last, IHTA84/S162C(2)(c). So if the balance of the liability outstanding on death can only be attributable to excluded property then, subject to the provisions of IHTA84/S162A (IHTM28014), any deduction for the

68 I set out the section as amended by the FA 2014 with effect from royal assent.

balance of the loan is disallowed.

Example 1

The trustees of an excluded property trust which contains a UK house worth £2m borrow £1.5m which is charged against the property.

£800,000 is used to acquire unlisted UK shares which qualify for business relief and

£700,000 is used to acquire excluded property.

£300,000 of the liability is repaid before the ten year anniversary leaving a liability of £1.2m. At that time the unlisted UK shares are valued at £900,000 and the excluded property is valued at £1m.

Under IHTA84/S162C(2) the liability is treated as having been repaid first on the part of the liability incurred to acquire the unlisted UK shares. As £800,000 of the loan was used for this purpose, the £300,000 that was repaid is treated as having partially discharged this part of the liability - leaving £500,000 as a loan used to acquire the UK shares.

Under IHTA84/S162B(2) the value of the unlisted UK shares that can qualify for business relief is reduced by £500,000 from £900,000 to £400,000. The remaining £700,000 liability that was used to acquire excluded property is disallowed by IHTA84/S162A.

So the value of the UK assets in the trust of £2.9m (the UK house and the unlisted UK shares) is reduced by the part of the debt that was used to acquire the UK shares, £500,000, and business relief of £400,000 to £2m – or the same as the value of the UK assets before any transactions took place. Business relief is allowed against the increase in the value of the UK unlisted shares.

Example 2

The trustees of an excluded property trust which contains a UK house worth £2m borrow £1.5m which is charged against the property. This time the trustees use the £1.5m to acquire

- £900,000 of excluded property,
- £350,000 of assets qualifying for agricultural relief and
- £250,000 of UK listed shares.

£700,000 of the liability is repaid before the ten year anniversary leaving a liability of £800,000. At that time the excluded property is worth £1m, the agricultural assets are worth £400,000 and the UK shares, £300,000.

Under IHTA84/S162C(2) the liability is treated as having been repaid first on the part used to acquire the UK shares. As £250,000 of the liability was used for this purpose, the first £250,000 of the amount discharged reduces the liability which can be deducted from the UK shares to nil.

Of the remaining £450,000 that was repaid, £350,000 was used to acquire agricultural assets which are worth £400,000 at the date of the

ten year anniversary. So, the next £350,000 of the amount repaid reduces the liability which can be taken against the agricultural assets under IHTA84/S162C(2)(b) to nil. As none of the remaining liability can be attributed to acquiring the agricultural assets, the full value of the agricultural assets may qualify for agricultural relief with no restriction under IHTA84/S162B.

The last £100,000 of the liability which has been discharged (£700,000 - (£250,000 + £350,000) = £100,000) is treated as reducing the liability incurred to acquire the excluded property under IHTA84/S162C(2)(c). This reduces that part of liability from £900,000 to £800,000. So the balance of the liability that was not repaid, £800,000 is attributed to the acquisition of excluded property and is disallowed by virtue of IHTA84/S162A.

The value of the UK assets in trust of £2.7m (the UK house, agricultural assets and quoted shares) is reduced by the agricultural relief to £2.3m and none of the liability is allowable.

In effect, the original £2m in the trust, plus the UK shares are now liable to tax. Although this may seem a harsh result given that the shares were acquired through borrowing, without a priority rule, it would be possible to manipulate assets and values to obtain an advantage.

65.30 Payment of disallowed liability

The payment of a disallowed debt is in principle a transfer of value, but relief will in principle be available under s.10 IHTA: there is no equivalent of a s.103(5) deemed PET.[69] A simple course if possible is to repay the borrowing at any time before the death. Repayment reduces the value of the estate, but qualifies for relief under s.10 IHTA 1984. So "deathbed" planning is possible.

65.31 Disallowance of liabilities not paid after death

Section 175A IHTA provides:

(1) In determining the value of a person's estate immediately before death, a liability may be taken into account to the extent that—

(a) it is discharged on or after death,

[i] out of the estate or from excluded property owned by the person immediately before death,

[ii] in money or money's worth, and

(b) it is not otherwise prevented, under any provision of this Act,

69 See 65.6.8 (Section 103(5) deemed PET).

> from being taken into account.
>
> (2) Where the whole or any part of a liability is not discharged in accordance with paragraph (a) of subsection (1), the liability or (as the case may be) the part may only be taken into account for the purpose mentioned in that subsection to the extent that [the commercial reason defence applies].

Subsection (1) is worded as an *allowance* for discharged liabilities: in order to identify the disallowance of undischarged liabilities, one needs to read subsections (1) and (2) together. The wording is convoluted, but it works.

I refer to this rule as the **"disallowance for liabilities not paid after death"**. That is not a short and convenient label, but I cannot think of a better one.

This disallowance only applies on death. It does not apply to lifetime transfers (failed PETs or chargeable transfers) or to 10 year and exit charges on trusts.

A deduction is not allowed if the creditor waives (releases) the debt as that is not a discharge out of the estate. But a deduction is allowed if:

(1) The debt is paid, and

(2) The creditor makes a gift back to the debtor.

This is commercially equivalent to a waiver by the creditor. That arrangement is not avoidance: it makes the practical difference that interest accruing on the debt becomes taxable.

65.31.1 *To the extent that it is discharged ... in money or money's worth*

If a debt for (say) 100 is discharged as to 50% by a payment of 50, then 50% of the debt is allowable.

If the debt is wholly discharged by the transfer of money's worth valued 50, then it would be sensible if only 50% of the debt is allowable; though it requires a purposive reading to reach that result.

65.31.2 *Commencement of disallowance for liabilities not paid after death*

Para 5 Sch 36 FA 2013 provides:

> (1) Subject to sub-paragraph (2),[70] the amendments made by this Schedule have effect in relation to transfers of value made, or treated as

70 This relates to the business/agricultural property disallowance: see 65.24.4 (Commencement of BPR/APR disallowance).

made, on or after the day on which this Act is passed.

So the new rules applies to pre-2013 debts, if the transfer of value (ie the death) is after 17 July 2013. This is an unfair commencement rule as in many cases, including those without any element of tax avoidance, existing liabilities will have been incurred in reliance of the current rules. But there it is.

65.32 Debt discharged "out of the estate"

65.32.1 *The "estate"*

Section 175A IHTA provides:

> (1) In determining the value of a person's estate immediately before death, a liability may be taken into account to the extent that—
>
> (a) it is discharged on or after death,[71]
>
> [i] out of the estate or
>
> [ii] from excluded property owned by the person immediately before death ...

"The estate" in (1)(a)[i] refers back to the "person's estate immediately before death" in the opening words in (1): the deceased's estate.

A liability is paid out of the estate if it is paid out of:

(1) property which was in the estate immediately before death, or
(2) property representing that property: IHT adopts the concept of a continuing fund.

"Estate" has its IHT meaning.[72] It includes in particular:

(1) settled property in which the deceased had an estate interest in possession, and
(2) GWR property.

Such property is treated as part of the deceased's estate immediately before death, and following the individual's death the property is no longer be treated as part of his or her estate. It is considered that does not matter: following the death the deceased has no estate at all. So the discharge of a debt on GWR property out of that property (or property representing such property) will satisfy the requirement.

The IHT Manual provides:

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71 The words "on or after the death" are otiose.

72 Section 272 IHTA provides: "In this Act, except where the context otherwise requires ... "estate" shall be construed in accordance with sections 5, 55 and 151(4) above".

> **IHTM28030 Liabilities: restricted deductions: meaning of 'out of estate'** [November 2013]
> In determining whether the loan has been discharged out of the estate, the word 'estate' has its normal meaning for Inheritance Tax (IHTM28027); but IHTA84/S175A(1)(a), extends this meaning for the purpose of this provision only to include any excluded property owned by the deceased.[73] It is important here that the excluded property was 'owned' by the deceased, taking the natural meaning of the word 'owned'. Excluded property that is also settled property in which the deceased had an interest is not property 'owned' by the deceased.
> Although the meaning of estate is extended in this way, the normal rule that a liability can only be deducted against assets at the same title applies (IHTM28397). Other than in exceptional circumstances, in reality, assets in the Free Estate are not available to trustees to settle trusts debts.

65.32.2 *Payment out of loan to PRs*

Suppose:

(1) An estate has a debt ("the pre-death liability").
(2) The creditor (or any other person) lends to the PRs, so the estate has a second debt ("the post-death liability").
(3) The PRs use the borrowed funds to pay the pre-death liability.

This is a matter of refinancing. The deduction is allowed even if the post-death liability is then discharged, but not out of the estate. That arrangement is not avoidance: it makes the practical difference that interest accruing on the pre-death liability becomes taxable.

This is important where:

(1) The estate had a pre-death liability.
(2) The deceased took out a life policy to fund repayment, and settled the policy.

If the trustees of the policy repay the pre-death liability (as would have been envisaged when the trust was made) the pre-death liability is not deductible.

The solution is that:

(1) The trustees lend to the PRs.

---

73 This is not strictly correct. Section 175A does not extend the meaning of "estate": it provides that debts may be allowed if paid out of the estate or out of excluded property. But it comes to the same thing.

(2) The PRs repay the debt out of the estate.
(3) The trustees may then waive the post-death liability.

HMRC agree. The IHT Manual provides:

> **IHTM28030 Liabilities: restricted deductions: meaning of 'out of estate'** [November 2013]
> ...
> There may be circumstances where the estate has very little in the way of liquid assets from which to repay a liability so the personal representatives may need to borrow money to actually repay the debts. Where this happens, with the result that the estate is charged with repaying that new debt, you can accept that the liability owed by the deceased has been repaid 'out of' the estate.
> *Example* (Kevin)
> K's estate is valued at £750,000, £700,000 of which is attributable to his home. A mortgage of £100,000 is secured against the house.
> The executors borrow £100,000 to repay the mortgage and secure the new loan on the house, so that the beneficiary receives the property charged with the new debt.
> You may accept that the liability has been discharged out of the estate.
> There is no need to raise any enquiries into the source of funds lent to the executors, including whether or not the beneficiary is the creditor for the new loan. Provided the mortgage has actually been repaid from funds charged against the estate, the deduction may be allowed as this has the same effect as the liability being discharged out of the estate had there been sufficient liquid assets.
> It is possible that the beneficiary[74] may be able to make a loan to the estate from the proceeds of an insurance policy held in trust outside the estate for the purposes of repaying the mortgage. Again, the source of the funds does not matter.

Although this passage refers to an illiquid estate, where the trustees "need" to borrow, the same would apply to a liquid estate (if it mattered).

65.33 Commercial reason defence

Section 175A IHTA provides:

> (2) Where the whole or any part of a liability is not discharged in accordance with paragraph (a) of subsection (1), [ie the liability is not paid out of the estate] the liability or (as the case may be) the part may

74 "The beneficiary" is presumably a slip for the Trustees of the insurance policy.

> only be taken into account for the purpose mentioned in that subsection to the extent that—
>
> (a) there is a real commercial reason for the liability or the part not being discharged,
>
> (b) securing a tax advantage is not the main purpose, or one of the main purposes, of leaving the liability or part undischarged, and
>
> (c) the liability or the part is not otherwise prevented, under any provision of this Act, from being taken into account.

Paras (a)-(c) contain an exception to the general rule that undischarged liabilities are disallowed. I refer to this as **"the commercial reason defence"**. The label is not entirely apt to cover all the requirements of (a) - (c) but no short label could do that.

There is no relief is the debt is discharged, but not out of the estate (even if that is done for commercial reasons).

65.33.1 *Commercial reason*

Section 175A IHTA provides:

> (3) For the purposes of subsection (2)(a) there is a real commercial reason for a liability, or part of a liability, not being discharged where it is shown that—
>
> (a) the liability is to a person dealing at arm's length, or
>
> (b) if the liability were to a person dealing at arm's length, that person would not require the liability to be discharged.

I abbreviate "real commercial reason" to "commercial reason" because "real" does not add anything to the meaning.[75] I refer to the requirements in (a) and (b) as **"commercial reason requirements (a) and (b)"**.

Section 175A(3) is not expressed to be a comprehensive definition of commercial reason. It is suggested that there could be a commercial reason even if commercial reason requirements (a) and (b) are not met; but that would be rare, as those conditions more or less encapsulate the meaning of "commercial" in this context.[76]

At what time does one ask whether commercial requirement (a) is met? A person may be dealing at arm's length at one time and not at another time. At what time does one ask whether commercial requirement (b) is met? It may be that a person (hypothetically) dealing at arm's length

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75 See 32.17.3 ("Genuine").

76 For further discussion see 32.5 ("Commercial" in Old Condition B).

would require the liability to be discharged at one time but not at another time.

Clearly, one cannot look at the position at the date of the death. It is suggested that one looks at the position at the time that the IHT is due and payable. The due date is normally when probate is applied for. If the commercial reason defence applies at that time, the debt is deductible. Since there is no provision for the possibility that IHT may subsequently fall due, it is suggested that it does not matter what happens later. This view increases the scope of the commercial reason requirements (a) and (b) but that does not matter as the commercial reason defence is still effectively policed by the tax motive rule.

HMRC say:

> 8.8 The 'commercial reason' test will apply at the time the decision is made not to repay the loan.[77]

However it may not be possible to identify that time.

65.33.2 *Tax motive rule*

The second requirement of the commercial reason defence is that:

> (b) securing a tax advantage is not the main purpose, or one of the main purposes, of leaving the liability or part undischarged ...

I refer to this as **"the tax motive rule"**.

Section 175A IHTA defines "tax advantage":

> (5) In subsection (2)(b)—
> "tax advantage" means—
> (a) a relief from tax or increased relief from tax,
> (b) a repayment of tax or increased repayment of tax,
> (c) the avoidance, reduction or delay of a charge to tax or an assessment to tax, or
> (d) the avoidance of a possible assessment to tax or determination in respect of tax.
> (6) In subsection (5) "tax" includes income tax and capital gains tax.

The definition is different from that in the excluded property

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77 HMRC, "Treatment of liabilities for inheritance tax: HMRC response to comments on Schedule 36 Finance Act 2013" (September 2013) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2013/09/130905%20IHT%20Liabilities%20-%20HMRC%20response%20note.pdf*

disallowance.[78]

What matters is the purpose for leaving the liability undischarged, not the purpose for creating it. Leaving a liability undischarged is not usually going to avoid IHT. It could avoid IT or CGT.

Again, the legislation is silent as to the time when the main purpose(s) are ascertained. Purpose may vary over time. It is suggested that one looks at the time the IHT is due. But since avoidance need only be one of the purposes, this problem may not often arise.

If one meets all the requirements of the commercial reason defence, then it does not matter if the debt is later waived.

The IHT Manual provides 3 examples.

65.33.3 *HMRC example 1: NRB debt scheme*

Example 1 is a (more or less) standard nil rate band debt scheme.[79]

> **IHTM28029 Restricted deductions: non-repayment of liabilities deducted against the estate on death** [November 2013]
>
> ...
>
> *Example 1* (Harvey and Wendy)
>
> H dies leaving a nil-rate band (NRB) discretionary trust under his Will with the residue of the estate passing to his wife, W.
>
> The trustees of the NRB trust exercise their powers and pass the whole of the H's estate to W in return for her agreeing to repay an amount equal to the NRB (£325,000). Interest is charged on the debt at 3% per annum, compounded annually.[80]
>
> On W's death four years later, interest has increased the liability from £325,000 to £365,790. The liability is not disallowed by any other part of the IHTA, so it can be taken into account to the extent that it is actually repaid out of the estate in money or money's worth under IHTA84/S175A(1)(a).

The HMRC analysis is as follows:

> Provided the whole £365,790 is repaid out of W's estate, the full sum can be deducted from her estate. The interest received by the NRB

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78 See 65.21.4 (Disallowable reason 1: tax avoidance purpose).

79 On these schemes, see Kessler, *Drafting Trusts & Will Trusts* (12th ed., 2014), para 18.3 (Classic NRB trusts).

80 Under the NRB schemes in practice, the debt is usually index-linked, and index-linking is not interest: see Kessler, *Drafting Trusts & Will Trusts* (11th ed., 2014), appendix 4 (Tax on payment of index-linked nil rate sum).

> trustees will be income of the trust and should be declared for Income Tax purposes.
> If, instead, only £325,000 is discharged from W's estate, that sum can still be deducted from her estate under IHTA84/S175A(1)(a). But there is unlikely to be any commercial purpose to the interest not being repaid as, had the creditor been at arm's length, they would have wanted the interest repaid as well. As a result, the £40,790 of the liability that is not repaid from the estate is not allowed as a deduction against the estate – but equally, the trustees will have no Income Tax liability.

HMRC argue that the commercial reason defence does not apply. They accept if is possible (if unlikely) that commercial requirements (a) or (b) may be met, if that is the case, the tax motive rule disallows the relief:

> Even if it could be shown that the liability incurred by the wife to the NRB trustees was incurred in an arm's length transaction, the provisions of IHTA84/S175A(2)(b) must be considered.

Does the author mean to suggest that the time to assess commercial reason requirement (a) is when the liability is incurred?

> The part of the liability not discharged may not be taken into account if the main purpose, or one of the main purposes, for not repaying the liability was to secure a tax advantage. If the trustees have waived the interest, it would result in the trust receiving less income than it otherwise would. This in turn would lead to a reduced Income Tax liability. A reduction of a charge to Income Tax falls within the definition of a tax advantage in IHTA84/S175A(45), so £40,790 of the liability that is not repaid from the estate is not allowed as a deduction against the estate.

I wonder about that. For basic rate taxpayer beneficiaries, the maximum tax advantage may be saving IT on the interest at 20% or less (allowing for the repayment of the trustees tax credit on a distribution to beneficiaries): is the saving of £8k likely to be a main purpose? Not if the estate is illiquid. The purpose of waiving the loan is to avoid the cost of borrowing.

65.33.4 *HMRC example 2: Loan from family trust on commercial terms*

The next example concerns a loan from a family trust:

> *Example 2* (David)
> D's estate includes a house valued at £800,000. There is a commercial mortgage of £200,000 from a family trust charged against the property.

> D leaves his house to his son, Roger. The trustees[81] are content that the house can be transferred to Roger provided that Roger takes over the mortgage and continues to make the repayments.
> Although the liability has not been repaid, the arrangements are commercial and there is no tax advantage arising from Roger taking over the mortgage, so the liability may be allowed as a deduction against the estate.

How does D "take over" the mortgage? The passage is not drafted by a lawyer. The usual way would be a tripartide agreement between (1) the PRs (2) the lender (3) D, under which:

(1) The lender discharges/releases the debt due from the PRs in consideration for which
(2) D promises to pay a like sum to the lender.

That would not strictly qualify for the commercial reason defence as that only applies if the debt is not discharged. HMRC may not take the point. The safe way to deal with the matter is for D to borrow, lend to the PRs who then repay the lender.

65.33.5 *HMRC example 3: Loan from family member repayable on 2nd death*

> *Example 3* (Adrian)
> A makes of loan of £25,000 to his father to help with living expenses, which is secured on his parent's house. A normal rate of interest is charged, but they agree to allow the interest to be added to capital sum owing. The liability is not to be repaid until after the death of both parents, so when A's father dies, two years later the loan is not repaid.

Of course s.103 FA 1986 may disallow the debt on the death of the father, but we must assume it does not.

The HMRC analysis is as follows:

> Since the loan was not due to be repaid until the death of the survivor, an arm's length creditor would not have any cause to seek repayment, so the liability may be allowed as a deduction against the estate.

More analytically, the commercial reason defence applies.

> On the mother's subsequent death, the liability must be repaid from the estate before it can be allowed as a deduction against the estate. If the accrued interest was not repaid, no deduction should be allowed for that

81 More accurately, PRs or executors; but nothing turns on the terminology.

sum.

It may be different if there is a break clause in the agreement.

> The position may be different if the loan agreement contains a 'break' clause that allows for early repayment. If a favourable rate of interest, or no interest, was charged and the repayment could be demanded after the first death, an arm's length creditor might reasonably be expected to call in the loan to gain a better return from the money. In these circumstances, if the loan is not repaid on the first death, the terms of IHTA84/S175A(2)(a) are unlikely to be met and the liability should be disallowed unless it is repaid, although this may be of limited impact if most of the estate passes to the surviving spouse.

The disallowance for debts not paid after death is irrelevant if the spouse exemption applies. The example may be more important for cohabitees.

65.34 Part payment of liability for exempt & chargeable property

A single debt may be used to finance the acquisition of:
(1) excluded property
(2) business or agricultural property
(3) chargeable property
If the debt is not repaid after death, it will be wholly disallowed. If the debt is wholly repaid after death, it will be (effectively) disallowed to the extent was used to finance excluded or business/agricultural property and allowable to the balance. What if the debt is repaid in part after death? Is the part repaid the allowable or the non-allowable part? Section 175A(7) IHTA provides the answer in the way most favourable to HMRC:

> Where the liability is discharged as mentioned in subsection (1)(a) only in part—
>
> (a) any part of the liability that is attributable as mentioned in section 162A(1) or (5) is, so far possible, taken to be discharged first,
>
> (aa) any part of the liability that is attributable as mentioned in section 162AA(1) is, so far as possible, taken to be discharged only after any part of the liability within paragraph (a) is discharged,
>
> (b) any part of the liability that is attributable as mentioned in section 162B(1)(b), (3)(b) or (5)(c) is, so far as possible, taken to be discharged only after any parts of the liability within paragraph (a) or (aa) are is discharged, and
>
> (c) the liability so far as it is not attributable as mentioned in

> paragraph any of paragraphs (a) to (b) is, so far as possible, taken to be discharged only after any parts of the liability within any of those paragraphs are discharged.[82]

This follows the pattern of the rules for excluded property/APR/BPR.[83] The IHT Manual provides:

> **IHTM28032 Restricted deductions: partial repayment of liabilities after death** [November 2013]
> Where a liability is partially repaid after death only the part of the loan that has been repaid will be allowed as a deduction, unless the balance that has not been repaid meets the conditions of IHTA84/S175A(2), (IHTM28029).
> Where borrowed money has been used to acquire a mixture of excluded property (IHTM28014) and relievable assets (IHTM28019) and the loan has been partially repaid, IHTA84/S175A(7) sets out the priority in which the partial repayment should be allocated against the assets of the estate. The provisions cover the situation where the single loan has been used to acquire other chargeable assets as well.
> Any part of the liability that is attributable to excluded property is treated as being repaid first, IHTA84/S175A(7)(a), with the result that although this part of the liability has been repaid, the deduction is still disallowed under IHTA84/S162A (IHTM28014), unless one of the exceptions is satisfied. If the partial repayment was greater than that part of the liability, the part of the liability that is attributable to relievable property is treated as being repaid next IHTA84/S175C(7)(b), so that this part of the loan is a valid deduction against the estate, but it will reduce the value of the property that can qualify for relief; ultimately reducing the relief to nil.
> And if the partial repayment was greater than the part of the liability attributable to both excluded and relievable property, the remainder of the liability can then be allowed as a deduction against the chargeable estate, IHTA84/S175A(7)(c).

The HMRC example has 3 parts:[84]

> *Example* [1] (Neville)
> N, who is non-UK domiciled, borrows £1.5m from an excluded property trust. He charges the liability against his existing UK chargeable

82 I set out the section as amended by the FA 2014 with effect from royal assent.

83 See 65.28 (Part payment of liability for exempt & chargeable property).

84 I have slightly altered the layout for enhanced clarity.

property worth £2m. He uses the £1.5m to acquire:

excluded property	£600,000
property qualifying for agricultural relief	£500,000
chargeable UK property	£400,000
	£1,500,000

When he dies the whole £1.5m remains outstanding.
The values of the assets have not changed; none of the exceptions to the general rules apply.

The Manual first considers the position if the debt is wholly repaid after death:

Under IHTA84/S162A the £600,000 used to acquire excluded property is disallowed. Under IHTA84/S162B the agricultural value of the agricultural property which can qualify for relief is reduced from £500,000 to nil.
If the liability is discharged in full from the estate after the date of death, the UK assets of £2.9m (UK property, agricultural land and other chargeable property) is reduced by
• the £500,000 liability set against the agricultural property and
• the £400,000 liability used to acquire chargeable UK assets,
leaving £2m in charge.

Example [2]: partial repayment after death

Assume however, that only £750,000 of the liability is discharged from the estate after death.
Under IHTA84/S175A(7)(a) the first £600,000 discharged is taken to have discharged the liability incurred to acquire excluded property. This part of the liability remains disallowed by IHTA84/S162A(1)(a).
Under IHTA84/S175A(7)(b) the next £150,000 is taken to have discharged part of the £500,000 liability incurred to acquire agricultural property. As only £150,000 of this liability is treated as having been discharged, only £150,000 is an allowed as a deduction from the value of the estate on death. This reduces the value of the property that can qualify for agricultural relief to £350,000, and assuming that relief is available, the chargeable value of the property is reduced to nil.
Under IHTA84/S175A, the agricultural property that makes up part of the UK assets of £2.9m is reduced to nil by a mixture of the liability (£150,000) and agricultural relief (£350,000) leaving a chargeable estate of £2.4m

Example [3]: partial repayment after death

Assume now that £1.3m of the liability is discharged from the estate after death.
Under IHTA84/S175A(7)(a) the first £600,000 repaid is taken to have discharged the liability incurred to acquire excluded property. Under

IHTA84/S175A(7)(b) the next £500,000 is taken to have discharged the liability incurred to acquire agricultural property.

As the value of the agricultural property is reduced to nil by deducting the liability, there is no agricultural relief. Under IHTA84/S175A(7)(c) the remaining £200,000 of the liability which has been discharged can be taken into account to reduce the value of the chargeable estate.

The deduction allowable under IHTA84/S175A is therefore £700,000 (£500,000 + £200,000) so the chargeable estate is reduced from £2.9m to £2.2m.

The attribution rule is unfair but it will not bring in any additional revenue to HMRC. In practice, if the issue arose, the PRs would repay the whole debt. If it is anticipated that may not happen, it would be better to take out separate loans, one for each class of property, so the PRs could decide which debt to take out.

65.35 Interaction of disallowance on death and IHT spouse exemption

175A(4) IHTA provides:

> (4) Where, by virtue of this section, a liability is not taken into account in determining the value of a person's estate immediately before death, the liability is also not to be taken into account in determining the extent to which the estate of any spouse or civil partner of the person is increased for the purposes of section 18.

The IHT Manual provides:

> **IHTM28030 Restricted deductions: interaction with spouse or civil partner exemption where liabilities are deducted against the estate on death** [November 2013]
>
> Where a liability is secured on a property that passes to the spouse or civil partner, the value by which the spouse or civil partner's estate is increased (being the net value of the property) could result in a charge arising against property that passes to the spouse or civil partner. This is because if the liability is not repaid, no deduction is allowed against the estate, but the spouse or civil partner's estate is only increased by the net value of the property.
>
> To be clear that spouse or civil partner exemption should continue to apply to the full value of the property that the spouse or civil partner receives, IHTA84/S175A(4) provides that where a liability is not taken into account in determining the value of a person's estate, the liability is also not to be taken into account in determining the extent to which the spouse or civil partner's estate is increased.

That seems misconceived. Section 18(1) IHTA provides:

> A transfer of value is an exempt transfer to the extent that the value transferred

[a] is attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner
[b] or, so far as the value transferred is not so attributable, to the extent that that estate is increased.

It is correct that the spouse's estate is only increased by the net value of the property, which restricts the exemption under [b]. But the IHT spouse exemption would still apply under [a]. If that is right, s.175A(4) is unnecessary, though it does no harm.

Example (James)
J makes of loan of £25,000 to his father to help with living expenses, secured on his parent's £500,000 house. The loan is interest-free and repayable on demand. On the father's death, the loan is not repaid as the son is content for it to remain outstanding until his mother's death. The property passes to his mother under his father's Will. An arm's length creditor would not leave the loan outstanding so the liability cannot be taken into account by virtue of IHTA84/S175A(2)(a). The liability is disallowed as a deduction against the estate so the chargeable value of the house is £500,000 rather than £475,000. But the liability is also not taken into account when considering spouse exemption. So even though the spouse actually receives the £500,000 subject to the £25,000 liability, spouse exemption applies to the full £500,000 value of the property.

If on the same facts the father had left the estate to charity, the debt would be disallowed and the charity exemption restricted to the net value.
J should have purchased a share in the father's house. Then the debt would not be disallowed.

65.36 When must the debt be discharged?

65.36.1 *The strict position*

A liability may be discharged after the time that an IHT account is delivered or after IHT is paid. The strict position is that:
(1) If at the time of payment of the IHT the debt has not been discharged, it is disallowed in computing the amount of IHT due.
(2) If the debt is subsequently discharged, IHT is recomputed if a claim is made under s.241 IHTA; note the 4 year time limit.

PRs cannot obtain probate until tax is paid but often cannot pay liabilities until they have probate. I doubt if the commercial reason defence was specifically designed to cover this (it is more likely that HMRC overlooked the problem) but it seems to me entirely apt to cover it. So the

liability will be deductible as long as there is no tax avoidance purpose.

65.36.2 *HMRC practice*

The IHT Manual provides:

> **IHTM28032 Restricted deductions: investigation of liabilities deducted against the estate on death** [November 2013]
> As the majority of liabilities taken as deductions against an estate will be at arm's length, the starting assumption is that all liabilities will be repaid. So, unless the personal representatives are aware beforehand that a liability is not going to be repaid and it is not otherwise allowable as a deduction, the IHT400 Notes allow the personal representatives to include all the deceased's liabilities when filling in the IHT400. There is no need to make any enquiries to establish that liabilities which are clearly commercial and at arm's length have been repaid, as it is more than likely that the creditor will want to recover the money owed to them. Examples here would be:
> - utility bills,
> - credit card bills,
> - council tax,
> - payments due to HMRC,
> - outstanding care fees,
> - professional fees (to the date of death),
> - overpaid pension,
> - payments for goods and services.
>
> If an arm's length liability for which a deduction is included is not actually repaid, form IHT400 would then be incorrect and the taxpayer is obliged to tell us about the adjustment to be made under IHTA84/S217.

Presumably this should be done when it becomes clear that the liability will not be repaid.

> Where, however, liabilities have been deducted which are not due to arm's length creditors, such as family members, family trusts or companies or liabilities deducted in connection with avoidance schemes, you should ask the taxpayer or agent to provide evidence that the money has been repaid. This might be a copy of the letter enclosing a cheque to the creditor or confirmation of receipt of the payment by the creditor. You should also obtain evidence that the liability has been repaid out of the estate; remembering the extended meaning of estate for this purpose (IHTM28027). This might be a copy of the bank statement from the personal representatives' bank account, or a ledger entry from the

appropriate solicitor's client account.
Where the personal representatives do not repay a liability during the normal administration of the estate and the exception at IHTM28028 does not apply, you should disallow the deduction and ask for the tax to be paid. If the liability is subsequently repaid, the deduction may then be allowed and the tax repaid, provided the claim for repayment is made within the 4 year period set out in IHTA84/S241. But you do not need to keep the file open to wait to see if the liability is repaid...

65.37 The 2013 disallowances: Commentary

The FA 2013 made 3 reforms, the excluded property disallowance; the BRP/APR disallowance; and the disallowance for liabilities not paid after death. They raise distinct issues and need to be considered separately.

65.37.1 *Purpose of disallowance for liabilities not paid after death*

One purpose (perhaps the only purpose) of the disallowance for liabilities not paid after death is to counter arrangements under which:
(1) an inheritance tax deduction is increased, by making a debt subject to interest; but
(2) the interest is not in fact paid, so there is no liability to income tax on it.
The most common cases will be:
(1) NRB discretionary trusts[85] funded by debt or charge arrangements.
(2) Home loan schemes.[86]
NRB trusts have not (usually) been created since 2007, and home loan schemes have not been created since 2004, but many made before then are still in existence.

The disallowance could apply in relation to other loans from family or family trusts, but I think that would be rather less common.

Taxpayers now have the choice between:
(1) IHT (due if the liability is not repaid) or
(2) income tax on interest, (if the liability to pay interest is paid).
That this is the purpose (or at least one purpose) of the disallowance is supported by the definition of "tax" which includes:
(1) IT (the target here is IT avoidance) and

85 See the discussion in the online update of my *Drafting Trusts & Will Trusts* accessible *http://www.kessler.co.uk*.

86 See 76.2.3 (Home loan schemes).

(2) CGT (the target is CGT avoidance, on the basis that the debts may be a secondhand debt, or a debt on a security, within the charge to CGT).[87]

It is possible that HMRC realised that their recent change of view (taking the position that home loan schemes do not work) is not sustainable; and s.175A was partly motivated (or maybe primarily motivated) by the desire to find an effective means of attacking pre-2004 home loan schemes. . Such schemes were avoidance, but the POAT regime offered taxpayers the option of keeping the home loan arrangement in exchange for paying POAT: HMRC have withdrawn from their side of the bargain.

There is a case for disallowing a deduction for interest not paid after the death, but it is difficult to see the case for disallowing other debts ("non-interest debts"). HMRC assert that there is scope for avoidance but I cannot see it. It might perhaps be said that if estate debts are not paid the beneficiaries of the estate have a windfall which may fairly be taxed. The way that the HMRC press release expresses it is that if debts are not repaid there is no "real reduction" in the value of the estate. But if debts are not repaid, there is a gift from the *creditor* to the debtor. That is not a gift which passes on death, so should not be subject to IHT.

Even if there were a case for disallowing non-interest debts (and I cannot see what it could be) there is no case for disallowing debts unless paid *out of the estate*. If I am right that the purpose of the rules is to ensure that IT (or CGT) on pre-death debts is not avoided by non-payment, all that matters is that the interest is paid. It does not matter whether it is paid out of the estate or not.

65.37.2 *Purpose of disallowance of liabilities attributed to excluded property*

HMRC say:

> 5.1 The principle behind disallowing any deduction for a liability which has been incurred to acquire excluded property is that a deduction should only be allowed if the acquired asset is chargeable to IHT. If the acquired asset is excluded property, there is already in effect a deduction for that asset from the value of the estate subject to IHT so HMRC does not believe that any further deduction should be made for the liability.[88]

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87 See 65.32.2 (Tax motive rule).

88 HMRC, "Treatment of liabilities for inheritance tax: HMRC response to comments on Schedule 36 Finance Act 2013" (September 2013) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2013/09/130905%20IHT%20*

65.37.3 *Purpose of disallowance of liabilities attributed to BPR/APR property*

HMRC say:

> 2.4 If a liability is incurred to acquire certain business assets or agricultural property and the loan is secured against those assets, the liability is deducted from the value of those assets and only the net value qualifies for relief. However, if the loan is secured on other assets in the estate, the liability is deducted from the value of the estate and relief is also given on the full value of the assets. The resulting tax advantage creates an incentive for loans to be secured against non-business assets, provides a basis for certain types of avoidance schemes, and discriminates against those businesses that borrow and secure the liability against their business assets.
>
> 2.5 The new provisions remove that tax advantage and ensure that all liabilities incurred to acquire property that qualifies for a relief are treated in the same way regardless of the nature of the property or how the loan has been secured. This consistent treatment eliminates the current discrimination, the basis for avoidance, the incentive to structure borrowing in a certain way, and the resulting distortion to borrowing arrangements.
>
> 7.2 The intention of the new proposals is not to prevent or deter individuals from starting a business or investing in one, but to remove the current difference in treatment for different types of qualifying assets and to close avoidance opportunities. HMRC does not believe that the changes will disrupt business activity or that they will prevent a business from securing a loan. The majority of business loans and overdrafts are unsecured or are secured against business assets, and are repaid before death, so most estates that have business liabilities and claim reliefs will be unaffected by the changes. Estates will continue to get a deduction for liabilities provided they are not used to acquire assets which are not chargeable to IHT and they are repaid after death (unless there are commercial reasons for the non-repayment and the non-repayment does not give rise to a tax advantage).
>
> 7.3 Reliefs such as APR and BPR are available so that farms and businesses do not have to be sold or broken up, thereby undermining their economic potential, to meet IHT bills. They are not intended to incentivise loans to be structured or secured in a certain way, so that those arrangements obtain a further tax advantage in addition to the

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Liabilities%20-%20HMRC%20response%20note.pdf

relief. The Government understands that investment decisions are made on the basis of a variety of factors, and believes that the inheritance tax system should neither penalise nor favour particular borrowing arrangements. The changes introduced by FA2013 are in line with this key principle and remove the current difference in treatment.[89]

65.37.4 *Comparison with non-debt financing*

HMRC say:

> 7.4 Stakeholders also commented that the new provisions will give a different result for those who borrow funds to acquire relievable property compared to those that realise their existing assets, and therefore the new rules will discourage borrowing. If two people invest the same amount in business assets but one sells some of their existing assets to fund the investment and the other borrows the necessary funds, the borrower's taxable estate will be greater than the seller's by the amount of the loan even though both of them have the same investment in the business, net wealth and net equity.
>
> 7.5 Although their overall position appears to be very similar at first glance, it is unlikely to be case in practice. The seller will have had to sell some of their assets to fund the investment, which would constitute an equity investment. They will no longer have access to those assets as they will no longer be in their estate; they will have incurred costs and possibly paid other tax charges as well, such as capital gains tax and/or stamp duty. On the other hand, the borrower can keep and continue to benefit from and enjoy all their assets whilst also investing in the business through securing loan finance. The two have quite different circumstances. HMRC acknowledges that the IHT position will be different for the seller and the borrower as a result of the new provisions, with the equity investment by the seller now more advantageous than a debt financed investment by the borrower from an IHT perspective. However, there is also an inconsistency in the current rules in how liabilities are treated for IHT purposes, which the new provisions address, as explained in paragraphs 2.4 and 7.3. The Government considers that it is more important to ensure that the tax system neither penalises nor encourages particular borrowing arrangements than continuing the previous position of treating

89 HMRC, "Treatment of liabilities for inheritance tax: HMRC response to comments on Schedule 36 Finance Act 2013" (September 2013) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2013/09/130905%20IHT%20Liabilities%20-%20HMRC%20response%20note.pdf*

investments by borrowers and sellers the same. [90]

65.37.5 *2013 changes to IHT deduction: How it seemed to HMRC*

I quote the press release announcing the 2013 changes at some length as:
(1) It illustrates the current state of UK tax policy formation.
(2) It illustrates the difficulties which may arise if one looks to a press release to identify the policy of tax provisions.

The FA 2013 introduced 3 reforms, but the press release treats all three as if they were a single item of reform.

I insert question marks at the more startling half-truths: no further elaboration is needed.

> **Inheritance tax: limiting the deduction for liabilities**
> **Who is likely to be affected?**
> Users and promoters of avoidance schemes and participators in arrangements which take advantage of the current IHT treatment of liabilities to reduce the value of an estate. (?)
> **General description of the measure**
> For most estates, liabilities owed by the deceased in the normal course of events where the debt has been repaid after death will continue to be deducted as they are now. (?)
> **Policy objective**
> The measure will remove the tax advantage that these schemes and arrangements seek to achieve, and ensure that the value of an estate subject to IHT reflects the normal economic consequences of incurring a liability. (?)
> **Background to the measure**
> The measure is a response to avoidance schemes and arrangements which exploit the current rules that allow a deduction for liabilities owed by the deceased against the value of an estate regardless of whether or not the debt is paid after death. Some arrangements involve contrived debts which are subsequently not repaid so there is no real reduction in the value of the estate; others involve loans used to acquire assets which are not chargeable to IHT, or which qualify for a relief, so that the value of the estate is doubly reduced.
> The measure has not been previously announced. There has been no

90 HMRC, "Treatment of liabilities for inheritance tax: HMRC response to comments on Schedule 36 Finance Act 2013" (September 2013) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2013/09/130905%20IHT%20Liabilities%20-%20HMRC%20response%20note.pdf*

consultation on the measure.

Summary of impacts[91]

2013-14	2014-15	2015-16	2016-17	2017-18
+5	+20	+15	+15	+15

Impact on individuals and households

This measure will only (?) affect individuals entering into avoidance schemes involving debts to artificially reduce the value of an estate.

The administrative impact of this measure is not on the deceased individual but rather on those acting as executors or administrators of the estate. (?) Personal representatives will need to ensure that any outstanding loans are repaid in order to claim the deduction against the value of the estate.

This measure will affect only a small number of individuals and households (?) as the base of estates that fall within the charge to IHT is fairly small (it is estimated for 2010-11 that there will have been approximately 17,000 estates left on death paying IHT, representing less than 4 per cent of the total). Of the estates left on death a few hundred are likely to be using one of these schemes. (?)

Impact on business including civil society organisations

There is unlikely to be any impact on most businesses because normal commercial debts will be unaffected. (?)[92]

No doubt the press release does not fully represent HMRC's thinking and motivation; every proposal of law reform has to be "sold" to its target audience(s). Subject to that, the principle of Hanlon's razor suggests it should be taken at face value. If this press release is taken as typical, the Court's policy of not having regard to press releases in the construction of statutes, or in the ascertainment of the policy of tax provisions, is a wise one.

65.37.6 *Commentary*

HMRC are wrong to classify the arrangements caught by the provisions as avoidance, or principally avoidance, except in the debased sense that anything one dislikes in tax involves avoidance.

The idea of a disallowance of (effectively) a double deduction is an

91 Author's footnote: These figures seem to me to be a significant underestimate; but that is a matter of impression rather than knowledge or research.

92 HMRC & HM Treasury budget announcement, "Overview of Tax Legislation and Rates" (March 2013) *http://www.hmrc.gov.uk/budget2013/ootlar-main.pdf*.

understandable policy; though so far as the provisions go beyond preventing a double deduction they are difficult to justify; and it is open to question whether the problem justifies the complication of the provisions.

These issues should have been debated before enactment; but in the UK tax system provisions brought in under a tax avoidance banner are exempt from the Tax Consultation Framework; the tax avoidance siren drowns out the sound of reasoned argument, and we are faced with the more familiar process of legislate first and think later. Had the matter been dealt with in accordance with the Tax Consultation Framework, it seems safe to say that different rules would have resulted.

I expect another round of amendments will follow soon.

65.38 Funeral expenses

Funeral expenses are not, strictly, a debt of the deceased, but there is a relief as if they were. Section 172 IHTA provides:

> In determining the value of a person's estate immediately before his death, allowance shall be made for reasonable funeral expenses.

The IHT Manual provides:

> **10376 Overseas funerals of non-domiciled deceased** [April 2010]
> You should allow overseas funeral expenses as a deduction against the UK estate, even if the deceased was not domiciled in the UK for IHT purposes.
> Although s.162(5) IHTA 1984 might seem to justify the deduction of such expenses from the non-UK estate, that sub-section cannot apply as funeral expenses are not a liability for the purposes of s.5 IHTA 1984 or s.162 IHTA 1984.

CHAPTER SIXTY SIX

IHT PLANNING BEFORE AND AFTER A CHANGE OF DOMICILE

66.1 IHT planning in anticipation of acquiring UK domicile

The basic strategy for the foreign domiciliary is to transfer their assets to a trust. If the settlor has a foreign domicile when at the time the trust is made, settled property can be excluded property and will retain that status indefinitely, even if the settlor later become domiciled here. This has been common practice since 1975, and HMRC accept it.

66.1.1 *Time limit*

The opportunity, once missed, cannot be regained so it is desirable to ascertain the exact moment when a UK domicile is acquired. There are three possibilities:

(1) The individual who has decided to make a permanent home in the UK will acquire a UK domicile as soon as they arrive here. Such an individual must carry out the tax planning before setting foot in this country.

(2) The individual who arrives here to take up residence without such an intention will acquire a UK domicile if and when they later form the intention to live here permanently. They must carry out the tax planning before their mind is made up, ie while their long-term intentions remain unclear.

(3) The individual who arrives and remains residing in the UK without deciding to live here permanently will acquire a deemed UK domicile after 15 to 17 years' residence here: see 61.2 (S.267 deemed UK domicile). This is the long-stop deadline for the IHT planning, although limited planning opportunities remain available for the deemed domiciliary: see 61.7 (Tax planning for the deemed domiciliary).

66.1.2 *Form of trust*

A life interest trust will normally be suitable, ie:

(1) income is to be paid to the settlor for life;

(2) subject thereto the trust fund held on discretionary trusts for the benefit of the family of the settlor.

Trust income will belong to the life tenant but (if not UK domiciled) they may mandate the trustees to retain the income and add it to capital. This may be useful to avoid relevant income: see 30.17 (Is income of life tenant relevant income?).

A simple discretionary settlement is a possible alternative.

66.2 IHT planning: Trust with foreign domiciled settlor

There are two general points. The first is to avoid UK situate property, at least at the time when it matters: see 62.23 (IHT planning for individual).

Trust property in a settlement created by a true foreign domiciliary can remain effectively free of IHT so long as the trust continues to exist. The trustees should be reluctant to appoint trust capital to a beneficiary who is or may become UK domiciled; that property may cease to be excluded property. On the contrary, if necessary, steps should be taken to extend its life by exercising powers of appointment or advancement.

If a UK domiciled beneficiary has substantial assets in their own estate then it may be worth adopting a policy of gradually spending their own assets while allowing their trust fund to accumulate or invest for capital growth. It may be attractive for the beneficiary to purchase an income tax efficient annuity.

66.3 Trust with UK domiciled settlor who later acquires foreign domicile

What is the best form of tax planning where a settlor has made a settlement while UK domiciled and later acquires a foreign domicile? If nothing is done the trust property cannot be excluded property.

A good solution is to transfer the trust property back to the settlor. That may be impractical if the settlor is not a beneficiary and commercial or foreign tax or UK CGT considerations make this course unattractive.

In such a case, a second-best but workable solution may be:

(1) the settlor creates a new trust; and

(2) the trustees of the old trust transfer the trust property to the new trust.

See 64.7 (Transfer from trust made by A to another trust made by A).

CHAPTER SIXTY SEVEN

IHT ON DEATH: WILLS AND IOVs

67.1 IHT spouse exemption

Section 18(1) IHTA provides:

> A transfer of value is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner or,
> [b] so far as the value transferred is not so attributable, to the extent that the estate is increased.

I refer to this as "**the IHT spouse exemption**".

67.1.1 *Cross references*

A full discussion of the IHT spouse[1] exemption needs a book to itself. Section 18(3) IHTA and s.56 IHTA contain anti-avoidance provisions which are not discussed because they are not close to the themes of this work, and I have discussed them elsewhere.[2] I deal with other IHT spouse exemption issues as they arise in the context of other topics, see:

73.2 (Restricted IHT spouse exemption for foreign domiciled spouse)
77.3.4 (IHT spouse exemption on death of account holder)
63.10 (GWR spouse exemption); 63.19 (IHT spouse exemption defence to GWR death charge).

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1 References to spouse, include a civil partner; see App 1.3 ("Spouse" and related expressions) and App 1.4 (Meaning of "civil partner").

2 There is a full discussion on the (almost) identical charity provisions in Kessler & Marre, *Taxation of Charities and Nonprofit Organisations*, (9th ed., 2013), (online version *http://www.taxationofcharities.co.uk*).

67.2 Interaction of IHT spouse exemption and excluded property

Suppose:

(1) H (not UK domiciled) dies leaving an estate which consists of:
   (a) UK property (not excluded property), and
   (b) foreign situate property (which is excluded property).
(2) Part of H's estate passes[3] to H's widow W.

This raises the interesting question of the interaction of the excluded property rules and the IHT spouse exemption. Sections 4 and 5 IHTA provide:

> **4 Transfers on death**
> (1) On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death. ...
> **5 Meaning of estate**
> (1) For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that ...
> (b) the estate of a person immediately before his death does not include excluded property...

The following propositions are clear:

(1) IHT is charged as if H made a transfer of value ("the deemed transfer of value").
(2) The estate of H immediately before H's death does not include H's excluded property.
(3) The value transferred by the deemed transfer of value is equal to the value of H's estate (which is the value of the UK situate property).

67.2.1 *Gift of excluded property to spouse*

Suppose that on the death of H only H's foreign situate (excluded) property passes to H's spouse. Does the spouse exemption apply? Section 18(1) IHTA provides:

> A transfer of value is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner or,

3 By will, by survivorship or by the relevant succession law; this makes no difference.

> [b] so far as the value transferred is not so attributable, to the extent that the estate is increased.[4]

The deemed transfer of value is not exempt under s.18(1)[a]. There is "property which becomes comprised in the estate of the spouse". However, the value transferred is not attributable to that property. That leaves the exemption in s.18(1)[b]. A transfer of value is an exempt transfer to the extent that the estate of the spouse is increased. The estate of the spouse is increased on the death of H.[5] It is therefore considered that the spouse exemption does apply on a plain reading of the words.[6] Is this result so absurd that the courts should not adopt a plain reading? I do not see why it should be regarded as absurd. If W is UK domiciled the application of the spouse exemption on the death of H is reasonable, because W's estate is increased and the property W receives will be subject to tax on the death of W. It might be said to be anomalous because a simple lifetime gift of excluded property by H to H's spouse would not be a transfer of value, so it would not qualify as an exempt transfer under the IHT spouse exemption. But of course in such a case the spouse exemption is not needed.[7] If the contrary view were adopted, then the practical consequence should not be to raise more funds for HMRC, but only to pose a trap for taxpayers and their advisors.

67.2.2 *Pecuniary legacy to spouse*

Suppose H leaves W a pecuniary legacy. The IHT Manual provides:

> **11013 Quantifying the exemption** [July 2011]
> ... *Example* ...
> • Where the will of a person domiciled abroad disposes of their UK estate and some or all of their world estate, exemption for pecuniary legacies should be given against the UK estate in the proportion it bears to the worldwide estate, and not against the UK estate alone. Any case where you have difficulty obtaining details of the world estate, or where

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4 In the case considered here the restriction in s.18(2) does not apply since H (the transferor) is not domiciled in the UK.

5 This is the case even if the property is excluded property in the estate of W (which will be the case if W was not UK domiciled). Excluded property is "property" for IHT and (except immediately before death) a person's estate includes their excluded property.

6 Exemption is given to the extent of the value of the property given to W.

7 The end result is consistent with the exemption for funeral expenses, which are set against UK property alone; see 65.37 (Funeral expenses).

> our official practice meets resistance, should be referred to Technical.

This is correct in relation to charities. The IHT charity exemption is more narrowly worded. But for spouses, it is not consistent with the words of s.18(1)[b]. It is suggested that the spouse exemption applies to the full extent of the pecuniary legacy. It makes no difference whether the pecuniary legacy is subsequently paid out of UK or foreign situate property.

Chapter 3 Part 2 IHTA (Allocation of Exemptions) does not shed much light on the issue. Section 36 IHTA provides that these rules apply where (*inter alia*) s.18 IHTA applies:

> in relation to a transfer of value but the transfer is not wholly exempt …

In the circumstances we are envisaging, the transfer will be "wholly exempt" if the value given to the spouse equals the value of the UK situate property. What happens if the value given to the spouse is less than the value of the UK situate property so the transfer is not wholly exempt? Let us assume that what the spouse receives is a "specific gift" as defined in s.42(1). Section 38(1) IHTA provides that:

> Such part of the value transferred shall be attributable to specific gifts as corresponds to the value of the gifts …

This confirms the view taken above.

67.3 Will drafting: General approach

There has always been considerable scope for tax saving through an appropriately drafted will. On disclosure rules on death, see 87.12 (Reporting on death of foreign domiciled individual).

67.3.1 *UK domiciled testator: Foreign domiciled beneficiaries*

Here the testator should in principle give their estate to beneficiaries absolutely so that the property may qualify as excluded property in their hands. A short-term discretionary will trust within s.144 IHTA is just as good from a tax viewpoint, and allows additional flexibility.

67.3.2 *Foreign domiciled testator: UK domiciled beneficiaries*

From an IHT viewpoint, the will should in principle provide that the estate is held on trust for the beneficiaries so that trust property situated outside the UK will remain excluded property.

67.3.3 *Gift to spouse by will: Foreign domiciled testator, foreign domiciled spouse*

Where a foreign domiciled testator has non-excluded property and excluded property, and the spouse is foreign domiciled so the IHT spouse exemption is fully available, the safe course will be:

(1) to give the non-excluded property to:
   (a) the spouse; or
   (b) a trust where the spouse has an interest in possession (better where the spouse is UK domiciled).
(2) to give excluded property to other persons.

A pecuniary legacy to the spouse should be charged on non-excluded property. Watch the drafting.

This course should avoid a dispute with HMRC. However, it is not necessary.

67.3.4 *Gift to spouse by will: UK domiciled testator and foreign domiciled spouse*

Where a UK domiciled testator has a foreign domiciled spouse, the usual IHT spouse exemption will only apply if the spouse makes the necessary election (ignoring the nil rate band allowance). That may or may not be desirable, depending on the position of the spouse.

The choice for the will lies between a discretionary will trust or an absolute gift to the foreign domiciled spouse. Which is better? If the property is given to the spouse, it is outside the scope of IHT thereafter, so long as it is not UK situate. If the property is given to a will trust, it remains within the scope of IHT, it is not excluded property, as the will trust has a UK domiciled settlor. So at first sight, the absolute gift seems better. Having said that, if property goes into the discretionary will trust and out to the spouse again within two years, the IHT position is just the same as a direct gift: s.144 IHTA 1984. And it may be desired to pass the property to others, perhaps giving it to the next generation (particularly if not UK domiciled). Also when the testator makes the will, one would not usually know the domicile position at the time of the death. If the spouse/civil partner lives long enough, she may become deemed UK domiciled for IHT purposes. All things considered, the discretionary will trust seems the more flexible and safer course for the will, in a routine case. In most cases, the will trust is likely to be wound up within two years. But the only cost is the cost of the deed of appointment.

67.3.5 *Charitable gift by will*

Where a foreign domiciled testator has non-excluded property and excluded property, the correct strategy will be:

(1) Give the non-excluded property to UK charities or EU charities which qualify for UK tax relief.[8]

(2) Give excluded property to other persons.

A pecuniary legacy to the charity should be charged on non-excluded property.

67.4 Instruments of variation ("IOVs")

The IHT Manual provides:

> **35094 Redirection of excluded property** [February 2006]
> Another scheme (see also IHTM35093) where the taxpayers seek to take advantage of the provisions of s.142 IHTA 1984 without there being a bona fide variation is where the estate contains excluded property such as government securities.
> The deceased, domiciled outside the UK, may leave property in this country to chargeable beneficiaries and excluded property to the spouse or civil partner. An IoV may then be used for the spouse's or civil partner's entitlement to be switched from excluded property to the ordinary UK estate without any change in the amount the spouse or civil partner receives.
> You should refer cases of this type immediately above to TG (IHTM01081) without making any preliminary enquiries provided the basic facts are clear.

I do not understand in what sense it could be said that this is not a "bona fide variation".[9] Section 142(5) IHTA expressly envisages an IOV relating to excluded property.

A variation of this kind cannot sensibly be challenged if properly carried out. If the author's view of the spouse exemption is right, however, an IOV would not be necessary. It may nevertheless be desirable as a useful precaution where a will has not been drafted in the manner recommended above.

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8 See Kessler & Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013), (online version *http://www.taxationofcharities.co.uk*).

9 It would be different if there was an arrangement under which the spouse later swapped the UK property for the excluded property.

67.5 Forced heirship, legitime & Sharia rights

It sometimes happens that:

(1) A will creates a trust ("the will trust").[10]

(2) A spouse or child ("the beneficiary") has a forced heirship right which may override the trust. Such rights are known as *legitime* in civil law jurisdictions (in Scotland, *legitim*); some jurisdictions apply principles of Sharia law which may also confer such rights.

There are express provisions for legitim in Scotland, which are not discussed here.[11]

The beneficiary's forced heirship right may be an asset for CGT purposes, so that disclaimer or other disposal of the right may give rise to a chargeable gain. A remittance basis taxpayer may not be concerned as the asset is not UK situate, and if a gain is deemed to accrue on a disclaimer of the forced heirship right, the gain cannot be remitted to the UK. Otherwise, the best course (if the beneficiary agrees, and if the foreign law allows) may be that the beneficiary disclaims the forced heirship right by an instrument in writing within two years of the death. The asset will then be ignored for CGT purposes: s.62 TCGA. The CGT analysis in the absence of a variation within s.62 is a difficult topic, not considered here.

Similarly, the beneficiary's forced heirship right might be property for IHT purposes.[12] A foreign domiciled beneficiary would not be concerned as the asset is not UK situate. Otherwise, the best course (if possible) may be that the beneficiary disclaims the forced heirship right by an instrument in writing within two years of the death. The right will then be ignored for IHT purposes: s.142 IHTA.

The testator (not the beneficiary) is the settlor of the will trust for tax purposes, notwithstanding the disclaimer.[13]

The position may be different if under the applicable law the effect of the forced heirship rights is that the will trust is void *ab initio*, so that

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10 Similar issues arise if the will makes a gift to another beneficiary who transfers the assets to a trust.

11 See Kessler & Grant, *Drafting Trusts & Will Trusts in Scotland* (2013) para 17.5 (Legal rights of legitim).

12 The forced heirship right may constitute a "settlement power" which is not property for IHT purposes.

13 See 80.13 (Disclaimer).

disclaimer is not possible; that would require an investigation into the applicable foreign law, which is not possible here.

CHAPTER SIXTY EIGHT

DOUBLE INHERITANCE TAXATION - INTRODUCTION

68.1 International estate and inheritance taxes

Many states (though by no means all) impose tax on the transfer of wealth occurring on death. These taxes may be divided into two types:

(1) The taxable person may be the deceased or his/her estate.

(2) The taxable persons may be the beneficiaries of the estate (the heirs).

In international tax terminology, type (1) is called an estate tax and type (2) is called an inheritance tax. Under this terminology IHT is strictly an estate tax and its title "inheritance tax" is a misnomer. However no confusion arises as long as one remembers that and I use the term "inheritance taxes" to include both types.

Jurisdiction to charge inheritance tax (as for income tax) is normally based one of two criteria:

(1) personal nexus to the state: domicile, residence or nationality or the deceased or of the beneficiary;

(2) situs of assets (a source rule).

These differing criteria are the cause of double inheritance taxation:

(1) **Residence-source conflict** when

   (a) State A imposes tax on the deceased (estate tax) or the heir (inheritance tax) because of their personal nexus to the state (residence, domicile or nationality),

   (b) State B imposes tax because the assets are situate in that state.

A residence-source conflict will result in the double taxation of the assets situate in state B.

(2) **Residence-residence conflict** when more than one state imposes tax on the same person because of their residence, domicile or nationality. A residence- residence conflict will typically result in double taxation on worldwide assets.

(3) **Source-source conflict** where state A regards an asset as situate in state A and state B regards the asset as situate in state B, because they have different rules determining situs. Here the conflict results in double taxation on the dual situate assets.

For a general discussion of the problems, see Study on Inheritance Taxes in EU Member States and Possible Mechanisms to Resolve Problems of Double Inheritance Taxation in the EU.[1]

68.2 Incorporation of IHT DTAs into UK law

International treaties (including DTAs) do not automatically become part of UK law, but must be incorporated into UK law by statute. Accordingly, s.158(1) IHTA provides:

> If Her Majesty by Order in Council declares—
>
> (a) that arrangements specified in the Order have been made with the government of any territory outside the UK with a view to affording relief from double taxation in relation to capital transfer tax payable under the laws of the UK and any tax imposed under the laws of that territory which is of a similar character or is chargeable on or by reference to death or gifts inter vivos, and
>
> (b) that it is expedient that those arrangements should have effect, the arrangements shall, notwithstanding anything in this Act, have effect
>
> [i] so far as they provide for relief from capital transfer tax, or
>
> [ii] for determining the place where any property is to be treated as situated for the purposes of the tax.

Under s.158(1)[ii] a DTA could in theory *increase* the scope of IHT, by providing that property which is not UK situate on general principles is to be regarded as UK situate. However in practice DTAs do not do this.

68.3 IHT double taxation treaties

In the following four chapters I consider:

(1) the pre-CTT IHT DTAs (India, Pakistan, Italy and France.)

(2) the USA IHT treaty

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1 Copenhagen Economics, commissioned by the European Commission, Directorate-General for Taxation and Customs Union, Aug 2010. *http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/2010/08/inheritance_taxes_report_2010_08_26_en.pdf*

(3) the Switzerland IHT treaty
(4) foreign IHT credit relief
The UK also has IHT DTAs with Ireland, Netherlands, South Africa and Sweden: I hope to discuss these in future editions.

68.3.1 *The OECD model*

The OECD approved their Estate and Inheritance Draft Model Convention in 1966. This model was revised in 1982 (Model Double Taxation Convention on Estates and Inheritances and on Gifts). It is therefore somewhat outdated.

68.4 EU law aspects and the future

The CJEU have ruled that EU law does not oblige Member States to eliminate double inheritance taxation.[2] However the European Commission are looking at this area. In 2011 the EC stated:

> EU citizens that inherit foreign property are frequently faced with a tax bill from more than one Member State. In fact, in extreme cases the total value of a cross-border inherited asset might even have to be paid in tax, because several Member States may claim taxing rights on the same inheritance or tax foreign inheritances more heavily than local inheritances. Citizens may be forced to sell inherited assets, just to cover the taxes, and small businesses may face transfer difficulties on the death of their owners. To tackle these problems, the Commission today adopted a comprehensive package on inheritance taxation. Through a Communication, Recommendation and Working Paper, the Commission analyses the problems and presents solutions related to cross-border inheritance tax in the EU. ...
> there are two main problems when it comes to cross-border inheritance tax in the EU:
> The first is double or multiple taxation, where more than one Member State claims the right to tax the same inheritance. Divergent national rules, a shortage of bilateral inheritance tax conventions, and inadequate national double tax relief measures can result in citizens being taxed twice or more on the same inheritance. Member States are free to apply national inheritance rules as they see fit once they are in line with EU rules on non-discrimination and free movement. The Commission is not proposing any harmonisation of Member States' inheritance tax rules. Instead it is recommending a broader and more flexible application of

2 Case C-67/08 *Block*.

> national double taxation relief measures so as to provide a pragmatic, speedy and cost-effective solution to the significant tax burdens facing many citizens. The Recommendation in today's Package suggests how Member States could improve existing national measures to ensure that there is adequate double tax relief. It sets out solutions for cases in which several Member States have taxing rights. The Commission invites Member States to introduce the appropriate solutions into national legislation or administrative practices.
>
> The second inheritance tax problem that citizens can encounter is discrimination...[3]
>
> Although cross-border inheritance tax problems may seriously affect individuals, revenues from domestic and cross-border inheritances taxes account for a very small share - less than 0.5% - of total tax revenues in Member States. Cross-border cases alone must account for far less than that figure.
>
> **Next steps**
>
> The Commission will launch discussions with Member States to ensure appropriate follow up to the Recommendation. ... In 3 years time, the Commission will present an evaluation report showing how the situation has evolved, and decide on this basis whether further measures are necessary at national or EU level. ...[4]

A consultation paper was published in April 2014.[5]

Accordingly, some major changes can be expected in this area in a few years time.

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3 See 60.11 (IHT and EU law).

4 Press release IP/11/1551. For the Communication, Recommendation and Staff Working Paper, see: *http://ec.europa.eu/taxation_customs/taxation/personal_tax/inheritance/index_en.htm*

5 EC, "Consultation on cross-border inheritance tax problems within the EU" *http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/inheritance/question_en.pdf*

CHAPTER SIXTY NINE

IHT DTAs: INDIA, PAKISTAN, ITALY, FRANCE

69.1 IHT double tax treaties: Introduction

In recent times the UK has had three death/gift taxes:
Estate Duty: 1894 - 1974
Capital Transfer Tax: 1974 - 1986
Inheritance Tax: 1986 -

In this chapter I consider the four IHT double tax treaties which were made in the Estate Duty era. I refer to these as "**the India, Pakistan, Italy and France IHT DTAs**"[1] or together as "**the Estate Duty DTAs**". These treaties are important to those who are deemed domiciled in the UK, but treaty-domiciled in India, Pakistan, Italy or France.

I comment only on the UK aspects of the treaties. Foreign law advice will also be needed in any case where a treaty applies. The provisions

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1 For some reason DTAs do not have short titles. The full titles are:
(1) Agreement between the Government of the United Kingdom and the Government of India for the avoidance of double taxation and the prevention of fiscal evasion with respect to duties on the estates of deceased persons [SI 1956 No. 998]
(2) Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Pakistan for the avoidance of double taxation and the prevention of fiscal evasion with respect to duties on the estates of deceased persons [SI 1957 No. 1522]
(3) Convention between the United Kingdom of Great Britain and Northern Ireland and France for the avoidance of double taxation with respect to duties on the estates of deceased persons [SI 1963 No. 1319]
(4) Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Italian Republic for the avoidance of double taxation and the prevention of fiscal evasion with respect to duties on the estates of deceased persons [SI 1968 No. 304]
Text accessible on *http://www.legislation.gov.uk*

relating to exchange of information are not discussed.

The four Estate Duty DTAs are similar but not identical, and the many small differences can be important. This does make a coherent exposition rather difficult. It is surprising that no standard model form was adopted, but there it is. It does make one appreciate the tremendous value of the OECD model IT/CGT convention.

69.2 Application of Estate Duty DTAs to IHT

India IHT DTA Art. I provides:

> The duties which are the subject of the present Agreement are
> (a) In India, the estate duty imposed under the Estate Duty Act, 1953, and
> (b) In the UK, the estate duty imposed in Great Britain.

The treaty refers to UK estate duty, but it is extended to IHT by s.158(6) IHTA:

> Where arrangements with the government of any territory outside the UK are specified under any Order in Council which—
> (a) was made, or has effect as made, under section 54 of the Finance (No 2) Act 1945 or section 2 of the Finance Act (Northern Ireland) 1946, and
> (b) had effect immediately before the passing of this Act,
> the Order shall, notwithstanding the repeal of that section by the Finance Act 1975 remain in force and have effect as if any provision made by those arrangements in relation to estate duty extended to capital transfer tax[2] chargeable by virtue of section 4 above; ...[3]

The treaty refers to estate duty imposed in Great Britain, it also applies to duty (and IHT) imposed in Northern Ireland.[4]

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2 The reference to CTT has effect as a reference to IHT: s.100 FA 1986.

3 The Italy treaty adds:
"The present Convention shall also apply to any other duties of a substantially similar character to the duties referred to in para (1) above which may be imposed in Great Britain or Italy subsequently to the date of signature of the present Convention."
This is also in the France and Pakistan DTAs. It is missing from the India treaty but it makes no difference as s.158 does the same work.

4 India IHT DTA Art. X provides: "The present Agreement shall apply in relation to the estate duty imposed in Northern Ireland as it applies in relation to the estate duty in Great Britain, but shall be separately terminable in respect of Northern Ireland by

The Pakistan, Italy and France IHT DTAs are substantially the same: see Arts. I and II of each DTA.

69.3 Interpretation

69.3.1 *Treaty definitions*

Art II(1) India IHT DTA provides some commonsense definitions:

> In the present Agreement, unless the context otherwise requires:—
> (a) The term "India" means all the States and territories comprised in the Union of India;
> (b) The term "United Kingdom" means Great Britain and Northern Ireland;
> (c) The term "Great Britain" means England, Wales and Scotland and does not include the Channel Islands and the Isle of Man;
> (d) The term "territory" when used in relation to one or the other Contracting Government means India or Great Britain, as the context requires;
> (e) The term "duty" means the estate duty imposed in India or the estate duty imposed in Great Britain, as the context requires.

69.3.2 *Undefined terms have domestic law meanings*

Art II(3) India IHT DTA provides:

> In the application of the provisions of the present Agreement by either Contracting Government, any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the law of that Contracting Government relating to duty.

This is (more or less) standard OECD model wording: see 57.11 (Undefined terms have domestic law meanings).

69.4 Treaty IHT exemption

Each treaty provides an IHT exemption in slightly different terms.

India IHT DTA Art. III(3) provides:

> [a] Duty shall not be imposed in Great Britain on the death of a person who was not domiciled at the time of his death in any part of Great Britain but was domiciled in some part of India on any property situated outside Great Britain:

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the same procedure as is laid down in Article XII." This was because Northern Ireland was from 1921 a separate unit for estate duty purposes.

> [b] Provided that nothing in this paragraph shall prevent the imposition of duty in Great Britain on any property which passes under a disposition or devolution regulated by the law of some part of Great Britain.

Italy IHT DTA Art. V(2) provides:

> Where duty is imposed in the territory of one Contracting Party on the death of a person who at the time of his death was not domiciled in any part of that territory but was domiciled in some part of the territory of the other Contracting Party, no account shall be taken, in determining the amount or rate of such duty, of property situated outside the former territory, provided that this paragraph shall not apply to duty imposed in the territory of a Contracting Party on property passing under a settlement governed by its law.

France IHT DTA Art. V(1) provides:

> Where a person was at the time of his death domiciled in some part of France duty shall not be imposed in Great Britain on any property which neither is situated in Great Britain, nor passes under a disposition or devolution regulated by the law of some part of Great Britain; and, in determining the amount or rate of duty payable in Great Britain, such property shall be disregarded.

I refer to this as "**treaty IHT exemption**".

The exemption applies to duty imposed on a death.[5] That includes the charge which applies on property in the individual's free estate, and property in an estate IIP trust.

It is considered that the exemption also applies to property within the GWR charge on death (assuming the property is not UK situate). Such property does not "pass under a disposition or devolution regulated by the law of some part of Great Britain" since it does not pass under a disposition at all.

Treaty exemption does not apply to property situated in Great Britain, but read literally, it does apply to property situated in Northern Ireland. It is suggested that India IHT DTA Art. X justifies a purposive construction under which references to property situated in Great Britain include property situated in Northern Ireland.

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5 This is stated expressly in the India, Pakistan and Italy IHT DTAs. In the France IHT DTA it is not stated expressly but is clearly implied.

The Pakistan IHT DTA contains an amusing error. Pakistan DTA Art.V(2) provides:

> Where a person at the time of his death was domiciled in some part of Pakistan and was not domiciled in some part of Great Britain, duty shall not be imposed in Great Britain on any property which for the purposes of duty passes or is deemed to pass on his death unless that property—
>
> (a) is situated in Pakistan [*sic*], or
>
> (b) passes under a disposition or devolution regulated by the law of some part of Great Britain;
>
> and, in determining the amount or rate of duty payable in Great Britain, property not falling within sub-para (a) or (b) shall be disregarded.

There is clearly a typographical error here and the word "Pakistan" in (a) should read "Great Britain".[6] It is considered that the error can be corrected as a matter of construction under the slip rule. HMRC practice (rightly) adopts this view.[7]

69.4.1 *Failed PET*

What about the charge on a lifetime PET which becomes a chargeable transfer because the transferor dies within 7 years, known as a "**failed PET**"? The treaties must be considered separately, since the wording of each treaty IHT exemption varies.

India and Italy IHT DTAs provide exemption from duty *on the death*. In the case of a failed PET, the IHT charge is on the lifetime transfer of

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6 I am grateful to Simon McKie for drawing this point to my attention. The corresponding mistake is made in Art V(1):

> "Where a person at the time of his death was domiciled in some part of Great Britain and was not domiciled in some part of Pakistan, duty shall not be imposed in Pakistan on any property which for the purposes of duty passes or is deemed to pass on his death unless that property—
>
> (a) is situated in Great Britain [*sic*], or
>
> (b) is settled property of which the deceased was life tenant where the settlor was domiciled in some part of Pakistan at the time that the settlement took effect, or
>
> (c) passes under a devolution regulated by the law of some part of Pakistan and in determining the amount or rate of duty payable in Pakistan, property falling within (a), (b), or (c) shall be disregarded.
>
> and, in determining the amount or rate of duty payable in Great Britain, property not falling within sub-para (a) or (b) shall be disregarded."

In some published versions the error has been corrected, but I am not aware of any authority for that. The original is accessible on *http://www.kessler.co.uk/tfd-archive*.

7 Private correspondence.

value. Strictly, the charge is not "on the death", even though it is only on the occasion of death that the transfer becomes chargeable. However a purposive construction is appropriate. The relief would have applied to the estate duty charge on lifetime gifts within 7 years of death. In substance the charge on failed PETs is a charge on death. This is a strong argument, for treaties are not interpreted strictly or literally. A relief for a charge "on" the death means a relief for a charge which becomes payable *at the time of* the death.[8]

In France, the IHT exemption does seem to apply to a failed PET since the words "on the death" are not present, and the point does not arise.

In Pakistan the case for IHT exemption seems somewhat weaker since it is a very loose construction to say that the charge on a failed PET is a charge on property which "passes or is deemed to pass" on a death (the terminology is from Estate Duty legislation where it had a somewhat technical meaning). Nevertheless the purposive argument is still arguable.

However there is a serious difficulty. Section 158(6) IHTA provides that the treaties have effect only in relation to IHT "chargeable by virtue of s.4 IHTA". The IHT charge on a failed PET is not under s.4, so the treaty does not have effect in relation to that charge. It is considered, therefore, that although the terms of the treaties of France (relatively clearly), India and Italy (reasonably clearly) and Pakistan (arguably) do provide relief for a failed PET, this does not help the taxpayer, because UK domestic law (in breach of the treaty obligations) does not do so.

HMRC take the view that treaty relief does not apply to a PET. This can be inferred from a passage in the IHT Manual:

> **IHTM13024 - Change of Domicile: Deemed Domicile** [November 2013]
> ...domicile does not include deemed domicile...when considering the double taxation agreements (IHTM27161) with France, Italy, India or Pakistan (though where there is a common law domicile in France, Italy, India or Pakistan, IHTA84/S267 can apply to chargeable lifetime transfers).

The conclusion is that there is no treaty relief for a failed PET. This is

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8 Further support can be found from the area of transferable nil-rate bands. This relief increase the nil-rate band "for the purposes of the charge to tax *on the death* of the survivor"; see s.8A(3) IHTA. HMRC accept that this relief applies to the charge on a failed PET.

odd, perhaps absurd. But the treaties give rise to many other anomalies. There is no relief on ten-year charges on trusts. There is no relief on a lifetime chargeable transfer which is not a PET, such as a straightforward gift to a trust.[9]

69.4.2 *Planning*

This raises tricky planning choices for a person who qualifies for treaty IHT exemption. One strategy is for an elderly individual *not* to make any gifts, to retain property until death. The lifetime gift may be taxable and the death estate tax free. But the risk of that approach is that by the time of the death the treaty may have been repealed. The lifetime gift may be better—if the donor survives seven, or at least three years.

Sometimes one spouse is and the other is not within the scope of the treaty. In that case inter-spouse gifts (or will trusts conferring an IIP on the appropriate spouse) will bring the property within the scope of the treaty.

69.5 Domicile requirements of treaty IHT exemption

Art II(2) India IHT DTA provides:

> For the purposes of the present Agreement, the question whether a deceased person was at the time of his death domiciled in any part of the territory of one of the Contracting Governments shall be determined in accordance with the law in force in that territory.

So the question of whether a person is domiciled in the UK is determined according to UK legal principles, and the question whether a person is domiciled in India is determined on Indian legal principles. This is needed because (on general treaty interpretation principles[10]), in the application of the DTA in the UK, the term domicile would otherwise be given its UK law meaning.

69.5.1 *Individual not UK domiciled*

A requirement for IHT exemption in the India and Pakistan DTAs is that the individual must not be domiciled in the UK (applying UK laws). For this purpose the IHT deemed domicile rules do not apply. Section 267(2) IHTA provides:

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9 It appears from an incoherent passage in the IHTM para 13024 that HMRC agree.

10 See 69.3.2 (Undefined terms have domestic law meanings).

> Subsection (1) above [deemed domicile rule] ... shall not affect the interpretation of any such provision as is mentioned in section 158(6) above [Estate Duty DTAs].

Similarly, s.267ZA(6) IHTA provides:

> An election under this section is to be ignored—
>
> (a) in interpreting any such provision as is mentioned in section 158(6), and
>
> (b) in determining the effect of any qualifying[11] double taxation relief arrangements in relation to a transfer of value by the person making the election.

The reason is that estate duty had no equivalent of the CTT/IHT deemed domicile rule. The subsequent application of a deemed domicile rule to the Estate Duty DTAs would have raised a number of difficulties.[12] The obvious solution was to keep the treaties free from the deemed domicile rules.

IHT exemption in the Italy IHT DTA also has the requirement that the individual is not domiciled in the UK. However, this treaty has a tie-breaker for an individual who is both domiciled in the UK and treaty-domiciled in Italy. If Italy wins under the tie-breaker, it is clear that the individual is regarded as not UK domiciled. So the requirement to be non-UK domiciled adds nothing.

IHT exemption in the France IHT DTA (which also has a domicile tie-breaker) does not include the requirement that the individual is not domiciled in the UK. Since the Italy IHT DTA (1968) came well after the France IHT DTA (1963) it is strange that the Italy wording did not copy the France one. But there it is.

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11 Defined in s.267ZA(7) IHTA: "For the purposes of subsection (6)(b) a qualifying double taxation relief arrangement is an arrangement which is specified in an Order in Council made under section 158 before the coming into force of this section (other than by way of amendment by an Order made on or after the coming into force of this section)."

12 It is an interesting question whether it would have been a breach of the treaties. Even if not a technical breach, the treaty countries could reasonably have objected. IHT deemed domiciled individuals would have suffered double taxation.
An alternative would have been to renegotiate existing treaties (introducing new rules at least for treaties which lacked a tie-breaker) but presumably that was thought to be impractical or too much trouble.

69.5.2 *Individual treaty-domiciled in foreign state*

The requirement for IHT exemption in each treaty is that the individual must be domiciled in the foreign state. But "domicile" here has a non-standard meaning so I refer to it as "**treaty-domicile**".

69.5.3 *Treaty-domicile: India*

The question whether one is domiciled in India is governed by the law of India. The law of domicile in India is governed by the Indian Succession Act 1925.[13] See Agrawal, *Private International Law in India* (2010); *Saini v State of Uttarakhand.*[14] That Act sets out statutory rules mostly based on the common law rules, and in *Saini* the Court referred to Halsbury's Laws of England, so it seems that Indian domicile law has not moved from its common law origins. India still applies the common law rule a married woman has the domicile of her husband as a domicile of dependency. However s.11 Indian Succession Act 1925 contains one provision which is not in English law:

> Any person may acquire a domicile in India by making and depositing in some office in India, appointed in this behalf by the State Government, a declaration in writing under his hand of his desire to acquire such domicile; provided that he has been resident in India for one year immediately preceding the time of his making such declaration.[15]

India is a single state for domicile purposes, so a person is domiciled in India, not in any part of India.[16]

69.5.4 *Treaty-domicile: Pakistan*

The Pakistan DTA is differently worded but the same in substance. Pakistan DTA Art. II(2) provides:

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13 *http://indianchristians.in/news/images/resources/pdf/indian_succession_act_1925.pdf*

14 AIR 2010 Utr 36 *http://www.indiankanoon.org/doc/1650776*

15 This is derived from a UK statute: s.2 Domicile Act 1861. this anticipated conventions with foreign states under which such rules could be mutually agreed. But no conventions were ever concluded, so the Act was a dead letter and finally repealed in 1971.

16 Article III India IHT DTA refers to a person being domiciled "in some part of India" but that may have reflected the position of the Princely States, and French and Portuguese territories, which subsequently became part of a unified India.

> For the purposes of the present Agreement, the question whether a deceased person was at the time of his death domiciled in any part of Great Britain or in any part of Pakistan shall be determined in accordance with the law in force in Great Britain and Pakistan respectively.

Thus the question whether one is domiciled in Pakistan is governed by the law of Pakistan.[17]

69.5.5 *Treaty-domicile: Italy and France*

Italy IHT DTA Art. II(2) repeats the India IHT DTA but goes on to add a tie-breaker clause:

> (a) For the purposes of the present Convention, the question whether a deceased person was domiciled at the time of his death in any part of the territory of one of the Contracting Parties shall be determined in accordance with the law in force in that territory.
> (b) Where by reason of the provisions of the preceding paragraph a deceased person is deemed to be domiciled in the territory of each of the Contracting Parties, then this case shall be solved in accordance with the following rules:
> (i) he shall be deemed to be domiciled in the territory of the Contracting Party in which he had a permanent home available to him at the time of his death; if he had a permanent home available to him in the territory of each of the Contracting Parties he shall be deemed to be domiciled in the territory of the Contracting Party with which his personal and economic relations were closest (centre of vital interests);

It is not often necessary to look beyond this point but, for completeness, the DTA continues.

> (ii) if the Contracting Party in whose territory he had his centre of vital interests cannot be determined, or if he had not a permanent home available to him in the territory of either Contracting Party, he shall be deemed to be domiciled in the territory of the Contracting Party

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17 *Dymond's Death Duties* (15th ed., 1973) states:

> "The Indian (and Pakistan) law (contained in the [Indian] Succession Act 1925) is basically similar to British law but somewhat less stringent in its requirements, ie. the conception of 'domicile' is a little nearer to that of 'residence'."

I would be grateful to any reader who could supply further information about the position under Pakistani law.

in which he had an habitual abode;

(iii) if he had an habitual abode in the territory of each of the Contracting Parties, or in the territory of neither, he shall be deemed to be domiciled in that of which he was a national;

(iv) if he was a national of both territories or of neither of them, the taxation authorities of the Contracting Parties shall determine the question by mutual agreement.

The tie-breaker wording follows the tie-breaker in the OECD Model Convention definition of residence, Art. 4(2) and reference should be made to the OECD Commentary.[18] France is the same as Italy: France IHT DTA Art. II(3). A key question is what is required for a person to be domiciled in Italy under Italian law.

69.6 Treaty-situs

The next requirement of treaty IHT exemption is that the property must not be situate in the UK. For this purpose the DTAs contain situs rules. It is therefore necessary to distinguish between ordinary IHT situs and what I shall call "**treaty-situs**". The rules are those recommended in a report on Double Taxation prepared for the League of Nations in 1923 by Professors Bruins and Seligman and our own Sir Josiah (later, Lord) Stamp, and the report is worth reading as it give the background. Some of the rules repeat the usual IHT situs rules and others are different.

69.6.1 *Treaty-situs: India, Pakistan, Italy*

India IHT DTA Art. IV(1) provides:

> Subject to para (2) of this Article, where a person was at the time of his death domiciled in any part of the territory of one of the Contracting Governments, ...

This is the case we are considering.

> ... the situs of any property *which for the purposes of duty passes or is deemed to pass on his death* shall, for the purposes of the imposition of duty and of the credit to be allowed under Art. VI, be determined exclusively in accordance with the rules in Art. V of the present Agreement.

However there is a condition in Art. IV(2):

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18 See 6.8 (Tie-breaker tests for individuals).

> Para (1) of this Article shall apply if, and only if, apart from the said Art. V—
>
> (a) duty would be imposed on the property under the law of each of the Contracting Governments; or
>
> (b) duty would be imposed on the property under the law of one of the Contracting Governments and would, but for some specific exemption, also be imposed thereon under the law of the other Contracting Government.

This condition will never be satisfied under the Indian treaty, since estate duty in India was repealed in 1985. (Significantly, about the same time, the Thatcher Government was drawing the teeth of CTT, though the UK did not follow India all the way to abolition.) So the treaty-situs rules in the India IHT DTA will never apply.

Pakistan is the same: Pakistan IHT DTA Art. III. Pakistan's estate duty was abolished in 1979. One wonders why these treaties have survived, more than three decades after losing their *raison d'être.*

Italy and France are substantially the same.[19] They omit the phrase italicised above, but those words add nothing.

The Italy treaty-situs rules ceased to apply in 2001 because Italy abolished its succession duty and estate duty (*imposta sull'asse ereditario globale*) – a Berlusconi reform. However, in November 2006 the Prodi Government reintroduced a succession tax.

69.6.2 *Treaty-situs: France and Italy*

France retains its duty on successions on death, so the treaty-situs rules are relevant. I here set out the rules in the French Treaty Art. 4 highlighting in italic those significantly different from IHT-situs:

> The rules referred to in paragraph 1 of Article III are:
>
> (a) land shall be deemed to be situated at the place where it is located; rights or interests (otherwise than by way of security) which constitute immovable property shall be deemed to be situated at the place where the land to which they relate is located; the question whether rights or interests constitute immovable property shall be determined in accordance with the law of the place where the land to which they relate is located;
>
> (b) tangible movable property (other than such property for which specific provision is hereinafter made) and rights or interests (otherwise than by way

19 Italy IHT DTA Art. III.

of security) therein shall be deemed to be situated at the place where it is located at the time of the deceased person's death or, *if in transitu, at the place of destination*; and bank or currency notes or other forms of currency recognised as legal tender in the place of issue shall be treated as tangible movable property for the purpose of this subparagraph;

(c) *debts, secured or unsecured, excluding those for which specific provision is made in this Article, but including debentures and debenture stock issued by a company, bills of exchange, promissory notes and cheques shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;

(d) *securities issued by any government, county council, département, municipality or other public authority shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;

(e) *shares or stock in a company (including any such property held by a nominee, whether the beneficial ownership is evidenced by scrip certificates or otherwise) shall be deemed to be situated at the place where the company was incorporated*;

(f) *moneys payable under a policy of assurance or insurance shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;

(g) an interest in a partnership, which term includes a société en nom collectif, a société en commandite simple *and a société civile* under French law, shall be deemed to be situated at the place where the business is principally carried on; *and in the case of a société civile immobilière this shall be where the land developed in accordance with the objects of the société is located*;

(h) goodwill as a trade, business or professional asset shall be deemed to be situated at the place where the trade, business or profession to which it pertains is carried on;

(i) ships and aircraft and shares thereof shall be deemed to be situated at the place of registration of the ship or aircraft;

(j) *patents, trade marks, designs, copyright, and rights or licences to use any patent, trade mark, design or copyrighted material shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;

(k) *rights or causes of action ex-delicto*[20] *surviving for the benefit of the estate of a deceased person shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;

(l) *judgment debts shall be deemed to be situated at the place where the deceased person was domiciled at the time of his death*;

(m) *any other right or interest shall be deemed to be situated at the place determined by the law in force in the territory of the Contracting Party where the deceased person was not domiciled at the date of his death*.

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20 ie torts, not contractual rights.

69.7 Proper law

Treaty IHT exemption in India, Pakistan and France does not apply to property which passes under a disposition or devolution regulated by the law of some part of Great Britain.

Italy is not quite the same. The restriction is that the exemption does not apply to property passing under a *settlement* with a UK law (so the exemption could apply in Italy to property passing under a UK law will, but not elsewhere).

This follows estate duty principles, where the territorial limits of the tax depended partly on domicile and situs (as IHT) but also on whether the proper law of the disposition or devolution under which the property passes was a law of the UK. The requirement is not appropriate for the IHT regime, but logic is not to be expected when Estate Duty treaties are left unamended to apply to IHT.

This is a complex topic, with many cases to consider. The starting point is *Philipson-Stow v IRC* [1961] AC 727 where a testator domiciled in England left a will governed by English law. The estate included land in South Africa. The land passed under a disposition regulated by the law of South Africa, both on the death of the testator and on the death of a life tenant many years later (the trust having retained the land).[21]

Where relief is lost because an English law will applies, the problem could in principle be resolved by an IoV, though the drafting would require some care.

69.8 Transferable nil-rate bands and IHT DT reliefs[22]

Section 8A(1) IHTA provides:

> This section applies where—
>
> (a) immediately before the death of a person (a "deceased person"), the deceased person had a spouse or civil partner ("the survivor"), and
>
> (b) the deceased person had unused nil-rate band on death.

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21 For further discussion, see the scholarly Dymond's Death Duties, (15th ed., 1973) pp 1286–1312 and Parkinson, "A disposition or devolution regulated by the law of some part of Great Britain: the Proviso to the Limitation of Taxing Rights in the IHT Treaties with France, India and Pakistan" [2011] PCB 126.

22 For other issues relating to transferrable nil-rate bands, see 73.5 (Transferable nil-rate band).

Section 8A(2) IHTA defines "unused nil-rate band on death":

> A person has unused nil-rate band on death if M > VT where—
> M is the maximum amount that could be transferred by a chargeable transfer made (under section 4 above) on the person's death if it were to be wholly chargeable to tax at the rate of nil per cent. (assuming, if necessary, that the value of the person's estate were sufficient but otherwise having regard to the circumstances of the person); and
> VT is the value actually transferred by the chargeable transfer so made (or nil if no chargeable transfer is so made).

The amount of the unused nil-rate band depends on the amount of the chargeable transfer on the death of the first spouse. If there is no chargeable transfer, the full nil-rate band is unused and is transferrable.[23]

If there would be a chargeable transfer (but for IHT DT relief) does DTA (if applicable) make the transfer non-chargeable, so as to restore the unused nil-rate band? The IHTM para 43025 provides:

> **Transferable Nil Rate Band: interaction of ability to transfer unused nil rate band with double taxation agreements, double taxation relief and successive charges relief** [October 2009]
> The extent to which an estate is chargeable to tax may be governed by a double taxation agreement [IHTM27161], or a liability to tax may be reduced to nil by double taxation relief [IHTM27181] or successive charges relief [IHTM22041].
> [1] Where, under the terms of a double taxation agreement, an asset is not subject to tax, then if this means that the chargeable estate is below the nil rate band, the amount unused is available for transfer.
> [2] However, where there is a liability to tax that is reduced to nil by either double taxation relief or successive charges relief, the nil rate band remains fully used. We do not repay any "excess" relief and there is no provision to convert "excess" relief into unused nil rate band.

Unilateral IHT credit relief takes the form of a credit against IHT. It falls within [2]. Where that relief applies there is still a chargeable transfer so that transferrable NRB relief does not become available.

The India France and Pakistan IHT DTAs provide that "duty shall not be imposed" on certain property. The USA DTA provides that certain property "shall not be taxable" in the UK. These reliefs fall within [1]. It is not obvious that this prevents there being a chargeable transfer but it

23 S.8A(3)(4) IHTA.

might be said to follow from a commonsense reading. Treaties are not to be construed technically. HMRC read the legislation in this way, so that the transferable nil rate band is available to the surviving spouse.

The Italy IHT DTA provides that "No account shall be taken, in determining the amount or rate of duty" on death, in relation to certain property. It is considered that the effect is the same as the other Estate Duty DTAs.

69.9 Claims for treaty IHT exemption

A claim is required for foreign IHT credit relief or for a refund of tax.[24] There is no requirement to make a formal claim for treaty IHT exemption. However if an IHT account is in principle required on a death,[25] a treaty saying that tax "shall not be imposed" or property "shall not be taxable" (as most of the Estate Duty DTAs or the USA IHT DTA) does not override this requirement. The same applies to the differently worded exemption in the Italy IHT DTA ("no account shall be taken in determining the amount or rate of duty...").

Similarly, for an individual who is IHT deemed domiciled, the US treaty does not override the duty to disclose a lifetime chargeable transfer or the making of a non-resident settlement.[26]

So the usual returns should be made with a claim for DT relief.

69.10 Deductions for purposes of DTAs

Article V(1) Italy IHT DTA provides:

> In determining the amount on which duty is to be computed, permitted deductions shall be allowed in accordance with the law in force in the territory in which the duty is imposed.

This seems unnecessary. Perhaps there were Estate Duty or foreign law reasons for it? I would be grateful to any reader who could explain.

There is, or at least there was, a rule of Belgian tax law which disallowed a deduction for charges on Belgium property owned by a non-resident.[27] Maybe the provision was intended to undo discrimination of that kind?

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24 See 72.9 (Claims for foreign IHT credit relief).

25 See 87.12 (Reporting on death of foreign domiciled individual).

26 See 87.11 (IHT reporting requirement on creation of settlement).

27 In *Eckelkamp* Case C-11/07 the rule was held to breach of EU free movement of capital.

But the wording is not quite apt for that.

Identical wording is found in the Pakistan Treaty art 5(3) and also in some post-CTT DTAs, eg USA IHT art.8(1). There is no equivalent in other treaties but the omission does not matter.

CHAPTER SEVENTY

IHT DTA: USA

70.1 USA IHT treaty: Introduction

This chapter considers the USA IHT Treaty.[1]

For some reason DTAs do not have short titles. I use the expression "**USA IHT DTA**" (or, for short, just DTA) to refer to the DTA dated 19 October 1978 officially called "the Convention between the Government of the USA and the Government of the UK for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates of deceased persons and on gifts".

I comment only on the UK aspects of the treaty. US law advice will be needed in any case where the treaty applies.

70.1.1 *Cross references*

Issues and wording which the USA IHT DTA has in common with other treaties are discussed elsewhere. See:

69.8 (Transferable nil rate bands and IHT DT reliefs)
69.9 (Claims for treaty IHT exemption)
69.10 (Deductions for purposes of DTAs)
72.8 (USA DTA: Credit for foreign IHT)
72.9 (Claims for foreign IHT credit relief).

70.2 Scope

Article 1 USA IHT DTA provides:

> This Convention shall apply to any person who is within the scope of a tax which is the subject of this Convention.

Thus the DTA applies to trustees as well as to individuals, even if the

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1 The text is accessible on *http://uniset.ca/misc/us-uk_esttax.html*

trustees are not themselves USA treaty-domiciled.

70.3 Taxes covered

Article 2 USA IHT DTA provides:

> (1) The existing taxes to which this Convention shall apply are:
> (a) in the US: the Federal gift tax and the Federal estate tax, including the tax on generation-skipping transfers; and
> (b) in the UK: the capital transfer tax.
> (2) This Convention shall also apply to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws.

The DTA applies to IHT which is "substantially similar" to CTT. (Also see s.100 FA 1986 which provides that references to CTT have effect as a reference to IHT.)

70.3.1 *"Tax"*

Article 3(f) USA IHT DTA provides:

> the term "tax" means:
> (i) the Federal gift tax or the Federal estate tax, including the tax on generation-skipping transfers, imposed in the US, or
> (ii) the capital transfer tax imposed in the UK, or
> (iii) any other tax imposed by a Contracting State to which this Convention applies by virtue of the provisions of para (2) of Article 2, as the context requires.

70.4 Definitions

The DTA provides commonsense definitions of the following terms, which are not set out here: US; UK; Enterprise; Competent Authority; Contracting State.

Article 3(2) USA IHT DTA gives terms not otherwise defined their domestic law meanings, following the OECD model wording and commentary, as it stood at the time of the DTA. See 57.11 (Undefined terms have domestic law meanings).

70.4.1 *"National"*

Article 3(e) USA IHT DTA provides:

the term "nationals" means:

(i) in relation to the US, US citizens, and

(ii) in relation to the UK any citizen of the UK and Colonies, or any British subject not possessing that citizenship or the citizenship of any other Commonwealth country or territory, provided in either case he had the right of abode in the UK at the time of the death or a transfer.

70.4.2 *"Decedent"*

The DTA uses the term "decedent" which is an Americanism for "deceased".

70.5 Treaty-domicile

For present purposes there are three types of domicile:

(1) domicile in the ordinary UK law sense (**"UK-law domicile"**)

(2) deemed UK domicile for IHT (**"deemed UK domicile"**)

(3) domicile for the purposes of the treaty (**"treaty-domicile"**)

The definition of treaty-domicile is distinctly non-standard. Article 4(1) USA IHT DTA provides:

> For the purposes of this Convention an individual was domiciled:
>
> (a) in the US:
>
> [i] if he was a resident (domiciliary) thereof or
>
> [ii] if he was a national thereof and had been a resident (domiciliary) thereof at any time during the preceding three years

The definition of "resident (domiciliary)" is crucial: this is a matter of USA law.[2]

Article 4(1) USA IHT DTA provides:

> For the purposes of this Convention an individual was domiciled: ...
>
> (b) in the UK:
>
> [i] if he was domiciled in the UK in accordance with the law of the UK [ie if UK-law domiciled]
>
> [ii] or is treated as so domiciled for the purpose of a tax which is the subject of this Convention [i.e. if deemed UK domiciled].

---

2 The term "resident" for estate tax is defined in Treasury Reg: 20.0-1(b). For gift tax see Treasury Reg: 25.2501-1(b).

Next come a series of tie-breakers to deal with persons who under Art 4(1)(a)(b) would be treaty-domiciled in both jurisdictions:

> (2) Where by reason of the provisions of para (1) an individual was at any time domiciled in both Contracting States, and
>
> (a) was a national of the UK but not of the US, and
>
> (b) had not been resident in the US for Federal income tax purposes in seven or more of the ten taxable years ending with the year in which that time falls,
>
> he shall be deemed to be domiciled in the UK at that time.
>
> (3) Where by reason of the provisions of para (1) an individual was at any time domiciled in both Contracting States, and
>
> (a) was a national of the US but not of the UK, and
>
> (b) had not been resident in the UK in seven or more of the ten income tax years of assessment ending with the year in which that time falls,
>
> he shall be deemed to be domiciled in the US at that time.
>
> For the purposes of this paragraph, the question of whether a person was so resident shall be determined as for income tax purposes but without regard to any dwelling-house available to him in the UK for his use.

The last sentence is based on wording formerly in the s.267 deemed domicile rule, see 61.2.5 (Meaning of "residence" for 17-year residence rule).

Where these tie-breakers fail to break the tie, we turn to Art. 4(4):

> Where by reason of the provisions of para (1) an individual was domiciled in both Contracting States, then, subject to the provisions of paras (2) and (3), his status shall be determined as follows:
>
> (a) the individual shall be deemed to be domiciled in the Contracting State in which he had a permanent home available to him. If he had a permanent home available to him in both Contracting States, or in neither Contracting State, he shall be deemed to be domiciled in the Contracting State with which his personal and economic relations were closest (centre of vital interests);
>
> (b) if the Contracting State in which the individual's centre of vital interests was located cannot be determined, he shall be deemed to be domiciled in the Contracting State in which he had an habitual abode;
>
> (c) if the individual had an habitual abode in both Contracting States or in neither of them, he shall be deemed to be domiciled in the Contracting State of which he was a national; and

(d) if the individual was a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

This is the standard OECD Model wording: see 6.8 (Tie-breaker tests for individuals).

70.5.1 *Resident of possession of the US*

Article 5(5) USA IHT DTA relates to nationality and treaty-domicile:

> An individual who was a resident (domiciliary) of a possession of the US and who became a citizen of the US solely by reason of his
> (a) being a citizen of such possession, or
> (b) birth or residence within such possession,
> shall be considered as neither domiciled in nor a national of the US for the purposes of this Convention.

US Revenue Ruling 87-95 lists the following as possessions of the United States: American Samoa, Baker Island, Guam, Howland Island, Jarvis Island, Johnston Island, Kingman Reef, Midway Islands, Northern Mariana Islands, Palmyra, Puerto Rico, Virgin Islands and Wake Islands.

I understand that these are mainly uninhabited islands so few (if any) individuals are affected by this provision.

70.6 IHT exemptions for individuals

Article 5 USA IHT DTA provides two exemptions for individuals. Article 5(1) provides:

> (a) [i] Subject to the provisions of Articles 6 (Immovable Property (Real Property)) and 7 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services) and the following paragraphs of this Article,
> [ii] if the decedent or transferor was domiciled in one of the Contracting States at the time of the death or transfer, property shall not be taxable in the other State.
> (b) Sub-para (a) shall not apply if at the time of the death or transfer the decedent or transferor was a national of that other State.

This can confer IHT exemption. To qualify for IHT exemption under Art. 5(1) the individual must be:

(1) treaty-domiciled in the USA and
(2) not a UK national.

Article 5(2) USA IHT DTA provides:

> Subject to the provisions of the said Articles 6 and 7, if at the time of the death or transfer the decedent or transferor
> [a] was domiciled in neither Contracting State and
> [b] was a national of one Contracting State (but not of both),
> property which is taxable in the Contracting State of which he was a national shall not be taxable in the other Contracting State.

Can this confer IHT exemption? In order to need and qualify for IHT exemption under art. 5(2):

(1) the individual must be:
   (a) treaty-domiciled in neither state (so in particular not UK domiciled or IHT deemed domiciled) and
   (b) a US national and not a UK national
(2) property must be taxable in the UK (or no relief is needed) so it must be UK situate.
(3) the property must be taxable in the USA.

This is just possible. Condition (1) is possible because a US national is not necessarily treaty-domiciled in the USA. If such an individual held UK situate property, it would be exempt from IHT under Art. 5(2) provided it was taxable in the USA. In practice though this will be rare.

These two exemptions applies to charges on death and on lifetime gifts. The exemptions even apply to UK situate property (so long as the property is not land or a permanent establishment).

70.7 IHT exemption for trusts

Article 5(4) USA IHT DTA provides:

> [a] Paras (1) and (2) shall not apply in the UK to property comprised in a settlement;
> [b] but, subject to the provisions of the said Articles 6[3] and 7[4], tax shall not be imposed in the UK on such property if at the time when the settlement was made the settlor was domiciled in the US and was not a national of the UK.

Article 5(4)[b] provides exemption from:

(1) IHT 10 year and exit charges.

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3 See 70.10 (Immovable property).

4 See 70.11 (Business property).

(2) The charge on the death of an individual with an estate IIP.
(3) GWR lifetime and death charges.

To qualify for IHT exemption under Art. 5(4) the settlor must at the relevant time be:

(1) treaty-domiciled in the USA and
(2) not a UK national.

The exemption applies even to UK situate assets (so long as the asset is not land or a permanent establishment).

It is an interesting question whether a common form grantor trust is a settlement for this purpose: it is (I think) a settlement for US purposes but not for IHT purposes.[5] It is also an interesting question whether or to what extent UK rules determining when a settlement is made (and who is the settlor) apply for the purposes of this relief. Subject to context, UK courts should apply the UK rules. But the best interpretation is that which gives effect to the object of avoiding double taxation without giving rise to double non-taxation.

70.8 Requirement to pay foreign tax

Article 5(5) USA IHT DTA provides:

> If by reason of the preceding paragraphs of this Article
> [a] any property would be taxable only in one Contracting State and
> [b] tax, though chargeable, is not paid (otherwise than as a result of a specific exemption, deduction, exclusion, credit or allowance) in that State,
> tax may be imposed by reference to that property in the other Contracting State notwithstanding those paragraphs.

The IHT Manual provides:

> **27177. Certification of disclosure and tax enforcement procedure with the USA** [January 2014]
> Before we give up our rights to tax property in accordance with Article 5(1) of the DTC with the USA, we need the US authorities to certify that
> - the assets have been disclosed to them and
> - any tax due has been paid or will be enforced.
>
> This is because Article 5(5) of the DTC allows us to tax the property if the USA is unable to enforce its right to tax. HMRC needs to give a similar certificate if Article 5(1) of the DTC requires the US authorities to give up their right to tax property.

5 See 84.6 (American revocable trusts (grantor trust)).

Until we have a form 742 from the US authorities certifying that the property has been disclosed and that tax has been paid or will be enforced, you should be not close any case where:

Article 5(1) operates to exclude some UK property from the charge to IHT, and

the case would be taxpaying without that exclusion.

You should explain this requirement to the taxpayer and send them two prints of Form 742. You should draw their attention to the paragraphs of the form that they must complete. Where the UK is giving up its taxing rights under the convention, only para 1 applies and paras 2 to 7 are not appropriate. You can close your case when you have received a form that is correctly completed and certified. Refer the case to Technical if there are any errors or any problems arise.

Where the USA gives up the right to tax property under Article 5(1), the US authorities will send two copies of US form 706 CE to us to certify.

Once you have checked the forms (you must not mark them in any way) you should send them to Technical together with the file and a note of any errors or omissions. Technical will then issue the appropriate certificate.

70.9 Dual-situate assets

Article 5(6) USA IHT DTA provides:

If at the time of the death or transfer

[a] the decedent or transferor was domiciled in neither Contracting State and

[b] each State would regard any property as situated in its territory and

[c] in consequence tax would be imposed in both States,

the competent authorities of the Contracting States shall determine the situs of the property by mutual agreement.

This is not relevant if IHT exemption or USA tax exemption applies. It is a different technique from dealing with the problem of dual-situate assets from that adopted in the Estate Duty DTAs, which set out their own treaty-situs rules (as did the former USA estate duty treaty.)

70.10 Immovable property

Article 6 USA IHT DTA provides:

(1) Immovable property (real property) may be taxed in the Contracting State in which such property is situated.

(2) The term "immovable property" shall be defined in accordance with the law of the Contracting State in which the property in question is situated, provided always that debts secured by mortgage or otherwise shall not be regarded as immovable property. The term shall in any case

> include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats, and aircraft shall not be regarded as immovable property.
> (3) The provisions of paras (1) and (2) shall also apply to immovable property of an enterprise and to immovable property used for the performance of independent personal services.

This is what one would expect.

70.11 Business property

Article 7(1) USA IHT DTA provides:

> Except for assets referred to in Article 6 (Immovable Property (Real Property)) assets forming part of the business property of a permanent establishment of an enterprise may be taxed in the Contracting State in which the permanent establishment is situated.

I do not set out the lengthy provisions relating to permanent establishment here, since this will rarely arise.

70.12 Extension of IHT spouse exemption

Under domestic IHT law, the usual IHT spouse exemption may be restricted when the transferor is UK domiciled and the spouse is foreign domiciled.[6] Article 8 restricts this restriction. There are separate provisions for absolute transfers and for transfers to a trust under which the spouse has an IIP. There is no relief for the situation where H has an interest in possession and on H's death W acquires an interest in possession (where the IHT spouse exemption is sometimes available under s.49D IHTA 1984).

70.12.1 *Relief for absolute inter-spouse transfer*

Article 8(3) USA IHT DTA provides:

> Property which passes to the spouse from a decedent or transferor who was domiciled in or a national of the US and which may be taxed in the UK shall, where

6 See 73.2 (Restricted IHT spouse exemption for foreign domiciled spouse).

(a) the transferor's spouse was not domiciled in the UK but the transfer would have been wholly exempt had the spouse been so domiciled, and

(b) a greater exemption for transfers between spouses would not have been given under the law of the UK apart from this Convention,

be exempt from tax in the UK to the extent of 50 per cent of the value transferred, calculated as a value on which no tax is payable and after taking account of all exemptions except those for transfers between spouses.

In order for this to be needed and to apply the following conditions must be satisfied:

The transferor is:

(a) Treaty-domiciled in the US or a US national.

(b) UK-law domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under IHT domestic law).

The transferee (spouse) is:

(a) not treaty-domiciled in the UK.

(b) not UK-law domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under IHT domestic law).

This relief applies on death and on lifetime transfers.

70.12.2 *Meaning of "spouse" in US/UK IHT DTT*

For IHT purposes, the term "spouse" has its UK law meaning.[7] Strictly a civil partner is not a spouse, so this is one of the rare occasions where there is a difference between the taxation of spouses and civil partners; but the introduction of same-sex marriages reduces the significance of that.[8] It is also arguable that the word "spouse" in relation to IHT should here be

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7 See 57.11 (Undefined terms have domestic law meanings).
A person who has entered into a same-sex marriage may be regarded as a spouse for US tax purposes, depending on the relevant state law; see *Windsor v US http://www.nysd.uscourts.gov/cases/show.php?db=special&id=185* but that is not relevant. IRS Revenue Ruling 2013-17 states: "For Federal tax purposes, the term "marriage" does not include registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law that are not denominated as a marriage under that state's law, and the terms "spouse," "husband and wife," "husband," and "wife" do not include individuals who have entered into such a formal relationship. This conclusion applies regardless of whether individuals who have entered into such relationships are of the opposite sex or the same sex."

8 See App. 1.3 ("Spouse" and related expressions).

construed loosely, to include civil partners.

70.12.3 *Transfer to settlement under which spouse has IIP*

Article 8(4) USA IHT DTA provides:

> (a) Property which on the death of a decedent domiciled in the UK became comprised in a settlement shall, if the personal representatives and the trustees of every settlement in which the decedent had an interest in possession immediately before death so elect and subject to sub-para (b), be exempt from tax in the UK to the extent of 50 per cent of the value transferred (calculated as in para (3)) on the death of the decedent if:
>
> (i) under the settlement, the spouse of the decedent was entitled to an immediate interest in possession,
>
> (ii) the spouse was domiciled in or a national of the US,
>
> (iii) the transfer would have been wholly exempt had the spouse been domiciled in the UK, and
>
> (iv) a greater exemption for transfers between spouses would not have been given under the law of the UK apart from this Convention.
>
> (b) Where the spouse of the decedent becomes absolutely and indefeasibly entitled to any of the settled property at any time after the decedent's death, the election shall, as regards that property, be deemed never to have been made and tax shall be payable as if on the death such property had been given to the spouse absolutely and indefeasibly.

In order for this to be needed and to apply the following conditions must be satisfied:

The transferor is:

(a) Treaty-domiciled in the UK.

(b) UK-law domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under domestic law).

The transferee (spouse) is:

(a) treaty-domiciled in the US or a national of the US.

(b) not UK-law domiciled or deemed UK domiciled (or else the IHT spouse exemption is not restricted under domestic law).

In addition:

(1) An election is required.

(2) The spouse must be entitled to an immediate IIP (this probably rules out relying on s.144 IHTA (discretionary will trusts)).

(3) This relief only applies on the death of the transferor.

70.13 Non-discrimination

Article 10(1)(a) USA IHT DTA provides:

> Subject to the provisions of sub-para (b), nationals of a Contracting State shall not be subjected in the other State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

This would extend IHT agricultural property relief to USA agricultural property, which could be relevant to companies holding agricultural land, but the point will not often arise.

Article 10 continues:

> (2) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.
> (3) Nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not domiciled in that Contracting State any personal allowances, reliefs and reductions for taxation purposes which are granted to individuals so domiciled.
> (4) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
> (5) The provisions of this Article shall apply to taxes which are the subject of this Convention.

70.14 Other articles

The following articles of the USA IHT DTA are not discussed here:

Article 11: mutual agreement procedure.
Article 12: exchange of information.
Article 13: diplomatic and consular officials.
Article 14: entry into force.
Article 15: termination.

CHAPTER SEVENTY ONE

IHT DTA: SWITZERLAND

71.1 Swiss IHT treaty: Introduction

This chapter considers the Swiss IHT Treaty[1].

For some reason DTAs do not have short titles. I use the expression "**Swiss IHT DTA**" (or, for short, just DTA) to refer to the DTA called "the Convention between the United Kingdom of Great Britain and Northern Ireland and the Swiss Federation for the avoidance of double taxation with respect to taxes on estates and inheritances".

I comment only on the UK (IHT) aspects of the treaty. Swiss law advice will be needed in any case where the treaty applies.

For the interaction of the DTA and transferable nil rate bands, see 69.8 (Transferable nil rate bands and IHT DT reliefs). For claims and disclosure issues see 69.9 (Claims for treaty IHT exemption) and 72.9 (Claims for foreign IHT credit relief).

71.2 Scope

Article 1 Swiss IHT DTA provides:

> This Convention shall apply:
>
> (a) to estates and inheritances where the deceased was domiciled, at the time of his death, in one or both of the Contracting States; and
>
> (b) to property comprised in a settlement made by a person who was domiciled, at the time the settlement was made, in one or both of the Contracting States.

71.3 Taxes covered

Article 2(1) Swiss IHT DTA provides:

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1 SI 1994 No 3214 *http://www.legislation.gov.uk/uksi/1994/3214/schedule/made*

The existing taxes to which this Convention shall apply are:

(a) in the UK, the inheritance tax, insofar as it applies to the estate of a deceased person (hereinafter referred to as "UK tax");

(b) in Switzerland, the cantonal and communal taxes imposed on estates and inheritances (hereinafter referred to as "Swiss tax").

Thus there is no relief for IHT on lifetime gifts or for 10-year and exit charges on trusts. There is relief for trusts conferring an estate interest in possession.

71.4 Definitions

The DTA provides commonsense definitions of the following terms, which are not set out here: UK; Switzerland; Contracting State; Enterprise; Competent Authority; tax.

Article 3(2) USA IHT DTA gives terms not otherwise defined their domestic law meanings, following the OECD model wording, as it stood at the time of the DTA. See 57.11 (Undefined terms have domestic law meanings).

71.4.1 *"National"*

Article 3(g) Swiss IHT DTA provides:

(g) the term "national" means:

(i) in relation to the UK, any British citizen or any British subject not possessing the citizenship of any other Commonwealth country or territory, provided he has the right of abode in the UK and any legal person, partnership, association or other entity deriving its status as such from the law in force in the UK;

(ii) in relation to Switzerland, any Swiss citizen and any legal person, partnership, association or other entity deriving its status as such from the law in force in Switzerland;

71.5 Treaty-domicile

The definition of treaty-domicile is non-standard. Article 4(1) Swiss IHT DTA provides:

For the purposes of this Convention, a deceased person was domiciled:

(a) in the UK if

[i] he was domiciled in the UK in accordance with the law of the UK or

[ii] is treated as so domiciled for the purposes of a tax which is the subject of the Convention;

That applies to a person who is UK-law domiciled and one who is deemed UK domiciled (s.267 deemed domicile or spouse election domicile).

Article 4(1) continues:

> For the purposes of this Convention, a deceased person was domiciled...
>
> (b) in Switzerland if he was domiciled or was resident in Switzerland in accordance with the law of Switzerland or if he was a Swiss national and Swiss civil law requires his succession to be ruled in Switzerland.

I assume this means:

> For the purposes of this Convention, a deceased person was domiciled:
>
> (b) in Switzerland if
>
> [i] he was domiciled *in Switzerland in accordance with the law of Switzerland* or
>
> [ii] was resident in Switzerland in accordance with the law of Switzerland or
>
> [iii] if he was a Swiss national and Swiss civil law requires his succession to be ruled in Switzerland.

That is, the words "and Swiss civil law requires his succession to be ruled in Switzerland" govern only [iii].

The treaty adds:

> However, a deceased person shall be deemed not to be domiciled in one of the States if that State imposes tax only by reference to property situated in that State.

I do not see how this could apply,[2] but it does not matter.

The definition of domiciled/resident in Switzerland in accordance with the law of Switzerland is crucial: this is a matter of Swiss law. The 1993 Protocol clarifies which Swiss law applies.[3]

Article 4(2) sets out a series of tie-breakers to deal with persons who under art 4(1) would be domiciled in both jurisdictions:

> (2) Where by reason of the provisions of paragraph (1) of this Article a deceased person was domiciled in both States, then, subject to the provisions of the attached Protocol, his status shall be determined as

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2 Perhaps it was included under a mistaken analogy with art 4(1) OECD model; see 6.7 (Exception where source tax only). Or perhaps there are Swiss tax reasons.

3 It provides: "The reference to Swiss civil law concerns chapter 6 of the loi fédérale sur le droit international privé of 18th December 1987."

follows:

(a) he shall be deemed to have been domiciled in the State in which he had a permanent home available to him; if he had a permanent home available to him in both States, he shall be deemed to have been domiciled in the State with which his personal and economic relations were closer (centre of vital interests);

(b) if the State in which he had his centre of vital interests cannot be determined, or if he did not have a permanent home available to him in either State, he shall be deemed to have been domiciled in the State in which he had an habitual abode;

(c) if he had an habitual abode in both States or in neither of them, he shall be deemed to have been domiciled in the State of which he was a national;

(d) if he was a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

This is standard OECD Model wording: see 6.8 (Tie-breaker tests for individuals).

The 1993 Protocol provides:

(1) With reference to Article 4:
An individual

[i] who was a national of one of the Contracting States without being a national of the other Contracting State and

[ii] who was domiciled in the State of which he was a national immediately before coming to the other State

shall not be domiciled in the other State for the purposes of this Convention if:

(a) [i] he was temporarily present in that other State by reason only of his employment or

[ii] was a spouse or other dependent of a person temporarily in that other State for such purpose; and

(b) that individual had retained the domicile of the State of which he was a national; and

(c) that individual had no intention of becoming a permanent resident of the other Contracting State.

This could help a Swiss national who is a long term employee in the UK as it could confer better treaty relief even after they become deemed UK domiciled, but that will not often arise. It could similarly hinder a UK national who is an employee in Switzerland as it could prevent them

claiming relief.

71.5.1 *Types of domicile*

When dealing with treaties it is always necessary to distinguish between three different concepts of domicile:

(1) domicile in the domestic English law sense (**"UK-law domicile"**);
(2) deemed UK domicile for IHT ("**deemed UK domicile**");
(3) domicile for the purposes of the treaty ("**treaty-domicile**").

The Swiss IHT DTA distinguishes between:

(1) "A person domiciled by virtue of the provisions of paragraph (1) of Article 4 solely in one of the Contracting States". I call that **"solely UK/Swiss domiciled"**. Someone who is "solely Swiss domiciled" cannot be UK-law domiciled or deemed UK domiciled for IHT purposes.
(2) "A person domiciled by virtue of the provisions of paragraph (1) of Article 4 in both Contracting States". I call that **"tiebreaker UK/Swiss domiciled"**. Someone who is tiebreaker Swiss domiciled is UK-law domiciled or deemed UK domiciled but treaty-domiciled in Switzerland because of the tiebreaker clause in the treaty.

71.6 IHT exemptions

There are special rules for immovable property and permanent establishments (articles 5 and 6 discussed below) and ships and aircraft (article 7 not discussed here).

Subject to that, Article 8 Swiss IHT DTA provides various exemptions for individuals.

71.6.1 *UK situate property of solely Swiss domiciliary*

Article 8(1) provides:

> (1) Subject to the following provisions of this Convention:
> (a) property not dealt with in Articles 5, 6 and 7 which is situated in either Contracting State and forms part of the estate of a person:
> (i) domiciled by virtue of the provisions of paragraph (1) of Article 4 solely in one of the Contracting States shall, subject to paragraph (2) of this Article, be taxable only in that latter Contracting State;

Thus UK situate property of a solely Swiss domiciliary qualifies for treaty

exemption on death even though not of course excluded property. To this rule there are four exceptions. Firstly property covered by articles 5, 6, 7 (land, PEs ships and aircraft). Secondly, shares in UK incorporated companies, as article 8(2) provides:

> Shares in a company incorporated in the UK which form part of the estate of a person domiciled by virtue of the provisions of paragraph (1) of Article 4 solely in Switzerland at the time of his death may also be taxed in the UK.

There is not much left for this treaty exemption to apply to, though it could be relevant (eg to UK situate debentures). From a planning point of view it is not generally important since it is usually possible for a solely Swiss domiciliary to avoid IHT by avoiding UK situate property but it could be useful for, say, UK situate chattels.

71.6.2 *Swiss situate property of tiebreaker Swiss domiciliary*

Article 8(1) provides:

> (1) Subject to the following provisions of this Convention:
>
> (a) property not dealt with in Articles 5, 6 and 7 which is situated in either Contracting State and forms part of the estate of a person ...
>
> (ii) domiciled by virtue of the provisions of paragraph (1) of Article 4 in both Contracting States shall, subject to paragraph (3) of this Article, be taxable only in the Contracting State in which it is situated;

Thus in principle Swiss situate property of a tiebreaker Swiss domiciliary qualifies for treaty IHT exemption on death even though not of course excluded property (because the individual is actually UK domiciled or IHT deemed domiciled). However five wide exceptions greatly restrict the scope of the rule. The first four are the exceptions mentioned above: property covered by articles 5, 6, 7 and 8(2) (UK land, PEs, ships and aircraft, and shares in UK companies.) Lastly, article 8(3) provides:

> Any property which is situated in Switzerland and which would be taxable only in Switzerland under paragraph (1)(a)(ii) of this Article may also be taxed in the UK if the deceased was:
>
> (a) by virtue of the provisions of paragraph (2) of Article 4 domiciled in the UK at the time of his death; or
>
> (b) by virtue of those provisions domiciled in Switzerland at the time of his death but:

(i) had been domiciled [ie treaty-domiciled] in the UK at any time within the five years preceding his death; and
(ii) was at that time a national of the UK without being a national of Switzerland.

Thus a person who is a UK national[4] cannot take advantage of this treaty IHT exemption until they have been treaty-domiciled in Switzerland for 5 years. A UK national cannot avoid IHT by becoming treaty-domiciled in Switzerland shortly before death. However a non-UK national who is actually UK domiciled or IHT deemed domiciled could in principle do so.

71.6.3 *Property outside UK and Switzerland*

I refer to property outside the UK and Switzerland as **"third country property."**
Article 8(1)(b) provides

(1) Subject to the following provisions of this Convention:
(b) property not dealt with in Articles 5, 6 and 7 which is not situated in either Contracting State and forms part of the estate of a person:
(i) domiciled by virtue of the provisions of paragraph (1) of Article 4 solely in one of the Contracting States shall be taxable only in that Contracting State;
(ii) domiciled by virtue of the provisions of paragraph (1) of Article 4 in both Contracting States shall, subject to paragraph (4) of this Article, be taxable only in the Contracting State in which, under paragraph (2) of Article 4, the deceased was domiciled at the time of his death.

Art.8(1)(b)(i) is not relevant for IHT since non UK situate property of a solely Swiss domiciliary is excluded property in any event. However art.8(1)(b)(ii) is important.

However in principle third country property of a tiebreaker Swiss domiciliary qualifies for treaty IHT exemption on death even though not of course excluded property (because the individual is actually UK domiciled or IHT deemed domiciled). However five wide exceptions greatly restrict the scope of the rule. The first four are the exceptions mentioned above: property covered by articles 5, 6, 7 and 8(2) (UK land, PEs, ships and aircraft, and shares in UK companies.) Lastly, article 8(4)

4 Unless also a Swiss national, ie a dual national.

provides a rule equivalent to article 8(3):

> Any property which is not situated in either Contracting State and which would be taxable only in Switzerland under paragraph (1)(b)(ii) of this Article may also be taxed in the UK if the deceased:
>
> (a) had been domiciled [ie treaty-domiciled] in the UK at any time within the five years preceding his death; and
>
> (b) was at that time a national of the UK without being a national of Switzerland.

Thus a person who is a UK national[5] cannot take advantage of this treaty IHT exemption until they have been treaty-domiciled in Switzerland for 5 years. A UK national cannot avoid IHT by becoming treaty-domiciled in Switzerland shortly before death. However a non-UK national who is actually UK domiciled or IHT deemed domiciled could in principle do so.

71.6.4 *Situs rule*

The 1993 Protocol provides:

> (3) With reference to Article 8:
> The situs of any property dealt with in that Article shall be determined by the law of the UK in effect at the date of entry into force of this Convention.

71.7 Extension of IHT spouse exemption

Under domestic IHT law, the usual IHT spouse exemption may be restricted when the transferor is UK domiciled and the spouse is foreign domiciled.[6] Article 10(2) restricts this restriction:

> Property which passes to the spouse from a deceased person who was domiciled in or a national of Switzerland and which may be taxed in the UK shall, where:
>
> (a) the spouse was not domiciled in the UK but the transfer would have been wholly exempt had the spouse been so domiciled, and
>
> (b) a greater exemption for transfers between spouses would not have been given under the law of the UK apart from this Convention,
>
> be exempt from tax in the UK to the extent of 50 per cent of the value

5 Unless also a Swiss national, ie a dual national.

6 See 73.2 (Restricted IHT spouse exemption for foreign domiciled spouse).

> transferred, calculated as a value on which no tax is payable and after taking account of all exemptions except those for transfers between spouses.

Civil partners are not mentioned (as the treaty was made before the introduction of civil partnerships). One might construe spouse widely to include "civil partner" particularly if Swiss tax law treats civil partners like spouses.

71.8 Immovable property

Article 5 Swiss IHT DTA provides:

> (1) Immovable property which forms part of the estate of a person domiciled in a Contracting State and which is situated in the other Contracting State may be taxed in that other State.
> (2)The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated provided always that debts secured by mortgage or otherwise shall not be regarded as immovable property. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, an interest in the proceeds of sale of land which is held on trust for sale, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.
> (3) The provisions of paragraphs (1) and (2) of this Article shall also apply to immovable property of an enterprise and to immovable property used for the performance of professional services or other activities of an independent character.

This is fairly standard form.

71.9 Business property

Article 6(1) USA IHT DTA provides:

> (1) Except for assets referred to in Articles 5 and 7 and in paragraph (2) of Article 8, movable property of an enterprise which forms part of the estate of a person domiciled in a Contracting State which is the business property of a permanent establishment situated in the other Contracting State, may be taxed in that other State.

This is standard form. I do not set out the lengthy provisions relating to permanent establishment here, since this will rarely arise.

71.10 Other articles

The following articles of the Swiss IHT DTA are standard forms and not discussed here:

Article 11: non-discrimination
Article 12: mutual agreement procedure.
Article 13: exchange of information.
Article 14: diplomatic and consular officials.
Article 15: entry into force.
Article 16: termination.

CHAPTER SEVENTY TWO

FOREIGN IHT CREDIT RELIEF

72.1 Foreign IHT credit: Introduction

"**Foreign IHT credit relief**" arises where foreign tax is set against UK IHT. This may be "**DTA IHT credit**" where a DTA confers a credit or "**Unilateral IHT credit**" where UK tax law (not a DTA) confers a credit.

In this chapter I first consider unilateral IHT credit, the four USA DTAs and the USA IHT DTA. I hope to deal with other treaties in future editions.

72.1.1 *Cross references*

The following matters are considered elsewhere:

69.8 (Transferable nil rate bands and IHT DT reliefs).
65.13 (Deduction for foreign taxes - as opposed to credit).
65.13.5 (Concession for foreign IHT on UK situate shares).

72.2 Unilateral IHT credit

Unilateral IHT credit is important as the UK does not have many IHT DTAs. Section 159(1) IHTA provides:

> Where the Board are satisfied that in any territory outside the UK (an "overseas territory") any amount of tax imposed by reason of any disposition or other event is attributable to the value of any property, then, if—
>
> (a) that tax is of a character similar to that of capital transfer tax[1] or is chargeable on or by reference to death or gifts inter vivos, and
>
> (b) any capital transfer tax chargeable by reference to the same disposition or other event is also attributable to the value of that property,
>
> they shall allow a credit in respect of that amount ("the overseas tax")

---

1 References to CTT include IHT: s.100(1)(b) FA 1986.

> against that capital transfer tax in accordance with the following provisions.

Statute calls this "unilateral relief" but I prefer the term "**unilateral foreign IHT credit**" (or foreign IHT credit relief) which seems clearer. I refer to the foreign tax (which statute calls "the overseas tax" as "**foreign IHT**".

Unilateral relief is based on the international understanding that the state where an asset is located has the primary right of taxation and the state whose claim to tax depends on a personal nexus (residence or, as in the UK, domicile) should provide unilateral relief for double taxation.

The IHT Manual provides:

> **27185 Introduction** [January 2014]
> ... Under Section 159 IHTA 1984, credit can be allowed on death and also in respect of lifetime dispositions where some type of gift tax is charged in the foreign country. The basic conditions to be satisfied in connection with a lifetime or death transfer are:
> - that both Inheritance Tax (IHT) and overseas tax must be chargeable by reference to the same event and attributable to the value of the same property, and
> - that the foreign tax is similar in character to IHT.
>
> In cases of doubt, you must ask for advice from Technical.

72.3 Requirement to pay foreign IHT

The requirement that the foreign IHT must actually be paid is slipped into the definition of "tax imposed". Section 159(6) IHTA provides:

> In this section references to tax imposed in an overseas territory are references to tax chargeable under the law of that territory and paid by the person liable to pay it.

The IHT Manual provides:

> **27185. Introduction** [January 2014]
> ... Before the relief can be finalised, the taxpayer or agent must produce evidence of payment of the foreign tax. This must be in the form of the assessment of foreign tax (or other document showing details of the property charged) and the official receipt.
> Once you decide the amount of relief available this should be entered in the ‹reliefs against tax' box in the appropriate COMPASS screen. If necessary, you must apportion the relief between the instalment and non-instalment option property assessments. (See IHTM31189)

72.4 Use of foreign IHT credit

Credit is only set against "that capital transfer tax" ie IHT attributable to the same property as is subject to the foreign IHT.

The IHT Manual provides:

> **27185. Introduction** [January 2014]
> ... The relief cannot exceed the amount of Inheritance Tax charged with respect to the particular item of property.
> For these purposes, the IHT attributable to any asset that is wholly exempt IHT is nil. Where the item is partly exempt, any IHT charged will be attributed to the chargeable part.
> Where Quick Succession Relief (IHTM22041) is allowed, the amount of IHT attributable to the property is the net amount after allowing the relief.

72.5 Amount of credit

The rules determining the amount of IHT credit differ depending on
(1) situs of property under UK law and
(2) situs of property under the foreign law.
The IHT Manual provides:

> **27185. Introduction** [January 2014]
> ... Because of the terms of S.159(2), (3) and (4) IHTA 1984 you will need to consider the situs (IHTM27071) of property according to UK law and, possibly, foreign law when allowing a credit for foreign tax. You must raise any questions to establish the situs as soon as it seems likely that a S.159 IHTA 1984 credit will be claimed. ...
> The amount of the credit allowed under Section 159 IHTA 1984 is the Sterling equivalent of the foreign tax paid (converted using the exchange rate on the date of payment) so far as that tax is attributable to the foreign property on which IHT has been paid. Any part of the sum paid to the foreign Revenue authorities representing interest or penalties should be excluded. So should any part of the foreign tax that is attributable to income accruing since the date of the transfer. ... SAV (Foreign) will provide the exchange rate...
> **27186 Procedure chart** [January 2014]
> To work out whether relief is due and which provisions it is due under you will need to consider the following questions:
> Is the property situated in the UK under UK law?
> - If the answer is 'yes' and the property is also situated in the foreign country under the law of that country, relief is due under

IHTA84/S159(3)(b),

- If the answer is 'yes' but the property is not situated in the foreign country under their law, no relief is due.
- If the answer is 'no' but the property is situated in the foreign country under UK law, relief is due under IHTA84/S159(2).
- If the answer is 'no' and the property is not situated in the foreign country under UK law, relief is due under IHTA84/S159(3)(a).

Relief should be given under IHTA84/S159 (2) rather than S159 (3)(a) where tax is paid, under an agreement between the provinces concerned:

- in Quebec or Ontario, or Quebec and British Columbia,
- on shares which are situated in the other province, under UK law.

Any case where the taxpayer or agent disagrees with our view that UK law applies, should be referred to Technical.

72.5.1 *Situs in overseas territory*

Section 159(2) IHTA provides:

> Where the property is situated in the overseas territory and not in the UK, the credit shall be of an amount equal to the overseas tax.

The IHT Manual provides:

> **27187. Relief under Section 159(2) IHTA 1984** [January 2014]
> Where the property concerned is situate (under UK law) in the foreign country, relief is due under Section 159(2) IHTA 1984 and the credit due is equal to the foreign tax paid.
> In practice, the credit cannot exceed the IHT attributable to the property concerned.

More accurately, the *credit* (as defined) can exceed the IHT attributable to the property, but this credit is only set against the IHT attributable to the property, so the amount of the relief is the lesser of the credit and that IHT. The IHT Manual goes on to give an example:

> *Example* (Bernice)
> B died in September 2002, leaving an apartment in Spain valued at £50,000. B's total estate amounts to £300,000 (there were no lifetime gifts), with total IHT payable of £20,000.
> The Spanish authorities charge tax equivalent to Sterling £4,000 on the apartment on B's death.
> The IHT payable on the apartment is:
> £50,000 × (£20,000/£300,000) = £3,333.33
> So, the double taxation credit due under Section 159(2) IHTA 1984 is restricted to £3,333.33.

The effect of the credit is that the total tax paid is the higher of the UK and the foreign IHT rates.

72.5.2 *Situs in third country or dual situate property*

Section 159(3) IHTA provides:

> Where the property—
> (a) is situated neither in the UK nor in the overseas territory, or
> (b) is situated both in the UK and in the overseas territory,
> the credit shall be of an amount calculated in accordance with the following formula—
>
> $$\frac{A}{A+B} \times C$$
>
> where
> A is the amount of the capital transfer tax,
> B is the overseas tax and
> C is whichever of A and B is the smaller.

The IHT Manual provides:

> **27188. Relief under Section 159(3) and Section 159(4) IHTA 1984** [January 2014]
> Relief is due under Section 159(3) IHTA 1984 where both the UK and another foreign country charge tax the same property and that property is situate:
> - neither in the UK nor in the foreign country, or
> - both in the UK and in the foreign country.
>
> Where relief is due under Section 159(3) IHTA 1984, it is given on a split credit basis and will be less than the foreign tax paid. [The Manual sets out the formula in s.159(3) and continues:]
> *Example 1*
> Country X and the UK both tax an item of property which is situate neither in Country X or UK.
> Country X charges tax of £40
> UK charges IHT of £60
> The credit is: 60/(60 + 40) × 40 = £24

HMRC IHT Customer Guide gives two examples of unilateral relief calculations:[2]

2 *http://www.hmrc.gov.uk/cto/customerguide/page20.htm#15*.

Example 1
Ann is domiciled in Ruritania, but is also treated as domiciled in the UK. She makes a gift of property situated in Utopia.

Item	Amount
UK inheritance tax (A)	£3,000
Ruritanian inheritance tax (B)	£1,000
C is the smaller of A and B	£1,000
Credit against UK IHT is £3,000 / (£3,000 + £1,000) ×£1,000 = £750	
Net UK tax	**£2,250**

Example 2
Tom is domiciled in Utopia but holds shares in a Ruritanian company, which maintains a duplicate share register in the UK. Under UK law we regard the shares as situated in the UK, but Ruritanian law regards them as situated in Ruritania. Tom dies (but his estate is not liable to Utopian tax).

Item	Amount
UK inheritance tax (A)	£1,000
Ruritanian inheritance tax (B)	£4,000
C is the smaller of A and B	£1,000
Credit against UK IHT is £1,000 / (£1,000 + £4,000) × £1,000 = £200	
Net UK tax	**£800**

This may not be fully adequate to eliminate double taxation. Where an IHT DTA applies a more generous form of credit may apply.

72.5.3 *Property taxed in more than one overseas territory*

Section 159(4) IHTA provides:

> Where tax is imposed in two or more overseas territories in respect of property which—
>
> (a) is situated neither in the UK nor in any of those territories, or
>
> (b) is situated both in the UK and in each of those territories, subsection (3) above shall apply as if, in the formula there set out,
>
> B were the aggregate of the overseas tax imposed in each of those territories and
>
> C were the aggregate of all, except the largest, of A and the overseas tax imposed in each of them. ...

The IHT Manual provides an example:

> **27188 Relief under Section 159(3) IHTA 1984 and Section 159(4)**
> [January 2014]

Example 2
Each of Country X, Country Y and the UK tax an item of property which is not situate in Country X, Country Y nor the UK.
Country X charges £40
Country Y charges £20
UK charges IHT of £60
The credit is 60/(60+40+20) × (40 + 20) = £30

72.5.4 *Interaction of s.159(2)(3)*

Section 159(5) IHTA deals with the interaction of the two reliefs:

> Where credit is allowed under subsection (2) above or section 158 above in respect of overseas tax imposed in one overseas territory, any credit under subsection (3) above in respect of overseas tax imposed in another shall be calculated as if the capital transfer tax were reduced by the credit allowed under subsection (2) or section 158; and where, in the case of any overseas territory mentioned in subsection (3) or (4) above, credit is allowed against the overseas tax for tax charged in a territory in which the property is situated, the overseas tax shall be treated for the purposes of those provisions as reduced by the credit.

The IHT Manual provides:

> **27188 Relief under Section 159(3) IHTA 1984 and Section 159(4)** [January 2014]
> ... If relief is due under Section 159(3)(a) IHTA 1984 or Section 159(4)(a) IHTA 1984, Section 159(5) IHTA 1984 must be considered when calculating the foreign tax paid (B in the formulas above). If the foreign country has allowed a credit against its tax for tax paid in another foreign country, please refer to Technical.
> Where relief is due under Section 159(3)(b) IHTA 1984 or Section 159(4)(b) IHTA 1984, above, the foreign tax at B is simply the gross amount paid. You do not need to take account of any credit for tax paid in another country.
> **27189. Procedure when both Section 159(2) and Section 159(3) IHTA 1984 apply** [January 2014]
> It may happen that relief is due under Section 159(2) IHTA 1984 (or convention relief under Section 158 IHTA 1984) and also under Section 159(3) IHTA 1984.
> If this is the case, Section 159(5) states that the credit allowed under Section 159(3) must be calculated on the basis that A in the formula (the Inheritance Tax paid) is the net amount of Inheritance Tax after allowing the credit under Section 158 or Section 159(2)

72.5.5 *Interaction of unilateral IHT credit relief and DTA credit relief*

Section 159(7) IHTA provides:

> Where relief can be given both under this section and under section 158 above [double tax treaties], relief shall be given under whichever section provides the greater relief.

The IHT Manual provides:

> **27200. Procedure when both forms of relief apply** [January 2014]
> Unilateral relief and relief under a DTC are **not** mutually exclusive. Where both reliefs would appeal to be due on the same item of property, relief is restricted by Section 159(7) IHTA 1984 to whichever is the greater. In practice, where the amount of credit is the same under either, the credit should be treated as convention relief.
> In cases where, either;
> - both reliefs are due, but the unilateral relief appears to be the greater or
> - the interaction of the two reliefs is particularly difficult.
>
> You must refer the case to Technical.
> Unilateral relief may be given for a State tax as well as unilateral or convention relief in respect of tax due in the country where the State is situate.
> *Example* (Giles)
> G, a British citizen, dies domiciled in the UK. His estate includes an apartment in New York, stocks and shares in US Companies and a New York bank account.
> The world-wide estate will be subject to UK tax, but US Federal Estate Tax will (because of the terms of the DTC) be payable only on the immovable property in the USA. The UK will give credit for the US tax under the DTC.
> NY State will also charge State Estate Tax on the movable assets situated there and the UK will give unilateral relief for this tax.
> But the total unilateral and convention credit cannot exceed the amount of UK IHT payable on the property concerned.

72.5.6 *Concession for Canada estate duty?*

The IHT Manual provides:

> **27186 Procedure Chart** [January 2014]
> Relief should be given under S159(2) IHTA 1984 rather than S159(3)(a) where tax is paid, under an agreement between the provinces concerned:

- in Quebec or Ontario, or Quebec and British Columbia,
- on shares which are situated in the other province, under UK law.

Any case where the taxpayer or agent disagrees with our view that UK law applies, should be referred to Technical.

Canada abolished estate duty in 1972. This passage is therefore 40 years out of date! For the current Canadian position, see 65.13.4 (Canadian income tax debts deducted for IHT). However it illustrates an approach which may perhaps be applied to federal estate duties in other federal jurisdictions, if there are any.

72.6 Planning

The rule is in short that the relief is the lesser of (1) foreign IHT and (2) UK IHT attributable to the same property. This requires careful planning to maximise the benefit of the relief.

Suppose T owns land in country X which on T's death will bear IHT in country X. If T makes a chargeable gift of the land (eg a gift by will to T's children) then the foreign IHT credit is available. If T makes an exempt gift (eg to T's spouse or to charity) the foreign IHT credit is lost. Foreign jurisdictions do not normally allow death duty exemption on the grounds that a gift is made to a UK charity.[3] For instance, suppose T wishes to makes a will giving foreign property to a UK charity. The gift may bear foreign death duties which are set against UK IHT so the effective IHT burden is reduced or eliminated.[4] It would be better:

(1) to give the foreign property to beneficiaries who are chargeable under UK law.
(2) to give other (perhaps UK) property to the UK charity which would otherwise bear inheritance tax at the full rate.

In some cases the matter could be put right by a deed of variation.

72.7 DTA IHT credit: USA DTAs

Article VI of the UK/France IHT DTA provides:

> Where one Contracting Party imposes duty on the death of a person who was domiciled in its territory at the time of his death on any property

3 In some cases EU member states may allow relief.

4 The position may be complicated further by foreign rules which make the rate of death duty depend on the relationship of the beneficiary to the deceased; forced heirship rules may also need to be considered.

which, under the present Convention, is situated in the territory of the other Contracting Party, the former Party shall allow against so much of its duty, ascertained in accordance with its law, as is attributable to that property a credit (not exceeding the amount of the duty so attributable) equal to so much of the duty imposed by the other Contracting Party as is attributable to such property.

Similarly, Art.VI of the UK/Italy IHT DTA provides:

(1) Where one Contracting Party imposes duty on any property which is not situated in its territory but is situated in the territory of the other Contracting Party, the former Party shall allow against so much of its duty (as otherwise computed) as is attributable to that property a credit (not exceeding the amount of the duty so attributable) equal to so much of the duty imposed in the territory of the other Contracting Party as is attributable to such property.

(2) For the purposes of this Article, the amount of the duty of a Contracting Party attributable to any property shall be ascertained after taking into account any credit, allowance or relief, or any remission or reduction of duty other than in respect of duty payable in the territory of the other Contracting Party

This does not add much to the unilateral IHT credit otherwise available under domestic law but it would be relevant for an asset which is UK situate under domestic situs rules but not UK situate under treaty situs rules.

India and Pakistan DTAs have similar articles but since these countries do not impose IHT, the articles have no effect.

72.8 USA DTA: Credit for foreign IHT

Article 9 USA IHT DTA provides:

(2) Where under this Convention the UK may impose tax with respect to any property other than property which the UK is entitled to tax in accordance with the said Article 6 or 7 (that is, where the decedent or transferor was domiciled in or a national of the UK), then, except in the cases to which para (3) applies, double taxation shall be avoided in the following manner:

(a) Where the US imposes tax with respect to property in accordance with the said Article 6 or 7, the UK shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property.

(b) Where the US imposes tax with respect to property not referred to in sub-para (a) and the decedent or transferor was a national of the UK and was domiciled in the US at the time of the death or transfer, the UK shall

credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property.

(3) Where both Contracting States impose tax on the same event with respect to property which under the law of the US would be regarded as property held in a trust or trust equivalent and under the law of the UK would be regarded as property comprised in a settlement, double taxation shall be avoided in the following manner:

(a) Where a Contracting State imposes tax with respect to property in accordance with the said Article 6 or 7, the other Contracting State shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the first- mentioned Contracting State with respect to that property.

(b) Where the US imposes tax with respect to property which is not taxable in accordance with the said Article 6 or 7 then

(i) where the event giving rise to a liability to tax was a generation-skipping transfer and the deemed transferor was domiciled in the US at the time of that event,

(ii) where the event giving rise to a liability to tax was the exercise or lapse of a power of appointment and the holder of the power was domiciled in the US at the time of that event, or

(iii) where (i) or (ii) does not apply and the settlor or grantor was domiciled in the US at the time when the tax is imposed,

the UK shall credit against the tax calculated according to its law with respect to that property an amount equal to the tax paid in the US with respect to that property. ...

(4) The credits allowed by a Contracting State according to the provisions of paras (1), (2) and (3) shall not take into account amounts of such taxes not levied by reason of a credit otherwise allowed by the other Contracting State. No credit shall be finally allowed under those paragraphs until the tax (reduced by any credit allowable with respect thereto) for which the credit is allowable has been paid. Any credit allowed under those paragraphs shall not, however, exceed the part of the tax paid in a Contracting State (as computed before the credit is given but reduced by any credit for other tax) which is attributable to the property with respect to which the credit is given.[5]

The IHT Manual provides:

27170. USA [January 2014]

Where relief takes the form of a simple waiver of taxing rights by one of the two countries, a special instruction applies (IHTM27177).

Where a DT credit is due you may allow the amount claimed on form IHT400 provisionally but the case must not be closed until the payment has been certified by the US authorities on Form 742.

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5 Art 9(5) deals with claims; see 72.9 (Claims for foreign IHT credit relief).

If a credit seems appropriate, send the taxpayer or agent two prints of Form 742 available from Technical. Ask them to complete the forms and return both copies to us. When you receive the completed Fors 742, send them to Technical, who will then send them on to the USA. The US authorities will keep one copy and certify the other and return it to us. The certified form must be checked and the appropriate credit allowed. If you have any difficulty applying the credit or calculating the tax attributable to the property please seek advice from Technical.

- The credit given cannot be more than the amount of tax payable in the UK on the property concerned.

Certificate of IHT paid for the US authorities

The US form 706 CE is forwarded to this Office in duplicate to be certified by us. The forms must be checked, but you must make sure you do not mark the forms themselves in any way. Send the forms and the file with a note of any error or omission to Technical once all the tax has been paid. If there no further enquiries and all tax has been paid, Technical will arrange for one copy to be certified and sent with a schedule of any necessary amendments to the US authorities; the other copy is filed. The taxpayer is informed that the certificate has been sent and is provided with a copy of any amending schedule.

Where a certificate of tax paid cannot be issued on application because the amount of tax has not been finalised and paid you should explain this to the taxpayer or agents. You should also remind them that they can lodge a provisional claim for a credit with the US authorities (although there is a time limit – under Article 9). When the case is ready you should refer the application and the file to Technical to issue the certificate.

If there is any adjustment of tax after a certificate has been issued the file must again be referred to Technical to issue an amending certificate.

72.9 Claims for foreign IHT credit relief

There is no domestic law provision requiring a claim for unilateral IHT credit relief or for IHT DT relief(unlike the position for IT and CGT where a claim is required by statute). However the treaties assume that a claim is to be made for a credit or a refund of tax and so by implication impose a claim requirement in these cases. The wording varies between treaties.

Article VII India IHT DTA provides:

1. Any claim for a credit or for a refund of duty founded on the provisions of the present Agreement shall be made within six years from the date of the death of the deceased person in respect of whose estate the claim is made, or, in the case of a reversionary interest where payment of duty is deferred until the date on which the interest falls into possession, within six years from that date.

2. Any such refund shall be made without payment of interest on the amount so refunded.

Article VII Pakistan IHT DTA is the same. Article VII France IHT DTA provides:

> 1. Any claim for a credit or for a refund of duty founded on the provisions of the present Convention shall be made within five years from the date of the death of the deceased person in respect of whose estate the claim is made, or, where the event causing duty to be payable occurs at some later date, within five years from that date.
> 2. Any such refund shall be made without payment of interest on the amount so refunded.

Article VII Italy IHT DTA is the same but lacks para 2.

Article 9(5) USA IHT DTA provides:

> Any claim for a credit or for a refund of tax founded on the provisions of the present Convention shall be made within six years from the date of the event giving rise to a liability to tax or, where later, within one year from the last date on which tax for which credit is given is due. The competent authority may, in appropriate circumstances, extend this time where the final determination of the taxes which are the subject of the claim for credit is delayed.

CHAPTER SEVENTY THREE

UK DOMICILIARY MARRIED TO FOREIGN DOMICILIARY

73.1 UK domiciliary married to foreign domiciliary: Introduction

This chapter considers the position of a UK domiciled individual who is married to a foreign domiciled spouse.[1] It is necessary to consider the various taxes separately.

73.1.1 *Cross references*

Joint bank accounts are considered elsewhere: see
77.3 (Joint account: IHT)
77.6 (Remittances from joint accounts).

73.2 Restricted IHT spouse exemption for foreign domiciled spouse

73.2.1 *Restriction on IHT spouse exemption*

Section 18(1) IHTA normally provides complete exemption for transfers between spouses.[2] Section 18(2) IHTA provides an important exception:

> If, immediately before the transfer, the transferor but not the transferor's spouse or civil partner is domiciled in the UK the value in respect of which the transfer is exempt (calculated as a value on which no tax is chargeable) shall not exceed
> [a] the exemption limit at the time of the transfer,
> [b] less any amount previously taken into account for the purposes of the exemption conferred by this section.

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1 References to "spouse", "marriage", and "widow/er" include a civil partner, civil partnership and a surviving civil partner; see App 1.3 ("Spouse" and related expressions) and App 1.4 (Meaning of "civil partner").

2 For the IHT spouse exemption generally, see 67.1 (IHT spouse exemption) ff; see too 63.10 (GWR spouse exemption).

So where:
(1) the transferor is UK domiciled (or deemed UK domiciled), and
(2) the transferee (the spouse of the transferor) is foreign domiciled
the exemption is in principle restricted to the specified amount. I refer to this as **"the restricted IHT spouse exemption"**.

This restriction does not apply the other way round, where the foreign domiciled individual makes a transfer to their UK domiciled spouse. That makes sense because such a transfer brings assets which would have been outside the scope of IHT within its scope.

The restriction does not apply where neither spouse is domiciled in the UK.

The restriction is modified by the USA and the Swiss IHT DTAs.[3]

The transferee spouse may elect to be treated as UK domiciled so as to avoid the restriction.[4]

Transfers which do not qualify for the IHT spouse exemption will be PETs unless some other exemption is in point.

73.2.2 *The amount of IHT spouse relief where spouse exemption is restricted*

Where the IHT spouse exemption is restricted, s.18 provides that the amount of relief is:

> [a] the exemption limit at the time of the transfer,
> [b] less any amount previously taken into account for the purposes of the exemption conferred by this section.

The exemption limit is defined in s.18(2A) IHTA:

> For the purposes of subsection (2), the exemption limit is the amount shown in the second column of the first row of the Table in Schedule 1 (upper limit of portion of value charged at rate of nil per cent).

That is the nil rate band amount (2014/15, £325,000).

An inter-spouse gift within the limit of the restricted spouse exemption is *not* a PET. Section 3A(1A)(b) IHTA provides that a PET is a transfer of value "which, apart from this section, would be a chargeable transfer".[5]

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3 See 70.12 (Extension of IHT spouse exemption).

4 See 61.6 (Spouse election domicile).

5 Transfers before 22 March 2006 are governed by s.3A(1) IHTA but the wording on this point is the same.

So if one spouse makes a gift to the other, that gift uses up the lifetime limit even though the gift is made more than seven years from the death and would otherwise qualify as an exempt transfer, as a PET.

The position is different for a gift of excluded property.[6] Such a gift is not a transfer of value at all and therefore it is not a transfer which qualifies for the spouse exemption and does not use up the restricted exemption.

The position is less clear for a transfer (outside s.11) which qualifies for the annual or normal expenditure exemptions. Such a transfer is an exempt transfer under those exemptions: does it also use up the limit for inter-spouse gifts? There is no clear answer in the legislation but it is suggested that these transfers do not use up the limit. That would better fit the scheme of the legislation.

The IHT Manual provides as follows:

> **11033. Spouse or civil partner domiciled outside UK** [November 2013]
> ... The restriction applies to
> - the value before grossing (IHTM26121)
> - the cumulative total of all transfers to a spouse or civil partner. So you must take into account the amounts allowed under earlier transfers to a spouse of civil partner whether or not they were domiciled or treated as domiciled in the UK at the time in considering whether the restriction is exceeded, and
> - since the exemption applies to transfers made by a individual, if that person has been married or in civil partnership with more than person, the restriction applies to the cumulative total of all transfers to all spouses or civil partners.
>
> Where the appropriate limit is exceeded, you should allocate the exemption in the way which is most favourable to the spouse or civil partner. Factors you should bear in mind include which assets bear the tax and whether business relief (IHTM25131), agricultural relief (IHTM24001) or any other reliefs are available.
> ***Example 1*** *(Mr and Mrs Allsop)*
> In May 2012, Mr A, who was domiciled in the UK transferred £200,000 to Mrs A, who was not domiciled in the UK. Of this transfer, £55,000 is exempt under IHTA1984/S18(2), and £145,000 is a PET (IHTN04057) and assumed to be exempt. Mr A dies in 2020 and leaves all his property

6 Likewise a gift within s.11 IHTA; see 73.4 (Disposition for maintenance of spouse and other exemptions).

to his wife, who remains domiciled outside the UK. Even though Mr A has survived for 7 years after making the transfer, the limited exemption under IHTA1984/S18(2) has all been used and is not available on his death.

***Example 2** (Mr and Mrs Costa)*

In January 2013 Mr C transfers a UK property worth £200,000 to Mrs C. Both are domiciled outside the UK. Exemption under IHTA1984/S18 (1) is available in full. In June 2013 Mr C is deemed to be domiciled in the UK and gives another UK property worth £300,000 to his wife, who remains domiciled outside the UK. The restriction on the exemption under IHTA1984/S18 (2) applies at this point.

At the time of the transfer that triggered the restriction, the spouse exemption available to Mr Costa was £325,000. He has already made a gift to Mrs Costa that qualified for exemption under IHTA84/S18 of £200,000, so the exemption available against this transfer is £125,000. This is because IHTA84/S18(2) reduces the amount of the limited exemption available by 'any amount previously taken into account for the purposes of the exemption conferred by this section'. This means that £175,000 of the transfer will be a PET to Mrs Costa and chargeable to tax if Mr Costa dies before July 2020. .

73.2.3 *EU law aspects*

Where the foreign domiciled spouse is domiciled in another member state, the discrimination before the 2013 changes took effect was unlawful in EU law: it was a breach of free movement of capital.

The government sought to justify the discrimination on the grounds of the "potential avoidance risk".[7] The general application of the spouse exemption on a gift to a foreign domiciled spouse would clearly lead to a loss of UK IHT. (The loss of tax is not "avoidance" in the strict sense, but nothing turns on that.) However the funds which fall outside the scope of UK IHT in principle fall within the scope of estate or gift taxes in the MS in which the spouse is resident or domiciled. If an inter-spouse gift gives rise to a tax saving it is because the MS concerned does not impose the tax or not at the UK's (comparatively) high rates. That does not justify the restriction on free movement of capital.[8]

The EC formally objected to the pre-2013 UK law:

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7 Public Bill Committee debate on Finance Bill, Hansard 13 May 2008 col.181.

8 See 60.8.6 (Counteracting tax advantages of non-residents); 60.11.1 (Discrimination against non-residents).

> The UK legislation provides that transfers between domiciled spouses or civil partners are exempt from inheritance tax. However, transfers between domiciled and non-domiciled spouses or civil partners are not exempt from inheritance tax. Furthermore, in the latter case the rules on the nil rate band applicable to subsequent transfers differ and may result globally in a higher taxation.[9] This difference in tax treatment of transfers between domiciled and non-domiciled spouses is of a discriminatory nature and contrary to EU rules (Article 18 TFEU).
> The Commission's request takes the form of a reasoned opinion (the second step of the infringement procedure)...[10]

HMRC's papers on the 2013 spouse exemption reform did not mention the EU law background, but this point must have been tacitly accepted.

The new law is fairer than the old, so supporters of the EU may claim it as a case where EU law has had a beneficial influence.

73.2.4 *Inter-spouse gifts before 6 April 2013*

Prior to 6 April 2013, s.18(2) IHTA provided:

> *If, immediately before the transfer, the transferor but not the transferor's spouse or civil partner is domiciled in the UK the value in respect of which the transfer is exempt (calculated as a value on which no tax is chargeable) shall not exceed £55,000 less any amount previously taken into account for the purposes of the exemption conferred by this section.*

The FA 2013 has made two changes:

(1) It increased the exemption from £55,000 to the nil rate band.
(2) It introduced the spouse election allows the spouse to opt out of the restriction.[11]

Section 178(4) FA 2013 provides the commencement rule:

> The amendments made by this section have effect in relation to transfers of value made on or after 6 April 2013.

Thus (subject to a claim where appropriate that EU law overrode domestic law) the old £55k limit applies to gifts made before 6 April 2013.

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9 The point is that an inter spouse gift (above the restriction) reduces the donor's nil-rate band.

10 Reference: IN/2010/2111; Memo Event Date: 24/10/201 *http://europa.eu/rapid/press-release_MEMO-12-794_en.htm?locale=en*

11 See 61.6 (Spouse election domicile).

Moreover, the IHT spouse election cannot be made for such gifts. These rules will continue to be relevant until 2020, when pre-2013 PETs will fall out of charge.

The IHT Manual shows that HMRC intend to take this point:

> **IHTM13046: Domicile: election by non-UK domiciled spouse or civil partner: the date the election takes effect** [November 2013]
> ... A consequence of this is that if a person domiciled in the UK makes a gift to their non-UK domiciled spouse or civil partner before 6 April 2013 and dies within 7 years, the £55,000 limit that applies before that date continues to apply (IHTM11033).
> Example (Jane & Kate)
> In May 2012, J, who was domiciled in the UK transferred £400,000 to her civil partner K, who was not domiciled in the UK.
> Of this transfer, £55,000 is exempt under IHTA1984/S18(2), and £345,000 is a PET and assumed to be exempt.
> J dies in 2017.
> The gift is now a failed PET and after deduction of the nil rate band, £20,000 will be subject to tax.

Where there has been a death before the 2013 rules take effect, a spouse domiciled in a MS should argue for the application of the IHT spouse exemption as a matter of EU law.

73.3 Spouse or widow of settlor becomes entitled to settled property

The termination of an estate interest in possession (during the life of the life tenant) is a transfer of value under s.52 IHTA. Section 53(4) IHTA provides:

> Tax shall not be chargeable under s.52 above if on the occasion when the interest comes to an end—
> (a) the settlor's spouse or civil partner, or
> (b) where the settlor has died less than two years earlier, the settlor's widow or widower or surviving civil partner,
> becomes beneficially entitled to the settled property and is domiciled in the UK.[12]

This relief only applies if the spouse is UK domiciled (or has made a spouse election). The restriction on s.53(4) relief is broadly consistent with the restriction to the spouse exemption considered above.

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12 Section 53 goes on to set out some exceptions not discussed here.

Section 54(2) IHTA sets out similar rules for the termination of an estate interest in possession on the death of the life tenant.

73.4 Disposition for maintenance of spouse and other exemptions

Where the IHT spouse exemption does not apply, another exemption may sometimes fill the gap. An inter-spouse gift may qualify for relief under s.11(1) IHTA:

> A disposition is not a transfer of value if it is made by one party to a marriage[13] or civil partnership in favour of the other party ... and is—
>
> (a) for the maintenance of the other party ...[14]

This should normally[15] apply, in particular, to the common case where an individual gives a half share in the family home to their spouse. The most basic requirement of "maintenance" is to have a secure roof over one's head.[16] In *Phizackerley v IRC*[17] the Special Commissioners correctly stated that the normal reason for such a gift is to give the donee spouse security in her own home. Unfortunately he concluded that it was not "for the maintenance" of the other party, it was to give the other party security. With respect, this can hardly be right, because "security" and "maintenance" are not alternatives. It is because the gift gives the spouse security that it is for her maintenance. But it will now be necessary to appeal to the High Court to establish this point.

A gift which is within s.11 IHTA (Disposition for family maintenance) is outside the scope of the GWR rules. For such a disposition is not a transfer of value; so it is deemed not to reduce the transferor's estate: s.3 IHTA. So by implication it must be treated as not being a "disposal by way of gift". (Any other conclusion would lead to absurd results. For a

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13 "Marriage" is defined to include a former marriage in certain cases: s.11(6) IHTA.

14 I mention for completeness the further relief in s.11(3) which overlaps with s.11(1). In practice an inter-spouse gift which qualifies under s.11(3) will also qualify under s.11(1).

15 It would be different if the purpose of the gift was not to provide for the spouse but some other purpose, such as IHT planning.

16 Lump sum payments can constitute "maintenance". Contrast s.2(1)(b) Inheritance (Provision for Family and Dependants) Act 1975 (formerly s.1(4) Inheritance (Family Provision) Act 1938) which states that lump sum payments may constitute "maintenance" for the purpose of the Act. This is also assumed in Sch 15 para 10(1)(d) FA 2004 (which takes gifts within s.11 out of the pre-owned assets rules).

17 [2007] STC (SCD) 328.

disposition between spouses within s.11 is not a transfer of value, and so not within the IHT spouse exemption, and so would come within the GWR rules even if both spouses were UK domiciled.)[18]

The normal expenditure exemption (s.21 IHTA) may also be in point. Gifts which qualify for this exemption are still within the reservation of benefit rule.

73.5 Transferable nil-rate band

Section 8A IHTA provides:

> (1) This section applies where—
> (a) immediately before the death of a person (a "deceased person"), the deceased person had a spouse or civil partner ("the survivor"), and
> (b) the deceased person had unused nil-rate band on death.

Section 8A(2) IHTA defines "unused nil-rate band on death":

> A person has unused nil-rate band on death if M > VT where—
> M is the maximum amount that could be transferred by a chargeable transfer made (under section 4 above) on the person's death if it were to be wholly chargeable to tax at the rate of nil per cent. (assuming, if necessary, that the value of the person's estate were sufficient but otherwise having regard to the circumstances of the person); and
> VT is the value actually transferred by the chargeable transfer so made (or nil if no chargeable transfer is so made).

The amount of the unused nil-rate band depends on the amount of the chargeable transfer on the death of the first spouse. If there is no chargeable transfer, the full nil-rate band is unused and is transferrable.[19]

The IHT Manual provides:

> **43042 Domicile of first spouse or civil partner to die** [October 2009]
> Every person, UK domiciled or not, is entitled to the full nil rate band that can be set against their estate that is subject to IHT.
> The availability of TRNB on the estate of the first to die of a non domiciled spouse or civil partner is calculated only by reference to property that is

18 If my view were wrong the further anomaly would arise that gifts of qualifying investments to charity would fall within the scope of GWR, because such gifts fall within s.12 IHTA and not s.102(5)(d) FA 1986; but it is not necessary to pursue that here.

19 S.8A(3)(4) IHTA.

potentially subject to an UK IHT charge. For a non domiciled spouse or civil partner, **VT** [IHTM43020] will be calculated only by reference to their estate in the UK. Assets held outside the UK, by a person not domiciled, or deemed domiciled in the UK, regardless of the devolution of those assets are not taken into account when calculating the available unused nil rate band.

Thus where the survivor dies in the UK and their spouse or civil partner, who held no UK assets, died abroad leaving all their all overseas assets to their children, none of the nil rate band was used on the first death and the personal representatives of the survivor may claim to transfer 100% of the nil rate band to the estate of the survivor.

Example[20]

Abdul [died] domiciled abroad. His only asset situated in the UK was a US dollar account containing US$250,000. He left this and the remainder of his estate to his son, Jamil who lives in the UK.[21] After the death, his wife, Soroya, moved to the UK to live with Jamil and died domiciled in the UK.[22]

The assets situated outside the UK are not liable to IHT. The US dollar account is left out of account [IHTM04380] in determining Abdul's estate at death. So although whole estate passed to Jamil, no property was chargeable to IHT, leaving the nil rate available for transfer in full on Soroya's death..

The next section needs to be amended to reflect the increase in the limit for the restricted spouse exemption.

IHTM43043 - Domicile: calculation where the domicile of the survivor at the first death is outside the UK [October 2009]

On the death of the first spouse or civil partner, exemption for assets passing to the surviving spouse or civil partner may be limited to £55,000 in accordance with s8(2) IHTA if the surviving spouse or civil partner was not domiciled or deemed domiciled in the UK. [IHTM11033]

If the entire estate passed to the surviving spouse or civil partner, anything over £55,000 is a chargeable legacy. Where the net estate is above the nil rate band plus £55,000 there will be no nil rate band to transfer, as illustrated below.

Example

Susan died in 2002/03. She left an estate worth £450,000 all to her husband Lars who is domiciled in Sweden.

Unused nil rate band calculation

M = £250,000

VT = £395,000 (Estate of £450,000 less limited spouse exemption of £55,000)

M is not greater than **VT**, so there is nothing to transfer.

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20 The HMRC example, as is the current trend, contains several facts which are wholly irrelevant to the tax position and which only serve to make it harder to identify the relevant points. The following footnotes identify these.

21 Where the son lives, and where he is domiciled (which might not be the same) are completely irrelevant to the example.

22 Where the widow lives and where she dies domiciled, are irrelevant to the example.

Where the net estate is less than the nil rate band plus £55,000, there will still be an amount of nil rate band available to transfer. This example shows how both the amount that the net estate is below the nil rate band, and limited spouse exemption combine to produce the amount of nil rate band available to transfer.

Example

Charles died in 2002/03. He left an estate worth £200,000 all to his wife Helga who is domiciled in Sweden.

Unused nil rate band calculation

M = £250,000

VT = £145,000 (Estate of £200,000 less limited spouse exemption of £55,000)

M is greater than **VT** by £105,000

Transferable nil rate band calculation

E =£105,000

NRBMD = £250,000 so

(105,000 ÷ 250,000) × 100 = 42.0000%

On Helga's death, the nil rate band on her death would be uprated by 42%. This approach will be appropriate on the death of the survivor when either

- they remain domiciled abroad and their UK assets exceed the single nil rate band, or
- between the first death and their own, they became domiciled, or deemed domiciled in the UK.

See too 69.8 (Transferable nil rate bands and IHT DT reliefs).

73.6 Inter-spouse gift of 100% BPR or APR property

This section considers a gift of property qualifying for 100% business or agricultural property relief from a UK domiciled individual to their non-UK domiciled spouse. It is necessary to consider IHT on the gift and the gift with reservation rules. For convenience I refer to "business property" but similar rules govern agricultural property.

73.6.1 *IHT on the gift*

In the normal case of a gift of property qualifying for 100% BPR, the value transferred by the gift is nil. However, s.113A IHTA provides:

Transfers within seven years before death of transferor

(1) Where any part of the value transferred by a potentially exempt transfer which proves to be a chargeable transfer would (apart from this section) be reduced in accordance with the preceding provisions of this Chapter, it shall not be so reduced unless the conditions in subsection (3) are satisfied.

The conditions which must be satisfied are set out in subsection (3):

> The conditions referred to in subsections (1) and (2) above are—
> (a) that the original property was owned by the transferee throughout the period beginning with the date of the chargeable transfer and ending with the death of the transferor; and
> (b) except to the extent that the original property consists of shares or securities to which subsection (3A) below applies that, in relation to a notional transfer of value made by the transferee immediately before the death, the original property would (apart from s.106 above) be relevant business property.

In brief, BPR is lost unless the property is retained by the donee for seven years. (There is an exception for replacement property which is not discussed here.)

73.6.2 *GWR on the gift if the donor survives seven years*

What about GWR? The position varies according to whether or not the donor survives seven years from the gift.

If the donor does survive seven years then s.113A has no application. By subsection (1) it applies to a PET *which proves to be a chargeable transfer*. If the donor survives seven years then the PET does not "prove to be a chargeable transfer". Accordingly the value transferred by the gift remains at nil. The gift therefore normally qualifies as an exempt transfer under:

(1) s.20 IHTA (small gifts); or
(2) s.18 IHTA (IHT spouse exemption).

The gift therefore falls outside the scope of the GWR rules by virtue of s.102(5) FA 1986.

The principle applies to:

(1) outright gifts of 100% BPR property whether or not to spouses;
(2) gifts to trusts under which the spouse has an interest in possession even if such gifts are not "outright gifts" (but consider s.102(5A)).

It does not matter that the property is sold or disposed of by the donee within the seven years as long as the donor has survived seven years. Section 113A(7A) IHTA provides:

> The provisions of this Chapter for the reduction of value transferred shall be disregarded in any determination for the purposes of this section of whether there is a potentially exempt or chargeable transfer in any case.

This is irrelevant because the disregard is only for the purposes of s.113A, not for the purposes of ss.18, 20 IHTA and s.102 FA 1986.

73.6.3 *GWR if donor dies within seven years*

The position is different if the donor dies within seven years. Suppose:
(1) H (UK domiciled) gives 100% BPR property to W (foreign domiciled);
(2) H dies within seven years;
(3) The conditions in s.113A(3) are not satisfied (for instance the property has been sold[23] or disposed of by the donee).

In that case the value transferred is *not* reduced: s.113A(1). It is considered that the disallowance of BPR applies for all purposes of IHT. So the gift falls outside the protection of ss.18 and 20 IHTA (assuming the value transferred exceeds the nil rate band limit and £250 respectively) and the GWR provisions can in principle apply.

It is impossible to believe anybody actually thought through these rules at the time the legislation was enacted. But these are the consequences of the words used and the result, if a little complicated, is relatively sensible.

73.7 Divorce settlement where IHT spouse exemption not available

Suppose:
(1) H transfers assets to W in order to settle a divorce claim, and
(2) The disposition falls outside the IHT spouse exemption.[24]

No IHT charge arises. First, the disposition is not a transfer of value, if made under court order.[25] Secondly, s.10 IHTA provides:

> **Dispositions not intended to confer gratuitous benefit**
> (1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either—
> (a) that it was made in a transaction at arm's length between persons not connected with each other, or
> (b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other.

H does not normally intend to confer any "gratuitous benefit" on W.

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23 Though there is a possibility of reinvestment relief in this case: see s.113B IHTA.

24 This may be because H is UK domiciled and W is not; or because the transfer is made after the marriage is dissolved.

25 See *McCutcheon on IHT* (6th ed., 2013), para 2.35. Relief may also be available under s.11 IHTA; see 73.4 (Disposition for maintenance of spouse and other exemptions).

(Assume the divorce settlement is negotiated at arm's length.) Accordingly the disposition falls within s.10 IHTA and is not a transfer of value for IHT purposes.

There is a theoretical HMRC argument that the condition in s.10(1)(b) IHTA is not satisfied. The argument would be that a divorce settlement cannot be "such as might be expected to be made in a transaction at arm's length between persons not connected with each other" since persons not connected with each other would not be in a divorce situation. In my view this argument is not correct. It is the old question of how far one carries the fiction of a deeming provision. The argument carries it too far because it reaches a conclusion which does not fit in with the scheme of the IHTA. IHT Manual (while not explicit) suggests that HMRC do not take the point.[26]

73.8 Associated operations on inter-spouse gift

The IHT Manual provides:

> **14833 Gifts between spouses or civil partner** [January 2010]
> Where property
> - given unconditionally by one spouse or civil partner to the other is
> - subsequently transferred by the latter to a third party,
>
> you cannot use the associated operations provisions to attribute the transfer to the first spouse or civil partner.
> The Chief Secretary to the Treasury assured Parliament that this would be HMRC's practice, and it was publicised in a Press Release dated 8 April 1975.
> However, where the transfer between spouses or civil partners is part of a more complex series of transactions which taken together are the means whereby one of them makes a disposition to a third party, it may be more appropriate to use the associated operations to allocate the transfer(s) to the correct transferor.

73.9 IHT planning for mixed marriage

73.9.1 *Simple gift to foreign domiciled spouse*

A simple and obvious short- and medium-term course is:

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26 IHTM 4165 [September 2008]: "Dispositions made on divorce or dissolution of a civil partnership (IHTM11032) for the benefit of a former spouse or civil partner, whether under a Court Order or as a result of arm's length negotiations, are normally within s.10 IHTA 1984."

(1) the UK domiciled spouse should give assets to their foreign domiciled spouse absolutely;
(2) the foreign domiciled spouse keeps the assets in a form where they are not UK situate, so they remain excluded property.

The gift may be a PET but that may not in practice be a serious concern. If the reservation of benefits rule applies, however, this effectively neutralises any tax saving. Indeed it may make the position worse. See 63.19 (IHT spouse exemption defence to GWR death charge). This often makes simple gifts impractical.

73.9.2 *Gift to foreign domiciled spouse, followed by settlement by spouse*

A more sophisticated option is:

(1) the UK domiciled spouse gives assets to their foreign domiciled spouse; and
(2) the foreign domiciled spouse subsequently gives the assets to a settlement.

In principle the property in the settlement may be excluded property. One advantage of this is if the donee spouse later becomes UK domiciled: see 66.1 (IHT planning in anticipation of acquiring UK domicile). Another advantage is CGT planning. A third advantage is that this should avoid the gifts with reservation rule.[27] This strategy only works if the UK domiciled spouse is not a settlor: see 80.36 (Planning to create trust with foreign domiciled settlor).

73.10 CGT spouse exemption

Section 58(1) TCGA provides:

> If, in any year of assessment,
> (a) an individual is living with his spouse or civil partner, and
> (b) one of them disposes of an asset to the other,
> both shall be treated as if the asset was acquired from the one making the disposal for a consideration of such amount as would secure that on the disposal neither a gain nor a loss would accrue to the one making the disposal.

I refer to this as "**the CGT spouse exemption**". This exemption applies regardless of the domicile of the spouses. It applies to sales at market value as well as gifts.

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27 See 63.15 (Gift to foreign domiciled donee who creates a settlement).

The relief does not apply to (1) unmarried couples or (2) married couples living apart. Section 58(2) contains (usually) immaterial exceptions which are not discussed here.

73.11 CGT planning for mixed marriage

73.11.1 *Asset yielding a gain*

Suppose the UK domiciled spouse owns an asset which will give rise to a gain on a disposal. A simple and obvious course is:

(1) The UK domiciled spouse transfers[28] the asset to their foreign domiciled spouse.

(2) The foreign domiciled spouse may be in a position to sell the asset without CGT.[29]

The GAAR might apply if there is an arrangement under which the donee returns the proceeds of sale to the donor.

Comparable points arise for losses: see 54.13 (Inter-spouse transfer).

73.11.2 *Non-resident spouse*

The relief applies regardless of residence, so similar planning points arise if one spouse is UK resident and the other is not. The CG Manual provides:

> **22300 NR spouse or NR civil partner** [August 2008]
> ... There is no longer any authority to treat a non-resident spouse as separated from a resident spouse merely because of their residence status. Similarly a non-resident civil partner may not be treated as separated from a resident civil partner merely because of their residence status. So the possibility of passing assets outside the UK tax net remains.

73.12 Income tax planning for mixed marriage

A simple and obvious course is:

(1) the UK domiciled spouse should give assets to their foreign domiciled spouse absolutely; and

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28 The transfer may be a gift or a sale at market value. The latter avoids the IHT problems discussed at 73.2 (Restriction on IHT spouse exemption for foreign domiciled spouse) and 63.10 (GWR spouse exemption) but take care on implementation, especially s.58(2) TCGA. In the case of a sale the spouse will need independent legal advice.

29 See 49.1 (Capital gains of UK residents).

(2) the foreign domiciled spouse invests in property giving rise to foreign investment income which is not remitted.

The inter-spouse gift, strictly, satisfies the transfer of asset conditions. The transferor would then fall within s.720 ITA since they have "power to enjoy" their wife's income. This is because s.714(4) ITA provides:

> In this Chapter references to individuals include their spouses or civil partners.

However, RI 201 provides relief:[30]

> Unless transactions are part of a wider arrangement, Revenue practice is not to seek to assess a UK domiciled individual on the income of a non-UK domiciled spouse, where that income arises from a transfer of assets by that spouse and would be outside the charge to tax under s 739 ICTA by virtue of the provisions of s 743(3) ICTA.

The ToA draft guidance cites this and then provides:

> **INTM600460 - General Conditions All Cases: The Individual: Introduction**
> This statement indicates broadly the approach that will be taken to individuals and their spouses or civil partners in relation to the application of these provisions. In general (unless there are wider arrangements) HMRC will not use transfer of assets to charge tax on one spouse or civil partner in respect of income arising to the other spouse or civil partner, where that spouse or civil partner has made a transfer of assets but is, for example, outside the charge because say of the application of non-UK domicile provisions. In effect, the general approach will be to apply the word individual (where the individual has a spouse or civil partner) in a way that is consistent with the individual who has the power to enjoy income of a person abroad, entitlement to capital sums or who receives benefits as a result of relevant transactions. But it may be equally valid in this context to use the term in a way that is consistent with an individual who, by means of relevant transactions, seeks to avoid a liability to income tax. Where spouses or civil partners are therefore in some way connected with relevant transactions and the results of such transactions, regard will be had to the particular facts where the extended meaning of individual may impact upon the potential

30 This is perhaps a concession but the better view is that the inter-spouse transfer is tax mitigation not tax avoidance so the motive defence applies. Tax Bulletin 81 states (obviously) that the same practice applies to civil partners.

charge.

The gift would also be a "settlement" for the purposes of s.624 ITTOIA. However, s.626 ITTOIA normally provides relief:

(1) The rule in s.624(1) does not apply in respect of an outright gift—
  (a) of property from which income arises,
  (b) made by one spouse to the other or one civil partner to the other, and
  (c) meeting conditions A and B.

(2) Condition A is that the gift carries a right to the whole of the income.

(3) Condition B is that the property is not wholly or substantially a right to income.

(4) A gift is not an outright gift for the purposes of this section if—
  (a) it is subject to conditions, or
  (b) there are any circumstances in which the property, or any related property[31]—
    (i) is payable to the giver,
    (ii) is applicable for the benefit of the giver, or
    (iii) will, or may become, so payable or applicable.

73.13 The GAAR and gifts between spouses

The GAAR guidance provides:

D19 **Gifts between spouses**

This example is intended to illustrate standard tax planning on gifts between spouses.

D19.1 ***Background***

D19.1.1 This example considers the capital gains tax position on an arrangement involving a gift of shares between spouses, followed by death of the transferee.

D19.2 ***The facts***

D19.2.1 In January 2012 Mr and Mrs Jones are told that Mrs Jones is terminally ill. In February Mr Jones gives his shares in an investment company, which are standing at a significant gain, to his wife. Under the terms of her Will as drafted at the date of the gift he will inherit those shares when she dies. Mrs Jones has full capacity at the time of the gift.

D19.2.2 Mrs Jones dies in June and the shares pass to Mr Jones under the terms of her Will. Mrs Jones has not executed a new Will since the gift.

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31 s.626(5) ITTOIA provides that:

"'Related property' has the same meaning in this section as in s.625."

So we turn to s.625(5) which provides:

"In this section 'related property', in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income from it."

D19.3 ***The relevant tax provisions***

Sections 58, 62(1)(b) and 62(4)(a) TCGA 1992.

D19.4 ***The taxpayer's tax analysis***

D19.4.1 The gift of the shares is a transfer between a husband and wife who are living together. This transaction is treated by s58 TCGA 1992 as taking place for such consideration as will give rise to neither a gain nor a loss.

D19.5 All the assets of the deceased which pass to his or her personal representatives are deemed to have been acquired by them at market value at the date of death under s62(1)(b)TCGA 1992. When beneficial ownership of any asset of the estate passes from the personal representatives to a legatee, S62(4)(a) TCGA 1992 provides that no chargeable gain shall accrue to the personal representatives.

D19.5.1 In summary, there is no chargeable gain on the gift of shares by Mr Jones to Mrs Jones and Mr Jones re-acquires the shares at market value at the date of his wife's death. In effect, the gain that has accrued during the earlier ownership of shares by Mr Jones has disappeared.

D19.6 ***What is the GAAR analysis under [s.207(2) FA 2013]?***

D19.6.1 The main purpose of the arrangement is to obtain a tax advantage. The gift of shares was made by Mr Jones in the hope of washing out the gains on the understanding that his wife would leave them back to him.

D19.6.2 *Are the substantive results of the arrangements consistent with any principles on which the relevant tax provisions are based (whether express or implied) and the policy objectives of those provisions?*

Yes. The principle of s58 TCGA 1992 is to allow assets to be transferred between spouses and between civil partners on the basis of no gain/no loss.

Assets passing on death to personal representatives are treated as taking place at market value and no gain is charged when the assets are passed to the legatees.

D19.6.3 *Do the means of achieving the substantive tax results involve one or more contrived or abnormal steps?*

The means of achieving the tax results depend upon the gift, the death of Mrs Jones and her choosing to leave the shares to Mr Jones in her Will. There are no abnormal or contrived steps here; the transactions are normal arrangements between spouses or civil partners.

D19.6.4 *Are the arrangements intended to exploit any shortcomings in the relevant tax provisions?*

No.

D19.6.5 *Do the tax arrangements accord with established practice and has HMRC indicated its acceptance of that practice?*

Yes. HMRC sets out in its instruction Manuals how these transactions are to be treated for CGT purposes.

D19.7 ***Conclusion***

D19.7.1 These arrangements can reasonably be regarded as a reasonable course of action in relation to the tax provisions having regard to all the circumstances. The GAAR would not apply.

D19.8 ***An alternative arrangement - What if the facts were the same as those above but the gift of shares was made on the day of Mrs Jones' death?***

D19.8.1 HMRC's view is that so long as Mrs Jones was in full capacity at the time of the

gift the analysis would be the same and that the GAAR would not apply. This assumes of course that the gift was validly completed prior to death.[32]

This example is not one of the topics discussed in this chapter, but it supports the view that planning of the type discussed in this chapter is not within the scope of the GAAR.

32 HMRC GAAR Guidance Part D (Examples) (April 2013) accessible *http://www.hmrc.gov.uk/avoidance/gaar-partd-examples.pdf*

CHAPTER SEVENTY FOUR

THE FAMILY HOME AND ITS CHATTELS

74.1 The family home and its chattels: Introduction

This chapter deals with two topics: the forthcoming charge to CGT on non-residents dwellinghouses; and the benefit in kind charge where residential property or chattels are held in a company.

The next chapter deals with the corporate residential property regime (the SDLT penal rate, ATED and ATED-CGT), and the general question of planning for the purchase or holding of residential property.

74.2 Forthcoming CGT charge on non-residents dwellinghouse

Non-residents are not normally subject to CGT on gains accruing to them, even if the gains accrue on UK situate assets.[1] However HMRC propose to extend CGT to gains accruing to non-residents disposing of UK residential property. The new charge will arise from April 2015 and apply only to gains arising from that date.

At the time of writing, the only material for discussion is a short[2] consultation document.[3] There is no point in a detailed discussion here, because shortly after publication of this book the consultation document will be superceded by a consultation response document or other announcements. It is sufficient to note that the new CGT charge will apply to all residences held by non-residents, whether individuals, trusts or companies.

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1 See 49.1 (Territorial scope of CGT).

2 The document is not short, at 41 pages, but only 11 of those pages actually contain a discussion of the proposed reforms.

3 HMRC & HM Treasury, "Implementing a capital gains tax charge on non-residents: consultation" (March 2014) *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298759/CGT_non-residents_condoc.pdf*

The charge will be restricted (for now?) to residential accommodation:

> The government does not intend to change the tax treatment for property, such as office and industrial buildings, which cannot be used as and are not in the course of being converted to a place to live.

There is no relief for property let to third parties (unlike ATED):

> 2.4 However, it would not be right to exclude all disposals of property used for commercial purposes, for example residential property used to generate income from letting. UK residents pay CGT when they sell a home that is not their main residence, including residential property that they have bought for rental purposes. The government believes that it would be unfair to charge CGT on residential property disposed of by a UK person who has the property as a second home, and not to do likewise when an equivalent residential property is disposed of by a non-resident landlord. The government also believes that gains made on disposals of residential property used as an investment should be subject to CGT.
> 2.5 In this respect, the CGT charge on non-residents will differ from the approach the government has introduced for enveloped property where ATED and the ATED-related CGT charge do not apply to property rental businesses.

It is difficult to find a convenient label for the new charge. "The Nonresidents Residence charge" (or variants) will not do. The best I can suggest is: **"the non-residents dwellinghouse charge"**.

74.2.1 *Double taxation relief*

Article 13(1) OECD model provides:

> Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

Article 13(5) OECD Model provides:

> Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

There is no relief where a DTA follows OECD model form, as the gain arises from UK situate land. Taxing rights are given to the residence state and not the source state, but not for land. Instead, foreign taxation should

give a credit for UK tax - but note there are likely to be different methods of computing gains.

74.3 Home owned by company: Benefit in kind charge

The charge on living accommodation is to be found in ss.97 and 102 ITEPA:

> **97 Living accommodation to which this Chapter applies**
> (1) This Chapter applies to living accommodation provided for—
> (a) an employee, or
> (b) a member of an employee's family or household,
> by reason of the employment.
> ...
> **102 Benefit of living accommodation treated as earnings**
> (1) If living accommodation to which this Chapter applies is provided in any period—
> (a) which consists of the whole or part of a tax year, and
> (b) throughout which the employee holds the employment,
> the cash equivalent of the benefit of the accommodation is to be treated as earnings from the employment for that year.
> (2) In this Chapter that period is referred to as "the taxable period".

The EI Manual contains much interesting material on these provisions which cannot be set out here for lack of space.

74.4 "Employee" "family" and "household"

74.4.1 *"Employee"*

For the meaning of "employee" see 22.2 ("Employer", "employee" and "employment") and 74.8 (Who is a shadow director?).

Former employees are not caught. HMRC agree. The EI Manual provides:

> **EIM11408 - Living accommodation: meaning of by reason of the employment: provided by someone other than the employer** [February 2006]
> ...Part 3 Chapter 5 ITEPA 2003 does not apply to a pensioner or a former employee. But if the continued use of living accommodation is provided after termination of employment see EIM12805 onwards [Termination payments and benefits]...

The disguised remuneration rules would need consideration.

74.4.2 *"Family"*

Section 721(4) ITEPA defines "family":

> For the purposes of this Act the following are members of a person's family—
>
> (a) the person's spouse or civil partner,
>
> (b) the person's children and their spouses or civil partners,
>
> (c) the person's parents, and
>
> (d) the person's dependants.

Stepchildren are excluded, as are parents-in-law. They will however still qualify as family if they are dependants.

Illegitimate children do not count as "children"; see s.721(6) ITEPA.[4] This is anomalous by contemporary standards but it will not often be relevant and the parent of illegitimate children is not likely to complain. Section 721(6) should obviously be repealed.

74.4.3 *"Household"*

Section 721(5) ITEPA provides:

> For the purposes of this Act the following are members of a person's family or household—
>
> (a) members of the person's family,
>
> (b) the person's domestic staff, and
>
> (c) the person's guests.

74.5 "By reason of the employment"

The expression "by reason of the employment" is extended by s.97(2) ITEPA so it does not mean "by reason of the employment" at all. In order to follow s.97(2) one needs to read it with s.97(1):

> (1) This Chapter applies to living accommodation provided for—
>
> (a) an employee, or
>
> (b) a member of an employee's family or household,
>
> by reason of the employment.
>
> (2) Living accommodation provided for any of those persons by the employer is to be regarded as provided by reason of the employment ...[5]

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4 In Scots law there are no illegitimate children so this does not apply to Scots domiciled individuals: s.21 Family Law (Scotland) Act 2006.

5 For completeness: s.97(2) continues:

"unless—

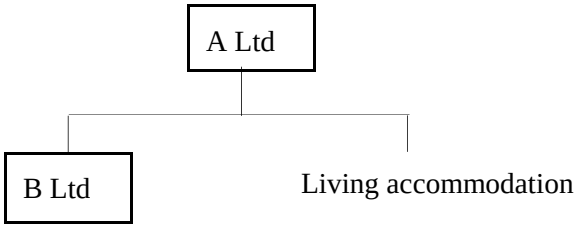
(a) the employer is an individual, and

Thus:

(1) Where the accommodation is provided by the employer, one does not ask whether it is actually provided by reason of employment: it is deemed to be so provided.

(2) Where accommodation is provided by a person other than the employer, the living accommodation charge only applies if the accommodation is actually provided by reason of the employment.

Suppose a company A owns living accommodation (occupied by T) and holds another company, B Ltd:



If T is an employee of A Ltd, T is in principle taxable on the living accommodation. The fact that the property is not provided by reason of the employment is irrelevant as the deeming provision in s.97(2) applies. If T is an employee of B Ltd, T is only taxed if T actually occupies the property by reason of T's employment.

B Ltd is (by definition) a person involved in providing the accommodation[6] but B Ltd is not deemed to provide the accommodation.

74.5.1 *Third party benefits*

The EI Manual provides:

> **EIM20503 - The benefits code: "by reason of the employment": expenses paid and benefits provided by someone other than the employer: third party benefits** [December 2011]
> Expenses payments and benefits made or provided by someone other than the employee's employer are often called "third party benefits". Such payments and benefits are within the rules in the benefits code (EIM20006) where they are made or provided "by reason of the employment" (EIM20501) under the normal meaning of those words.

(b) the provision is made in the normal course of the employer's domestic, family or personal relationships."

The exception is not relevant here.

6 See 74.10.1 (Person involved in providing the accommodation).

But they are not chargeable under those rules if they are otherwise chargeable as earnings, for example, under Section 62 ITEPA 2003. Examples of benefits which are chargeable as earnings are at EIM00530 onwards.

Interaction of "by reason of the employment" with Section 62 ITEPA 2003

It is important to understand the distinction between Section 62 on the one hand, and Sections 70(1) and 201(2) on the other hand. Section 62(1) applies to earnings "in relation to an employment", including anything that is an "emolument of the employment" (Section 62(2)(c)). Section 70(1) and Section 201(3) apply to expense payments and benefits provided "by reason of the employment". Section 62 is based on what was previously Section 19 ICTA 1988, which charged to tax emoluments "from an employment". Case law shows that the phrase "by reason of the employment" has a wider meaning than "from the employment" (EIM00600). The words "from the employment" are not reproduced in Section 62 but earnings chargeable under that section include emoluments "of the employment" and in this context "of the employment" has the same meaning as "from the employment".

Case law guidance: by reason of the employment

In *Wicks v Firth* (56 TC 338) Lord Denning said that "by reason of the employment" covered cases where an employee would not have received a benefit unless he had been an employee. The employment must be one of the causes of the benefit being provided. It need not be the sole cause or even the main one. But it must be an operative cause in the sense that it was a condition of the benefit being granted.

In the same case Lord Oliver said that the question to ask is "what is it that enables the person concerned to enjoy the benefit?" If the answer to that question properly includes "the employment" as one of the factors then that is "by reason of" the employment.

In *Mairs v Haughey* (66 TC 273) Lord Chief Justice Hutton preferred Lord Oliver's way of expressing the test. In particular where the employment was only an incidental factor in past history, and not a current reason for the benefit being provided, his view was that did not amount to "by reason of employment".

These judicial comments were given as general observation and whilst they carry weight they are not a legally binding restriction on the meaning of the words "by reason of". In practice you can normally assume that a benefit which is provided by someone other than the employer and which is plainly connected with the employee's employment has been provided by reason of the employment...

The EI Manual provides:

> **EIM11408 - Living accommodation: meaning of by reason of the employment: provided by someone other than the employer** [February 2006]
> ... Where the living accommodation is provided by someone other than the employer, it is necessary to show that the individual's employment is a factor in its provision. The employment need not be the main reason or the only one so long as it is a factor (see EIM20503).

This goes too far and is not consistent with the first passage cited above.

74.6 Accommodation available but not used

EIM provides:

> **11405 Living accommodation: meaning of provided: the legislation** [February 2006]
> ...
> Provided is not defined in the legislation and its meaning has not been considered by the courts in relation to a charge under s.145 ICTA 1988. (s.145 has now become part of Part 3 Chapter 5 ITEPA 2003). The word provided must be given its ordinary dictionary meaning of supplied or furnished with a thing.
> In some cases provided will mean available for use whereas in others it will mean actually used (see EIM11406 for more detail). The meaning of provided is often an issue in the case of provided holiday living accommodation.
> **11406 Living accommodation: Meaning of provided: Practical considerations** [February 2006]
> For details of the relevance of the word "provided" in living accommodation cases see EIM11405.
> In deciding in a particular case whether provided means available for use, or means actually used, the following questions should be asked.
> - Who can use the living accommodation? We accept that if living accommodation is genuinely available for use by more people than could actually use it at any one time then provided only means the periods actually used. For example if five unrelated employees were allowed to use an employer owned two bedroom holiday villa we would only seek a provided living accommodation charge on each employee for the period in which that employee actually used the villa.
> - Why was the living accommodation bought or rented and how has it been used since acquisition? If the living accommodation was

bought as holiday accommodation for a director and family, provided is likely to mean available for use. By contrast if it was bought as a genuine letting business by the employer and has been let out commercially then provided will only mean the periods of actual use by the employee.

For examples illustrating these points see example EIM11421 onwards.

EIM 11421 to 11423 provides three examples:

11421. Living accommodation: Meaning of provided: Example 1 [October 2007]

[Example 1 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The employer advises that the sole reason the property was bought was as a holiday home for the husband and wife. It has only been used by them as a holiday home.*

[Emphasis added to show how example 1 differs from the others]

We would argue in this case that provided is equivalent to available for use. Assuming that the flat was habitable for the whole of the year we would seek a benefit under Part 3 Chapter 5 measured on availability for the whole of the year. The employer may argue that the husband and wife work full time and that this prevents them using the flat for more than the 4 weeks in the year of actual use and so they are effectively only provided with it for 4 weeks. We do not accept that argument.

If the cost of the accommodation exceeds £75,000, then the amount of the cash equivalent would be calculated in accordance with s.106 ITEPA 2003 (see EIM11472). As the annual value is based on the open market rental, under ESC A91b the Inland Revenue restricts the cash equivalent of the benefit to step 1 of s.106. This would mean that the cash equivalent for the tax year would be £15,600 (£500 × 26 + £100 × 26). Under s.108 that would be split between the husband and wife in whatever way was just and reasonable, presumably half each in this case (see EIM11472).

11422. Living accommodation: Meaning of provided: Example 2 [October 2007]

[Example 2 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The company bought the property to let as a commercial letting business. They have employed professional agents to let the property and have managed to let the property for*

12 weeks of the year in addition to the period it was used by the husband and wife directors.

[Emphasis added to show how example 2 differs from the others]

In this case we would accept that provided is equivalent to actual use.

If the cost of the accommodation exceeds £75,000, then the amount of the cash equivalent would be calculated in accordance with s.106 ITEPA 2003 (see EIM11472). As the annual value is based on the open market rental, under ESC A91b the Inland Revenue restricts the cash equivalent of the benefit to step 1 of s.106. This would mean that the cash equivalent for the tax year would be £1,200 (£15,600 × 4/52). Under s.108 ITEPA 2003 that would be split between the husband and wife in whatever way was just and reasonable, presumably half each in this case (see EIM11472).

You may ask why the s.105 ITEPA 2003 charge is not £1,600 (being 3 weeks at £500 in the skiing season and 1 week at £100 outside the season). The answer is that the wording of s.105(3) requires us to look at a proportion of the annual rent rather than the rent for the actual weeks it was used.

11423. Living accommodation: Meaning of provided: Example 3 [December 2006]

[Example 3 is as follows:]

A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. *The employer says that the property was bought to let commercially and for the use of other employees of the company. In fact there have been no commercial lettings during the year and it has only been used for one week of the year by an employee of the company who was the director's secretary.*

[Emphasis added to show how example 3 differs from the others]

This is a case where in practice we would seek to test whether what the employer was telling us was correct. For example, what if any evidence is there of attempts to let the property commercially or to advise other employees of the company of its availability for use by them? Based on that evidence it is then a matter of judgement whether in reality the sole reason the property was bought was as a holiday home for the husband and wife directors, in which case the tax consequences would be as in example EIM11421. Or it may be that genuine attempts have been made to let the property commercially and make it available for use by other employees of the company, in which case the tax consequences in example EIM11422 will follow.

74.7 Shadow directors

The House of Lords decided in *R v Dimsey & Allen* 74 TC 263 that the benefit in kind provisions apply to shadow directors. The reasoning continues to apply under ITEPA. The charge is unfair to a shadow director who does no work for the company. Income tax should be a tax

on income. This is a tax on nothing.[7]

EI Manual states:

> **11413 Living accommodation: Avoidance area: Shadow directors** [February 2006]
>
> A person in accordance with whose directions or instructions the directors of a company are accustomed to act is deemed to be a director of that company by s.67(1) ITEPA. Where such a person (known as a shadow director) is provided with living accommodation by the company the individual will be within Part 3 Chapter 5 ITEPA in the same way as if the individual had held a formal appointment as a director. ...
>
> Many shadow directors are individuals who, although not domiciled in the UK, have come to work and reside here. In order to avoid a possible charge to inheritance tax, which could be imposed if such an individual died whilst working in the UK, an arrangement is made to set up an offshore company that owns the UK property in which the individual lives. Where the individual is a shadow director of that offshore company s.97(2) ITEPA deems the UK property to be provided to the shadow director by reason of the deemed employment.

In practice taxpayers (if they have considered the matter at all) generally seem to have taken the view on their facts that they are not shadow directors. HMRC have themselves had to identify the cases suitable for investigation. But in the author's experience even cases that HMRC have identified are not often pursued with much gusto. Perhaps (this is surmise) HMRC "officially" take the point to deter IHT planning, but at the same time don't bother much about it in practice because of the unfairness of the charge. If so, the tactic (while contrary to the rule of law) works up to a point. Taxpayers cannot afford to plan on the assumption that HMRC's benign neglect of the provisions will apply to them.

74.8 Who is a shadow director?

Section 67(1) ITEPA provides:

> In the benefits code "director" ... includes any person in accordance with

7 The problem did not unduly concern the House of Lords because of the countering unfairness to HMRC of the case where the services of a shadow director were as valuable as a full-time employee. It appears that two wrongs made a right to tax.

> whose directions or instructions the directors of the company (as defined above) are accustomed to act.

Such a person is referred to as a "shadow director".[8]

In *Secretary of State for Trade and Industry v Deverell* Morritt LJ comments on this in numbered paragraphs:[9]

> (1) The definition of a shadow director is to be construed in the normal way to give effect to the parliamentary intention ascertainable from the mischief to be dealt with and the words used. In particular, as the purpose of the Act is the protection of the public and as the definition is used in other legislative contexts, it should not be strictly construed because it also has quasi-penal consequences in the context of the Company Directors Disqualification Act 1986.

This suggests that the comments in *Deverell* will apply in all contexts where the standard definition of "shadow director" is used, including tax contexts. It is difficult to argue that the "shadow director" concept should have a different meaning in a tax context than in the director disqualification context of *Deverell*. But *Deverell* is considering "shadow directorship" in the context of a commercial trading company. The position of a relatively quiescent property holding company is different.

> ... (2) The purpose of the legislation is to identify those, other than professional advisers, with real influence in the corporate affairs of the company.

This paraphrase does not take us very far because it only raises the question as to what is meant by "real[10] influence".

> But it is not necessary that such influence should be exercised over the whole field of its corporate activities. ...

This is uncontentious. The income tax charge could apply where a trust held a company holding both a home and investments, even though the

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8 A note on terminology. This useful and now familiar label was first used in the Companies Act 1980. The wording of the concept behind the label goes back to the Companies (Particulars as to Directors) Act 1917.

9 [2001] Ch 340 at p.354. *cf.* Kerr LJ's comment on "quotable pontific paragraphs, preferably numbered" in his readable memoir *As Far as I Remember*, Hart Publishing, (2006) p.285.

10 The dangerous and beguiling word "real" is normally an indicator of vague if not sloppy legal thinking.

"shadow director" did not give "instructions" relating to the investments but only to the home.

> (3) Whether any particular communication from the alleged shadow director, whether by words or conduct, is to be classified as a direction or instruction must be objectively ascertained by the court in the light of all the evidence.

Obviously.

> In that connection I do not accept that it is necessary to prove the understanding or expectation of either giver or receiver. In many, if not most, cases it will suffice to prove the communication and its consequence. Evidence of such understanding or expectation may be relevant but it cannot be conclusive.

This is extraordinary. "Directions or instructions" are a subset of "communications" and the feature that distinguishes them is that a person giving instructions expects them to be followed and the person receiving them understands this.

> Certainly the label attached by either or both parties then or thereafter cannot be more than a factor in considering whether the communication came within the statutory description of direction or instruction.

This at least is correct.

> (4) Non-professional advice may come within that statutory description. The proviso excepting advice given in a professional capacity[11] appears to assume that advice generally is or may be included.

This is equally extraordinary, for the concept of "directions or instructions" is the antithesis of the concept of "advice". The distinguishing feature is that the former is mandatory and the other is not. Of course, one may slide into the other. For instance, if a solicitor advises a company that a particular act is required by law, that failure to act would be a criminal offence, and that if the company broke the law the solicitor

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11 See s.67(2) ITEPA:

> "... a person is not to be regarded as a person in accordance with whose directions or instructions the directors of the company are accustomed to act merely because the directors act on advice given by that person in a professional capacity."

would refuse to act, such advice may arguably be characterised as a direction or an instruction. Since the proviso excepting advice given in a professional capacity can be taken to refer only to this situation it does not shed any light on the general meaning of "shadow director". The inference from the proviso excepting advice is invalidly drawn.[12]

> Moreover the concepts of "direction" and "instruction" do not exclude the concept of "advice" for all three share the common feature of "guidance".

The less said about this line of reasoning the better.

> (5) It will, no doubt, be sufficient to show that in the face of "directions or instructions" from the alleged shadow director the properly appointed directors or some of them cast themselves in a subservient role or surrendered their respective discretions. But I do not consider that it is necessary to do so in all cases. Such a requirement would be to put a gloss on the statutory requirement that the board are "accustomed to act" "in accordance with" such directions or instructions. It appears to me that Judge Cooke, in looking for the additional ingredient of a subservient role or the surrender of discretion by the board, imposed a qualification beyond that justified by the statutory language.

If the statutory language were: "in accordance with whose *wishes* the directors were accustomed to act" this would be a fair comment. But the expression "directions or instructions" shows that the position must be one where the shadow director commands and the properly appointed directors obey.

The points made in the passage are wholly negative. That is, in determining the issue of "shadow directorship":

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12 The Court of Appeal overlooked the explanation in *Gore-Browne on Companies* (loose-leaf), para 25.4.2:

> "The saving for professional advice might appear, at first sight, to support a wider interpretation of the definition, for the saving would be unnecessary unless a wider meaning were given to that definition. There are two possible explanations. The first, and probably correct, explanation is that the saving appears as a result of pressure from the relevant professions to ensure that no attempt can be made even to argue that their activities are, as such, within the scope of shadow director provisions in company legislation. The second is that it is intended to deal with the case where professional advice is obtained from a person who happens to be a member of the company and, as an ‹insider', potentially a shadow director."

(1) The understanding or expectation of the parties is *not* conclusive.
(2) The label attached by the parties is *not* conclusive.
(3) The fact that the communication is "advice" is *not* conclusive (except in the case of professional advice).
(4) The fact that the properly appointed directors surrender their discretions or act in a "subservient" role is *not* essential.

This does not answer the question: how *does* one identify a shadow director? The mere fact that there is a stream of communications from the individual to the company, which is acted on by the company, is not conclusive. The author regularly sends "communications" to the internet bookshop Amazon, and Amazon act on those communications without fail. Yet the author is not a shadow director of Amazon. The author regularly sends directions (a cheque is a direction) to his bank and Barclays act on those directions without fail. Yet the author is not a shadow director of Barclays Bank. In the 4th edition of this work I therefore concluded:

> that one can expect some back-tracking, refinement or qualification from the Courts in cases they regard as more meritorious than that of Mr. Deverell.

This has now been confirmed by *Ultraframe v Fielding*:[13]

> 1267 ... where the alleged shadow director is also a creditor of the company, he is entitled to protect his own interests as creditor without necessarily becoming a shadow director.
> 1268 [Counsel] submitted that it is critical to distinguish the position of a lender (whether or not also a shareholder) from that of a director. A lender is entitled to keep a close eye on what is done with his money, and to impose conditions on his support for the company. This does not mean he is running the company or is emasculating the powers of the directors, even if (given their situation) the directors feel that they have little practical choice but to accede to his requests. Similarly with customers who may, because of their buying power, be able effectively to dictate conditions to their suppliers (or the other way around). In other words a position of influence (even a position of strong influence) is not necessarily a fiduciary position. To find otherwise would place a wholly unfair and unnatural burden on men of business. In broad terms, I accept this submission.

13 [2005] EWHC 1638, [2007] WTLR 835.

The approach which applies to a creditor of the company also applies to a beneficiary of a trust which holds the company: they are entitled to "protect his own interests … without necessarily becoming a shadow director … In other words a position of influence (even a position of strong influence) is not necessarily a fiduciary position [ie is not necessarily a shadow directorship]."

HMRC sometimes argue that where someone resides in a property held by a company which is held by a trust of which that person is a beneficiary, it is (at least) highly likely that that person must be a shadow director.[14] This is unjustified for the reason set out in *Ultraframe*.

Suppose a person treats the property owned by the company as their own and has no dealings with the directors: they just ignore them. They do nothing (except perhaps charge their fees). In such a case the company may be a sham (or nomineeship). Whether or not that is so, the individual is not a shadow director. They give no instructions.

A non-resident person may be a "shadow director".

74.8.1 *When is an agent of a company a shadow director?*

HMRC accepted that the activities of an agent appointed by trustees to manage the day to day affairs of a trust are not normally relevant in determining the place of general administration (formerly relevant for the purposes of CGT trust residence).[15] It is suggested that a similar principle applies in the context of shadow directorship. An agency agreement under which the occupier of a property is responsible for routine maintenance matters on behalf of the company would not make the individual a "shadow director" as long as the decision to enter into contract was properly made by the directors and the directors properly supervise the work of the individual. This should not be difficult if the directors understand their duties are to all beneficiaries of the trust (not just to the settlor) and if the individual occupier of the property also understands this. It would be different if the agency agreement covered matters not usually delegated by an investment company to an agent.

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14 Note that there is no support for this view in the HMRC Manuals. Employment Income Manual 11413 [February 2006] states correctly that *where* an individual residing in property is a shadow director, there is a benefit-in-kind charge. It conspicuously does *not* state that the mere fact of occupation makes a shadow directorship "highly likely".

15 See the 5th edition of this book, para 5.6.2.

74.8.2 *Arranging that an occupier is not a shadow director*

Suppose an existing company purchases a home on the open market for a UK resident foreign domiciliary. The choice of a home is a personal one and the individual would normally have to give a "communication" to the company which HMRC may regard as "directions or instructions". So it would normally be difficult to ensure that the individual was not a shadow director (at least applying *Deverell* at face value).

The position is different if:

(1) trustees purchase property directly, and
(2) the trustees transfer the property to a foreign company on their own initiative and without reference to the occupier.

The trustees may reason that if the life tenant dies (or on a ten year anniversary), the UK property would not be excluded property and a charge to inheritance tax would arise – the liability for which would fall on the trust fund. In discharge of their fiduciary duty they could transfer the property to a foreign company to create excluded property and protect the trust from the liability. The point is that the occupier has *not* instructed or even requested the company to purchase the property for them.[16] SDLT makes this expensive but the variant idea of assigning a contract entered into by the trustees may be practical.

It would be best if the directors and trustees were separate persons. All communications should be through the trustees and not the directors of the company. If the foreign domiciliary desires to sell and, perhaps, purchase another property, they should communicate their wishes to the trustees. Then:

(1) The trustees could put the company into liquidation. The liquidator would sell the property.
(2) Alternatively, the trustees may sell the company. That has stamp duty advantages, and should be attractive for a purchaser who is a foreign domiciled individual or non-resident trust.

The procedure may then be repeated for a new purchase. In these circumstances it would continue to be difficult for HMRC even to argue that the occupier was a shadow director.

74.9 The cash equivalent: ss.105 and 106 computations

The charge is on the "cash equivalent". Section 103 ITEPA provides:

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16 I am grateful to Peter Vaines for this suggestion.

Method of calculating cash equivalent
(1) The cash equivalent is calculated—
(a) under s.105 if the cost of providing the living accommodation does not exceed £75,000; and
(b) under s.106 if the cost of providing the living accommodation exceeds £75,000.

Thus there are two methods of calculating the cash equivalent, here called a s.105 computation and a s.106 computation. This is for historical reasons, the s.106 computation having been introduced by the FA 1983 to supplement the ancestor of s.105. This structure makes the law twice as complicated as it need be.

74.10 Cost of providing accommodation

One needs to know the "cost of providing living accommodation":
(1) in order to decide between the s.105 and s.106 computation;
(2) in order to make the s.106 computation (if applicable, as it usually is).
This expression is defined in s.104:

General[17] **rule for calculating cost of providing accommodation**
For any tax year the cost of providing living accommodation is given by the formula A + I – P

In short, *A* is **A**cquisition cost, *I* is **I**mprovement cost, and *P* is **P**ayment of reimbursement. In full detail:

A is any expenditure incurred in acquiring the estate or interest in the property held by a person involved in providing the accommodation,
I is any expenditure incurred on improvements to the property which has been incurred before the tax year in question by a person involved in providing the accommodation, and
P is so much of any payment or payments made by the employee to a person involved in providing the accommodation as represents—
(a) reimbursement of A or I, or
(b) consideration for the grant to the employee of a tenancy or sub-tenancy of the property.

I consider reimbursement further in 74.17 (Property purchase financed by the foreign domiciliary).

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17 For the exception see 74.13 (Revaluation of cost in cases of delayed occupation).

74.10.1 *Person involved in providing the accommodation*

Section 112 ITEPA provides the wide definition:

> For the purposes of this Chapter "person involved in providing the accommodation" means any of the following—
> (a) the person providing the accommodation;
> (b) the employee's employer (if not within para (a));
> (c) any person, other than the employee, who is connected[18] with a person within para (a) or (b).

This defined phrase is only used in the definition of "cost of providing living accommodation".[19] ITEPA EN explains:

> 412. This definition makes it clear that it is necessary to look beyond the employer and the apparent owner of an interest in the accommodation. This is anti-avoidance legislation to counter schemes which depress the cost to the employer by using intermediate owners of interests.

74.11 Accommodation costing £75,000 or less: section 105 computation

Section 105 applies where the cost of providing accommodation does not exceed £75,000. This was a meaningful figure when the legislation was introduced in 1983 but inflation, the Chancellor's friend, has whittled away the real value of this limit so it must be exceptional now to find a purchase of less than £75,000. One might think the s.105 computation was a dead letter and one can turn directly to s.106. But s.106 refers back to s.105 so one needs to make the s.105 computation even in a s.106 case.

Section 105 ITEPA provides:

> **Cash equivalent: cost of accommodation not over £75,000**
> (1) The cash equivalent is to be calculated under this section if the cost of providing the living accommodation does not exceed £75,000.
> (2) The cash equivalent is the difference between—
> (a) the rental value of the accommodation for the taxable period, and
> (b) any sum made good by the employee to the person at whose

18 Section 718 ITEPA provides:
"Section 993 of ITA 2007 (how to tell whether persons are connected) applies for the purposes of this Act."

19 See 74.10 (Cost of providing accommodation) and 74.13 (Revaluation of cost in cases of delayed occupation).

> cost the accommodation is provided that is properly attributable to its provision.

The key concepts are "rental value of the accommodation" and "making good".

74.11.1 *"Rental value of the accommodation"*

As from 22 April 2009, s.105 ITEPA provides:

> (3) The "rental value of the accommodation" for the taxable period is (subject to subsections (4) and (4A) the rent which would have been payable for that period if the property had been let to the employee at an annual rent equal to the annual value. ...
> (4) Subsection (4A) applies where—
> (a) a rental amount is payable by the person ("P") at whose cost the accommodation is provided in respect of the whole or part of the taxable period ("the relevant period"), and
> (b) the amount so payable is payable at an annual rate greater than the annual value.
> (4A) Where this subsection applies—
> (a) subsection (3) does not apply to the relevant period, and
> (b) instead the "rental value of the accommodation" for the relevant period is the rental amount payable by P in respect of the relevant period.
> (4B) A reference in subsection (4) or (4A) to a rental amount payable by P in respect of the relevant period is to the sum of—
> (a) any rent for the period payable by P, and
> (b) any amount attributed to the period in respect of a lease premium (see sections 105A and 105B)
> (5) If the rental value of the accommodation for the taxable period does not exceed any sum made good by the employee as mentioned in subsection (2)(b), the cash equivalent is nil.

The key expression is "annual value". This is defined in s.110 ITEPA but it is not usually necessary to refer to that for UK property. ITEPA Explanatory Note states:

> 404. [Section 110] does not affect the Inland Revenue practice of using the gross rateable value as a proxy for "annual value". That practice will continue. The main use of this section is to provide guidance on how to arrive at the annual value of properties for which rent is not paid and in practice is only needed in cases where no gross

rateable value can be found.[20]

The EI Manual provides:

> **11434 Living accommodation: Meaning of annual value for United Kingdom properties** [February 2006]
> The amount of annual value for UK properties is set out in the table below.
>
Country	**When first valued**	**Annual value to take**
England & Wales	All cases	The 1973 gross rating value
Northern Ireland	All cases	The 1976 gross rating value
Scotland		100/270 × 1985 gross rating value
Anywhere in UK	No gross rating value set	Ask the appropriate District Valuer to confirm any estimated figure provided by the employer that you want to check.[21]

> For the formula to convert a net rating value figure to a gross rating value figure see EI Manual 11438 [March 2009].

Thus for most purposes the s.105 computation is rateable value less sums "made good" to the employer. That is usually a trivial amount which has no relation to the value of the benefit of the living accommodation. It is a substantial amount in two cases:

(1) where the company employer pays a market rent for the property;
(2) where the property is not UK situate (and so there is no rateable value).

This practice (which is concession not law) exists for historical reasons. It is not surprising the Tax Law Rewrite did not think it appropriate to express all this in ITEPA. The rules are incoherent.

74.11.2 *"Making good": Meaning*

The EI Manual provides:

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20 Likewise the EN at Change 23:

> "These provisions [ss.110 and 207 ITEPA] will clarify how to find annual values in respect of those properties for which the practice of using gross rateable values or a proxy for them is inapplicable – for example overseas properties. In the case of both these and other properties, all the current practices used in quantifying the cash equivalent of the benefit of living accommodation will continue."

21 The Manual continues:

> "If no such estimate is provided or the estimate is not acceptable the District Valuer will provide a (not negotiated) figure. If the taxpayer does not accept that figure the District Valuer will try to agree a figure with the taxpayer. For the procedure for referring to the District Valuer see EI Manual 11437 [February 2006]."

> **21120 The benefits code: What is meant by "making good"** [July 2006]
> "Making good" simply means giving something in return for the benefit. What is being made good is the expense incurred by the employer or other person providing the benefit. It follows that in order to make good that expense the employee will give money, or something that can be measured in money. Usually the employee will "make good":
> - by a direct payment or
> - by deduction from salary or
> - by a suitable debit to the employee's current account in the employer's books and records.
>
> Any of these methods is acceptable.
> The giving of services by the employee, or anything that is not measured in money terms is not "making good", see *Stones v Hall* (60 TC 737).
> **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**[22]
> As regards "making good" by waiver of remuneration see EI Manual 21122.

It is clearly "making good" if:
(1) the company pays the costs of maintenance and insurance; and
(2) the individual reimburses the company by a cash payment.
Does the employee make good the cost if they pay the cost of maintenance and insurance directly? Section 110 ITEPA envisages that this expenditure will be paid by the employer. In addition, the maintenance of the building is probably not a "sum" made good. EIM Manual is equivocal:

> **11439. Living accommodation: annual value of UK property: Employee responsible for repairs or insurance.** [July 2006]
> ...
> An employee may be responsible for the cost of repairs or insurance under the terms of his or her lease or employment. *(This text has been withheld because of exemptions in the Freedom of Information Act*

22 [Author's Note] The "text withheld" announcement was added in June 2006. Previously the Manual stated "In any case where the taxpayer argues that an interest-free loan has been made to this employer specifically to make good the cost or value of a benefit, make a submission to Personal Tax (Technical), Solihull." That instruction probably survives in the withheld text.

2000.)[23] As regards the discharge of the employee's pecuniary liability in respect of such items *see* EIM00580.

Note that the payment of a sum "making good" may constitute taxable property income of the company which receives it. The IHT and CGT implications may also need to be considered, but the sums involved are not usually significant.

74.11.3 *Making good: Timing*

EIM provides:

> **21121. The benefits code: When must making good take place?** [February 2006]
> The legislation does not set a time limit on the "making good". This will usually happen shortly after the expense is incurred by the person providing the benefit. But you need not object to a belated "making good" if it is done within a reasonable time of the employee becoming aware that the chargeable benefit can be reduced, in whole or in part, by reimbursing the expense incurred by the provider.
> What constitutes a "reasonable time" will depend on the facts of the case. Do not allow a deduction for "making good" which takes place after a charge to tax on the benefit concerned has become final and conclusive.

74.12 Accommodation over £75,000: section 106 computation

Section 106 ITEPA provides:

> **Cash equivalent: cost of accommodation over £75,000**
> (1) The cash equivalent is calculated under this section if the cost of providing the living accommodation exceeds £75,000.
> (2) To calculate the cash equivalent—
> *Step 1* Calculate the amount that would be the cash equivalent if s.105 applied (cash equivalent: cost of accommodation not over £75,000).

See 74.11 (Accommodation costing £75,000 or less: section 105

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23 The text formerly read:
"If an employee claims an adjustment to the annual value (derived from the table in EI Manual 11434) because the facts of an employee's case are not those envisaged by s.110 ITEPA, make a full report to Personal Tax (Technical), Solihull."
It seems a safe bet that that passage survives in the withheld text.

computation).

> *Step 2* Calculate the following amount ("the additional yearly rent")—
> ORI × (c) – £75,000)

In short, *ORI* is **O**fficial **R**ate of **I**nterest; *C* is **C**ost. In full detail:

> ORI is the official rate of interest in force for the purposes of Chapter 7 of this Part (taxable benefits: loans) on 6 April in the tax year, and
> C is the cost of providing the accommodation calculated—
>
> (a) in accordance with s.104 (general rule for calculating cost of accommodation),[24] or
>
> (b) in a case where s.107 applies (special rule for calculating cost of providing accommodation), in accordance with that section instead.[25]

The label "additional yearly rent" is misleading: the "additional yearly rent" calculated in this way will not bear a close relationship with any actual market rent.

> *Step 3* Calculate the rent which would have been payable for the taxable period if the property had been let to the employee at the additional yearly rent calculated under step 2.

This step reduces the "additional *yearly* rent" to that for the "taxable period" (defined in s.102(2)).

> *Step 4* Calculate the cash equivalent by—
>
> (a) adding together the amounts calculated under steps 1 and 3, and
>
> (b) (if allowed by subsection (3)) subtracting from that total the excess rent paid by the employee.
>
> (3) In step 4—
>
> (a) para (b) only applies if, in respect of the taxable period, the rent paid by the employee in respect of the accommodation to the person providing it exceeds the rental value of the accommodation for that period as set out in s.105(3) or (4)(b), as applicable, and
>
> (b) "the excess rent" means the total amount of that excess.

In short, the charge is (1) the s.105 computation (rateable value) and (2) (official rate of interest on purchase price less £75,000) less rent.

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24 See 74.10 (Cost of providing accommodation).

25 See 74.13 (Revaluation of cost in cases of delayed occupation).

This works (more or less) where the s.105 computation is based on the nominal amount of rateable value. It gives double taxation where the s.105 computation is based on actual market rental value. ESC A91 gives relief here:

> *Living accommodation provided by reason of employment*
> This concession applies to living accommodation treated as earnings under ITEPA 2003 Part 3, Chapter 5. Where ITEPA 2003 s.106 applies and the cash equivalent of the benefit of the accommodation is calculated by reference to the annual rent the property might fetch on the open market, the Inland Revenue will disregard "the additional yearly rent". If "the additional yearly rent" is disregarded then the amount of "the excess rent" is deemed to be nil.[26]

74.13 Revaluation of cost in cases of delayed occupation

Normally the s.106 computation is based on the employer's acquisition cost (ie historic cost). Market value of the property later is not relevant. This rule could favour the HMRC, but as time passes it is likely to favour the taxpayer. In one case only there is an adjustment to market value. Section 107(1) ITEPA provides:

> This section contains a special rule for calculating the cost of providing living accommodation which—
> (a) operates for the purposes of step 2 of s.106(2) (calculating the additional yearly rent), and
> (b) accordingly only operates where the cost of provision for the purposes of s.106(1) (as calculated under s.104) exceeds £75,000.

In practice condition (b) will almost always be satisfied (except perhaps for property purchased many years ago).

Section 107(2) ITEPA provides:

> This section applies if, throughout the period of 6 years ending with the date when the employee first occupied the accommodation ("the initial date"), an estate or interest in the property was held by a person involved in providing the accommodation.
> It does not matter whether it was the same estate, interest or person throughout.

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26 I do not understand the point of the last sentence, for if the additional yearly rent is disregarded, the "excess rent" is irrelevant.

In short, this condition is that the property has been owned by the company for six years before the employee moves in.
Section 107(3) ITEPA provides:

> For any tax year the cost of providing the living accommodation for the purposes mentioned in subsection (1)(a) is given by the formula—
>
> MV + I – P

In short, *MV* is **M**arket **V**alue; *I* is **I**mprovement cost; *P* is **P**ayments in return. In full detail:

> MV is the price which the property might reasonably be expected to have fetched on a sale in the open market with vacant possession as at the initial date,
>
> I is any expenditure incurred on improvements to the property which has been incurred during the period—
>
> (a) beginning with the initial date, and
> (b) ending with the day before the beginning of the tax year, by a person involved in providing the accommodation, and
>
> P is so much of any payment or payments made by the employee to a person involved in providing the accommodation as represents—
>
> (a) reimbursement (up to an amount not exceeding MV) of any expenditure incurred in acquiring the estate or interest in the property held on the initial date,
> (b) reimbursement of I, or
> (c) consideration for the grant to the employee of a tenancy or sub-tenancy of the property.

This may arise where:
(1) a foreign domiciliary (or trust) purchases a company holding a property acquired more than six years previously;
(2) an individual then occupies the property and becomes a shadow director.

Next is an anti-avoidance provision to block an obvious scheme to devalue MV. Section 107(4) ITEPA provides:

> In estimating MV no reduction is to be made for an option in respect of the property held by—
>
> (a) the employee,
> (b) a person connected with the employee, or
> (c) a person involved in providing the accommodation.

Lastly, for completeness, there is transitional relief where the employee first occupied the property before 31 March 1983: para 21 Sch.7 ITEPA.

74.14 Accommodation provided for more than one employee

Section 108 ITEPA provides:

> **Cash equivalent: accommodation provided for more than one employee**
> (1) If, for the whole or part of a tax year, the same living accommodation is provided for more than one employee at the same time, the total of the cash equivalents for all of the employees is to be limited to the amount that would be the cash equivalent if the accommodation was provided for one employee.
> (2) The cash equivalent for each of the employees is to be such part of that amount as is just and reasonable.

EIM provides at 11411:

> **11411 - Living accommodation: provided to more than one employee in the same period: practical points** [February 2006]
> The following is an example of how s.108 ITEPA 2003 works.
> An employer provides a ten room house for the shared use of three unrelated employees. Each employee has sole use of a bedroom and shared use of the other seven rooms. Without s.108 the cash equivalent of the benefit of the living accommodation provided to each employee would be 80% of the whole house. However s.108 limits the sum of the charges on the three of them to one full charge on the whole house. If there are no special factors each employee will be chargeable on the cash equivalent of a benefit of 33.3% of the cash equivalent for the whole house.
> Section 108 is not relevant in some family situations. For example a husband and wife both work for the same employer and live together in a house provided by their employer. The husband's job is the one that has accommodation provided with it and the wife's does not. The true construction here is that the living accommodation is only provided by the employer to the husband and the wife lives in it with her husband as part of normal domestic arrangements. So the full living accommodation charge would be on the husband with no charge on the wife.
> By contrast for an example of s.108 being relevant in a family situation see example EIM11421.

74.15 Ways to avoid benefit in kind

Ways to avoid the entire benefit in kind charge are (in short):

(1) to ensure that the occupier is

(a) not an officer (ie not a director or company secretary), which is straightforward;
(b) not an employee (which should be straightforward); and
(c) not a "shadow director"; or

(2) not to use a company; or
(3) to reimburse the company for its expenditure.

74.16 Reimbursement as solution to IT charge

Reimbursement of "A" and "I" will solve the s.106 charge if it reduces the "cost of providing the accommodation" to nil (or at least to below £75,000). It does not avoid the s.105 charge **(**but that may be trivial or avoided by "making good" or arranging that the individual is not a shadow director).

74.16.1 *Who makes the reimbursement?*

Reimbursement is only deductible if it is made by the employee. For example, if

(1) a company purchases property;
(2) an individual (F) reimburses the cost;
(3) another individual (G) comes to occupy the property (and is a shadow director);

then F's reimbursement will not reduce the s.106 computation for G. Again, if a member of the family or household of the shadow director occupies the property, and that member of the family or household reimburses the company, that reimbursement will not reduce the s.106 computation for the shadow director. In practice this is not likely to happen often.

The IHT and CGT implications of making the reimbursement need to be considered.

74.17 Property purchase financed by the foreign domiciliary

Sometimes a company structure is set up specifically for the purpose of purchasing the home. That is, there is an arrangement under which:

(1) The individual agrees in principle to purchase a property.
(2) The individual:
(a) lends the purchase price to a company, or
(b) transfers the purchase price to a trust which lends the purchase price to a wholly owned company.

(3) The company makes the purchase.

This section considers whether an arrangement of this kind offers a defence to the benefit in kind charge.

74.17.1 *"Making good" and s.105 computation*

The s.105 computation allows a deduction for:

> any sum made good by the employee to the person at whose cost the accommodation is provided that is properly attributable to its provision.

The taxpayer would have to show that the interest forgone on the interest-free loan from the individual (directly or indirectly to the company):

(1) is a "sum", and

(2) "makes good" the provision of the accommodation.[27]

Whether the interest forgone "makes good" the provision of accommodation is a question of fact. Assuming the reason the interest is forgone is to enable the company to provide the accommodation, this condition should be satisfied.

Whether the interest forgone is a "sum" is a question of law; it is suggested that the word should not be construed strictly or technically, and an amount of interest forgone may be a "sum". See 74.11.2 ("Making good": meaning).

74.17.2 *Loan to company as defence to section 106 computation*

Sums "made good" are not deductible as such in the s.106 computation. Rent is deductible in a s.106 computation but the interest forgone on an interest-free loan is not rent. No-one suggests that the company would be taxable on the interest forgone as property income!

It has been suggested that a company financed by an interest-free loan has not incurred expenditure. If this is so then it is a complete answer to the s.106 charge because the figure *A* in the formula for the cost of providing accommodation is reduced to zero. The suggestion is raised in Brandon, *Taxation of Non-UK Resident Companies and their Shareholders*, paras 5.3.3.8 to 5.3.3.15 citing *Wicks v Firth* [1983] STC 25 at 31:

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27 It is assumed that the interest forgone exceeds the annual or rateable value of the accommodation, which will normally be the case.

> The scholarships were provided at the cost of ICI and not at the cost of the Trustees because the Trustees with moneys supplied by ICI were only performing fiduciary duties …

However (as Stephen Brandon QC recognises), it is a step from this to argue that a company which is not performing fiduciary duties does not incur expenditure. If the house is in the accounts of the company as an asset, how could it have acquired that asset without "incurring expenditure"? Suppose the boot were on the other foot: a company lent money interest-free to a shadow director to finance his own purchase. Would anyone accept that the company had provided the accommodation purchased by the individual? This is an argument to take *in extremis*.

74.17.3 *Reimbursement by the individual*

In computing the "cost" of providing the accommodation one may deduct payments representing reimbursement. This deduction would reduce the s.106 computation.[28] However, the interest forgone on the loan is not "reimbursement". In addition, it is also not a "payment".

74.17.4 *Release of loan*

A possible solution would be for the individual to release the debt which is due to them from the company.

Statute requires a "payment" representing a reimbursement. It is a moot point whether the release of the debt would be a "payment". One should take the cautious view that it may not be. The matter should be dealt with as follows:

(1) The individual transfers the funds to the company. They should be received in the company's bank account. This should be accompanied by a letter to the company saying: "I have today procured the payment of £X to your account. This is reimbursement for the expenditure you have incurred in acquiring [the property]. However, I require repayment of the debt due to me of £X."
(2) The company may then use its funds to repay its debt due to the individual.

Although this is a circular transaction (the payment being matched by immediate repayment) that does not nullify it for tax purposes: compare *MacNiven v Westmoreland* [2001] STC 237.

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28 See 74.16 (Reimbursement as solution to IT charge).

If the company incurs additional improvement expenditure in the future, this should be matched by further reimbursements so the total cost of providing the living accommodation (A+I–P) remains less than £75,000.

The reimbursement of the company is not a transfer of value for IHT purposes if the individual is (or is treated as) the beneficial owner of the company. For the same reason the reimbursement is not a disposal by way of gift and so is outside the scope of s.102 FA 1986 (gifts with reservation).

The effect of the gift (the reimbursement) is to increase the value of the shares of the company without any corresponding rise in the CGT base cost. So the gift increases the chargeable gain on the disposal. This should not matter so long as the law remains in its current form.

74.17.5 *Reimbursement: Timing*

When must reimbursement be made? It is considered that the time limit is the same as for "making good". Reimbursement must be done within a reasonable time of the taxpayer becoming aware that the benefit in kind charge can be reduced by reimbursement.[29] In practice HMRC accept this.

74.18 Co-ownership defence to living accommodation charge

This section considers the position where an individual owns a share in the property jointly with the company.

Co-ownership raises similar but not identical issues for all provisions which charge tax on benefits, such as s.87 TCGA, s.731 ITA, s.203 ITEPA, and IHT gift with reservation rules as well as the living accommodation charge. The discussion here is limited to the case where an individual and a company are co-owners. Similar but not identical issues arise with these provisions where an individual and a trust are co-owners.

74.18.1 *The land law position*[30]

The starting point is to ascertain the rights of the co-owners as a matter of land law. Co-owned land in England and Wales is always held on trust. The person(s) holding legal title to the land are here called "the trust-of-

29 See 74.11.3 (Making good: timing)

30 I am grateful to Charles Harpum for his assistance on this section.

land trustees".[31] The position is governed by the Trusts of Land and Appointment of Trustees Act 1996.[32] Section 12(1) TOLATA provides:

> A beneficiary who is beneficially entitled to an interest in possession in land subject to a trust of land is entitled by reason of his interest to occupy the land at any time if at that time—
>
> (a) the purposes of the trust include making the land available for his occupation (or for the occupation of beneficiaries of a class of which he is a member or of beneficiaries in general), or
>
> (b) the land is held by the trustees so as to be so available.

Prior to 1997, a co-owner of land had a right to occupy that land, in the absence of any contrary indication or agreement with the other co-owners:

> It has been well established law ... that a tenant-in-common under a trust for sale has the right to occupy the whole property without payment of rent ...[33]

This co-ownership right has been superseded and replaced by s.12 TOLATA. In *IRC v Eversden*, Lightman J explained:

> On and after 1 January 1997 when the TOLATA came into force, a tenant in common in equity ... was no longer automatically entitled ... to occupation of the property purchased. Section 12 of the TOLATA provided that he should only become so entitled if one of two alternative conditions were satisfied…[34]

While arguments might be advanced to the contrary this analysis should be followed, because it is a clear and workable rule. Otherwise it would

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31 (The term used in the legislation is "the trustees of land".) The company may be the (or one of the) trust-of-land trustees; it makes little practical difference and no difference at all for tax. (If the company is not a trustee it can apply to court to require the trustees to exercise their powers.) The shares in the company may also be held on trust but that trust is not relevant here.

32 Further consideration is needed for:

(1) Land outside England and Wales.

(2) Jointly owned chattels.

TOLATA does not apply in Northern Ireland. I would be grateful to any reader who could inform me of the position in Scotland.

33 *IRC v Lloyds Private Banking* [1998] STC 559 at p.561; likewise *City of London Building Society v Flegg* [1988] AC 54 at p.81.

34 [2002] STC 1109 at [24] reported 75 TC 340 under the name *IRC v Greenstock's Executors*.

be necessary to consider the pre-1997 law and try to work out the combined effect of that when read with s.12.[35]

In the following discussion, the entitlement to occupy land conferred by s.12(1) is called the "statutory occupation right".

The individual will obviously have a statutory occupation right to occupy the property under s.12 because:

(1) They are a beneficiary under the trust-of-land.
(2) They are beneficially entitled to an interest in possession in the land.
(3) Both conditions (a) and (b) of s.12(1) are satisfied:[36]
    (a) the purposes of the trust-of-land include making the land available for their occupation; and
    (b) the land is held by the trust for land trustees so as to be available for the purpose.

The company does not have a statutory occupation right. It does not meet the conditions of s.12(1). No third person would have a statutory occupation right even if the company sold or sub-let their interest under the trust-of-land to that person. The third person would not satisfy conditions (a) or (b) of s.12(1).[37]

The trust-of-land trustees have various powers, but they do not have

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35 Barnsley "Co-owner rights to occupy land" [1998] CLJ 123 is a minority view; contrast Smith, *Plural Ownership* (2005) p.136.
This conclusion is not affected by *Re Byford* [2003] EWHC 1267; [2004] 1 P&CR 159. In this case the co-owners were a wife and her former husband's trustee in bankruptcy. The issue was the relative size of their shares. The wife claimed a larger share because she had paid the mortgage since her husband's bankruptcy. The issue is not covered by any provision in TOLATA. So the common law principles (known as "equitable accounting") applied. The general principle of equitable accounting is that one co-owner cannot take the benefit of an increase in the value of the property without making an allowance for what has been expended by the other in order to obtain it. Thus the wife had credit for her payments of mortgage capital and improvement expenditure. She wanted credit for interest payments, but it was held that she must set against that credit the benefit of occupation (the wife had occupied the property and the trustee in bankruptcy of course had not occupied). There is nothing in this which affects rights of occupation or other rights under ss.12, 13 TOLATA; though note Helen Conway's criticism in [2003] *The Conveyancer* 533.

36 Though it would suffice if only one of the conditions of s.12(1) were satisfied.
Section 12(2) provides: "Subsection (1) does not confer on a beneficiary a right to occupy land if it is either unavailable or unsuitable for occupation by him." This will not apply here.

37 Also s.12(2) TOLATA would probably apply, though it is not necessary to rely on that.

power to override the individual's occupation right or to require them to pay an occupation rent. This is fundamental so I set out the provisions in detail.

Section 13(1) TOLATA provides:

> Where two or more beneficiaries are (or apart from this subsection would be) entitled under s.12 to occupy land, the trustees of land [ie the trust-of-land trustees] may exclude or restrict the entitlement of any one or more (but not all) of them.

The trust-of-land trustees cannot under s.13(1) override the individual's statutory occupation right because it is not the case that "two or more beneficiaries are … entitled under s.12 to occupy land".

Section 13(6) TOLATA provides:

> Where the entitlement of any beneficiary to occupy land under s.12 has been excluded or restricted, the conditions which may be imposed on any other beneficiary under subsection (3) include, in particular, conditions requiring him to—
>
> (a) make payments by way of compensation to the beneficiary whose entitlement has been excluded or restricted, or
>
> (b) forgo any payment or other benefit to which he would otherwise be entitled under the trust so as to benefit that beneficiary.

The trust-of-land trustees cannot require the individual to pay compensation (an occupation rent) to the company under s.13(6) because the company has no statutory occupation right: s.13(6) assumes that compensation can only be required in a case where:

(1) a co-owner had such a right; and

(2) the right was excluded or restricted (which can only be done under s.13(1)).

Section 13(3) TOLATA provides another power:

> (3) The trustees of land [ie the trust-of-land trustees] may from time to time impose reasonable conditions on any beneficiary in relation to his occupation of land by reason of his entitlement under s.12.
>
> …
>
> (5) The conditions which may be imposed on a beneficiary under subsection (3) include, in particular, conditions requiring him—
>
> (a) to pay any outgoings or expenses in respect of the land, or
>
> (b) to assume any other obligation in relation to the land or to any activity which is or is proposed to be conducted there.

The trust-of-land trustees can do little under s.13(3) except to require the individual to pay outgoings.[38]

It is reasonably clear that ss.12–14 TOLATA are a comprehensive code and there is no common law right to an occupation rent except in a case of ouster.

The trust-of-land trustees also have power to sell the property but the court has discretion either to prevent or to require a sale.[39] The question here is whether the court would require a sale of the property if the individual did not want a sale but the company did. In my opinion a court would not do so, unless either the individual no longer wished/ceased to occupy the property, or the company had a good reason for a sale, eg it was insolvent. Section 15(1) TOLATA provides:

> The matters to which the court is to have regard in determining an application for an order under s.14 include—
>
> (a) the intentions of the person or persons (if any) who created the trust,
>
> (b) the purposes for which the property subject to the trust is held,
>
> (c) the welfare of any minor who occupies or might reasonably be expected to occupy any land subject to the trust as his home, and
>
> (d) the interests of any secured creditor of any beneficiary.

None of these factors would support a sale.[40]

In short, the company, although co-owner, can do almost nothing while the individual remains in occupation, except require them to pay the

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38 In particular, the trust-of-land trustees cannot use this power to require the individual to pay an occupation rent, as that must be done under s.13(6) or not at all. Otherwise s.13(6) would be entirely otiose. There is a further restriction in s.13(7) but that is not so important here.

39 Sections 6, 14 TOLATA.

40 An individual's position is even stronger if they have more than a 50% share, as s.11(1) TOLATA normally gives them further support. This provides:

> "The trustees of land shall in the exercise of any function relating to land subject to the trust—
>
> (a) so far as practicable, consult the beneficiaries of full age and beneficially entitled to an interest in possession in the land, and
>
> (b) so far as consistent with the general interest of the trust, give effect to the wishes of those beneficiaries, or (in case of dispute) of the majority (according to the value of their combined interests)."

See too s.15(3) TOLATA which requires a court to have regard to the beneficiary with a majority share. But it is not necessary to rely on this.

outgoings.

Since this is the case, then the fact that the company does nothing, and the individual remains in occupation, does not mean that the company has provided accommodation, or conferred a benefit, in the years in which the individual occupies. This is because the individual has the right of occupation independently of anything the company does or can do.

In *IRC v Eversden*[41] the settlor gave a trustee co-owner a 95% share in a house, the settlor retaining 5%. The settlor continued to occupy. It was held that the trustee had not provided a benefit as the settlor was entitled to occupy. This took place before the TOLATA 1996 but the position would be the same under the TOLATA.

The matter is made more complicated by *Christensen v Vasili* 76 TC 116. This concerned a co-owned car. The question was whether there was a tax charge under (what is now) s.144 ITEPA which applies where a car is "made available" to an employee. The Special Commissioner held that the car was not made available:

> As co-owners the employer and employee each have the right to use the car, but they each have that right because they are each owners, not because one has "made available" the car to the other.[42]

This conclusion was plainly right. Unfortunately it was flatly if unconvincingly rejected in the High Court:

> In their ordinary sense, the question "who made the car available to Mr. Vasili?" must be answered in the sense that his employer did so ...[43]

It is suggested that *Vasili* must be distinguished from the normal co-ownership situation because:

(1) in *Vasili* both employer and employee were entitled to possession of the car: in the co-ownership situation considered here the company is not entitled to occupation;

(2) in *Vasili* the car belonged to the employer before he sold a 5% share to the employee. In that sense the employer made the car available. The position would have been different if the car had been purchased in those shares from the outset.

It is unfortunate that *Eversden* was not cited in *Vasili* since the two cases

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41 [2002] STC 1109 reported 75 TC 340 under the name *IRC v Greenstock's Executors*.

42 76 TC 116 at p.124, para 22.

43 76 TC 116 at p.131, para 13.

are difficult to reconcile.

74.18.2 *Employment-related benefit*

It might be argued that the company co-owner provides a benefit other than living accommodation:

(1) If the company is the trustee, by not exercising its powers of sale (or to require the individual co-owner to pay an occupation rent); or

(2) If the company is not sole trustee, by consenting to the trustees not exercising those powers.

There is normally no benefit here because the trustees have no such powers. If there were a benefit, the value of the benefit is "the expense incurred in or in connection with the provision of the benefit". The company incurs no expense, so the value of the benefit for tax purposes is nil.[44]

If the company incurs costs of maintenance, that is an employment related benefit.

74.18.3 *Benefit provided by company entering into co-ownership arrangement*

It follows that the company provides a significant benefit to the individual when and if it uses its funds to acquire a share as co-owner (unless it pays a discounted price for the share). Could this benefit be taxable?[45]

In *IRC v Eversden (Greenstock's Executors)* trustees purchased a 95% share in a house ("Meadows"), and the settlor purchased 5%. The judge said:

> Under the agreement with the trustees (providing as it did for the settlor to pay 5% of the purchase price of Meadows and acquire in consequence a right of occupation) *the trustees conferred on the settlor the right to occupy Meadows for an indefinite period rent free*.[46]
> (Emphasis added)

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44 It is considered that this particular benefit does not "consist of an asset being placed at the disposal of the employee" so the valuation is not in accordance with s.205 ITEPA.

45 This issue does not arise where the company receives its share of the land gratuitously.

46 75 TC 340, [2002] STC at p.1129. The point was rightly not appealed. Prior to purchasing Meadows another house in joint ownership had been sold. The position for Meadows would be different if the sale of the first house had been conditional on the purchase of Meadows (the new one), that is, if the settlor only agreed to join in the sale of the first if the trustee agreed to join in the purchase of Meadows.

This took place before the TOLATA 1996, but the position would be the same now.

In a case where the company provides its funds towards a joint purchase of a new property, and the individual holds as co-owner, the company has provided a benefit of indefinite rent-free occupation; more accurately the benefit is giving the individual the opportunity to acquire a right to indefinite rent-free occupation at a "knockdown price". The benefit is provided at the time the company completes the contract to purchase the land as co-owner.

The benefit would in principle be chargeable in co-ownership cases under s.87 TCGA or s.731 ITA. Since there are no express valuation rules the charge would be on the market value, which would have to be ascertained as best as one can in the light of the circumstances.

For employment income purposes the position is different. It is arguable that:

(1) The benefit is not the provision of living accommodation.
(2) The value of the benefit for IT purposes is nil because:
    (a) The company incurs no expense in connection with its provision. (The purchase price is not such an expense, because the money going out is matched by a property share coming in.)
    (b) The special valuation rules of ss.205, 206 ITEPA do not apply.

74.18.4 *The HMRC view*

The EI Manual provides at 11414:

> **Living accommodation: Avoidance area: Co-ownership cases**
> [July 2007]
> In these cases the employer and employee co-own the living accommodation. The usual arrangement is that the employer and employee own the property as tenants in common through a trust.
> A tenant in common has a legal right to use 100% of the property 100% of the time even though a tenant in common may only own a much smaller interest in the property (say 30%). It is argued against us in such a case that the employee's rights to use the living accommodation come from the employee's legal rights as a tenant-in-common. So it is argued that no living accommodation has been provided by reason of the employment.
> There are arguments to support a benefit charge within Part 3 Chapter 5 ITEPA in these cases and the strength of those arguments will depend on the facts of the case. PAYE Technical for any case in which you

want to argue the point.[47] Your submission should include a copy of any trust deed under which the land is held.

It is interesting to note that HMRC accept that there is not always a charge in co-ownership cases: "it depends on the facts of the case". That is consistent with the view taken here.

In the context of s.87 TCGA, the current HMRC view is that there is an annual benefit which is the difference between:

(1) the rental value of the property in question; and
(2) the hypothetical rental value of a hypothetical property of a value equal to the proportionate value of the taxpayer's share in the property, ie if the taxpayer holds a 50% share, one looks to the rental value of a property worth 50% of the actual property.[48]

But this view is very difficult to defend.

74.19 Other defences to BiK charge

74.19.1 *The caretaker's defence*

Section 99 ITEPA provides:

> **Accommodation provided for performance of duties**
> (1) This Chapter does not apply to living accommodation provided for an employee if it is necessary for the proper performance of the employee's duties that the employee should reside in it.
> (2) This Chapter does not apply to living accommodation provided for an employee if—
> (a) it is provided for the better performance of the duties of the employment, and
> (b) the employment is one of the kinds of employment in the case of which it is customary for employers to provide living accommodation for employees.

It has been suggested that one can use this to avoid the charge. The idea is to enter into a contract whereby the individual who is to occupy the property does so as caretaker for the company. This does not work. While it may normally be necessary or customary for a caretaker to reside in accommodation, a person does not become a "caretaker" just by being labelled as such. If the individual is occupying an extremely valuable

47 *Sic*. Presumably a phrase such as "Please submit your papers to ..." was accidentally omitted from the start of this sentence.

48 Private correspondence.

property with only nominal caretaking duties, this is not the same "type of employment" as a normal caretaker. The EI Manual rightly provides:

> **11342 Living accommodation exemption: Necessary for proper performance of the duties: Types of employee** [May 2010]
> Part 3 Chapter 5 ITEPA does not apply to living accommodation provided for an employee if it is necessary for the proper performance of the duties that the employee live in the accommodation provided (see EI Manual 11341).
> The following types of employee may be accepted as being within the exemption: ... Caretakers living on the premises. This only covers those with a genuine full time caretaking job. ...

74.19.2 *Payment of rent*

The payment of rent will count as "making good" for the s.105 computation and reduce the s.106 computation. However, this proposal raises the problems of IT on the rent. Also, to reduce the s.106 computation to zero, the rent may have to exceed the market rent, especially for very valuable properties.[49]

74.19.3 *Lease premiums*

The FA 2009 inserts the long and complex provisions of s.105A, 105B ITEPA, which I hope to consider in a future edition.

The EIM suggests an argument that premiums should sometimes be treated as rent. This was discussed in detail in the 2008/09 edition of this work, but I expect that HMRC will generally abandon that point now (if indeed they ever took it seriously).

74.20 Foreign homes relief

Section 100A(1) ITEPA provides a relief which I call "**foreign homes relief**":

> This Chapter does not apply to living accommodation outside the UK provided by a company for a director or other officer of the company ("D") or a member of D's family or household if—
> (a) the company is wholly owned by D or D and other individuals (and no interest in the company is partnership property), and
> (b) the company has been the holding company of the property at

49 By contrast a market rent for the use of chattels will prevent there being a "benefit" for the purposes of the benefit in kind charge on chattels.

all times after the relevant time.

I refer to the company providing the property as "**the provider company**". I refer to the condition in (1)(a) as"**the wholly owned condition**" and the condition in (1)(b) as "**the holding company condition**". Thus the relief applies where:

(1) The provider company provides accommodation for a director[50] of the provider company ("D") or a member of D's family or household. If the accommodation is provided for an employee who is not a director (or a member of a director's family or household) of the provider company the relief will not apply. In practice that is not likely to matter.
(2) The provider company meets the wholly owned condition.
(3) The provider company meets the holding company condition.

74.20.1 *Wholly owned condition*

The relief does not apply if any shares in the provider company are held by a trust or partnership, or if some of the shares are held by a company. The position for 100% subsidiaries is considered below.

74.20.2 *Holding company condition*

Before considering the definition of "holding company of the property" it is necessary to set out a subsidiary definition. Section 100A(4) ITEPA defines "relevant interest in the property":

> "Relevant interest in the property" means an interest under the law of any territory that confers (or would but for any inferior interest confer) a right to exclusive possession of the property at all times or at certain times.

We can now turn to the definition of "holding company" of the property. Section 100A(2) ITEPA provides:

> The company is "the holding company of the property" when—
> (a) it owns a relevant interest in the property,
> (b) its main or only asset is that interest, and
> (c) the only activities undertaken by it are ones that are incidental to its ownership of that interest.

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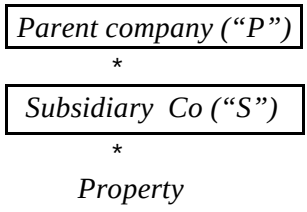
50 Or other officer; for brevity references to "directors" in this section include other officers.

74.20.3 *Subsidiary holding company*

Suppose the property is held via a subsidiary company thus:



S is in principle the holding company of the property but it does not meet the wholly owned condition. P is not the holding company of the property within s.100A(2). However s.100A(3) ITEPA provides:

> The company is also "the holding company of the property" when—
> (a) a company ("the subsidiary") which is wholly owned by the company [*ie the parent company]* meets the conditions in paras (a) to (c) of subsection (2),
> (b) the company's [*ie the parent company's]* main or only asset is its interest in the subsidiary, and
> (c) the only activities undertaken by the company *[ie the parent company]* are ones that are incidental to its ownership of that interest.

Thus P also qualifies as "the holding company of the property." Strictly this does not help as P is not the company providing the accommodation but in practice the relief is clearly intended to apply here.

74.20.4 *"The relevant time"*

Section 100A(5)(6) ITEPA defines "relevant time":

> (5) "The relevant time" is the time the company first owned a relevant interest in the property; but this is subject to subsection (6).
> (6) If—
> (a) none of D's interest in the company was acquired directly or indirectly from a person connected with D, and
> (b) the company owned a relevant interest in the property at the time D first acquired an interest in the company,
> "the relevant time" is the time D first acquired such an interest.

74.20.5 *Exceptions*

Section 100B ITEPA sets out three wide exceptions to this narrow relief:

(1) Section 100A(1) does not apply if subsection (2), (3) or (4) applies.

The first two exceptions concern connected[51] companies:

(2) This subsection applies if—
  (a) the company's interest in the property was acquired[52] (directly or indirectly) from a connected company at an undervalue, or
  (b) the company's interest in the property derives from an interest[53] that was so acquired.

(3) This subsection applies if, at any time after the relevant time—
  (a) expenditure in respect of the property has been incurred (directly or indirectly) by a connected company, or
  (b) any borrowing of the company (directly or indirectly) from a connected company has been outstanding (but see subsection (7). ...

(7) For the purposes of subsection (3)(b), no account is to be taken of—
  (a) any borrowing at a commercial rate, or
  (b) any borrowing which results in D being treated under Chapter 7 (taxable benefits: loans) as receiving earnings.

Lastly there is an all-purpose tax motive restriction:

(4) This subsection applies if the living accommodation is provided in pursuance of an arrangement[54] the main purpose, or one of the main purposes, of which is the avoidance of tax or national insurance contributions.

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51 "Connected" is very widely defined in s.100B(9) ITEPA:
"In this section ‹connected company' means—
  (a) a company connected with D, with a member of D's family or with an employer of D, or
  (b) a company connected with such a company."

52 Section 100B(5) ITEPA provides a commonsense definition:
"In subsection (2), references to the acquisition of an interest include the grant of an interest."

53 Section 100B(6) ITEPA provides a commonsense definition:
"For the purposes of that subsection [subsection (2)], an interest is acquired at an undervalue if the total consideration for it is less than that which might reasonably have been expected to be obtained on a disposal of the interest on the open market; and ‹consideration' here means consideration provided at any time (and, for example, includes payments by way of rent)."

54 Section 100B(8) ITEPA provides an unnecessary definition (this seems now to be in the Parliamentary drafter's handbook):
"In subsection (4) ‹arrangement' includes any scheme, agreement or understanding, whether or not enforceable."

74.20.6 *Commentary*

Foreign homes relief would serve as a case study for what has gone wrong with tax reform in the Blair/Brown administration. Almost every restriction on this relief is anomalous. Why should there be a relief for a company owning land and not for chattels? Yachts and aeroplanes are generally held through companies. Why should the relief apply to companies held by individuals and not by trusts? We need rationalisation and simplification, not yet another narrowly targeted relief. But there it is.

74.21 Benefit in kind: Remittance basis taxpayer

This section deals with the position of a remittance basis taxpayer who is an employee, director or shadow director and receives the benefit in kind of living accommodation.

A specified amount (the cash equivalent) "is treated as earnings from the employment". I refer to this as **"BiK earnings"**.

74.21.1 *Are BiK earnings "chargeable overseas earnings"?*

BiK earnings qualify as "chargeable overseas earnings" if (in short) the duties of the employment are performed wholly outside the UK.[55] Thus one has to ascertain:

(1) what the duties are;

(2) where they are performed.

To ascertain the duties of an employee or formally appointed director is straightforward. To ascertain the duties of a shadow director is problematic. A shadow director has no positive "duties" in the normal sense of the word.

It might be argued that a shadow director has no "duties" within the meaning of s.23 ITEPA. The consequence would be anomalous.[56] I think a court is not likely to accept this. If a shadow director is deemed to have an employment, it follows that they should be deemed to have some "duties".

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55 See 22.12 (Chargeable overseas earnings).

56 (1) Benefits in kind of a UK resident foreign domiciled shadow director would never qualify as chargeable overseas earnings.

(2) Benefits in kind of a non-resident shadow director would never be subject to tax.

The harder question is: exactly what are the (deemed) "duties" of the "employment" of a shadow director? The duties may be regarded as the instructions or directions which they give to the properly appointed directors.

Another possible view is that everything that the shadow director does for the company (or its assets) is regarded as part of their (deemed) "duties"; or alternatively everything they do if:

(1) they act with the consent of the formally appointed directors; or
(2) their actions concern matters which would (apart from them) be the responsibility of the actual directors.

Whichever of these is correct, where a company holds a UK dwelling house, it would be difficult in practice for a UK resident foreign domiciled individual to ensure that all his "duties" are performed outside the UK. However, it should be possible in other cases, eg where the BiK consists of non-UK situate accommodation or chattels, or for the BiK of employment-related loans. It may help to have a contract of employment which sets out the duties (all of which are to be performed abroad).

74.21.2 *Are BiK earnings remitted to the UK?*

If BiK earnings are "chargeable overseas earnings", they are taxable only if remitted to the UK.

If the accommodation is not in the UK then the BiK earnings are not on any view remitted here.

If the accommodation is in the UK, common sense suggests that there ought to be a charge. But there is a sound technical argument that the deemed earnings cannot be remitted because they do not exist. The tax charge arises only if the earnings are remitted. The property (or the benefit of its occupation) is not the same as the earnings.

HMRC may not agree. The EI Manual provides:

> **20508 Expense payments to and benefits provided for a director or employee whose earnings are taxable on remittance** [February 2006]
> The earnings of a director or employee, except in an excluded employment (EI Manual 20007), who is chargeable on remittances to the UK under either s.22 or s.26 ITEPA include
> - expenses payments remitted to the UK
> - expenses paid in the UK
> - *benefits provided or enjoyed in the UK (for example, a motorbike available for use in the UK)...*

> **EIM40303 Meaning of "remitted to the United Kingdom": benefits in kind and UK-linked debts**[57] [January 2009]
> *Benefits in kind*
> The definition of "remitted to the United Kingdom" in Section 809L ITA 2007 (see EIM40302) includes general earnings brought to, received in or used in and enjoyed in the United Kingdom in a form other than money. The benefits code as defined by Section 63(1) ITEPA 2003 provides a number of examples of earnings that are capable of satisfying the definition including taxable benefits arising from the provision of:
> * *living accommodation*
> * loans
> * cars available for private use.

This view was doubtful before 2008, but it is even harder to defend under the ITA remittance basis because where there is deemed income or gains, the statute specifically deals with the issue by deeming some assets to be derived from those income or gains.

74.22 Benefits in kind: Non-resident individual

This section deals with the position of a non-resident individual who is an employee, director or shadow director and receives benefits in kind. Earnings are taxable only in respect of duties performed in the UK.[58] Thus one must ascertain:

(1) what the duties are;
(2) whether the earnings are in respect of the duties;
(3) where the duties are performed.

The question of what (if any) are the "duties" of a shadow director is discussed in the above paragraph. I conclude there are no real duties but there are deemed duties. Are the earnings "in respect of" the deemed duties? It is tentatively suggested that the answer is "no". Certainly if there were no deemed duties there would be no earnings, but that is not enough. The benefit of living accommodation (which the earnings represent) would arise independently of the deemed duties. There is no income tax avoidance possibility here, because in the sort of case where substantial services were provided by a shadow director (as valuable as an

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57 I am not sure when this text was updated, though it was in place by August 2009. The term "UK-linked debts" is out of date after the 2008 reforms, but it does not matter.

58 See 22.18 (Non-resident employee).

actual director) then the earnings could be in respect of the duties.[59]

If I am wrong on "in respect of", but all the "duties" are performed outside the UK, the non-resident shadow director is not subject to tax under the benefit in kind provisions. If some of them are performed here, there is an apportionment. The difficulty of apportionment is immense, which suggests that my interpretation of "in respect of" is the correct one. This conclusion is also consistent with the POA non-residence exemption (though consistency between different tax codes does not count for much).

In practice, so far as the author is aware, HMRC do not assess non-resident individuals on benefits in kind. Of course, in many cases, collection of tax would be problematic. But it is significant that EI Manual para 11413 [February 2006] refers only to UK residents.

74.23 Other planning possibilities using companies

More complex possibilities involve:
(1) acquiring a property,
(2) granting (say) a ten-year lease to trustees or to the individual, and
(3) transferring the freehold reversion to a company. Watch SDLT.

The living accommodation charge would not apply, because the company would not be providing living accommodation. Similar arrangements can be carried out with options. In practice, arrangements of this complexity would not often be needed.

74.24 Dealing with companies at risk of IT charge

Many company structures have been set up in the past. The risk of a living accommodation charge depends on the facts of every case, but in practice it is often a serious concern. What can be done?

74.24.1 *Planning involving winding-up of the company*

If practical, the safest course is to extract the property from the company so as to put an end to the charge (or risk of a charge) under the benefit in kind rules. One way to do this for trusts, where the occupier has a recognised interest in possession, is to liquidate the company.

The liquidation may give rise to a capital gain which may rule out this course. The property will be in the estate of the life tenant for IHT purposes but in practice that may not be too much of a problem: see 75.46

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59 See *R v Dimsey & Allen* [2002] 1 AC 509 at [19].

(Home owned by foreign domiciliary). Another company structure may be entered into later, as set out above.

Another possibility might be for a company to sell the property to the trust, the purchase price remaining outstanding as a loan. In principle the loan is deductible from the value of the property, thus substantially reducing any IHT exposure. See 65.11 (Deduction for debts of trustees). Watch SDLT. CGT may rule out this course.

Another possibility may be to reimburse the company for the cost of providing the accommodation. Watch the CGT implications.

74.24.2 *Planning not involving winding up the company*

CGT may make it impractical to wind up the company. In that case take stringent steps to ensure that the individual is not a shadow director.

74.25 Dealing with living accommodation enquiries in practice

In practice, as *Al Fayed v Advocate General* frankly reports,[60] shadow directorship arguments before the decision in *R v Dimsey & Allen* were "settled by horse trading as opposed to on any strict statutory basis". It is likely that this will continue to be the case. Except for companies which were very carefully set up and run, HMRC will at least be able to exact a sum equal to the cost of litigating the issue before the first-tier tribunal or beyond.

74.26 Living accommodation charge: Commentary

Anyone who has followed the text to this point will agree that the law in this area is seriously defective. It is unnecessarily complicated, rests to a large part on formal and informal concessions, and is sometimes so very unfair that HMRC do not exert themselves to act in accordance with the law as correctly set out in their own Manuals. The following reforms would solve these problems:

(1) Abolish the s.105 charge and extend s.106 to cover the first £75,000 of acquisition cost. All the concessions would then drop away.
(2) It would be fair to charge a little less than ORI rates, since residential market rents are less than the official rate of interest.
(3) The application of the charge to shadow directors who do no real work for the company is a nonsense. Given the widespread use of

60 [2002] STC 910 para 44.

holding companies to hold wealth, *Dimsey & Allen* is arguably one of the worst tax decisions made by the House of Lords in recent times. Simply to abolish the charge (reversing *R v Dimsey & Allen*) would go too far the other way, since it is fair that a shadow director who receives what is in reality remuneration from a company should be charged. The solution is to restrict the rule that any benefit from an employer is deemed to be "by reason of employment". The deeming should not apply to a shadow director (whose connection with the company may be tenuous). That would strike the right balance.

The present BiK rules are being used by HMRC as a raid on ill-advised taxpayers or as a weapon to discourage IHT planning (placing homes in companies for IHT reasons). The latter is not the purpose for which the BiK rules were designed, and it is not surprising that they do not do this job well.

74.27 Section 731 charge

One should arrange, if possible, that any trust or company holding the home and chattels has no relevant income within s.731. Otherwise the use of the property would be a benefit giving rise to an income tax charge on the occupier.[61] This only applies if the benefit is not otherwise chargeable to income tax. If there is a shadow director charge, there is no charge under s.731. One possibility is to arrange that the amount of the shadow director charge is a small one (eg by a reimbursement of the company's expenditure). Whatever the charge is, it will avoid a taxable benefit under s.731.

74.28 Transfer pricing and non-resident company holding family home

The transfer pricing provisions (in short) deem transactions between persons under common control to be at arm's length prices.[62] HMRC accept that transfer pricing applies only to transactions between two "enterprises".[63]

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61 See 30.4.4 (Interest-free loan and enjoyment of asset in kind).

62 See 17.6 (Transfer pricing and thin capitalisation).

63 Accepting the argument of Venables "The Transfer Pricing Provisions and Benefits from Offshore Structures", 8 OTR 165. See INTM 432090:

"**412030. The affected persons: Enterprises** [August 2012]
Section 147 TIOPA 2010 refers to provision made or imposed between any two (connected) persons, suggesting a broad scope for the schedule, as the term persons includes bodies corporate, partnerships and individuals. However, subsection (1)(d) requires the actual

Where a non-resident company controlled by foreign trustees provides accommodation in the UK for the use of a beneficiary rent free, no charge

provision to be compared with the arm's length provision that would have been made between independent enterprises.

Section 164 TIOPA 2010 requires Part 4 to be construed in accordance with the OECD model convention, as interpreted by the OECD transfer pricing guidelines. Article 9 of the convention sets out the arm's length principle by reference to conditions made or imposed between enterprises. Article 3 defines enterprise as "the carrying on of any business".

This suggests that Part 4 TIOPA 2010 should be applied only where both parties are enterprises, but that this term should be interpreted broadly. The term encompasses more than trading activity, but a natural interpretation implies an intention to make profit or gain, or to undertake activity in a businesslike or commercial way.

In most situations where Part 4 TIOPA 2010 potentially applies there is likely to be little doubt that both the parties to a provision are enterprises. Situations where this may be less clear include the potential application of the schedule to individuals and to charities. It is clear that both individuals and charities can act in a way that would cause them to be regarded as enterprises. This conclusion will follow whenever a trade is being carried on or in other cases where activity is carried on in an organised way with a view to profit or gain. The nature of the activity and whether it carries a commercial flavour will also be relevant.

It is necessary to consider whether a particular provision to which Part 4 TIOPA 2010 potentially applies is one made between two enterprises. Hence it is possible that different conclusions will follow for different provisions made by the same person - some transactions may be made in a capacity unrelated to an enterprise that is being carried on while others may be made in the context of the enterprise.

Examples - Individuals:

- Participation in the management or control of a company does not in itself constitute the carrying on an enterprise. It follows that the office of director, or other employment by a controlled company would not normally constitute a provision made between two enterprises.
- If a company provides residential accommodation rent free to a participant who just makes personal use of it as their home, transfer pricing rules would not generally apply (though other tax rules, eg relating to employee benefit or distributions, might well be relevant).
- Similarly, holding investments in a close investment holding company would not constitute an enterprise for the purpose of considering provisions made between the company and the individual.
- Holding properties for rent in general does constitute an enterprise. However, if an individual holds property principally for private purposes, incidental letting activity that is intended to offset costs rather than to generate income is not likely to constitute an enterprise.
- Lending to connected companies may or may not constitute an enterprise. If the activity is undertaken in a businesslike way with a view to generating gains on shares in the company, this is likely to represent a form of enterprise. On the other hand, isolated loans where the intention is to provide long term funding for a family business may well not be made in the context of an enterprise.
- Where an individual is carrying on an enterprise, it follows that the SME exemption will potentially apply, provided the employment and financial limits are met. These limits will apply on an aggregate basis, including the individual and all connected businesses, including those carried on by controlled companies."

to tax arises since the individual is not an enterprise. Tax Bulletin 46 (April 2000) provides:

> **Will a charge be imputed on a non-resident landlord providing rent-free residential accommodation within the UK to a UK individual who is a participant?**
> It will not be Inland Revenue practice to impute a charge under Sch 28AA [ICTA] in these circumstances.

The provisions could apply in the (unusual) case where:[64]

(1) the individual is using the accommodation in an enterprise, but that is not "just personal use";
(2) a rent (less than a market rent) is charged.

74.29 SDLT on living accommodation charge

Para 12 Sch 4 FA 2003 provides:

> (1) Where a land transaction is entered into by reason of the purchaser's employment, or that of a person connected with him, then—
>
> (a) if the transaction gives rise to a charge to tax under Chapter 5 of Part 3 of the ITEPA (taxable benefits: living accommodation) and—
>
> (i) no rent is payable by the purchaser, or
>
> (ii) the rent payable by the purchaser is less than the cash equivalent of the benefit calculated under s.105 or 106 of that Act,
>
> there shall be taken to be payable by the purchaser as rent an amount equal to the cash equivalent chargeable under those sections;
>
> (b) if the transaction would give rise to a charge under that Chapter but for s.99 of that Act (accommodation provided for performance of duties), the consideration for the transaction is the actual consideration (if any); ...

This will not usually affect a foreign domiciliary who occupies a UK home through a company, even if the foreign domiciliary is a shadow director and within the BiK provisions. The reasons are:

(1) The acquisition of a licence (as opposed to a lease) is not a land transaction. The distinction between lease and licence is fraught but

64 The same point was formerly made in IHTM432090. This was withdrawn but HMRC practice has not changed.

usually the individual will occupy under licence and not a lease.

(2) Even if the shadow director acquires a lease, they will not usually do so by reason of their employment. The extended definition in the BiK code[65] does not apply here.

74.30 Chattels held by companies

Chattels situate in the UK may be placed in a company for the same reasons as the family home: to make them excluded property. This raises IT problems similar but not identical to the living accommodation charge.

74.30.1 *The charge*

The charge is in s.203(1) ITEPA:

> The cash equivalent of an employment-related benefit is to be treated as earnings from the employment for the tax year in which it is provided.

The key expressions are "employment-related benefit" and "cash equivalent".

74.30.2 *Employment-related benefit*

This is defined in s.201(2) ITEPA:

> In this Chapter—
> "benefit" means a benefit[66] or facility of any kind;

There is no benefit – and so no charge – if full consideration is paid for the use of chattels. This is so even if the amount paid is less than the "cash equivalent" as it usually will be; contrast the living accommodation charge. HMRC accept this.[67] EI Manual provides:

> **21002 What is meant by a "benefit"** [February 2006]
> However, something (other than a loan where special provisions apply, see EIM26101 and EIM26111) which is a "fair bargain" (EIM21004) between the employer and the employee is not a "benefit".

Section 201(2) continues:

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65 See 74.5 ("By reason of the employment").

66 For the meaning of "benefit" see 30.4 (Benefit).

67 HMRC do not argue that the word "facility" applies to a facility which is not a benefit in the ordinary sense. Thus s.201(2) is a non-definition of benefit (it only says that "benefit" means benefit); but non-definitions are quite common in tax legislation.

> "employment-related benefit" means a benefit, other than an excluded benefit,[68] which is provided in a tax year—
>
> (a) for an employee, or
>
> (b) for a member of an employee's family or household,
>
> by reason of the employment.[69]

74.30.3 *"Cash equivalent" etc*

This is defined in s.203(2) ITEPA:

> The cash equivalent of an employment-related benefit is the cost of the benefit less any part of that cost made good[70] by the employee to the persons providing the benefit.

This takes us to the elaborate definition of "cost of the benefit". The starting point is s.204 ITEPA:

> The cost of an employment-related benefit is the expense incurred in or in connection with provision of the benefit (including a proper proportion of any expense relating partly to provision of the benefit and partly to other matters).

There are two exceptions to this basic rule:
(1) asset made available without transfer;
(2) transfer of used or depreciated asset.
Point (2) is not discussed here. The rule in (1) is in s.205 ITEPA:

> (1) The cost of an employment-related benefit ("the taxable benefit") is determined in accordance with this section if—
>
> (a) the benefit consists in—
>
> (i) an asset being placed at the disposal of the employee, or at the disposal of a member of the employee's family or household, for the employee's or member's use, or
>
> (ii) an asset being used wholly or partly for the purposes of the employee or a member of the employee's family or household, and
>
> (b) there is no transfer of the property in the asset.
>
> (2) The cost of the taxable benefit is the higher of—
>
> (a) the annual value of the use of the asset, and

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68 "Excluded benefit" is defined in s.202.

69 For the definitions of expressions used here see 22.2 ("Employer", "employee" and "employment").

70 See 74.11.2 ("Making good": meaning) for a discussion on "made good".

(b) the annual amount of the sums, if any, paid by those providing the benefit by way of rent or hire charge for the asset,

together with the amount of any additional expense.

This takes us to the definitions of "annual value" and "additional expense":

(3) For the purposes of subsection (2), the annual value of the use of an asset is—

(a) in the case of land, its annual rental value;[71]

(b) in any other case, 20% of the market value[72] of the asset at the time when those providing the taxable benefit first applied the asset in the provision of an employment-related benefit (whether or not the person provided with that benefit is also the person provided with the taxable benefit). ...[73]

(4) In this section "additional expense" means the expense incurred in or in connection with provision of the taxable benefit (including a proper proportion of any expense relating partly to provision of the benefit and partly to other matters), other than—

(a) the expense of acquiring or producing the asset incurred by the person to whom the asset belongs, and

(b) any rent or hire charge payable for the asset by those providing the asset.[74]

74.30.4 *Asset available but not used*

EI Manual provides:

21631 Cash equivalent of assets placed at the disposal of a director or employee [May 2010]

Note that a tax charge may arise if the asset is available for the use of the director or employee. Whether or not it is used is immaterial. This is because the legislation refers to the benefit as being an asset "placed

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71 "Annual rental value" is defined in s.207 ITEPA. This charge only applies to land other than living accommodation, so in practice it is not important.

72 "Market value" is defined in a commonsense way in s.208 ITEPA.

73 There is transitional relief where those providing the taxable benefit first applied the asset in the provision of an employment-related benefit before 6 April 1980.

74 EIM states at 21631:

> This will include expenditure on running costs and could include expenditure on alterations or improvements, repairs, maintenance, etc depending on whether it was incurred for the purpose of providing the benefit. It would not include interest paid on a loan to acquire the asset.

at the disposal of" the employee. Assets commonly placed at the disposal of directors and employees to which the rule applies are yachts, aircraft, paintings, furniture, TV sets and video machines.

This is correct. The EI Manual gives examples:

21633. Assets placed at the disposal of a director or employee: Example [February 2006]

The following example shows how the chargeable benefit relating to a yacht is calculated. It would apply to all other assets except cars, vans, land and buildings.

Facts

On 6 April a company buys a yacht on the open market for £25,000.

It immediately makes this available for the sole use of a director and his family throughout the tax year.

In the same year the company spends £2,400 on insurance, fuel, maintenance, servicing and mooring charges for the yacht. It also pays £4,500 interest on a loan obtained to purchase the yacht.

The company requires the director to pay £1,500 a year for the use of the yacht.

Calculation of the benefit

The amount chargeable on the director for the benefit from the yacht being made available for his and his family's use is:

"Annual value of the use of" the yacht: 20% of its market value of £25,000	5,000
Running costs borne by the employer	2,400
	7,400
Less "made good" by the director	1,500
Amount of the benefit	5,900

Notes on the example

Note that in the example the "market value" of the yacht is taken as £25,000 as this was the open market price paid by the company immediately before it was first applied as a benefit.[75]

If the company had leased the yacht for £6,000 a year from 6 April, £6,000 would have been substituted for the "annual value of the use of the yacht" of £5,000 shown above (see EIM21630 and EIM21632).

If, exceptionally, the company had leased the yacht for less than the "annual value" of £5,000, the lease rent would have been disregarded. The calculation would have remained as shown in the example above, based on the annual value of £5,000.

The interest paid on the loan to buy the yacht does not enter into the benefit calculation.

21634 Particular benefits: Assets placed at the disposal of a director or employee: Asset unavailable for part of a year [May 2010]

75 [Author's Note] This would not be correct if the yacht was purchased new, as market value would be the secondhand value, which is lower.

Where an asset is not available for part of a year the annual value of its use has to be apportioned (s.204 ITEPA 2003).

For instance, if in the example at EIM21633 the yacht is only made available to the director from 6 October, the chargeable benefit is:

- one half (6/12 months) of the annual value of its use plus
- expenditure on the asset by the person providing it from 6 October to the following 5 April less
- any amount made good by the director (see EIM21120).

21635 Particular benefits: Assets placed at the disposal of a director or employee: Asset also used in the business or by other employees [February 2006]

An apportionment of the full amount of a benefit is required if an asset is made available to two or more directors and employees or is provided partly to the employee as a benefit and is also used partly by the employer in its business (see EIM21200).

For example, if a yacht is made available to two directors and they agree that its availability is shared equally by them, apportion one half of the benefit to each of them. Similarly if the yacht is used partly for business purposes, such as hiring to customers, a proper proportion of the full annual value of its use would not be chargeable.

21636 Particular benefits: Assets placed at the disposal of a director or employee: Asset used by the employee partly for private purposes and partly for work purposes [February 2006]

When an asset is available for the private use of a director or employee but it also has to be used in the performance of his duties, the director or employee may be able to get relief for the work use. This is accomplished by treating the value of the benefit as if it were expenditure so that the business proportion can qualify for deduction under s.336 to 338 ITEPA 2003 (see EIM31620 onwards).

Note that a deduction will not be due if the private and business use of the asset is concurrent, such as a suit of ordinary clothes worn at work (see EIM31660). Only if the use of the asset is at some times exclusively for business, such as a fax machine provided to the employee at home partly for work use, will a part deduction be due (see EIM31661). See example EIM31617.

21637 Particular benefits: Assets placed at the disposal of a director or employee: Assets used partly for private purposes and partly for work purposes: Mixed use benefit; Background to example in EIM21638 [May 2010]

See EIM21638 for an example of the interaction between:

- the calculation of the cash equivalent of a benefit where an asset is placed at the disposal of a director or employee (s.205(1)(a)(i) ITEPA 2003) and
- making an apportionment of that benefit where it is available to a director and for "other matters" (s.204 ITEPA 2003).

Where a benefit is provided partly for the use of a director or employee and partly for "other matters" the cost of the benefit must be apportioned (see EIM21200) between the different uses.

Note that an asset placed at the disposal of a director or employee

represents a benefit (s.205(1)(a)(i)) regardless of the use, if any, to which the director or employee puts the asset. But see EIM21631 for details relating to the two alternative measures of charge and when to apply one or the other.

If the asset is used wholly for business purposes, this does not prevent the provision of the asset representing a benefit. If the business use satisfies the terms of s.365(1) ITEPA 2003, the director or employee will be entitled to a deduction equivalent to the full amount of the benefit, leaving no amount chargeable to tax. **But this is not the same as there being no benefit.** A benefit has been provided but because of the deduction for business use, the chargeable amount has been reduced to nil.

If the benefit is used by a director or employee for private purposes and for business purposes, the business use is not an "other matter" which can be included in the amount of the benefit to be apportioned under Section 204 ITEPA 2003. The full amount of the mixed use of the benefit is chargeable to tax, subject to a deduction under s.365(1) ITEPA 2003 for any business use that meets the conditions of s.336 to 338 ITEPA 2003 (see EIM21210).

On the other hand, use of the asset by other employees, or by the employer company (for example, for transporting goods or customers), or hire to third parties, are "other matters" to be taken into account in an apportionment.

There are no hard and fast rules for calculating the proportion of cost attributable to different uses but the end result should produce an apportionment that is reasonable in the light of the facts of the case and the statutory context in s.204 (see EIM21200).

See the example at EIM21638.

21638 Particular benefits: Assets placed at the disposal of a director or employee: Assets used partly for private purposes and partly for work: Example [May 2010]

For some background information relevant to this example see EIM21637.

Facts

- On 6 June a company purchases a 10 seater aircraft for £800,000,
- the principal shareholder of the company and managing director (MD) holds a pilot's licence,
- the plane is kept at an airfield near to both the company premises and the MD's home. It is available to the MD to use at all times – sometimes, at weekends, he decides on the spur of the moment to take a flight on the plane. The plane is not available to any other director or employee unless given specific permission,
- the company incurs costs on the plane of £20,000 for the 9 months from 6 June to 5 April for landing fees, fuel, insurance, etc.,
- when he uses the plane for private purposes the MD reimburses the company £100 per day as a contribution towards the employer's costs.
- Inspection of the logbook for the period 6 June to 5 April (274 days) shows use as follows:
  1. 10 days – by the MD for travel to business meetings
  2. 20 days – by the company (using an outside pilot hired by the day) to

deliver sensitive documents to customers in remote locations

3. 10 days – commercial hire to third parties at £2,000 per day
4. 10 days – another director of the company wishes to learn to fly and uses the plane for flying lessons with an instructor
5. 60 days – private use by the MD.

What is the amount of the benefit chargeable on the MD?

Section 205(2)(a) ITEPA 2003 determines that when an asset is placed at the disposal of a director or employee (see EIM21631), the amount of the cash equivalent of the benefit is the annual value (s.205(3)(b)) plus additional expenses.

Annual value of plane (£800,000 × 9/12 × 20%)	£120,000
Additional expenses	£20,000
Total amount of the benefit	£140,000

As the plane is made available for several different purposes, if any of those purposes amounts to an "other matter" (s.204), an apportionment of the benefit may be due. Use by the MD, whether for business or private purposes, is not an "other matter". But use by other employees, or use by the company, are "other matters" – 2, 3 and 4 above which amount to 40 days in total.

The amount of the benefit is based on the 274 days in the year when the plane was available for use. On 40 days it was used for "other matters" and the benefit must be apportioned accordingly. On the remaining 234 days it was entirely at the disposal of the director to use as and when he wished. If the plane was not available to the director, or not solely available to him, on all these days, the calculation of the benefit could be different (see EIM21639(. the calculation of the benefit must be:

- apportioned to take account of these other matters and
- reduced by any amount made good by the MD to the employer.

Total amount of the benefit	£140,000
Less proportion for "other matters" (40/274)	£20,438
Benefit after apportionment	£119,562
Less made good by MD (£100 × 60)	£6,000
Amount of the benefit chargeable	£113,562

Finally, if the director's use of the plane satisfies the terms of s.336 ITEPA 2003 he will be due a deduction under s.365(1) for the amount of expenses on business purposes that could have been deducted if incurred by him. This figure may be quantified based on the facts of the case. In this instance the MD used the plane for a total of 70 days in the year, 10 days for business and 60 days for private purposes. A reasonable basis for calculating the deduction due under s.365(1) may be 10/70 of the chargeable benefit – 10/70 × 113,562 = 16,223.

Less deduction for business use (10/70 days)	£16,223
Amount chargeable on MD	£97,339

Note it is necessary to use judgement and common sense when determining the amount that would have been deductible for expenses under s.365(1).

In this case a deduction of approximately £1,600 per day has been allowed for the MD's travel to business meetings. This may seem a large amount but if the alternative is for the company to hire a similar plane for the day at the commercial rate of £2,000, for which the MD paid himself and was later

reimbursed by the company, he would be entitled to a deduction for this amount. Apart from extreme cases, it is better not to become involved in a debate concerning what form of transport (and at what cost) is suitable for the director to use to attend meetings.

The other director who uses the plane for flying lessons will also be chargeable on a benefit based on his 10 days private use of the plane.

74.30.5 *Conveyancing issues for chattels*

The Bills of Sale Act 1878 (in short) applies where a person makes a transfer of goods (a "Bill of Sale" is widely defined) and retains possession of the goods. This could apply on a transfer to a trust or to a company. The transfer is void as against the trustees in bankruptcy of the transferor unless the Bill of Sale is registered in a public register. This is to prevent fraud on creditors. However, it really does not matter if a transfer of chattels is void as against a trustee in bankruptcy, in the event that the individual became bankrupt. After all, every gift and transaction at an undervalue can in principle be set aside by a trustee in bankruptcy for two years, under s.339 Insolvency Act 1986, but no-one suggests that has significant tax implications for solvent taxpayers. Thus it is not necessary to register the transfer of the chattels (the "Bill of Sale") under the Act.

74.31 "Person providing benefit"

This is defined in s.209 ITEPA:

> **Meaning of "persons providing benefit"**
> For the purposes of this Chapter the persons providing a benefit are the person or persons at whose cost the benefit is provided.

CHAPTER SEVENTY FIVE

CORPORATE RESIDENTIAL PROPERTY

75.1 Introduction

This chapter considers three tax charges on corporate residential property held by companies and some company-like entities:

(1) A 15% SDLT charge on acquisition. I refer to this as **"the SDLT penal rate"**. I do not think that is tendentious, though it is not, of course, the statutory term.
(2) Annual Tax on Enveloped Dwellings (**"ATED"**)
(3) CGT on dwellings within ATED (**"ATED-CGT"**)

I refer to them together as the **"corporate residential property ("CRP") regime"**.

At the end of the chapter there is a general discussion of planning issues for the family home, in the light of the discussion in this and the previous chapter.

HMRC have published ATED guidance **("HMRC ATED guidance")**.[1]

The CRP regime is not deliberately aimed at foreign domiciliaries (as far as one can tell) but those are in practice the most affected. A full discussion would require a long book to itself. I focus on the aspects most important to the themes of this book, but I include a general discussion, as it is necessary to view the rules in the round. It will take some years to work out the effect of the provisions in detail.

The legislation is found in three distinct places:

(1) The SDLT penal rate is in Sch 4A FA 2003
(2) ATED is in FA 2013
(3) ATED-CGT is in TCGA

Some definitions therefore need to be written out three times. But brevity

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1 *http://www.hmrc.gov.uk/so/ated-tech-guide.pdf*

and simplicity were not material considerations to those responsible for rules.

The CIOT comment on the drafting:

> We believe that ATED is an example of poor drafting due to time pressure. The [tax law rewrite] improvements in this respect are not being maintained.[2]

It seems to me that the problems lie more in the conception than in the drafting. The development of the law can be traced from:

(1) A consultation document (May 2012) tendentiously entitled "Ensuring the fair taxation of residential property transactions".[3] I refer to it as **"The Residential Property Consultation Document".**

(2) A consultation response document, which I call **"the Residential Property Consultation response"**.[4]

These are now of mainly historic interest. It should however be recorded that from March to December 2012 no-one had any idea of what were the rules governing the taxation of residential property above £2m.

75.1.1 *"Enveloping"*

Budget 2012 referred to purchase by companies as **"enveloping".** I half balk at this neologism: it is a simplistic reification which hinders clarity of thought. In 2013 it was put into the name of the tax, ATED, so we have to put up with it, but there is much to be said for the use of scare quotation marks around the word.

75.1.2 *The reduction in CRP thresholds*

Budget 2014 announced a reduction in the threshold from £2m to £500k,

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2 CIOT, "Office for Tax Simplification Review of Definitions in Tax Legislation Response" (2013) para 5.2. *http://www.tax.org.uk/Resources/CIOT/Documents/2013/12/131220%20OTS%20review%20of%20definitions%20in%20tax%20legislation%20-%20CIOT%20comments.pdf*

3 *http://www.hm-treasury.gov.uk/d/consult_ensuring_fair_taxation_residential_property_transactions.pdf.*

4 HMRC, "Ensuring the fair taxation of residential property transactions: summary of responses" (December 2012) *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/190256/summary_of_responses_ensuring_fair_taxation_of_residential_property_transactions.pdf*

introduced in a staggered way.[5]

The extension to the penal rate of SDLT took effect for transactions where the effective date (normally the date of completion) is on or after 20 March 2014. I do not consider the transitional relief for contracts entered into before 20 March 2014 but completed on or after that date.

The extension for ATED is introduced in two stages in 2015 and 2016.

(1) ATED will apply to residential properties worth more than £1 million from 1 April 2015. Properties within the £1m - £2m band will be subject to an annual ATED charge of £7,000. There is a minor transitional relief that first year returns applicable to this band will not be required until 1 October 2015 and payment by 31 October 2015.
(2) ATED will apply to residential properties worth more than £500,000 from 1 April 2016. Properties within the £1m - £2m band will be subject to an annual ATED charge of £3,500.

The extension to ATED-CGT charge is also supposed to take effect in two stages:

(1) ATED-CGT is supposed to apply to properties worth more than £1 million from 6 April 2015. The charge will apply only to that part of the gain that is accrued on or after that date.
(2) ATED-CGT is supposed to apply to properties worth more than £500k from 6 April 2015. The charge will again apply only to that part of the gain that is accrued on or after that date. Gains outside ATED-CGT will continue to be treated as at present.

The FA 2014 contains the SDLT legislation and the prospective ATED legislation for 2015 and 2016.

The extension to ATED-CGT is supposed to be introduced in Finance Bill 2015. The decision to defer the legislation was a sensible one, as ATED-CGT needs to be seen in the context of the forthcoming non-residents dwellinghouse CGT charge. Once CGT is extended to a non-residents dwellinghouse, there is not, in fact, much point in retaining ATED-CGT at all, let alone extending it. The relatively small differences in rates and computation rules do not justify the complexity of two distinct sets of rules. But we must wait and see what happens.

The Residential Property Consultation Document provided:

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5 HMRC press release, "Changes to the taxation of high value UK residential property held by certain non-natural persons" (19 March 2014).

> 2.50 The charging bands will remain the same and there is no intention to lower the starting threshold.

In the 2013/14 edition of this work I referred to this and said:

> There is no need to lower the starting threshold, as inflation will gradually achieve that. £2m is a substantial threshold, but I expect it will not be increased in line with inflation, so it will gradually reduce in real terms. Thus someone purchasing a property worth £1.5m or even £1m needs to consider the likelihood that the property will become worth more than £2m in due course. Someone purchasing a property worth more than £2m must allow for the value to move up into the higher bands of tax in due course.
>
> Although there is a promise not to alter the charging bands, I am not sure if that is meant to be a promise not to increase the rates; even if there were such a promise, I would not place much reliance on it. These are some of the imponderable factors to take into account before purchasing or retaining a property in a company.

I was wrong to expect HMRC to keep the promise in the consultation document. Can one rely on anything in such documents? They apply only until HMRC change their mind. There is an intangible cost in a breach of commitments of this kind which cannot be measured in a TIIN. But there it is.

Budget 2014 justified the reduction in the threshold in the following words:

> [1] ATED has raised 5 times the amount forecast for 2013-14, with significantly more properties above £2 million in envelopes than expected.
>
> [2] As well as discouraging SDLT avoidance, ATED incentivises commercial activities by providing relief where, for example, a property is rented out.[6]

Point [1] is due primarily to the lack of a disincorporation relief.[7] It should not have caused a surprise.

Point [2] will leave the reader rubbing their eyes. An incentive for commercial activities in the case of corporate ownership but not in the case of non-corporate ownership? Perhaps it is not intended to be taken

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6 Budget 2014 para 1.193,

7 See *http://www.hmrc.gov.uk/ated/basics.htm*

seriously. When HMRC wish to make a reform, it has become common to justify it by every possible argument, good or bad.

The proportion of UK property worth over £500,000 is difficult to ascertain. Land Registry data records that 6.4% of residential properties sold in England and Wales in 2012-2013 exceed £500,000, and 1.3% exceed £1m.[8]

75.2 SDLT penal rate

Para 3 Sch 4A FA 2003 provides:

> (1) Where this paragraph applies to a chargeable transaction—
>
> (a) the amount of tax chargeable in respect of the transaction is 15% of the chargeable consideration for the transaction ...
>
> (2) This paragraph applies to a chargeable transaction if—
>
> (a) the transaction is a high-value residential transaction, and
>
> (b) the condition in sub-paragraph (3) is met.

75.3 "High-value" residential transaction

There is the usual cascade of definitions.

75.3.1 *"Interest in a single dwelling" and appurtenant rights*

First para 1(1) sch 4A FA 2003 provides a commonsense definition:

> In this paragraph "interest in a single dwelling" means so much of the subject-matter of a chargeable transaction as consists of a chargeable interest in or over a single dwelling (together with appurtenant rights).

"Appurtenant rights" are aggregated with the dwelling so:

(1) Their value is taken into account in determining whether market value passes the SDLT or ATED thresholds.

(2) Appurtenant rights are charged at the SDLT penal rate and subject to ATED-CGT along with the principal interest.

Para 9 sch 4A FA 2003 provides a commonsense definition:

> In this Schedule—
>
> "appurtenant rights", in relation to a chargeable interest that is, or is part of, the subject-matter of a transaction, means any rights or interests appurtenant or pertaining to the chargeable interest that are acquired

8 See Land Registry House Price Index *http://www.landregistry.gov.uk/public/house-prices-and-sales*

with it.

Where will one draw the limit of gardens and grounds? CGT private residence cases may be helpful, though without the limit to the "permitted area" of (in short) half a hectare.

75.3.2 *"Higher threshold interest"*

Para 1(2) sch 4A FA 2003 defines "higher threshold interest":

> An interest in a single dwelling is a higher threshold interest for the purposes of this Schedule if chargeable consideration of more than £500,000 is attributable[9] to that interest.

75.3.3 *"High-value" residential transaction*

Then para 2 sch 4A FA 2003 defines *high-value residential transaction*:

> (1) Sub-paragraphs (2) to (8) apply to a chargeable transaction whose subject-matter consists of or includes a higher threshold interest.
> (2) If the main subject-matter of the transaction consists entirely of higher threshold interests, the transaction is a high-value residential transaction for the purposes of paragraph 3.

In 2013, when the threshold was £2m, the expression "high-value" residential transaction was apt. Now it is reduced to £500k it is no longer apt, though when discussing the statutory provision, it may be easier to continue to apply the statutory terminology, but scare quotation marks seem appropriate.

75.4 Corporate purchaser condition ("non-natural person")

Para 3(3) sch 4A FA 2003 provides:

> The condition is that—
> (a) the purchaser is a company,
> (b) the acquisition is made by or on behalf of the members of a partnership one or more of whose members is a company, or
> (c) the acquisition is made for the purposes of a collective investment scheme.

HMRC use the term **"non-natural" person** as label for a body which is

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9 "Attributable" is (unnecessarily) given a commonsense definition in para 9 sch 4A FA 2003: "attributable" means attributable on a just and reasonable basis.

within para 3(3), that is, a company, a partnership including a company partner, or a CIS. The term is inapt and tends to conceal the complex and arbitrary nature of the concept(s) to which it refers. However it is necessary to have a short label, and no short label could correctly describe this disparate group of entities. It is also convenient to adopt a consistent usage. In order to keep in mind the artificiality of the expression I refer to "non-natural persons" using scare quotation marks.

I refer to the condition in para 3(3) as **"the corporate purchaser condition"**.

The following do not count as "non-natural persons" and so are not within the scope of the SDLT penal rate or ATED:

Trustees

Personal representatives

Clubs and unincorporated associations[10]

HMRC appear to have anticipated that the corporate purchaser condition may not be well drafted. Para 3(10) sch 4A FA 2003 provides power to amend by statutory instrument:

> The Treasury may by order amend this paragraph for the purpose of limiting the circumstances in which the condition in subparagraph (3) is to be treated as met.

75.4.1 *"Partnership"*

Para 1 Sch 15 FA 2003 provides a definition:

> In this Part of this Act a "partnership" means—
>
> (a) a partnership within the Partnership Act 1890,
>
> (b) a limited partnership registered under the Limited Partnerships Act 1907, or
>
> (c) a limited liability partnership formed under the Limited Liability Partnerships Act 2000 or the Limited Liability Partnerships Act (Northern Ireland) 2002,
>
> [d] or a firm or entity of a similar character to any of those mentioned above formed under the law of a country or territory outside the United Kingdom.

Para [d] brings in foreign law LLPs, which are not normally classified as partnerships for tax purposes.

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10 See 75.4.2 ("Company").

Para 3(6)(7) sch 4A FA 2003 relate to the complex anti-avoidance provision concerning certain partnership transactions; these are not discussed here as a discussion of partnership SDLT would need a chapter to itself.

Section 167 FA 2013 provides the identical definition for ATED.[11]

75.4.2 *"Company"*

Para 9 sch 4A FA 2003 defines "company"

> In this Schedule—
> "company" means a body corporate other than a partnership.[12]

This is otiose: the drafter has overlooked the existing definition in s.100 FA 2003.

The penal rate applies to UK and non-UK resident companies.

Section 166(1) FA 2013 provides a similar definition for ATED:

> In this Part "company" means a body corporate but does not include—
> (a) a corporation sole, or
> (b) any partnership (see section 167(1)).

75.4.3 *"Collective investment scheme"*

Para 9 Sch 4A FA 2003 provides the standard referential definition:

> In this Schedule—
> "collective investment scheme" has the same meaning as in Part 17 of the Financial Services and Markets Act 2000 (see section 235 of that Act);

Section 174 FA 2013 provides the same definition for ATED.

75.4.4 *Joint purchasers*

Para 3(5) sch 4A FA 2003 deals with joint purchasers:

> If there are two or more purchasers acting jointly, the condition in sub-paragraph (3) [the corporate purchaser] is treated as met if it is met in relation to at least one of those purchasers.

This is not fair, but the provision is intended to be penal.

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11 Except that s.167(1)(a) refers to the Partnerships Act 1890, which is a surprising error, as the Act was correctly named in the FA 2003.

12 "Partnership" is defined in para 1 sch 15 FA 2003.

75.5 Trusts

75.5.1 *Trustee purchaser*

Para 3(4) sch 4A FA 2003 excludes corporate trustees:

> References in sub-paragraph (3) [corporate purchaser condition] to a company do not include a company acting in its capacity as trustee of a settlement.

This is needed as SDLT does not have the IT/CGT rule that trustees are deemed to be separate persons.[13]

75.5.2 *Beneficiary purchaser*

A purchaser of an equitable interest may be caught as they may acquire a chargeable interest.

75.5.3 *Bare trusts*

Para 3(8) sch 4A FA 2003 provides:

> For the purposes of sub-paragraph (3), paragraph 3 of Schedule 16 (bare trustees) applies as if sub-paragraphs (2) and (3) of that paragraph were omitted.

To follow this one needs to set out para 3 sch 16, amended as para 3(8) directs:

> (1) Subject to sub-paragraph (2), where a person acquires a chargeable interest or an interest in a partnership as bare trustee, this Part applies as if the interest were vested in, and the acts of the trustee in relation to it were the acts of, the person or persons for whom he is trustee.
> ~~(2) Sub-paragraph (1) does not apply in relation to the grant of a lease.~~
> ~~(3) Where a lease is granted to a person as bare trustee, he is treated for the purposes of this Part, as it applies in relation to the grant of the lease, as purchaser of the whole of the interest acquired.~~
> (4) Where a lease is granted by a person as bare trustee, he is to be treated for the purposes of this Part, as it applies in relation to the grant of the lease, as vendor of the whole of the interest disposed of.

Para 3(1) is the commonsense rule that a bare trust is transparent for SDLT.

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13 See 5.3 (Trustees treated as single and distinct person).

The exception in para 3(2)(3) is to block an avoidance scheme under which a rack rent lease was granted to a nominee of the vendor, and then assigned for no value to the tenant.

Para 3(2)(3) sch 16 FA 2003 is excluded for ATED because otherwise a company purchaser might avoid the penal rate by arranging for the vendor to grant a lease to a non-corporate nominee for the purchaser.[14]

The reason for the exception in para 3(4) is unclear but as the charge is paid by the purchaser, not the vendor, it may not matter.

75.6 Consideration in form of rent

Para 3(9) sch 4A FA 2003 provides:

> In the case of a transaction for which the whole or part of the chargeable consideration is rent, this paragraph has effect subject to section 56 and Schedule 5 (amount of tax chargeable: rent).

75.7 Apportionment

The rest of para 2 sch 4A FA 2003 deals with apportionment:

> (3) If the main subject-matter of the transaction includes a chargeable interest other than a higher threshold interest, the transaction ("the primary transaction") is to be treated for the relevant purposes [including the SDLT penal rate][15] as two separate chargeable transactions as follows—
>
> (a) a transaction whose subject-matter is all the higher threshold interests, together with any appurtenant rights;
>
> (b) a transaction whose subject-matter is the remainder of the subject-matter of the primary transaction.
>
> (4) For those purposes, the chargeable consideration for a transaction treated as occurring under sub-paragraph (3) is so much of the chargeable consideration for the primary transaction as is attributable to that transaction.

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14 I am grateful to Justin Bryant for his comments on this provision.

15 Para 2 sch 4A FA 2003 provides the definition:

"'Relevant purposes' means the purposes of—

(a) paragraphs 3, 5 to 5K and 6A to 6H of this Schedule,

(b) section 55 (amount of tax chargeable: general),

(c) Schedule 5 (amount of tax chargeable: rent),

(d) Schedule 6B (transfers involving multiple dwellings), and

(e) any other provision of this Part, so far as it is necessary because of any of paragraphs (a) to (d) to treat the purposes in question as relevant purposes."

(5) The transaction mentioned in sub-paragraph (3)(a) is a high-value residential transaction for the purposes of paragraph 3.

75.8 Linked transactions

Para 4 Sch 4A FA 2003 provides:

(1) Sub-paragraphs (2) and (3) apply if—

(a) the subject-matter of a chargeable transaction includes a chargeable interest in or over a dwelling,

(b) one or more land transactions, the subject-matter of each of which includes a chargeable interest in or over the dwelling, are linked to that chargeable transaction, and

(c) the total consideration attributable to the interests mentioned in paragraphs (a) and (b) (and to any appurtenant rights, but disregarding any rent) is more than £500,000.

(2) Each of those chargeable interests is treated as a higher threshold interest for the purposes of this Schedule.

(3) If the condition in paragraph 3(3) is met in the case of the transaction mentioned in sub-paragraph (1)(a), it is also treated as met in the case of each transaction mentioned in sub-paragraph (1)(b) that is a chargeable transaction.

75.9 SDLT penal rate reliefs

The following reliefs apply:

Business of letting, trading or redeveloping properties: para 5

Trades involving making a dwelling available to the public: para 5B

Financial institutions acquiring dwellings in the course of lending: para 5C

Dwellings for occupation by certain employees/partners: para 5D

Farmhouses: para 5F

75.10 Annual tax on enveloped dwellings (ATED)

A note on terminology: The term proposed in Budget 2012 was "Annual Residential Property Tax". The current term was announced in March 2013. No reason was given for the change but "ATED" is more focussed, and less likely to concern taxpayers worried about future residential property taxes. The label given to a tax is important for politics, as the community charge/poll tax debate illustrates.

Section 94 FA 2013 provides:

(1) A tax (called "annual tax on enveloped dwellings") is to be charged

> in accordance with this Part.
> (2) Tax is charged in respect of a chargeable interest if on one or more days in a chargeable period–
> (a) the interest is a single-dwelling interest and has a taxable value of more than £1 million,[16] and
> (b) a company, partnership or collective investment scheme meets the ownership condition with respect to the interest.

The requirements for a charge are (in short):

(1) A residence valued above £2m; this is split into 3 requirements:
  (a) A chargeable interest (in short, UK land)
  (b) A single-dwelling interest (in short, a single dwelling)
  (c) Taxable value (in short, market value) above £2m
(2) The ownership condition

SDLT is a tax on acquisition of a chargeable interest, so it is charged once, on the acquisition. By contrast, ATED is a tax on ownership, and it is charged annually.

75.11 The corporate ownership condition

Section 94(2)(b) FA 2013 provides that ATED is charged if:

> a company, partnership or collective investment scheme meets the ownership condition with respect to the interest.

There has to be a company, partnership or CIS, ie a "non-natural" person.[17]

Section 94 FA 2013 provides:

> (4) A company meets the ownership condition with respect to a single-dwelling interest on any day on which the company is entitled to the interest (otherwise than as a member of a partnership or for the purposes of a collective investment scheme).
> (5) A partnership meets the ownership condition with respect to a single-dwelling interest on any day on which a member of the partnership that is a company is entitled to the interest (as a member of the partnership).

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16 The figure is reduced to £500k from 1 April 2016: see HMRC, *Changes to the taxation of high value UK residential property held by certain non-natural persons, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293952/TIIN_9000_changes_to_the_taxation_of_high_value_UK_residential_property.pdf*

17 See 75.4 (Corporate purchaser condition ("non-natural person")).

(6) A collective investment scheme meets the ownership condition with respect to a single-dwelling interest on any day on which the interest is held for the purposes of the scheme.

For clarity I refer to this as **"the corporate ownership condition"**. It is the ATED equivalent of the SDLT corporate purchaser condition.

The corporate ownership condition is the distinguishing feature of ATED.

75.11.1 *"Entitled"*

Section 95 FA 2013 provides:

(1) In this Part "entitled" means beneficially entitled—
(a) whether solely or jointly with another person, and
(b) whether as a member of a partnership or otherwise.
This is subject to subsection (2).

Section 95 FA 2013 provides 3 exceptions:

(2) References in this Part to entitlement to a single-dwelling interest (or any other chargeable interest) do not include—
(a) entitlement in the capacity of a trustee[18] or personal representative, or
(b) entitlement as a beneficiary under a settlement.[19]
(3) Subsection (1)(b) does not apply where the contrary is specified.

A corporate trustee does not meet the corporate ownership condition as it is not "beneficially" entitled to the interest.

A foundation is in principle a company, and, perhaps, beneficial owner, though they are not used as a means of SDLT avoidance.

75.11.2 *Company in liquidation*

The CT Manual provides:

CTM36125 - Particular topics: company winding up etc: beneficial ownership of shares [June 2012]
When winding-up commences, a company loses its beneficial interest in its assets. The company may retain legal title and possession of the

18 The reference to trustee is otiose, since a trustee is not beneficially entitled.

19 Section 95(4) FA 2013 provides a referential definition: "In this section "settlement" has the same meaning as in Part 4 of FA 2003 (see paragraph 1 of Schedule 16 to that Act)."

assets but it loses beneficial ownership of the assets. This includes shares owned in other companies (see *Ayerst v C and K (Construction)* 50 TC 651). The effect is that, where the provisions of the Acts depend on such shareholdings, they can no longer be taken into account when the company owning the shares commences winding-up.

Does the charge to ATED cease when winding up commences?

75.11.3 *"Beneficially entitled": Joint ownership*

Section 94 FA 2013 provides:

> (7) If a company is jointly entitled[20] to a chargeable interest (as a member of a partnership or otherwise), then regardless of whether the company is entitled as a joint tenant or tenant in common (or, in Scotland, as a joint owner or owner in common) the ownership condition is regarded as met in relation to the whole chargeable interest.

This is an unfair rule, but the provisions are intended to be penal, not fair.

75.12 Chargeable person

Section 96(1) F 2013 provides:

> The chargeable person is liable to pay tax charged under this Part.

The definition of chargeable person is broadly what one would expect.

75.12.1 *Chargeable person: company owner*

Section 96(2) FA 2013 provides:

> (2) "The chargeable person" means–
> (a) in relation to tax charged by virtue of section 94(4), the company;

75.12.2 *Chargeable person: company owner*

Section 96(2) FA 2013 provides:

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20 Section 174 FA 2013 provides a commonsense definition:
"jointly entitled" means–
(a) in England and Wales, beneficially entitled as joint tenants or tenants in common,
(b) in Scotland, entitled as joint owners or owners in common,
(c) in Northern Ireland, beneficially entitled as joint tenants, tenants in common or coparceners.

(2) "The chargeable person" means ...

(b) in relation to tax charged by virtue of section 94(5), the responsible partners.[21]

Section 96(4) FA 2013 provides:

The liability of the responsible partners to pay tax charged on them under this Part is joint and several.

75.12.3 *Chargeable person: CIS owner*

Section 96(3) FA 2013 provides:

In relation to tax charged by virtue of section 94(6) "the chargeable person" means–

(a) if the collective investment scheme is a unit trust scheme, the trustee of the scheme;

(b) if the collective investment scheme is an open-ended investment company, the body corporate referred to in section 236(2) of the Financial Services and Markets Act 2000;

(c) in relation to an EEA UCITS which is not an open-ended investment company or unit trust scheme, the management company for that UCITS;

(d) in any other case, the person who has day-to-day control over the management of the property subject to the scheme.

75.12.4 *More than one chargeable person*

Section 104 FA 2013 provides:

Tax in respect of a given single-dwelling interest is charged only once for any chargeable day even if more than one person is "the chargeable person" with respect to the tax charged

75.13 *Joint owners*

Section 97 FA 2013 provides:

(1) Subsection (2) applies if

(a) a company is within the charge for a chargeable period with

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21 Section 95(5) FA 2013 provides the definition: "The reference in this section to "the responsible partners" are to all the persons who are members of the partnership concerned on the first day in the chargeable period on which the partnership meets the ownership condition with respect to the single-dwelling interest."

respect to a single-dwelling interest by virtue of section 96(2)(a) and

(b) one or more other persons are jointly entitled to the interest on the first day in that period on which the company is within the charge with respect to it.

(2) The company and the other person or persons are jointly and severally liable for the tax charged for that period with respect to the interest (whether or not those other persons are also within the charge with respect to the interest on the day in question).

Presumably a right of reimbursement is implied.

75.14 Rate of ATED

Section 99 FA 2013 provides:

(1) The amount of tax charged for a chargeable period with respect to a single-dwelling interest is stated in subsection (2) or (3).
(2) If the chargeable person is within the charge with respect to the single-dwelling interest on the first day of the chargeable period, the amount of tax charged is equal to the annual chargeable amount.

This is straightforward unless there is a change of ownership during the chargeable period.

75.14.1 *"Annual chargeable amount"*

Section 99(4) FA 2013 provides:

The annual chargeable amount for a single-dwelling interest and a chargeable period is determined in accordance with the following table, by reference to the taxable value of the interest on the relevant day.

Annual chargeable amount	*Taxable value of the interest on the relevant day*
[£3,500	More than £500,000but not more than £1 million.][22]
[£7,000	More than £1 million but not more than £2 million.][23]
£15,000	More than £2 million but not more than £5 million.
£35,000	More than £5 million but not more than £10 million.
£70,000	More than £10 million but not more than £20 million.
£140,000	More than £20 million.

The rates can be expressed as follows:

22 This takes effect from 1April 2016: see s.104 FA 2014.
23 This takes effect from 1April 2016: see s.103 FA 2014.

Property Value	**ATED**	**% of value**
£2m to £5m	£15,400	0.3% - 0.75%
£5m to £10m	£35,900	0.35% - 0.7%
£10m to £20m	£71,850	0.35% - 0.7%
£20m +	£143,750	< 0.1% - 0.7%

Rather than a straight *ad valorem* charge, APRT uses a banding system. This has been pejoratively described as a "cliff-edge" system, but it was the right decision, as it avoids the necessity for an exact valuation.[24] The consequence is that:

(1) The lower value properties in the range pay the highest rate of tax (computed as a proportion of property value).
(2) Striking results as the value tips over the band:
   (a) Residential property worth £2m will not attract ATED, but if it was worth 1p more then APRT of £15k p/a is payable.
   (b) Residential property worth £5m will also pay ATED of £15,000 p/a, but if it is worth 1p more the rate will be £36k p/a.

However the unfairness at the margins may be mitigated by planning: perhaps renovate the kitchen leaving work outstanding on the valuation date; the ATED saving may fund the renovation.

ATED rates may be less, or slightly more, than the IHT 10 year charges on a relevant property trust: that depends on whether the property is near the top or the bottom of the ATED band. At the very top of the price range, ATED is much less than the IHT. This is surprising until one remembers that ATED is not intended to counter IHT planning using companies.

75.14.2 *Increase of annual chargeable amounts*

Section 101 FA 2013 provides for indexation:

> (1) If the consumer prices index for September in 2013 or any later year ("the later year") is higher than it was for the previous September, section 99(4) applies in relation to chargeable periods beginning on or after 1 April in the year after the later year with the following amendments.
> (2) For each of the annual chargeable amounts stated in the table in section 99(4) (as it applies in relation to chargeable periods beginning

24 Unlike, the much criticised SDLT rates, where valuations are not usually needed, so the banding system has no practical advantage to set against the unfairness.

in the previous 12 months) there is substituted the indexed amount.
(3) "The indexed amount" is found by–
(a) increasing the previous amount by the same percentage increase as the percentage increase in the consumer prices index, and
(b) rounding down the result to the nearest multiple of £50.
(4) In this section "consumer prices index" means the all items consumer prices index published by the Statistics Board.
(5) The Treasury must, before 1 April 2014 and before each subsequent 1 April, make an order stating the amounts that by virtue of this section are to be the annual chargeable amounts for chargeable periods beginning on or after that date.

Indexation is by reference to the CPI and not the RPI.[25]

75.15 Change of ownership during chargeable period

It is necessary to consider the position of the previous owner and the new owner (for convenience here called vendor and purchaser, though the rules do not require a sale).

75.15.1 *Position of purchaser*

The rule is commonsense expressed in a complex way.

The starting point is s.99(3) FA 2013. One needs to read (3) with (2) to follow the sense:

(2) If the chargeable person is within the charge with respect to the single-dwelling interest on the first day of the chargeable period, the amount of tax charged is equal to the annual chargeable amount.
(3) Otherwise, the amount of tax charged is equal to the relevant fraction of the annual chargeable amount.

75.15.2 *"Relevant day"*

The definition of relevant fraction uses the term relevant day.

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25 The CPI and RPI are similar. The precise weights attached to the individual items in each index differ and the RPI includes a number of items chosen to represent owner-occupier housing costs, including mortgage interest payments and depreciation costs, which are excluded from the CPI. See *http://www.ons.gov.uk/ons/rel/cpi/cpi-rpi-basket/2012/index.html*.
Parliament decided about 2012 to use the CPI instead of the RPI which is said to be a more appropriate measure of the general level of prices, a more accurate reflection of consumer shopping patterns, and more consistent with international indices. It is the basis of the Bank of England's inflation target.

Section 99(5) FA 2013 provides:

> The "relevant day" is ...
>
> (b) for the purposes of subsection (3), the first day in the chargeable period on which the chargeable person is within the charge with respect to the interest.

75.15.3 *"Relevant fraction"*

Section 99(6) FA 2013 provides:

> The relevant fraction is (N ÷ Y) where–
>
> "N" is the number of days from (and including) the relevant day to the end of the chargeable period;
>
> "Y" is the number of days in the chargeable period.

75.15.4 *Relief for vendor*

The vendor is in the first instance charged for the entire chargeable period, even if there is a disposal during the period.

Section 106 FA 2013 provides the relief:

> (1) Where
>
> [a] tax is charged for a chargeable period with respect to a single-dwelling interest and
>
> [b] the adjusted chargeable amount is greater than the initial charged amount,
>
> the amount of tax charged is taken to be increased to the adjusted chargeable amount...
>
> (3) Subsection (4) applies where–
>
> (a) tax is charged for a chargeable period with respect to a single-dwelling interest,
>
> (b) the adjusted chargeable amount is less than the initial charged amount, and
>
> (c) a claim for relief is made under this subsection.
>
> (4) The amount of tax charged for the period with respect to the interest is taken to be reduced (at the end of the chargeable period) to the adjusted chargeable amount.
>
> (5) Relief under subsection (3) must be claimed–
>
> (a) in an ATED return, or
>
> (b) by amending an ATED return.
>
> (6) The claim must be delivered by the end of the chargeable period following the one to which the claim relates.
>
> (7) Relief under subsection (3) may be given by repayment of tax or otherwise.

75.15.5 *"Initial charged amount"*

Section 106(2) FA 2013 provides:

> In this section "the initial charged amount" means the amount of tax charged under section 99 for the period in respect of the interest.

75.15.6 *Adjusted chargeable amount*

Section 105 FA 2013 provides:

> (1) In relation to a person on whom tax is charged for a chargeable period with respect to a single-dwelling interest, the "adjusted chargeable amount" is the total of the daily amounts for all the days in the period on which the chargeable person is within the charge with respect to the interest.
> (2) The daily amount for any such day ("the actual day") is–
> $(1 \div Y) \times A$

That could be written more simply as $(A \div Y)$

> where–
> "Y" is the number of days in the chargeable period;
> "A" is the annual chargeable amount for the single-dwelling interest, determined (under section 99(4)) on the basis that the actual day is the relevant day.

75.16 Taxable value

Section 102(1) FA 2013 provides:

> (1) The taxable value of a single-dwelling interest on any day ("the relevant day") is equal to its market value at the end of the latest day that–
> (a) falls on or before that day, and
> (b) is a valuation date in the case of that interest.

Valuation is on the "valuation date".

75.16.1 *Ascertaining market value*

CGT rules apply for determining market value. Section 98(8) FA 2013 provides:

> For the purposes of this Part "market value" is to be determined as for the purposes of the TCGA 1992 (see, particularly, section 272 of that Act).

One is valuing the interest held by the chargeable person, not the land as such. The Residential Property Consultation Document provides:

> 2.32 Where there is a freehold interest and one or more subordinate leasehold interests in the same dwelling, and each is owned by unconnected persons within the charge, each will need to value their distinct interest and each may be liable to the annual charge based on those valuations. So, for example, when a property is purchased on a lease but the freehold is owned by a separate company, then both the freehold and the leasehold will be valued and the annual charge applied separately to the freehold (if valued over £2 million) and the leasehold (if valued over £2 million if also owned by a non-natural person).

There is no deduction for a mortgage, as CGT principles apply: see s.26(3) TCGA:

> An asset shall be treated as having been acquired free of any interest or right by way of security subsisting at the time of any acquisition of it, and as being disposed of free of any such interest or right subsisting at the time of the disposal...

It is considered that this rule is implied by applying CGT valuation principles.

The Residential Property Consultation Document provides:

> 2.44 ... 'Market value' will be defined in similar terms to the definitions used for capital gains tax, as described in the Royal Institution of Chartered Surveyors Valuation Standards UKGN3 and the VOA Guidance Manuals: *http://www.voa.gov.uk*/

75.16.2 *"Valuation date"*

Section 102(2) FA 2013 provides:

> Each of the following is a valuation date in the case of any single-dwelling interest–
>
> (a) 1 April 2012;
>
> (b) each 1 April falling 5 years, or a multiple of 5 years, after 1 April 2012.

In short, we revalue every 5 years, so diarise 2017 now: January 2017 to review the position, though 1 April will be the valuation date.

75.16.3 *Revaluation on disposal*

Section 102 FA 2013 provides:

> (3) The following are also valuation dates in the case of any single-dwelling interest to which a company is entitled on the relevant day (otherwise than as a member of a partnership)–
>
> (a) the effective date of any substantial acquisition by the company of a chargeable interest in or over the dwelling concerned;
>
> (b) the effective date of any substantial disposal of part (but not the whole) of the single-dwelling interest.

Section 102 FA 2013 provides equivalent rules for a corporate partnership and a CIS:

> (4) The following are also valuation dates in the case of any single-dwelling interest to which a company is entitled on the relevant day as a member of a partnership–
>
> (a) the effective date of any substantial acquisition as a result of which a chargeable interest in or over the dwelling concerned became an asset of the partnership,
>
> (b) the effective date of any substantial disposal of part (but not the whole) of the single-dwelling interest.
>
> (5) The following are also valuation dates in the case of any single-dwelling interest that is on the relevant day held for the purposes of a collective investment scheme–
>
> (a) the effective date of any substantial acquisition, made for the purposes of the scheme, of a chargeable interest in or over the dwelling concerned;
>
> (b) the effective date of any substantial disposal of part (but not the whole) of the single-dwelling interest.

75.16.4 *"Disposal" and "Acquisition"*

Section 102 FA 2013 provides:

> (6) In this section references to a disposal of part of a single-dwelling interest include the grant of a chargeable interest out of the single-dwelling interest.
>
> (7) The grant of an option does not count as the grant of a chargeable interest for the purposes of subsection (6).

75.16.5 *Practice and guidance on valuation*

The Residential Property Consultation Document provides:

> 2.37 Property valuations for the annual charge will be self-assessed by the persons liable to the charge and submitted to HMRC as part of their annual charge tax return. HMRC will have powers to enquire into returns and also to make assessments so that non-compliance can be effectively challenged.

75.16.6 *Is a professional valuation needed?*

The Residential Property Consultation Document provides:

> 2.39 HMRC guidance will set out that a valuation provided to a taxpayer by a suitably qualified valuer of real estate would normally protect the taxpayer from possible penalties should it be subsequently established that their property has been significantly undervalued. A self valuation would bear a higher risk of not providing such protection.

That depends on the facts and will not be true in all cases.

> 2.40 Non-natural persons who believe they own a residential dwelling below, but in the region of, £2 million pounds may be liable to penalties if they fail to take proper care to establish a correct valuation on the appropriate date, and the property interest is in fact worth more than £2 million....
> 2.42 The valuation should provide a point valuation (i.e. a specific price).

There is no need for a point valuation, but it would help HMRC identify borderline cases, and is required for an HMRC pre-return banding check.

> The property can then be placed within one of the banding structures in Table 2.A. ...
> 2.43 Valuations submitted to HMRC will be subject to checking by the Valuation Office Agency (VOA).

HMRC offer inconsistent advice on the issue of whether an independent valuation is needed:

> 3.49 HMRC will not routinely expect taxpayers to commission a professional valuation of their property, which may be expensive. It will seek to use information it already possesses or can readily access to check a customer's declaration.
> 3.50 Just like for any other tax, the taxpayer must make an honest self appraisal of its liability, or lack of liability, and provide a reasonable valuation of the dwelling.
> 3.51 HMRC is not specifying any particular requirements for this: it is

up to the taxpayer to decide what is appropriate in particular circumstances, taking into account when the property was bought and what comparisons can be made from local sales and purchases.

75.16.7 *HMRC valuation service*

HMRC say:

Pre-return banding checks

In certain circumstances, you can ask HMRC to carry out a check on your property details and valuation to see if you need to pay ATED. This is called having a ‹pre-return banding check' (PRBC).

When to ask for a PRBC

Customers might want to contact HMRC where a property is valued at an amount close to one of the band thresholds. This is so they can agree which ATED band the property falls into, or whether it falls outside the tax as it is deemed to be under the £2 million or less threshold. This is called having a PRBC and is available to customers who meet the following:

- you are not due a relief that will reduce the ATED charge to nil
- the value you have placed on the property falls within 10 per cent of a banding threshold

If your property is valued between the thresholds shown below you may be able to apply for a PRBC using the form that will be available on the HMRC website from 1 June 2013.

When they receive your PRBC application form, HMRC will send you an acknowledgement and provide you with a reference number. They aim to provide a response to your application within 30 working days of receiving it.

HMRC will only confirm that they agree to the banding you propose, and not the specific valuation of the property. You can't use this confirmation for any other taxation purposes.

HMRC will either:

- agree that the band that you have chosen is appropriate based on the information you have provided
- ask for further information from you to help them make a decision about whether you have chosen the correct band
- tell you that they don't agree with the valuation band you have chosen

If you decide you need a PRBC, it's important that you apply at least 30 working days before the date on which you need to send your return - the earlier the better. This means HMRC can tell you their decision - particularly if they need more information before giving that decision - in time for you to use it when sending your return.

In some cases, the inside of the building might need to be inspected as part of the check. HMRC will normally be able to accept valuations prepared by a professional property valuer but they reserve the right to:

- enquire into any subsequent ATED returns
- challenge valuations included in those returns where they consider there is a risk that the return or valuation is wrong

What to do if you don't receive your PRBC in time

If you didn't leave enough time for HMRC to give you a PRBC decision, or they have asked you for more information, you might not get their decision in time for the date you need to send your ATED return. If you think you might need to pay ATED then you should send the return along with the appropriate payment of tax. That way you can avoid accruing interest or becoming liable for a penalty for sending the return late.

You should base your ATED return on the banding you think is most appropriate. HMRC may decide to open an enquiry into your return to enable them to continue considering the appropriate banding for your property.

You must include your PRBC reference number on any return or correspondence that you sent to HMRC.

Remember that if you don't complete and send HMRC a return or payment, or you send it late or make a mistake on it, you may have to pay a penalty and interest.

If, after you've sent your return and payment, HMRC tells you that they don't agree with your valuation and you have underpaid, you should complete an amended return and send it, with the additional payment, as soon as you can.

Interest will be payable on any ATED paid late, but HMRC won't charge a penalty if you were waiting for a PRBC decision when your return was due.

If HMRC tells you that they don't agree with your valuation and you've overpaid then you need to send an amended return with a claim for repayment. HMRC will repay you any ATED you've overpaid, and you might be able to claim interest.

If you don't agree with HMRC's decision

You should send your return based on your best estimate of the value of your property. HMRC may decide to open an enquiry into your return to enable them to look in more detail at the appropriate banding for your property.

Where you believe that your property is worth £2 million or less and that a return is not due, HMRC may issue a 'determination' to you based on the banding that they believe to be correct. A 'determination' is where

> HMRC makes a 'best estimate' of the ATED that you owe based on their valuation of your property and issues a demand for payment. You can appeal against this determination if you don't agree with it.
> You should include your PRBC reference number on any return or correspondence that you send to HMRC.[26]

The disadvantage of a PRBC may be a greater likelihood of a valuation dispute.

75.17 "Chargeable period"

This term matters because ATED is charged by reference to chargeable periods.

Section 94 FA 2013 provides:

> (3) The tax is charged for the chargeable period concerned...
> (8) The chargeable periods are–
> (a) the period beginning with 1 April 2013 and ending with 31 March 2014, and
> (b) each subsequent period of 12 months beginning with 1 April.

75.18 "Chargeable interest"

This term matters because ATED is charged on a chargeable interest.

Section 107(1) FA 2013 provides:

> In this Part "chargeable interest" means–
> (a) an estate, interest, right or power in or over land in the United Kingdom, or
> (b) the benefit of an obligation, restriction or condition affecting the value of any such estate, interest, right or power.

This is the same as the definition of "chargeable interest" for SDLT, in s.48 FA 2003.

Section 107(2) FA 2013 provides:

> Where two or more persons are jointly entitled to a chargeable interest the chargeable interest is not regarded, for the purposes of this Part, as consisting of separate interests corresponding to the shares (if any) that those persons have by virtue of their joint entitlement.

75.19 "Exempt interest"

"Exempt interest" is a label for a set of rules: when the drafter wishes to

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26 *http://www.hmrc.gov.uk/ated/pre-return-banding-checks.htm*

provide exemption it is done by making the interest exempt.

Section 107(3) FA 2013 provides:

> An exempt interest is not a chargeable interest for the purposes of this Part.

There are three types of exempt interest.[27]

The position is effectively the same as for SDLT: see s.48 FA 2003.[28]

75.19.1 *Security interest*

Section 107(4) FA 2013 provides:

> (4) The following are exempt interests–
> (a) any security interest;

Section 107(5) FA 2013 provides a commonsense definition:

> In subsection (4) "security interest" means an interest or right (other than a rent charge[29]) held for the purpose of securing the payment of money or the performance of any other obligation.

If a company lends to a X unsecured, X has an asset but not an interest in land, so not a chargeable interest. If the loan is secured on land, the asset is an interest in land, but an exempt interest and so still not a chargeable interest.

75.19.2 *Licence and tenancy at will*

Section 107(4) FA 2013 provides:

> The following are exempt interests ...
> (b) a licence to use or occupy land;
> (c) in England and Wales or Northern Ireland, a tenancy at will.

75.20 "Single-Dwelling interest"

This term matters as ATED only applies if the chargeable interest is a single-dwelling interest.

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27 For completeness, s.107 FA 2013 provides:
"(7) The Treasury may by regulations provide that any other description of interest or right in or over a dwelling is an exempt interest."

28 The SDLT legislation provides that an advowson, franchise or manor is an exempt interest, but that is not needed here as these are not dwelling-interests.

29 Section 107(6) FA 2013 makes appropriate provision for Scotland which does not use the term "rentcharge".

75.20.1 *The general rule*

Section 108 FA 2013 provides the general rule:

> (1) References in this Part to a "single-dwelling interest" are to be read in accordance with this section.
> (2) A chargeable interest that is exclusively in or over land consisting (on any day) of a single dwelling is a single-dwelling interest (on that day).

Section 108 FA 2013 defines "in":

> (5) A single dwelling interest is referred to as a single-dwelling interest "in" the dwelling concerned.
> (6) A single-dwelling interest in one dwelling is distinct from any single-dwelling interest in another dwelling, even if the dwellings stand successively on the same land.

Is this looking at the position if a building is knocked down and rebuilt?

75.20.2 *Apportionment*

Section 108(3) FA 2013 deals with a single interest in multiple dwellings (which will not be common):

> Where a person is entitled to a chargeable interest that is exclusively in or over land consisting (on any day) of two or more single dwellings–
> (a) provisions referring to a "single-dwelling interest" operate as if the person had (on that day) a separate chargeable interest in or over each dwelling, and
> (b) the chargeable interest in or over each dwelling is therefore a single-dwelling interest.

Section 108(4) FA 2013 deals with a single interest in a dwelling and other land (eg a house and accompanying estate):

> Where a person is entitled to a chargeable interest in or over land that on any day consists of one or more single dwellings and non-residential[30] land–
> (a) provisions referring to a "single-dwelling interest" operate as if the person had (on that day) a separate chargeable interest in or

30 Section 108(7) FA 2013 provides a commonsense definition of non-residential land: "In this section–
(a) "non-residential land" means land that is not a dwelling or part of a dwelling;"

over each dwelling and a further separate chargeable interest in or over the non-residential land, and

(b) the chargeable interest in or over each dwelling is therefore a single-dwelling interest.

75.20.3 *"Dwelling"*

Section 108(7) FA 2013 provides a partial definition:

> In this section ...
>
> (b) references to a dwelling include a part of a dwelling.

Unlike the SDLT penal rate, ATED provides for the amalgamation of property interests in some circumstances so that a 'dwelling' for the purposes of ATED may encompass a number of single dwellings in a building or which stand in the same grounds, if there is private access between them.

75.21 Different interests held in the same dwelling

Section 109 FA 2013 provides:

> (1) Subsection (2) applies if on one or more days in a chargeable period–
>
> (a) a company is entitled to two or more single-dwelling interests in the same dwelling, or
>
> (b) two or more single-dwelling interests in the same dwelling are held for the purposes of the same collective investment scheme.
>
> (2) This Part has effect with respect to that chargeable period as if those separate interests constituted just one single-dwelling interest, the taxable value of which on any day is the sum of the taxable values of the separate interests.
>
> (3) In calculating the taxable values of the separate interests for the purposes of subsection (2), the market value of each interest is determined, under the provisions of TCGA 1992 applied by section 98(8), on the assumption that the other interest or interests are placed on the open market with that interest (on the valuation date appropriate to that interest).

Why is this needed?

75.22 Interests held by connected persons

The rule that the taxable value is the value of the interest held by the chargeable person would give rise for scope for tax planning by splitting interests.

Section 110(1) FA 2013 provides:

> (1) If on any day
>
> [i] a company ("C") is entitled to a single-dwelling interest in a dwelling and
>
> [ii] another person ("P") who is connected with C is entitled to a different single-dwelling interest in the same dwelling,
>
> this Part has effect–
>
> (a) in relation to C as if C were on that day entitled to P's single-dwelling interest as well as C's single-dwelling interest, and
>
> (b) (if P is a company) in relation to P as if P were on that day entitled to C's single-dwelling interest as well as P's single-dwelling interest.

An obvious case is if A Ltd (a company) holds the reversion and B (a connected person and, perhaps, an individual) holds a lease. A Ltd is taxed as if it holds both interests.

This will raise problems for the common case of a block of flats where the residents hold a lease and the reversion is held by a company of which the residents are the owners (typically a company limited by guarantee of which the residents are the members).

See 75.13 (Joint owners).

75.22.1 *£500k exemption*

Section 110(2) FA 2013 provides:

> This subsection provides for an exception to subsection (1).
>
> Where P is an individual, C is not treated on the day in question as entitled to P's single-dwelling interest unless on that day C is entitled to a single-dwelling interest in the dwelling that is a freehold or leasehold interest with a taxable value of more than £500,000.

75.22.2 *Collective investment scheme*

Section 110 FA 2013 provides a similar rule for a CIS:

> (3) If on any day a single-dwelling interest ("the scheme interest") is held for the purposes of a collective investment scheme and a person ("P") who is connected with the scheme is entitled to a different single-dwelling interest in the same dwelling, this Part has effect–
>
> (a) in relation to the scheme, as if both those separate interests were on that day held for the purposes of the scheme, and
>
> (b) (if P is a company) in relation to P as if P were (on that day)

entitled to the scheme interest as well as P's single-dwelling interest.

(4) If on any day a single-dwelling interest in a dwelling is held for the purposes of a collective investment scheme ("the first scheme") and another interest in the same dwelling is held for the purposes of another collective investment scheme ("the second scheme") that is connected with the first scheme, this Part has effect

(a) in relation to the first scheme, as if both the interests were held on that day for the purposes of that scheme, and

(b) in relation to the second scheme, as if both the interests were held on that day for the purposes of that scheme.

(5) See also-

(a) section 97, for provision about the liability to tax of persons treated under this section (read with section 104) as jointly entitled to a single-dwelling interest;

(b) paragraph 55 of Schedule 33, for provision about returns in cases involving joint entitlement.

(6) The provisions mentioned in subsection (5) are to be read as including corresponding provision for cases where the same single-dwelling interest is treated under this section as held—

(a) for the purposes of different collective investment schemes, or

(b) by a company and for the purposes of a collective investment scheme.

(7) In the application of this section in Scotland-

(a) the reference to a freehold interest is to the interest of the owner;

(b) the reference to a leasehold interest is to a tenant's right over or interest in property subject to a lease.

75.22.3 *Interaction with reliefs*

Section 111 FA 2013 provides:

(1) References in section 110 to a person do not include—

(a) a public body, as defined in section 153,

(b) a body listed in section 154(2) (bodies established for national purposes).

(2) Subsections (1) to (4) of section 110 do not apply in relation to a single-dwelling interest if—

(a) the day in question is relievable with respect to that interest by virtue of section 150 (providers of social housing),

(b) by virtue of section 151 (charitable companies) the ownership condition is regarded as not met with respect to the interest on

that day, or

(c) the taxable value of the interest on that day is taken to be zero by virtue of section 155 (dwelling conditionally exempt from inheritance tax).

(3) Subsection (4) applies where the separate interests (the "relevant interests") that under section 110 (or that section and section 109) are treated as constituting, on a day, just one single-dwelling interest ("the combined interest") include—

(a) a freehold or leasehold interest, and

(b) a leasehold interest ("the inferior interest") granted out of that interest.

(4) If the inferior interest is the most inferior relevant interest, the combined interest, and the dwelling itself (where relevant), are regarded for the purposes of the relevant relieving provisions as being exploited, on the day mentioned in subsection (3), in the way the inferior interest is exploited on that day.

(5) If the inferior interest is an interest in part only ("the sub-let part") of the land that is the subject-matter of the combined interest, subsection (4) has effect in relation to the combined interest only so far as that interest relates to the sublet part.

(6) In this section "the relevant relieving provisions" means sections 132 to 150.

(7) The inferior interest counts as "the most inferior relevant interest" if no relevant interest (see subsection (3)) is a leasehold interest granted out of it.

(8) In this section the reference to a leasehold interest includes the interest of a lessee under an agreement for a lease.

(9) In the application of this section to Scotland—

(a) the reference to a freehold interest is to the interest of the owner;

(b) the reference to a leasehold interest is to a tenant's right over or interest in property subject to a lease;

(c) the reference to an agreement for lease includes missives of let.

75.23 Partnerships

75.23.1 *ATED treatment of partnership*

Section 167(2) FA 2013 provides:

> This Part has effect as follows in relation to a partnership (for instance, a limited liability partnership formed as mentioned in subsection (1)(c)) that is itself capable of being entitled to, or of acquiring or disposing of, a chargeable interest–

A common law partnership is not capable of being beneficially entitled to any interest. But this would apply to a LLP. (This is what the drafter had in mind with the words in brackets).

Section 167(2) continues:

> (a) transactions entered into on behalf of the partnership are treated as entered into by or on behalf of the partners;
> (b) where the partnership is entitled to a single-dwelling interest, this Part has effect as if the partners were jointly entitled to the interest (and the partnership had no entitlement to it).

This makes partnerships transparent for SDLT. It is the rough equivalent of the LLP provisions governing IT, CGT and IHT.[31]

> (3) For the purposes of this Part a partnership is treated as the same partnership despite a change in membership if any person who was a member before the change remains a member after the change.
> (4) For the purposes of this Part—
> (a) a collective investment scheme is not regarded as a partnership, and
> (b) accordingly, a member of a partnership by or on whose behalf a single-dwelling interest is held for the purposes of a collective investment scheme is not regarded as entitled to the interest as a member of the partnership.

75.23.2 *Administration*

Section 167 FA 2013 provides:

> (5) Anything required or authorised by this Part to be done by or in relation to the responsible partners for a partnership may instead be done by or in relation to any representative partner or partners.
> (6) A representative partner means a partner nominated by a majority of the partners to act as the representative of the partnership for the purposes of this Part of this Act.
> (7) Any such nomination, or the revocation of such a nomination, has effect only after notice of the nomination, or revocation, has been given to an officer of Revenue and Customs.

75.24 Tax consequences of paying ATED

Where the property is owned by a company which is owned by a

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31 See 41.8 (Limited liability partnership); 82.34.4 (Situs of LLP).

settlement, the payment of tax by a beneficiary may be a transfer of value for IHT. Does it make the beneficiary a settlor?

Bringing funds into the UK to pay the ATED may be a remittance of the funds.

75.24.1 *ATED deduction for Income Tax/Corporation tax on rent*

The CIOT ask:

> 2.12 Where it is not possible to fall within a relief from ATED (for example due to the connection conditions and definition of non-qualifying persons), but nevertheless the property is used for business purposes (for example a property letting business) please can you confirm that the ATED would be deductible for corporation tax (or income tax in the case of a non-resident landlord company) purposes in computing the profits assessable to UK tax.

In principle a deduction should be available.

75.25 ATED Reliefs

Section 132 FA 2013 provides:

> (1) Subsection (2) applies where tax is charged, in respect of a single-dwelling interest, for a chargeable period that includes one or more days that are relievable as a result of any of the provisions listed in subsection (3) (or for more than one such period).
> (2) For any such period, the adjusted chargeable amount is to be calculated on the basis that the chargeable person is not within the charge with respect to the interest on any relievable day.

Section 132(3) FA 2013 sets out 10 reliefs:

> (3) The provisions are—
> s.133 (property rental businesses);
> s.134 (rental property: preparation for sale etc);
> s.137 (dwellings opened to the public);
> s.138 (property developers);
> s.139 (property developers: exchange of dwellings);
> s.141 (property traders);
> s.143 (financial institutions acquiring dwellings in the course of lending);
> s.145 (occupation by certain employees or partners);
> s.148 (farmhouses);
> s.150 (providers of social housing).

The only relief discussed in this work is the relief for a property rental business.

75.25.1 *DT relief*

ATED is not a tax similar to IT or CGT, so it will not fall within DTAs in the OECD model form.

75.26 Property rental business

It is convenient to start with some definitions:

75.26.1 *"Property rental business"*

Section 133(4) FA 2013 puts (I think) a commonsense definition in convoluted drafting:

> A business is a "property rental business" for the purposes of subsection (3) if it is a property business as defined in Chapter 2 of Part 4 of CTA 2009, but–
>
> (a) the question whether or not a business is a property rental business for the purposes of subsection (3) is determined without reference to whether or not any profits of the business are chargeable to corporation tax (and section 204(2) of CTA 2009 is therefore disregarded), and
>
> (b) for the purposes of this subsection the "rents or other receipts" referred to in section 207(1) of CTA 2009 are taken not to include excluded rents

The definition incorporates the CTA 2009 definition with amendments.[32]

Para (a) makes sense: s.204(2) CTA 2009 would restrict the term to property business within the scope of corporation tax; that is disapplied, so the ATED definition extends to a property business of a non-resident company, which falls within the scope of income tax.

One disregards "excluded rents". Section 133(6) FA 2013 provides:

> In this Part "excluded rents" means rents within any of classes 2 to 6 in the table in section 605(2) of CTA 2010.

So we turn to s.605(2) CTA 2010:

> Class 2 Rent in respect of an electric-line wayleave.

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32 For that definition, see 17.2 ("Property business": terminology)

Class 3 Rent in respect of the siting of a pipeline for gas.
Class 4 Rent in respect of the siting of a pipeline for oil.
Class 5 Rent in respect of the siting of a mast or similar structure designed for use in a mobile telephone network or other system of electronic communication.
Class 6 Rent in respect of the siting of a wind turbine.

I would be grateful for any reader who could suggest why this is needed.

75.26.2 *"Qualifying" property rental business*

Section 133(3) FA 2013 provides:

> In this Part "qualifying property rental business" means a property rental business that is run on a commercial basis and with a view to profit.

For these expressions see 12.10.6 ("Commercial" Trade).

75.26.3 *Relief for property rental business*

Armed with these definitions, we can turn to the relief. Section 133 FA 2013 provides:

> (1) A day in a chargeable period is relievable in relation to a single-dwelling interest if on that day the interest–
>
> (a) is being exploited as a source of rents or other receipts (other than excluded rents) in the course of a qualifying property rental business carried on by a person entitled to the interest, or
>
> (b) steps are being taken to secure that the interest will, without undue delay, be so exploited in the course of a qualifying property rental business that is being carried on, or is to be carried on, by a person entitled to the interest.

75.26.4 *Property for sale or for conversion*

The relief in s.133(1) would not apply if the property is for sale or being converted. Section 134 FA 2013 provides a further relief:

> (1) A day ("day X") on which a person ("P") is entitled to a single-dwelling interest is relievable in relation to that interest if–
>
> (a) on day X the dwelling is unoccupied and any of the first to fourth conditions is met (see below),

I refer to **"rental property relief conditions 1-4"**

> (b) day X is preceded by one or more days ("qualifying days") that are relievable under section 133 in relation to the interest and

on which P, or a relevant partner,[33] was entitled to the interest, and

(c) the days (if any) between day X and the last of the qualifying days to precede day X are all relievable under this section.

75.26.5 Rental property relief conditions

Section 134(1) FA 2013 continues:

First condition [property for sale]
The first condition is that steps are being taken to secure that the interest will be sold without undue delay.
Second condition [demolition]
The second condition is that–

(a) steps are being taken to secure that the dwelling will be demolished without undue delay, and

(b) if it is intended that a new dwelling will be constructed on the site of the existing dwelling, the intention is that it will be used in a relievable way.

Third condition [conversion]
The third condition is that–

(a) steps are being taken to secure that the dwelling will be converted into a different dwelling without undue delay, and

(b) it is intended that the new dwelling will be used in a relievable way.

Fourth condition [conversion]
The fourth condition is that steps are being taken to secure that the dwelling will be converted into a building other than a dwelling without undue delay.
(2) A dwelling is "used in a relievable way" for the purposes of subsection (1) if the single-dwelling interest in question is exploited in such a way, or held in such a way and for such purposes, (or, as the case requires, the dwelling itself is exploited or used in such a way) that a day of such exploitation, ownership or use would be relievable under any of sections 133, 137, 145 and 148.

75.26.6 *"Without undue delay"*

Section 133(5) FA 2013 tries to define "undue delay":

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33 Defined in s.134(3) FA 2013: "relevant partner", where P is (on day X) entitled to the interest as a member of a partnership, means a person who was at the time in question carrying on the qualifying rental property business concerned as a member of that partnership.

"In subsection (1)(b)
"without undue delay" means without delay except so far as delay is justified by commercial considerations or cannot be avoided."

Since this definition (if it can be called such) only applies for s.133, it is repeated verbatim in s.134(3).

75.26.7 *Non-qualifying occupier: Disapplication of present relief*

Section 133(2) FA 2013 provides:

> A day is not relievable by virtue of subsection (1) or section 134 in the case of a single-dwelling interest if on that day a non-qualifying individual is permitted to occupy the dwelling.

75.26.8 Disapplication of future relief

Section 135 FA 2013 provides:

> (1) Subsection (2) applies if on a day in a chargeable period ("the day of non-qualifying occupation")–
>
> (a) a single-dwelling interest to which a person ("the landlord") is entitled is being exploited as mentioned in section 133(1)(a) or steps are being taken to secure that the interest will be so exploited, as mentioned in section 133(1)(b), and
>
> (b) a non-qualifying individual is permitted to occupy the dwelling.
>
> If this condition is satisfied, s.135(2) disapplies rental property relief (in short) for the next 3 years:
>
> (2) No subsequent day in that chargeable period, or in any of the subsequent 3 chargeable periods, that meets the continuity of ownership condition and would (in the absence of this subsection) be relievable by virtue of section 133(1)(b) is treated as relievable by virtue of that provision unless a day of qualifying use falls between that day and the day of non-qualifying occupation.
>
> (3) A day meets the continuity of ownership condition if on that day—
>
> (a) the landlord is entitled to the single-dwelling interest, or
>
> (b) if the landlord carried on or (as the case requires) intended to carry on the property rental business in partnership, another member of the partnership is entitled to the interest.

75.26.9 *Disapplication of past relief*

Section 135(4) FA 2013 provides:

> Subsection (5) applies if a person who is a non-qualifying individual in

relation to a single-dwelling interest occupies the dwelling on a day in a chargeable period ("the day of non-qualifying occupation").

If that condition is satisfied, s.135 disapplies past relief for the present and preceding year:

(5) An earlier day in that or the preceding chargeable period ("the earlier day") is not relievable by virtue of section 133(1)(b) or 134 if a relevant person is entitled to the single-dwelling interest on that day.
(6) In subsection (5) "relevant person" means—
(a) a person who is entitled to the single-dwelling interest on the day of non-qualifying occupation, or
(b) if a person falling within paragraph (a) is or has been a member of a partnership whose members have at any time exploited the single-dwelling interest as a source of rents and receipts in a property rental business, any other member of that partnership.
(7) Subsection (5) does not apply in relation to the earlier day if a day that is relievable by virtue of section 133(1)(a) falls between that earlier day and the day of non-qualifying occupation.
(8) For the purposes of this section—
(a) "day of qualifying use", in relation to a single-dwelling interest, means a day that is relievable in the case of the interest by virtue of section 133(1)(a);
(b) occupation of any part of a dwelling is regarded as occupation of the dwelling.

75.27 Meaning of "non-qualifying" individual

75.27.1 *"Non-qualifying individual"*

Section 136 FA 2013 provides about the widest definition that the drafter could devise:

(1) In sections 133 and 135 "non-qualifying individual", in relation to a single-dwelling interest, means any of the following–
(a) an individual who is entitled to the interest (otherwise than as a member of a partnership),
(b) an individual ("a connected person") who is connected with a person entitled to the interest,
(c) if a person is entitled to the interest as a member of a partnership, an individual who is, or is connected with, a qualifying member of that partnership,
(d) an individual ("a relevant settlor") who is the settlor in relation to a settlement of which a trustee is (in the capacity of trustee)

connected with a person who is entitled to the interest,
(e) the spouse or civil partner
[i] of a connected person or
[ii] of a relevant settlor,
(f) [i] a relative
[A] of a connected person or
[B] of a relevant settlor,
[ii] or the spouse or civil partner
[A] of a relative of a connected person or
[B] of a relevant settlor,

Thus an uncle or aunt of T is not a connected person; but they are non-qualifying individuals because they are "relatives" (defined to include brother or sister) of a connected person (the parent of T). But the nephew or niece of T is a qualifying individual, as they are not "relatives" (as defined) of any connected person.

(g) a relative of the spouse or civil partner of a connected person or of a relevant settlor,
(h) the spouse or civil partner of a person falling within paragraph (g), or
(i) an individual who is
[i] a major participant in a relevant collective investment scheme or
[ii] is connected with a major participant in a relevant collective investment scheme.

75.27.2 *Supplemental definitions*

Section 136 FA 2013 provides six supplemental definitions:

(2) In subsection 1(c) "qualifying member", in relation to a partnership, means an member of the partnership who is entitled to a 50% or greater share–
(a) in the income profits of the partnership, or
(b) in the partnership's assets.
(3) In subsection (1)(i) "relevant collective investment scheme", in relation to a single-dwelling interest, means a collective investment scheme that meets the ownership condition with respect to the interest.
(4) A person who participates in a collective investment scheme is a "major participant" in the scheme if the person–
(a) is entitled to a share of at least 50% either of all the profits or income arising from the scheme or of any profits or income arising from the scheme that may be distributed to participants, or

(b) would in the event of the winding up of the scheme be entitled to 50% or more of the assets of the scheme that would then be available for distribution among the participants.

(5) The reference in subsection (4)(a) to profits or income arising from the scheme is to profits or income arising from the acquisition, holding, management or disposal of the property subject to the scheme.

(6) For the purpose of subsection (1), section 1122 of CTA 2010 (as applied by section 172) has effect as if subsections (7) and (8) of that section (application of rules about connected persons to partnerships) were omitted.

(7) In this section–

"relative" means brother, sister, ancestor or lineal descendant;

"settlement" and "settlor" have the same meaning as in Chapter 5 of Part 5 of ITTOIA 2005 (see section 620 of that Act).

(8) In subsection 1(d) "trustee" is to be read in accordance with section 1123(3) of CTA 2010 ("connected persons": supplementary).

75.28 ATED Definitions

75.28.1 *"Chargeable day" and "within the charge"*

Section 170 FA 2013 provides:

(1) Any day on which the conditions in section 94(2) are met with respect to a single-dwelling interest is a "chargeable day" for that interest;

(2) Where a day is a chargeable day as a result of subjection (1), the chargeable person is "within the charge" with respect to a single-dwelling interest on that day.

75.29 ATED-CGT

Section 2B(1) TCGA provides:

A person (other than an excluded person) ("P") is chargeable to capital gains tax in respect of any ATED-related chargeable gain accruing to P in a tax year on a relevant high value disposal.

I abbreviate "ATED-related gains" (or losses) to **"ATED-gains"** (or losses). We need to distinguish this charge from ordinary CGT; I refer to it as **"ATED-CGT"**.

Section 2B(3) TCGA provides:

Capital gains tax is charged on the total amount of ATED-related chargeable gains accruing to P in the tax year on relevant high value

disposals, after deducting ring-fenced ATED-related allowable losses in relation to that year.

75.30 Rate of ATED-CGT

Section 4(3A) TCGA provides:

> The rate of capital gains tax in respect of gains chargeable under section 2B accruing to a person in a tax year is 28%.

75.31 Partnerships

Partnerships are treated as transparent in accordance with normal CGT rules. A gain on the disposal of a UK residential property is apportioned between the partners in accordance with their shares in the property. To the extent that any gains are apportioned to "non-natural" partners ATED-CGT is chargeable on them.

An "excluded person" is not within ATED-CGT. Section 2B(2) TCGA provides:

> A person is "excluded" if the person is an individual, the trustees of a settlement or the personal representatives of a deceased person and—
>
> (a) the gain accrues on a disposal of any partnership assets and the person is a member of the partnership, or
>
> (b) the gain accrues on a disposal of any property held for the purposes of a relevant collective investment scheme and the person is a participant in relation to the scheme.

Non-partnerships do not need to be "excluded" as they are not within the scope of ATED in the first place.

75.32 "Relevant high value disposal"

Section 2C(1) TCGA provides:

> A disposal on which a gain or loss accrues to P is a "relevant high value disposal" if conditions A to D are met.

I refer to **"ATED-disposal conditions A to D"**.

75.32.1 *ATED-disposal condition A: Chargeable interest*

Section 2C(2) TCGA provides:

> Condition A is that the disposal is of the whole or part of a chargeable interest ("the disposed of interest").

"The disposed of interest" is a slovenly expression, but it is easiest to follow the statutory terminology.

75.32.2 *ATED-disposal condition B: Single-dwelling interest*

Section 2C(3) TCGA provides:

> Condition B is that the disposed of interest has, at any time during the relevant ownership period, been or formed part of a single-dwelling interest.

75.32.3 *ATED-disposal condition C: ATED applies*

Section 2C(4) TCGA provides:

> Condition C is that—
> (a) P, or
> (b) if the disposed of interest is a partnership asset, the responsible partners, or
> (c) if the disposed of interest is held for the purposes of a relevant collective investment scheme, the person who has day-to-day control over the management of the property subject to the scheme,
>
> has or have been within the charge to ATED with respect to that single-dwelling interest on one or more days in the relevant ownership period which are not relievable days in relation to the interest.

This incorporates the requirements and reliefs of ATED.

75.32.4 *ATED-disposal condition D: £2m threshold*

Section 2C(5) TCGA provides:

> Condition D is that the amount or value of the consideration for the disposal exceeds the threshold amount (see section 2D).

75.32.5 *Minor definitions*

Section 2C TCGA provides:

> (6) In this section and section 2D...
> "the relevant ownership period" means the period which begins—
> (a) if an election has been made under paragraph 5 of Schedule 4ZZA, with the day on which P acquired the chargeable interest or, if later, 31 March 1982, and
> (b) in any other case, with the day on which P acquired the chargeable interest or, if later, 6 April 2013,

and ends with the day before the day on which the disposal occurs; "relievable day" means a day which is "relievable" by virtue of any of the provisions mentioned in section 132 of the Finance Act 2013 (ATED: effect of reliefs) and in respect of which a claim has been made under section 106(3) of that Act...

(7) For the purposes of Condition C—

(a) Part 3 of the Finance Act 2013 applies, in relation to any part of the relevant ownership period falling before 1 April 2013, as if section 94(8)(a) of that Act (first chargeable period for ATED) read "the period beginning with 31 March 1982 and ending with 31 March 1983", and

(b) when determining whether any day falling before 1 April 2013 is a relievable day, the definition of "relievable day" in subsection (6) above is to read as if the words "and in respect of which a claim has been made under section 106(3) of that Act" were omitted.

75.33 "The threshold amount"

Section 2D TCGA provides:

(1) This section applies to determine "the threshold amount" in relation to a disposal which meets Conditions A to C in section 2C ("the current disposal").

(2) If–

(a) the current disposal is not a part disposal of an asset, and

(b) P has not made any relevant related disposals,

the threshold amount is £2 million, subject to subsection (5) (joint interests).

75.33.1 *Part disposals or related disposals*

Section 2D TCGA provides:

(3) If paragraphs (a) and (b) of subsection (2) do not both apply, the threshold amount is the relevant fraction of £2 million, subject to subsection (5) (joint interests).

Section 2D(4) TCGA then defines the relevant fraction:

(4) "The relevant fraction" is (C÷TMV)

In short, C is **C**onsideration and TMV is **T**he **M**arket **V**alue. In full detail:

"C" is the amount or value of consideration for the current disposal;

"TMV" is what would be the market value, at the time of the current

disposal, of a notional asset comprising–

(a) the disposed of interest (see section 2C(2)),

(b) if the current disposal is a part disposal, any part of the chargeable interest held by P that remains undisposed of immediately following that part disposal,

(c) any chargeable interest (or part of a chargeable interest) which was the subject of a relevant related disposal, and

(d) any chargeable interest (or part of a chargeable interest) held by P at the time of the current disposal which, if P had disposed of it at that time, would have been the subject of a relevant related disposal.

75.33.2 *Disposal of share*

Section 2D TCGA provides:

(5) If the disposed of interest is a share of the whole of–

(a) a chargeable interest, or

(b) part of a chargeable interest,

subsections (2) and (3) have effect as if the references to "£2 million" were to the joint share fraction of that amount.

(6) The joint share fraction is the fraction of the whole of the chargeable interest or part represented by the disposed of interest.

Co-owned property is caught even if held by unconnected persons.

75.33.3 *"Relevant related disposal"*

Section 2D(7) TCGA provides:

"Relevant related disposal", in relation to the current disposal, means any disposal by P which–

(a) meets Conditions A to C in section 2C in circumstances where the single-dwelling interest referred to in Condition C is–

(i) the single-dwelling interest by virtue of which Condition C is met in relation to the current disposal, or

(ii) another single-dwelling interest in the same dwelling as that interest, and

(b) was made in the period of 6 years ending with the day on which the current disposal occurs, but not before 6 April 2013.

75.34 Taper relief

Section 2F TCGA provides:

(1) This section applies to an ATED-related gain which accrues on a

relevant high value disposal and is chargeable to capital gains tax by virtue of section 2B.

(2) There is excluded from the gain so much of it as exceeds five-thirds of the difference between-

(a) the amount or value of the consideration, and

(b) the threshold amount (within the meaning of section 2D) in relation to the disposal.

Does this work?

(3) But where the relevant fraction is less than 1, subsection (2) has effect as if the amount determined under that subsection were the relevant fraction of that amount.

75.34.1 *The relevant fraction*

Section 2F TCGA provides:

(4) "The relevant fraction"-

(a) in a case where the ATED-related gain is determined in accordance with paragraph 3 of Schedule 4ZZA, [rebasing] has the meaning given by paragraph 3(4) of that Schedule, and

(b) in a case where the ATED-related gain is determined in accordance with paragraph 6 of that Schedule, has the meaning given by paragraph 6(5)(a) of that Schedule.

(5) Nothing in this section restricts any gain which is not ATED-related, or affects any loss (whether or not ATED-related), accruing on the relevant high value disposal.

Para 3 applies in a rebasing case, and para 6 applies in a non-rebasing case.

75.35 Computation of ATED-related gain

Para 1 Sch 4ZZA TCGA provides:

1 This Schedule applies for the purposes of determining in relation to a relevant high value disposal made by a person ("P")-

(a) whether a gain or loss which is ATED-related accrues to P on the disposal, and

(b) whether a gain or loss which is not ATED-related accrues to P on the disposal.

75.36 Assets held on 5 April 2013: Rebasing

Para 2 Sch 4ZZA TCGA provides:

2 If the interest disposed of was held by P on 5 April 2013-
(a) paragraph 3 applies for the purposes of computing the gain or loss accruing to P which is ATED-related, and
(b) paragraph 4 applies for the purposes of computing the gain or loss accruing to P which is not ATED-related.

75.36.1 *ATED-related gain computation*

Para 3 Sch 4ZZA TCGA provides the general rule:

> 3 (1) An amount equal to the relevant fraction of the notional post-April 2013 gain or loss is the ATED-related gain or loss (as the case may be).

75.36.2 *"Notional post-April 2013 gain"*

Para 3 Sch 4ZZA TCGA provides the definition:

> (2) "Notional post-April 2013 gain or loss" means the gain or loss which (in the absence of section 2B and this Schedule) would have accrued on the relevant high value disposal had P acquired the interest on 5 April 2013 for a consideration equal to its market value on that date.

This imposes a rebasing at 5 April 2013.
Para 3 Sch 4ZZA TCGA provides:

> (3) For the purposes of sub-paragraph (2), the amount of the gain or loss accruing to P is to be computed (whether or not that would otherwise be the case) as if P were within the charge to capital gains tax (but not within the charge to corporation tax on chargeable gains).

This is a convoluted way to exclude corporate indexation relief. Does it do anything else?

75.36.3 *"The relevant fraction"*

Para 3 Sch 4ZZA TCGA provides:

> (4) "The relevant fraction" is (CD ÷ TD)

In short, CD is **C**hargeable **D**ays and TD is **T**otal **D**ays. In full:

> "CD" is the number of days in the relevant ownership period which are ATED chargeable days;
> "TD" is the total number of days in the relevant ownership period.

75.36.4 *"The relevant ownership period"*

Para 3 Sch 4ZZA TCGA provides:

> (5) "The relevant ownership period" means the period beginning with 6 April 2013 and ending with the day before the day on which the relevant high value disposal occurs.

75.36.5 *"ATED chargeable day"*

Para 3 Sch 4ZZA TCGA provides:

> (6) "ATED chargeable day" means any day by virtue of which condition C in section 2C(4) would be met in relation to the relevant high value disposal.

Condition C is being within the charge to ATED.[34]

75.36.6 *ATED/Non-ATED gain computations*

A gain on a disposal may be:
(1) partly ATED-related and
(2) partly non-ATED related (and so within the ordinary CGT regime).
In order to follow the computation, one must first review some defined terms.

75.36.7 *"Notional pre-April 2013 gain or loss"*

Para 4 Sch 4ZZA TCGA provides:

> (2) "The notional pre-April 2013 gain or loss" means the chargeable gain or allowable loss which would have accrued on 5 April 2013 had the interest been disposed of for a consideration equal to its market value on that date.
> (3) For the purposes of sub-paragraph (2), the amount of the gain or loss accruing to P is to be computed (whether or not that would otherwise be the case) as if P were within the charge to corporation tax on chargeable gains (but not within the charge to capital gains tax).

This is a convoluted way to include corporate indexation relief.

> (4) Paragraph 3(2) and (3) (meaning of "notional post-April 2013 gain or loss") also applies for the purposes of this paragraph.

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34 See 75.32.3 (ATED-disposal condition C: ATED applies).

75.36.8 *"Notional indexation allowance"*

Para 4 Sch 4ZZA TCGA provides:

(5) "Notional indexation allowance" means the relevant fraction of an amount equal to the difference between-

(a) the indexation allowance which (in the absence of section 2B and this Schedule) would be made under Chapter 4 of Part 2 in determining the chargeable gain accruing on the relevant high value disposal were that gain being computed for corporation tax purposes, and

(b) the indexation allowance which is made under Chapter 4 of Part 2 in determining the notional pre-April 2013 gain.

75.36.9 *"Relevant fraction"*

(6) "The relevant fraction" is (TD-CD) ÷ TD
Where "CD" and "TD" have the same meaning as in paragraph 3(4).

75.36.10 *Computation*

Armed with these terms, we can turn to the computation itself.
Para 4 Sch 4ZZA TCGA provides:

4 (1) The gain or loss accruing on the relevant high value disposal which is not ATED-related is computed as follows.
Step 1
Determine the amount of the notional pre-April 2013 gain or loss.
Step 2
In a case where there is a notional post-April 2013 gain-

(a) determine the amount of that gain remaining after the deduction of the ATED-related chargeable gain determined under paragraph 3, and

(b) adjust that remaining gain by reducing it by the notional indexation allowance.

Step 3
In a case where there is a notional post-April 2013 loss, determine the amount of that loss remaining after deduction of the ATED-related allowable loss determined under paragraph 3.
Step 4
Add-

(a) the amount of any gain or loss determined under Step 1, and

(b) the amount of any adjusted gain determined under Step 2 or (as the case may be) any loss determined under Step 3, (treating any amount which is a loss as a negative amount).

If the result is a positive amount, that amount is the chargeable gain on the relevant high value disposal which is not ATED-related.
If the result is a negative amount, that amount (expressed as a positive number) is the allowable loss on the relevant high value disposal which is not ATED-related.

75.37 Election out of rebasing

Para 5 Sch 4ZZA TCGA provides:

> 5 (1) A person may make an election under this paragraph for paragraphs 2 to 4 not to apply in relation to a chargeable interest[35] held by (or any part of which is held by) the person on 5 April 2013.
> (2) An election is irrevocable.

An election will be advantageous if the property is standing at a loss on 5 April 2013.

75.37.1 *Time limit and procedure for the election*

Note the deadline for the election. Para 5 Sch 4ZZA TCGA provides:

> (3) An election must be made by being included in a tax return under the Management Act for the tax year in which the first relevant high value disposal by the person of the chargeable interest (or any part of it) on or after 6 April 2013 occurs.
> (4) The reference in sub-paragraph (3) to an election being included in a return includes an election being included by virtue of an amendment of the return.
> (5) All such adjustments are to be made, whether by way of discharge or repayment of tax, the making of assessments or otherwise, as are required to give effect to an election.

75.38 Computation for assets acquired after 5 April 2013

Para 6 Sch 4ZZA TCGA provides:

> 6 (1) This paragraph applies if-
> (a) an election is made by P under paragraph 5 in respect of the chargeable interest which (or a part of which) is the subject of the relevant high value disposal, or
> (b) the chargeable interest (or part) disposed of by the relevant high

35 Para 5 Sch 4ZZA TCGA contains defines this term by reference: (6) In this paragraph "chargeable interest" has the same meaning as in Part [ATED] of FA 2013 (see section 107 [chargeable interests] of that Act).

value disposal was not held by P throughout the period beginning with 5 April 2013 and ending with the disposal.

That is, para 6 applies to post-5 April acquisitions, or if an election is made out of rebasing. As before, one needs to compute (1) ATED-related gains and (2) non-ATED related gains.

75.38.1 *Computation of ATED-related gain*

Para 6 Sch 4ZZA TCGA provides:

> (2) The ATED-related gain or loss accruing on the relevant high value disposal is computed as follows.
> *Step 1*
> Determine the amount of the gain or loss which would accrue to P, ignoring section 2B and this Schedule (but not the remainder of this Step).
> For this purpose, the amount of the gain or loss is to be computed (whether or not that would otherwise be the case) as if P were within the charge to capital gains tax (but not within the charge to corporation tax on chargeable gains).[36]
> *Step 2*
> An amount equal to the relevant fraction of that gain or loss is the ATED-related gain or loss accruing on the relevant high value disposal.

75.38.2 *Computation of non-ATED-related gain*

Para 6 Sch 4ZZA TCGA provides:

> (3) The gain or loss accruing on the relevant high value disposal which is not ATED-related is to be computed as follows.
> *Step 1*
> In a case where there is a gain under Step 1 of subparagraph (2)-
> (a) determine the amount of the gain remaining after the deduction of the ATED-related chargeable gain, and
> (b) adjust the remaining gain by reducing it by an amount equal to the notional indexation allowance.
> That adjusted gain is the gain accruing on the relevant high value disposal which is not ATED-related.
> *Step 2*
> In a case where there is a loss under Step 1 of subparagraph (2), determine the amount of the loss remaining after deduction of the

36 This is a convoluted way to exclude corporate indexation relief.

ATED-related loss.
That remaining loss is the loss accruing on the relevant high value disposal which is not ATED-related.

75.38.3 *"Notional indexation allowance"*

Para 6 Sch 4ZZA TCGA provides:

(4) "Notional indexation allowance" means the relevant fraction of the indexation allowance which would have been made under Chapter 4 of Part 2 in determining the gain under Step 1 in subparagraph (2) were that gain being computed for corporation tax purposes.

75.38.4 *"Relevant fraction"*

Para 6 Sch 4ZZA TCGA provides:

(5) Subject to sub-paragraph (6), "the relevant fraction"—
(a) in sub-paragraph (2) has the same meaning as in paragraph 3(4), and
(b) in sub-paragraph (4) has the same meaning as in paragraph 4(6).
(6) For the purpose of determining the relevant fraction under subparagraph (5), paragraph 3(5) has effect as if the relevant ownership period began on the day on which P acquired the interest or, if later, 31 March 1982.

75.39 ATED-losses

Section 2B TCGA provides:

(4) Subsections (5) to (7) apply in relation to an ATED-related allowable loss accruing to P in a tax year on a relevant high value disposal.
(5) The loss is not allowable as a deduction from ATED-related chargeable gains accruing in any earlier tax year on relevant high value disposals.
(6) Relief is not to be given under this Act more than once in respect of the loss or any part of the loss.
(7) Relief is not to be given under this Act in respect of the loss if, and so far as, relief has been or may be given in respect of it under the Tax Acts.
(8) The only deductions which can be made from ATED-related chargeable gains are those permitted by this section.

Section 2B(10) provides some supplemental definitions:

In this section:

"ring-fenced ATED-related allowable losses", in relation to a tax year, means–

(a) any ATED-related allowable losses accruing to P in the tax year on relevant high value disposals, and

(b) so far as they have not been allowed as a deduction from ATED-related chargeable gains accruing in any previous tax year on relevant high value disposals, any ATED-related allowable losses accruing to P in any previous tax year (not earlier than the tax year 2013-14) on such disposals.

75.40 Interaction with other taxes, anti avoidance rules and reliefs

75.40.1 *Section 13 TCGA*

Section 13(1A) TCGA provides:

(1A) But this section does not apply if the gain is an ATED-related gain chargeable to capital gains tax by virtue of section 2B (capital gains tax on ATED-related gains).

This takes ATED-gains outside s.13.

75.40.2 *Section 86, 87 TCGA*

ATED-CGT does not overlap with s.86, 87 TCGA as gains accruing to trusts are not ATED-gains. (The drafter may have formed the view that a company could not constitute a settlement for s.87 purposes).

75.40.3 *Private residence relief*

ATED-CGT does not overlap with private residence relief, as that only applies to gains accruing to individuals or trusts, which do fall within ATED-CGT.

75.40.4 *Interaction of ATED-CGT and DTAs*

There is no relief where a DTA follows OECD model form as the gain arises from UK situate land.

75.40.5 *Shadow director charges*

There are no provisions dealing with the interaction with shadow director charges (which include SDLT) so there could in theory be double taxation here. In practice HMRC may not be assiduous to pursue shadow directors, now that the corporate residential property regime achieves the object of discouraging tax planning through companies.

75.41 Charities

A charitable trust does not fall within ATED as it is not a "non-natural" person.

A charitable company would fall within the charge. Relief is available under s.151 FA 2013. For a discussion, see Kessler & Marre, *Taxation of Charities and Non-profit Organisations* (9th ed., 2013), para 38.11 (ATED).[37]

75.42 Application to Scotland

ATED applies to a chargeable interest, defined as an interest in land in the UK, so it applies in Scotland.

Section 80I[38] Scotland Act 1998 provides:

> (1) A tax charged on any of the following transactions is a devolved tax—
>
> (a) the acquisition of an estate, interest, right or power in or over land in Scotland;
>
> (b) the acquisition of the benefit of an obligation, restriction or condition affecting the value of any such estate, interest, right or power.

ATED is not a tax charged on acquisition, so it is not a devolved tax. By contrast, Land and Buildings Transaction Tax (the Scots equivalent of SDLT) is a devolved tax. If the object of ATED is the prevention of avoidance of SDLT/LBTT, then ATED ought to be a devolved tax also. Perhaps no-one noticed, or cared, or perhaps it was thought too difficult to amend the statute. Perhaps a single UK wide tax was thought to be simpler; but simplicity is not a value which rests comfortably with devolution.

75.43 SDLT issues on winding up companies holding land

In the course of winding up of a company holding a UK residence, the company (acting by its liquidator) will normally transfer the land to the shareholders. I refer to this as **"the transfer on liquidation"**. This section considers whether the transfer is subject to SDLT.

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37 Online version *http://www.taxationofcharities.co.uk*

38 That is, 80 with a capital *I*, not 801.

75.43.1 *SDLT basic principles*

Section 43(1) FA 2003 provides:

> In this Part a "land transaction" means any acquisition of a chargeable interest.

A transfer on liquidation is a land transaction.
Section 49(1) FA 2003 provides:

> A land transaction is a chargeable transaction if it is not a transaction that is exempt from charge.

The transfer on liquidation is a chargeable transaction.
Section 55(1) FA 2003 provides:

> The amount of tax chargeable in respect of a chargeable transaction to which this section applies is a percentage of the chargeable consideration for the transaction.[39]

The amount of SDLT depends on the amount of the chargeable consideration. If there is no chargeable consideration there is no SDLT.

75.43.2 *"Chargeable consideration"*

The starting point in the definition of chargeable consideration is para 1(1) Sch 4 FA 2003:

> The chargeable consideration for a transaction is, except as otherwise expressly provided, any consideration in money or money's worth given for the subject-matter of the transaction, directly or indirectly, by the purchaser or a person connected[40] with him.

"Consideration" is a term commonly used in tax and other statutes. The term is not usually defined in tax legislation. It is a technical term from English contract law. In a tax statute it will in principle bear its contract law meaning:

> The word "consideration" is a term of art in English law, and I think that, used in an English statute, it must be assumed to bear its ordinary meaning in the law, save in so far as the provisions of the statute

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39 Section 55(1A) sets out exceptions not relevant here.

40 Defined para 1(2) Sch 4 FA 2003: "Section 1122 of the CTA 2010 (connected persons) applies for the purposes of sub-paragraph (1)."

indicate some other meaning.[41]

While context may of course show that "consideration" is used in a special sense,[42] that is not the case here.

Regard should be had to the English[43] contract law textbooks for a full discussion of the meaning of "consideration". In outline, there is "consideration" for a disposal where the disposal forms part of a bargain, under which the purchaser/transferee undertakes to provide some benefit to the vendor/transferor in return for which the vendor transfers the property to the purchaser. There must be a promise to the vendor which is enforceable as a matter of contract law. The meaning of "consideration" is "the price of a promise".[44]

The transfer of a property to shareholders in the course of liquidation is not for consideration, as there is no bargain between the shareholders and the company. (Likewise the transfer from a trust to a beneficiary.)

HMRC agree:

> **Stamp Duty Land Tax on de-enveloping transactions**
> Companies may look to 'de-envelope' a property for a number of reasons, including taking themselves and the persons to whom they distribute the property outside the scope of ATED. Such de-enveloping may occur by a capital distribution to the shareholders following the liquidation of the company. The tax consequences of de-enveloping will

41 *C&E Commissioners v Apple & Pear Development Council* [1985] STC 383 at p.389. The same view was taken in another context in *R v Braithwaite* [1983] 1 WLR 385 at p.391: "In our view the meaning of the word "consideration" must be the legal meaning of it and not any common or garden meaning; that really goes without saying. ... In our judgment the word "consideration" connotes the existence of something in the shape of a contract or a bargain between the parties. ... Consideration deals with the situation where there is a contract or a bargain and something moving the other way."

42 For instance, in the VAT context of *Apple & Pear*, an EU law concept of "consideration" was adopted in preference to the English contract law meaning. In the family context of s.1(3) Inheritance (Provision for Family and Dependants) Act 1975, there could be consideration (provision of benefits) without any contract; but not in the property law context of s.10 of the same Act: *Jelley v Iliffe* [1981] Fam 128 at p.136.

43 Scots law has no concept of consideration.

44 *Dunlop Pneumatic Tyre Co v Selfridge* [1915] AC 847 at p.855. Another classic definition is: "some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other"; *Currie v Misa* (1875) LR 10 Ex 153 at p.162.

depend on whether there is any consideration given by the shareholders for the transfer of the property.
There will be two situations where HMRC will not consider there to be any consideration given.
The first is where the company is debt free: its only asset is the property and there are no liabilities (other than issued share capital). In such a situation the shareholders have given no consideration directly or indirectly for the property and therefore there is no SDLT liability.

75.43.3 *Transfer to corporate shareholder*

Further consideration is needed when the transferee is a company (the issue discussed here does not arise on a transfer to an individual).
Section 53 FA 2003 provides:

> (1) This section applies where the purchaser [ie, transfer] is a company and—
>
> (a) the vendor is connected with the purchaser...
>
> (1A) The chargeable consideration for the transaction shall be taken to be not less than—
>
> (a) the market value of the subject-matter of the transaction as at the effective date of the transaction...

However in the case of a transfer on liquidation, s.54 FA 2003 will normally provide relief:

> (1) Section 53 (chargeable consideration: transaction with connected company) does not apply in the following cases.
> In the following provisions "the company" means the company that is the purchaser in relation to the transaction in question.
> ...

Where the transfer is to a corporate trustee, relief is in principle available under case 2:

> (3) Case 2 is where—
>
> (a) immediately after the transaction the company holds the property as trustee, and
>
> (b) the vendor is connected with the company only because of section 1122(6) of the Corporation Tax Act 2010.[45]

If case 2 does not apply (ie if the company purchaser is not a trustee) relief

45 See 85.12 (Connection with trustees).

is in principle available under case 3:

> (4) Case 3 is where—
>
> (a) the vendor is a company and the transaction is, or is part of, a distribution of the assets of that company (whether or not in connection with its winding up), and
>
> (b) it is not the case that—
>
> (i) the subject-matter of the transaction, or
>
> (ii) an interest from which that interest is derived,
>
> has, within the period of three years immediately preceding the effective date of the transaction, been the subject of a transaction in respect of which group relief was claimed by the vendor.

It is possible to envisage circumstances where relief does not apply, but that will rarely if ever happen in practice.

75.43.4 *Company owes debt*

Suppose the company owes a debt. This typically arises if the company has borrowed to purchase the property and owes money to a bank. The company cannot transfer the property to the shareholders and leave the debt outstanding, at least if the debt is to non-shareholders.

Para 8(1) Sch 4 FA 2003 provides:

> Where the chargeable consideration for a land transaction consists in whole or in part of—
>
> (a) the satisfaction or release of debt due to the purchaser or owed by the vendor, or
>
> (b) the assumption of existing debt by the purchaser,
>
> the amount of debt satisfied, released or assumed shall be taken to be the whole or, as the case may be, part of the chargeable consideration for the transaction.

This applies only if the release or assumption of the debt is consideration for the transaction. The point is that the consideration for SDLT purposes is the face value of the debt (the amount owed), and not its market value (which may be less).

Thus if there is an arrangement under which the shareholders undertake to pay the company's debt in consideration for the transfer, (in contract law terminology, a novation) there is a SDLT charge on the amount of the debt. HMRC say:

> **Stamp Duty Land Tax on de-enveloping transactions**
>
> ... where there is a third party (non-shareholder) loan secured on the

property when the company is liquidated, the transfer of the property by the company on a distribution will attract SDLT under paragraphs 1 and 8 of Schedule 4 FA 2003 where there is an assumption by the shareholder(s) of liability for the debt.[46]

Para 8(1A) Sch 4 FA 2003 provides:

> Where—
>
> (a) debt is secured on the subject-matter of a land transaction immediately before and immediately after the transaction, and
>
> (b) the rights or liabilities in relation to that debt of any party to the transaction are changed as a result of or in connection with the transaction,
>
> then for the purposes of this paragraph there is an assumption of that debt by the purchaser, and that assumption of debt constitutes chargeable consideration for the transaction.

This will not apply if the debt is unsecured, before or after the transaction.

Para 8 continues with provisions dealing with apportionment:

> (1B) Where in a case in which sub-paragraph (1)(b) applies—
>
> (a) the debt assumed is or includes debt secured on the property forming the subject-matter of the transaction, and
>
> (b) immediately before the transaction there were two or more persons each holding an undivided share of that property, or there are two or more such persons immediately afterwards,
>
> the amount of secured debt assumed shall be determined as if the amount of that debt owed by each of those persons at a given time were the proportion of it corresponding to his undivided share of the property at that time.
>
> (1C) For the purposes of sub-paragraph (1B), in England and Wales and Northern Ireland each joint tenant of property is treated as holding an equal undivided share of it.
>
> (2) If the effect of this paragraph would be that the amount of the chargeable consideration for the transaction exceeded the market value of the subject-matter of the transaction, the amount of the chargeable consideration is treated as limited to that value.
>
> (3) In this paragraph—
>
> (a) "debt" means an obligation, whether certain or contingent, to pay a sum of money either immediately or at a future date,
>
> (b) "existing debt", in relation to a transaction, means debt created

46 *http://www.hmrc.gov.uk/so/stamps-de-enveloping.htm* (20 December 2013).

or arising before the effective date of, and otherwise than in connection with, the transaction, and

(c) references to the amount of a debt are to the principal amount payable or, as the case may be, the total of the principal amounts payable, together with the amount of any interest that has accrued due on or before the effective date of the transaction.

The SDLT Manual comments on the apportionment provisions:

> **SDLTM04040a - Scope: How much is chargeable: Non-cash consideration: Assumption or release of a debt: Examples** [September 2012]
>
> **Example 1**
>
> A property is transferred by V into the ownership of V and P in equal shares subject to a subsisting mortgage.
>
> P assumes liability for all or part of the debt.
>
> Notwithstanding P's actual liability, which is probably for all of the debt, P is treated as assuming debt equal to 50% of the amount owing. This is because he is treated as owing none before the transaction and 50% after it.
>
> **Example 2**
>
> A property is owned by V and P in 70:30 shares.
>
> It is transferred to the sole ownership of P subject to a subsisting mortgage.
>
> Assuming V is released from the debt or P agrees to indemnify V there is an assumption of debt by P.
>
> P is treated as assuming debt equal to 70% of the amount owning.
>
> This is because P is treated as owing 30% before the transfer and 100% after it...

Suppose:

(1) Shareholders subscribed for new share capital.

(2) The company used the proceeds of the share subscription to repay the debt.

(3) The company was put into liquidation.

This is not caught by para 8(1) as the satisfaction of the debt is not consideration for the land transaction; it is not caught by para 8(1A) as the debt will not be secured at the time of the transaction. The question is whether it is caught by s.75A FA 2003 (anti-avoidance).

75.44 Section 75A: Anti avoidance

Section 75A(1) FA 2003 provides:

This section applies where—

(a) one person (V) disposes of a chargeable interest and another person (P) acquires either it or a chargeable interest deriving from it,

(b) a number of transactions (including the disposal and acquisition) are involved in connection with the disposal and acquisition ("the scheme transactions"), and

(c) the sum of the amounts of stamp duty land tax payable in respect of the scheme transactions is less than the amount that would be payable on a notional land transaction effecting the acquisition of V's chargeable interest by P on its disposal by V.

75.44.1 *"Transaction"*

Section 75A(1) FA 2003 provides:

(2) In subsection (1) "transaction" includes, in particular—

(a) a non-land transaction,

(b) an agreement, offer or undertaking not to take specified action,

(c) any kind of arrangement whether or not it could otherwise be described as a transaction, and

(d) a transaction which takes place after the acquisition by P of the chargeable interest.

(3) The scheme transactions may include, for example—

(a) the acquisition by P of a lease deriving from a freehold owned or formerly owned by V;

(b) a sub-sale to a third person;

(c) the grant of a lease to a third person subject to a right to terminate;

(d) the exercise of a right to terminate a lease or to take some other action;

(e) an agreement not to exercise a right to terminate a lease or to take some other action;

(f) the variation of a right to terminate a lease or to take some other action.

For the concept of a transaction "involved in connection with" a disposal and acquisition, see 75.44.7 (Company owes debt to non-shareholders).

75.44.2 *The notional land transaction*

Section 75A(4) FA 2003 provides:

Where this section applies—

(a) any of the scheme transactions which is a land transaction shall

be disregarded for the purposes of this Part, but

(b) there shall be a notional land transaction for the purposes of this Part effecting the acquisition of V's chargeable interest by P on its disposal by V.

Section 75A(5) FA 2003 defines the chargeable consideration:

> The chargeable consideration on the notional transaction mentioned in subsections (1)(c) and (4)(b) is the largest amount (or aggregate amount)—
>
> (a) given by or on behalf of any one person by way of consideration for the scheme transactions, or
>
> (b) received by or on behalf of V (or a person connected with V within the meaning of section 1122 of the Corporation Tax Act 2010) by way of consideration for the scheme transactions.

Section 75A(6) FA 2003 defines the effective date:

> (6) The effective date of the notional transaction is—
>
> (a) the last date of completion for the scheme transactions, or
>
> (b) if earlier, the last date on which a contract in respect of the scheme transactions is substantially performed.

75.44.3 *Incidental transactions*

Section 75B(1) FA 2003 provides the relief:

> In calculating the chargeable consideration on the notional transaction for the purposes of section 75A(5), consideration for a transaction shall be ignored if or in so far as the transaction is merely incidental to the transfer of the chargeable interest from V to P.

Section 75B(5) FA 2003 deals with cases of partial relief:

> The exclusion required by subsection (1) shall be effected by way of just and reasonable apportionment if necessary.

Section 75B FA 2003 defines "incidental":

> (2) A transaction is not incidental to the transfer[47] of the chargeable interest from V to P—
>
> (a) if or in so far as it forms part of a process, or series of

47 Section 75B(6) FA 2003 defines transfer: "In this section a reference to the transfer of a chargeable interest from V to P includes a reference to a disposal by V of an interest acquired by P."

transactions, by which the transfer is effected,

(b) if the transfer of the chargeable interest is conditional on the completion of the transaction, or

(c) if it is of a kind specified in section 75A(3).[48]

(3) A transaction may, in particular, be incidental if or in so far as it is undertaken only for a purpose relating to—

(a) the construction of a building on property to which the chargeable interest relates,

(b) the sale or supply of anything other than land, or

(c) a loan to P secured by a mortgage, or any other provision of finance to enable P, or another person, to pay for part of a process, or series of transactions, by which the chargeable interest transfers from V to P.

(4) In subsection (3)—

(a) paragraph (a) is subject to subsection (2)(a) to (c),

(b) paragraph (b) is subject to subsection (2)(a) and (c), and

(c) paragraph (c) is subject to subsection (2)(a) to (c).

75.44.4 *Miscellaneous*

Section 75C FA 2003 provides:

(1) A transfer of shares or securities shall be ignored for the purposes of section 75A if but for this subsection it would be the first of a series of scheme transactions.

(2) The notional transaction under section 75A attracts any relief under this Part which it would attract if it were an actual transaction (subject to the terms and restrictions of the relief).

(3) The notional transaction under section 75A is a land transaction entered into for the purposes of or in connection with the transfer of an undertaking or part for the purposes of paragraphs 7 and 8 of Schedule 7, if any of the scheme transactions is entered into for the purposes of or in connection with the transfer of the undertaking or part.

(4) In the application of section 75A(5) no account shall be taken of any amount paid by way of consideration in respect of a transaction to which any of sections 60, 61, 63, 64, 65, 66, 67, 69, 71, 74 and 75, or a provision of Schedule 6A or 8, applies.

(5) In the application of section 75A(5) an amount given or received partly in respect of the chargeable interest acquired by P and partly in respect of another chargeable interest shall be subjected to just and reasonable apportionment.

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48 See 75.44.1 ("Transaction").

(6) Section 53 applies to the notional transaction under section 75A.
(7) Paragraph 5 of Schedule 4 applies to the notional transaction under section 75A.
(8) For the purposes of section 75A—
(a) an interest in a property-investment partnership (within the meaning of paragraph 14 of Schedule 15) is a chargeable interest in so far as it concerns land owned by the partnership, …
(8A) Nothing in Part 3 of Schedule 15 applies to the notional transaction under section 75A.
(9) For the purposes of section 75A a reference to an amount of consideration includes a reference to the value of consideration given as money's worth.
(10) Stamp duty land tax paid in respect of a land transaction which is to be disregarded by virtue of section 75A(4)(a) is taken to have been paid in respect of the notional transaction by virtue of section 75A(4)(b)...

75.44.5 *Exceptions*

Section 75A(7) FA 2003 provides:

> This section does not apply where subsection (1)(c) is satisfied only by reason of—
> (a) sections 71A to 73, or
> (b) a provision of Schedule 9.

75.44.6 *Company owes debt to shareholders*

Suppose the company owes a debt to its shareholders. This typically arises if the shareholders have lent funds to purchase the property and the debt is outstanding.

HMRC say:

> **Stamp Duty Land Tax on de-enveloping transactions**
> Companies may look to 'de-envelope' a property for a number of reasons, including taking themselves and the persons to whom they distribute the property outside the scope of ATED. Such de-enveloping may occur by a capital distribution to the shareholders following the liquidation of the company. The tax consequences of de-enveloping will depend on whether there is any consideration given by the shareholders for the transfer of the property.
> There will be two situations where HMRC will not consider there to be any consideration given....
> The second of these situations will be where there is debt but this debt

> is owed solely to the shareholder. This is a situation that HMRC has given its views on before and we confirm that the guidance in SDLT Technical News issue 5 (August 2007) still applies. The relevant part is replicated below....
>
> **SDLT Technical News issue 5 (August 2007)**
>
> **Transfer of property on winding up - loan from shareowners**
>
> We would not seek to argue that the dividend in specie should bear SDLT in a situation for example where A owns the shares of B Ltd. A lends money to the company to buy property, the loan being secured by mortgage on the property.
>
> Later B Ltd is wound up and there is a transfer to A as beneficial owner of the equity. That is the reason for the Transfer. The loan is not released etc, but obviously the mortgage will be taken off as the lender also owns the property because of the liquidation.
>
> Clearly (?) in this scenario A has not assumed any liability or given any other form of consideration.[49]

The position does not seem so clear to me, but HMRC do not take the point.

75.44.7 *Company owes debt to non-shareholders*

HMRC say:

> **Stamp Duty Land Tax on de-enveloping transactions**
>
> ... There may be situations where a company had a third party debt that has been repaid as a result of shareholder action (either through the subscription for more issued share capital or by replacing the third party debt with shareholder debt), prior to its liquidation. In such cases it is possible that on distribution of the property there will be no charge to SDLT as it will be a distribution in similar circumstances to the first two situations outlined above.
>
> However, section 75A FA 2003 could apply where the shareholder of a company provides funds to the company to allow it to discharge its debt, before acquiring the property from the company if those actions are involved in connection with that disposal or acquisition. Whether section 75A applies will depend on the facts of each case.
>
> There will be cases where discharging the debt has not occurred as part of the arrangements for the transfer of the property from the company to the shareholders. Equally, there will be cases where the discharge of the debt was one of a number of transactions involved in connection

49 *http://www.hmrc.gov.uk/so/stamps-de-enveloping.htm* (20 December 2013).

with the disposal and acquisition of the property.

There is some judicial guidance that may assist the correct application of section 75A in the decision of the First-tier Tribunal (Tax) in the appeal of *Project Blue Ltd v HMRC*.[50]

For example, the decision (at paragraph 227) confirms that section 75A applies regardless of the purposes or motives of the parties:

> "Whilst it is clear that the purpose of section 75A is to counteract the avoidance of SDLT, the provision contains no requirement that the taxpayer should have a tax avoidance motive or purpose as a precondition or defence to the application of the provision …Parliament obviously intended that the provision should apply regardless of motive".

The Tribunal emphasised that each of the subparagraphs (a) to (c) of section 75A(1) should be construed in the context of the other subparagraphs, rather than as self-standing tests (see paragraph 238 of the decision). In a straightforward de-enveloping situation, the company should be 'V' and the shareholder(s) 'P'.

As to whether in that case transactions are 'involved in connections with the disposal and acquisition', the Tribunal states amongst other things (paragraph 250 of the decision):

> "The word "involved" denotes some form of participation (ie involvement). Thus, a transaction which is part of a series of transactions will not be "involved" with other transactions simply because it is part of a series or sequence of successive conveyancing transactions. The linkage must be more than merely being a party in a chain of transactions and the test must be more than a "but for" test (or, as the classicists would put it, a sine qua non test) otherwise the word "involved" would be deprived of significant meaning."[51]

75.45 Corporate residential property regime: Commentary

The CRP regime (SDLT penal rate, ATED, and ATED-CGT) should be evaluated as a single programme of tax reform.

75.45.1 *Purpose of the residential property regime*

The Residential Property Consultation Response Document provides:

> 1.8 One of the sources of property tax avoidance which the Chancellor highlighted in his Budget speech "...is the way some people avoid the stamp duty the rest of the population pays including by using companies

50 [2013] UKFTT 378 (TC).

51 *http://www.hmrc.gov.uk/so/stamps-de-enveloping.htm* (20 December 2013).

to buy expensive residential property".

1.9 To address this form of avoidance, and to ensure the owners of high value residential property pay their fair share of tax, the Chancellor announced a threefold approach:

- First, the introduction from 21 March 2012 of a 15 per cent rate of SDLT on acquisitions of residential dwellings costing more than £2million by certain non-natural persons (companies, partnerships including a company and collective investment vehicles);
- Second, from 1 April 2013, an annual charge on residential property valued over £2million owned by certain non-natural persons; and
- Third, from 6 April 2013, the extension of Capital Gains Tax (CGT) to gains on the disposal of residential property valued over £2million by non-resident companies and others (but not individuals).

The object is not to raise tax but to prevent the use of corporate owners of companies. Thus the charges are not a tax but a penalty for entering into arrangements or for not unwinding them. In this respect it is like the pre-owned asset regime.[52]

75.45.2 *Response to consultation*

The announcement was preceded by what was called a consultation. In the 2012/13 edition of this work I said:

> The professional bodies will be severely critical. But I expect that HMRC will pay no attention - some will in fact be pleased[53] - and procure the legislation along the proposed lines.

The ICAEW response to consultation provided:

> 191. While we understand the Government's policy concern about the avoidance of SDLT, taken as a whole this package of measures is of serious concern, adding considerable extra complexity and uncertainty into the UK tax system and imposing new administrative burdens on both HMRC and taxpayers while maintaining the unsatisfactory "slab" system of taxation used by SDLT.
>
> 192. ...taken as a whole these measures in effect apply a punitive tax regime to residential properties held in companies and are designed to discourage the holding of residential property through companies. However, the regime will apply regardless of whether the company concerned eventually sells the property which will give rise to an SDLT

52 See 76.39 (Commentary).

53 See 1.9 (The tax consultation framework).

> charge on the purchaser in the normal way. This appears unfair – it would be reasonable to allow the company to elect out of this regime in exchange for providing an undertaking that SDLT would be paid in the normal way if the company was ever sold rather than the property – although we accept that such a measure would add complication to an already highly complicated provision.
> 193. There are many reasons other than tax as to why residential property is held through a company. ...
> 203. The new ATED runs to 60 clauses and two schedules and occupies 49 pages of draft legislation. It adds considerable extra complexity into the UK tax system. In addition there are 10 pages of draft legislation for the new CGT charge on UK companies to apply to disposals from 6 April 2013. It is our opinion that this is too tight a timetable in which to design workable new rules for disposals after 6 April 2013, and we believe that the introduction of the rules should be deferred for a year to allow time for the rules to be finalised and for those affected to take advice and where needed make changes to existing arrangements.[54]

The STEP consultation response provides:

> 4.1 We are disappointed that, contrary to the Government's overarching aim of tax simplification, it proposes to introduce a new tax to prevent the exploitation of existing legislation in relation to SDLT, rather than address the ineffectively drafted legislation to resolve the problem. Not only does the legislation introduce a completely new tax, it imposes additional compliance requirements which will be costly in time and fees for both clients and HMRC alike. All this complexity is created in pursuit of a policy which HM Treasury announced was not intended to raise revenue, but to deter "enveloping and to create more equal tax treatment between UK residents and non-residents".
> 4.2 Indeed, we would suggest that the original goal has been achieved already in relation to high value properties, by the increase in the rate of SDLT for transfers to non-natural persons to 15% with effect from 21 March 2012. We would be interested in HMRC's statistics, if these exist, showing a trend to the contrary.
> 4.3 However, we feel that there is a risk that the fact that the SDLT rates for residential properties have gone to 7% and 15% could potentially have the following impacts:
> • These higher SDLT charges now probably justify the cost of due diligence on a company by the purchaser (which might not have been

54 TAXREP 21/13 (ICAEW REP 25/13) FINANCE BILL 2013 Comments on the draft clauses published on 11 December 2012 (February 2013).

the case in the past).
- The corporate entity still represents a way of reducing SDLT on the effective transfer of the property to nil.
- The CGT charge on [ATED] related gains will never arise if the property is not sold from the company.

75.45.3 *Merits of the CRP regime*

The stated objection to corporate purchasers is that resale of the company allows avoidance of SDLT. This raises various questions:

(1) How much SDLT has been avoided in this way? I suspect not much:
   (a) There is no evidence that SDLT was usually a major factor in the choice of a company purchaser (IHT and non-tax reasons were much more important)
   (b) Purchasers would generally prefer to purchase the land, not the company.

   It might be that the increase in the non-corporate rate of SDLT, now 7%, would increase attractiveness of this SDLT planning.

(2) Are there other or better methods of addressing the problem?

None of this has been addressed.

75.45.4 *Objections to the CRP regime*

There are a number of objections to the CRP regime:

There are good non-tax reasons why it may be desired to purchase land in a company or a trust. In fact most offshore trusts used foreign companies to hold land, as a matter of routine, regardless of tax, because:

(1) limited liability
(2) conflict of laws issues; the validity of a disposition of immovable property and the settlor's capacity to make it are determined by the law of the State where the property is situated.
(3) convenience of segregation of a trustees assets.

This is recognised in the relief given to companies holding non-UK properties.[55]

Complexity: The legislation for the CRP regime extends to 100 pages. There are very few tax problems to which 100 pages of legislation is the right answer; and SDLT avoidance using companies is not one of them.

The House of Lords Economic Affairs Committee agreed:

---

55 See 74.20 (Foreign homes relief).

> We share our witnesses' concern about whether the problem the legislation seeks to address justifies its length and complexity, particularly in view of the Government's commitment (!) to a simpler tax system. In line with our earlier recommendation on better consultation, we think that there were probably simpler and more effective ways of achieving the Government's objectives. We recommend that the lessons from the development of these measures should be learned and applied to the design of future tax policies. [56]

The CRP regime reflects an unexamined assumption that tax planning involving residential properties is more objectionable than other tax planning. It may reflect the Liberal Democrat desire for a mansion tax ("Mansion tax" at present is a slogan: apart from the fact that it involves residential property of above average value, it does not have any settled meaning.)

75.45.5 *Procedural weaknesses in introduction of the regime*

The flawed procedure in the introduction of the CRP regime is also worth recording, though it is a familiar story to those who remember the debacle of the FA 2008:

(1) The provisions were introduced in breach of the proper procedure set out in the Tax Consultation Framework.[57] This is a return to the rabbit out of a hat approach to tax reform.

(2) The uncertainty imposed imponderable choices on those wishing to purchase property or wondering what to do with existing structures.

(3) The CRP regime was a breach of the promise of stability on foreign domicile taxation[58] – though probably no-one had seriously believed that. Nevertheless, the chutzpah of the Residential Property Response Document deserves to be recorded:

> 3.71 ...The likelihood that the measures would impact on non-domiciled individuals more than UK citizens was also raised as a concern.
>
> **Government Response**
>
> 3.72 The Government has taken on board comments raised through this question.

---

56 House of Lords Select Committee on Economic Affairs *The Draft Finance Bill 2013* (March 2013) para 213 *http://www.publications.parliament.uk/pa/ld201213/ldselect/ldeconaf/139/139.pdf*

57 See 1.9 (The Tax Consultation Framework).

58 See 1.8 (The promise of stability).

There is no further reference to the point.

In the 2013/14 edition I concluded:

> Law enacted on this basis cannot be expected to be satisfactory and is not likely to be stable.

The prediction of instability has been borne out by the FA 2014. But at the present time there seems to be no prospect of serious discussion taking place.

75.45.6 *Some ways forward*

A minimal reform would be to make the SDLT and ATED charges avoidable by an election that the company should be regarded as transparent for UK IHT, CGT and SDLT. The election out of the POA charge is a precedent.[59] That would allow the use of companies for non-tax reasons to continue.

A more radical reform would be the repeal of SDLT, in accordance with Mirrlees recommendations ("a strong contender for the UK's worst-designed tax") and replace it with a form of rates.[60] The CRP regime would then fall by the wayside.

75.46 Planning 1: Home owned by foreign domiciliary

There are several ways to arrange the ownership of a UK family home for a foreign domiciled individual. The first possibility is that the individual should own the property directly. This has the attraction of simplicity.

The property is in the individual's estate and in principle within the scope of IHT on his death. One possible method to mitigate this problem is to provide by will that the property should pass to the individual's surviving spouse, or to a trust under which the spouse has an interest in possession. That normally postpones IHT until the occasion of the death of the survivor of the individual and spouse.[61]

The risk of IHT may quite cheaply be covered by insurance. Watch that the insurance policy is not subject to IHT on the death of the individual:

---

59 See 76.33 (POA election) and contrast the US tick the box regime. Double taxation aspects would need consideration but would not be insoluble.

60 IFS Green Budget 2013 accessible *http://www.ifs.org.uk/budgets/gb2013/gb2013.pdf*.

61 See 63.19 (IHT spouse exemption defence to GWR death charge).

(1) Arrange that the policy is not UK situate[62] (so the policy is excluded property); or
(2) transfer the policy to a trust (under which the individual is excluded) but possible IHT charges on the trust make this unattractive for UK situate property.

The amount to be insured will need to be reviewed from time to time in line with house inflation and possible changes in the rate of IHT.

It would be possible to take steps to avoid IHT even at short notice, if the death of the owner became imminent by:

(1) a sale
(2) a transfer of the property to a company so as to acquire excluded property status (the SDLT penal rate is significant but the IHT charge is much greater).

So in practice the IHT risk should be limited to the risk of the sudden death of the individual (or the sudden joint deaths of individual and spouse).

There will be no CGT on the sale of property if main private residence relief applies. If the individual has another residence inside or outside the UK, it may be appropriate to make an election under s.222 TCGA.

There is in principle a taxable remittance, if the purchase price is paid out of foreign income or chargeable gains within the scope of the remittance basis.

Similar points apply to chattels in the home except there is no CGT exemption, apart from the exemption for chattels under £6,000: s.262 TCGA.

75.46.1 *Non-tax aspects of direct ownership*

The use of a trust or company avoids the need for an English grant of probate after the death of the individual.

Personal ownership may be necessary, or at least desirable, in order to secure that the owner of a long lease acquires the right to enfranchisement.

Further consideration will be needed for property in Scotland and Northern Ireland.

75.47 Planning 2: Home owned by estate IIP trust

The IHT position is broadly the same as absolute ownership by the foreign domiciled individual. This course is only practical, however, for estate IIP

62 See 82.25 (Insurance policy).

trusts where:
(1) the life tenant is the settlor; or
(2) the settlor is dead; or
(3) the settlor has no interest in the settlement; or
(4) the settlor can be excluded from a sub-fund (which will hold the UK home); or
(5) the settlement was made before 18 March 1986.

Otherwise HMRC may argue that there is a charge on the death of the settlor under the GWR rules.[63]

In the case of a non-resident trust, the occupation of the property is a capital payment received in the UK, giving a possible s.87 charge if chargeable gains accrue to the trust. Chargeable gains may arise on a disposal of the house, if the private residence exemption is not fully available, for instance if:
(1) the grounds exceed the "permitted area"; or
(2) there is another private residence which qualifies for the relief; or
(3) in relation to chattels which do not qualify for exemption.

75.48 Home owned by discretionary trust

In principle a discretionary trust or non-estate IIP trust could hold the UK home between ten year anniversaries. This might be a convenient short or medium term way to hold a family home. This course is only practical, however, where:
(1) the settlor is dead; or
(2) the settlor has no interest in the settlement; or
(3) the settlor can be excluded from a sub-fund (which will hold the UK home); or
(4) the settlement was made before 18 March 1986.

Otherwise HMRC may argue that there is a charge on the death of the settlor under the GWR rules.[64]

75.49 Home owned by non-resident company

75.49.1 *IHT advantages and sham*

For inheritance tax, the obvious course is for the UK home of a foreign domiciliary to be owned beneficially by a foreign company. The shares

63 See 63.9 (Gift of excluded property).
64 See 63.9 (Gift of excluded property).

in the company are not UK situate, and qualify as excluded property for IHT. The company would usually be held by an offshore trust.

An argument that an arrangement of this kind was a sham was rejected in *Skyparks v Marks* [2001] WTLR 607. But sham is a question of fact in each case. In some badly created structures the taxpayer may wish to argue that the company is a sham, or that it holds its assets as nominee, to avoid a benefit in kind charge or other charges associated with companies.

75.49.2 *Ownership by non-resident company: CGT*

The company will not be subject to CGT or corporation tax on chargeable gains provided it is not resident.

If the company is owned by an individual, the gains will be treated as accruing to the individual under s.13 TCGA.[65]

If the company is held by a trust, the gains would be treated as accruing to the trust, and so be s.2(2) amounts for s.87 purposes.

75.50 Planning

75.50.1 *New purchase*

Purchase by a company has the following advantages:

(1) IHT
(2) SDLT on sale of company
(3) CGT on sale of company

However, the general rule for residential property above £500k will be not to purchase by a "non-natural" person because of:

(1) The SDLT penal charge.
(2) ATED

A "non-natural" person purchasing a property worth under that amount needs to consider the likelihood that the property will sooner or later be worth more than £500k (in nominal terms) and fall within ATED.

75.50.2 *Unwinding existing arrangements?*

For existing structures, the question is whether to wind up or retain.

Winding up the company is sometimes known as "de-enveloping" but I do not think that the neologism is needed, and I do not use it.

The case for retention: In return for paying ATED, you may have:

(1) IHT advantage of excluded property.

---

65 See 53.31 (Private residence relief).

(2) SDLT advantage of being able selling shares in the company free of SDLT. It would take 10 or 20 years for ATED to equal the 7% SDLT on a non-corporate purchase; but:
   (a) ATED is payable sooner and will be index linked (at least)
   (b) A vendor may want to purchase the property, not the company. (The scope of SDLT avoidance by sale of companies rather than of land is more limited than the authors of the CRP regime appear to think.)

   So it will not often be cost-effective to chose to pay ATED, just for the SDLT saving, unless the shareholders anticipate a prompt sale of the company.
(3) ATED-CGT was a reason not to retain property in a company, but the extension of CGT to non-residents in 2015 alters this. Unless CGT private residence relief would apply it is in principle better to hold in a company which could be sold free of CGT, though a purchaser might want some discount to reflect the disadvantages of holding through a company. Those who liquidated companies in 2013/14 in order to avoid ATED-CGT may now come to regret their decision.

Winding up the company will give rise to gains accruing to the company, and gains on the disposal of shares. Thus there will often be a CGT cost under s.13 or s.87 TCGA which will usually exceed any other tax saving. There is no relief for the CGT charges. The result is a strong incentive to retain the company structure.

All the professional bodies made the point. ICAEW said:

> Given that these are punitive measures, there needs to be proper transitional provisions and time given for existing structures to be reorganised or unwound without giving rise to further tax charges. The policy is to discourage "enveloping" residential property valued at more than £2m but the proposals do not provide for taxpayers to effectively "de-envelop" existing arrangements....[66]

The STEP consultation response provided:

> 4.4 The rebasing provisions as currently drafted will not incentivise UK resident non-domiciled individuals to de-envelope due to the interaction between the new rules and ss13 and 87 TCGA 1992. The rebasing rule seems only of benefit to non-resident structures where the

66 TAXREP 21/13 (ICAEW REP 25/13) FINANCE BILL 2013 Comments on the draft clauses published on 11 December 2012 (February 2013).

beneficiaries/shareholders are all also non-resident.

The absence of any relief for existing structures means that in many cases unwinding companies is prohibitively expensive, so if the object of the reforms is to encourage winding up companies, that object will not be achieved. Instead the owners will bear the brunt of the CRP regime in an arbitrary and unfair way. The House of Lords Economic Affairs Committee acknowledged this point:

> We recommend that the Government should consider whether more could be done, possibly deferring the charge on any gain, to help those affected to de-envelope their properties without incurring high tax costs.[67]

But no-one took any notice of that.

67 House of Lords Select Committee on Economic Affairs *The Draft Finance Bill 2013* (March 2013) para 196 *http://www.publications.parliament.uk/pa/ld201213/ldselect/ldeconaf/139/139.pdf*

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TAXATION OF NON-RESIDENTS AND FOREIGN DOMICILIARIES 2014-15

VOLUME FIVE

by

JAMES KESSLER QC

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CHAPTER SEVENTY SIX

PRE-OWNED ASSETS

76.1 Pre-owned assets: Introduction

This chapter considers the provisions in Schedule 15 FA 2004 ("**POA provisions**"). A full discussion of this topic needs a book to itself.[1] This chapter focuses on the matters closest to the themes of this book, but it is necessary to review the general rules to understand these matters in their context.

The supplementary regulations (whose title is so long it cannot sensibly be used)[2] are referred to as "**the POA Regulations 2005**".

"**The CIOT Statement**" gives HMRC answers to a number of questions raised by CIOT, STEP and LITRG.[3]

The label "pre-owned assets" is convenient but inaccurate since the charge may apply to property not previously owned by the taxpayer.

The provisions impose three charges to income tax which I call:

(1) "**The POA land charge**"
(2) "**The POA chattel charge**"
(3) "**The POA intangible property charge**"

Land, chattel and intangible property are given commonsense definitions.[4]

76.2 Purpose of POA rules

The POA rules were designed to counter three distinct IHT avoidance

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1 And indeed such a book has been written: Chamberlain & Whitehouse, *Pre-Owned Assets and Estate Planning* (3rd ed., 2009).

2 The Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations 2005.

3 *http://www.step.org/resources/policy_and_technical/uk_policy/2006/pre-owned_assets_-_responses.aspx?link=contentMiddle*. The current version of the statement is dated 31 August 2006; earlier versions were dated October 2005 and March 2006.

4 Para 1 Sch 15 FA 2004.

schemes:

(1) Eversden schemes
(2) Ingram schemes
(3) Home loan schemes

In order to understand the provisions it is necessary to understand the schemes at which they were addressed.

76.2.1 *Eversden schemes*

There was only one scheme, but the analysis now depends on whether the asset involved was land or not.

In relation to land, the IHT Manual explains:

> **IHTM44101 - Pre-owned assets: specific avoidance schemes: land - settlement on interest in possession trusts** [March 2012]
> This scheme, known as an ‹Eversden' scheme, involved a spouse putting their marital home into a trust under which the other spouse had a life interest. ... The transaction is exempt from Inheritance Tax and excluded from the reservation of benefit provisions. The life interest(s) are then terminated in most of the fund so that each spouse is treated as making a transfer at that later time. The termination of the life interest meant that the spouse(s) make a PET; but it was not a gift so that it was not caught by the reservation of benefit provisions. The spouses continued to occupy the property through their life interests in the parts of the property retained by the trustees.
> HMRC challenged the scheme and lost in the case of *Eversden v IRC* [2003] STC 822.[5] Consequently, legislation was introduced with effect from 20 June 2003 to reverse the decision (IHTM14318). ...

The HMRC analysis is as follows:

> • where the scheme was effected on or after 20 June 2003:
> the property will be subject to a reservation of benefit for Inheritance Tax purposes by reason of FA86/S102(5A).[6]
> As a result the [POA GWR] exemption under FA04/Sch15/Para11(3) will apply to the settlor.[7]
> There may be a separate reservation of benefit when the spouse's interest in possession terminates and which is treated as a gift under

5 *IRC v Eversden (Greenstock's Executors)* 75 TC 340.
6 See 63.10.2 (Restriction on GWR spouse exemption).
7 See 76.19 (GWR exemptions).

FA86/S102ZA.[8]

This is all somewhat theoretical since the scheme would not be done after 20 June 2003.

- where the scheme was effected before 20 June 2003, the arrangement succeeds in avoiding the reservation of benefit provisions. However, provided the spouse's life interest continues until their death, there will be no POA charge because the transaction is an excluded transaction under FA04/Sch15/Para(10)(1)[9]
- if, however, the spouse's life interest comes to an end during their lifetime, the transaction will not longer be an excluded transaction by virtue of FA04/Sch15/Para10(3) so the POA charge will arise from that point on the settlor, assuming the settlor occupies of the property.

If the spouse's qualifying interest in possession ends after 18 March 2006, she may also be subject to a separate inheritance tax charge on her death under FA86/S102ZA if she still benefits from the property. But as she did not, herself, disposed of this interest in the property, she is not subject to the POA charge.

The scheme could also be used for property other than a dwelling house:

> **IHTM44110 - Pre-owned assets: specific avoidance schemes: intangibles - settlement on interest in possession trusts** [Mar 2012]
> Intangible property may also be settled using an Eversden scheme, where the chargeable person settles cash on interest in possession trusts for their spouse or civil partner, which the trustees then invest in, say, a bond. If the terms of the settlement fall within the definition in FA04/Sch15/Para8 similar results to the scheme involving land apply.
> For example, if the spouse or civil partner's interest in possession ends during their lifetime and the property is now held on discretionary trusts of which the settlor is one of the potential beneficiaries, the POA charge will apply where the settlement was effected before 20 June 2003.
> However, the excluded transaction provisions have no application with regard to intangible property so FA04/Sch15/Para10(1), which may have a bearing in respect of schemes involving land, has no relevance.
> If the settlement was effected on or after 20 June 2003 the property is subject to a reservation of benefit by virtue of FA86/S102(5A) and the POA charge will not apply.

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8 See 63.17 (GWR on termination of interest in possession).

9 See 76.10.4 (Transfer to trust where spouse has interest in possession).

76.2.2 *Ingram schemes*

There were two varieties of these schemes; I describe both as **"Ingram schemes"**. The IHT Manual explains:

> **IHTM44100 - Pre-owned assets: specific avoidance schemes: land - lease carve-out scheme** [March 2012]
> This scheme, known as an ‹Ingram' scheme, involved a nominee structure where an individual gives their home to nominees who then grant the individual a lease to occupy the house. The lease is usually for 21 years or less at a peppercorn rent. The nominee then gives the property, subject to the lease, away to (usually) the individual's children. The individual continues to occupy the property under the lease.

The HMRC analysis is as follows:

> There is no loss to the transferor's estate when the property is given to the nominees and the individual does not reserve a benefit in the property that was given away - the freehold reversion - although they continue to occupy the property.
> HMRC challenged the scheme and lost in the case of *Ingram v IRC* [1999] STC 37. Consequently, legislation was introduced with effect from 8 March 1999 to reverse the decision (IHTM14360). The impact of this legislation on the POA charge is as follows
> - where the scheme was effected on or after 9 March 1999, the property will be subject to a reservation of benefit for Inheritance Tax purposes by reason of FA86/S102A. As a result the exemption under FA04/Sch15/Para11(3) will apply,
> - where the scheme was effected before 9 March 1999, the arrangement succeeds in avoiding the reservation of benefit provisions and will be subject to the POA charge under FA04/Sch15/Para3(2).
>
> ...
> **IHTM44102 - Pre-owned assets: specific avoidance schemes: land - reversionary leases** [March 2012]
> This scheme is an arrangement where a donor grants a long lease of their property for say 999 years to the proposed donee, and the lease does not take effect until some future date. The period for deferral is usually less than 21 years to avoid breaching the terms of s.149(3) Law of Property Act 1925.
> *Example (Victor)*
> V, who has owned his house since 1990, grants a 999-year lease to his daughter ... in 1998 but it is not to take effect until 2018. V continues to occupy the property.

The HMRC analysis is as follows:

> The effect of this transaction is that
> - V has made a PET of the lease. The loss to his estate will be the difference between the unencumbered freehold and the freehold subject to the lease,
> - V continues to occupy the property as the freeholder, and
> - the value of the freehold interest remaining in V's estate will decline as the time for the lease to commence approaches.
>
> Where a reversionary lease scheme is established before 9 March 1999 - the date legislation was introduced to counteract *Ingram* schemes - the arrangement succeeds in avoiding the reservation of benefit provisions so long as the lease does not contain any terms that are currently beneficial to the donor, such as covenants by the lessee to, say, maintain the property. Consequently, the donor will be subject to the POA charge under FA04/Sch15/Para3(2).
>
> ...
>
> Where a reversionary lease scheme is established on or after 9 March 1999 it was originally considered that FA86/S102A would apply because the donor's occupation would be a "significant right in relation to the land". If that were correct, the reservation of benefit rules would apply and there would be no POA charge.
>
> However, where the freehold interest was acquired more than 7 years before the gift (this is the significance of giving the date of V's purchase in the example above), the continued occupation by the donor is not a significant right in view of FA86/S102A(5), so the reservation of benefit rules cannot apply and a POA charge arises instead.

Section 102A was misdrafted, but POA now fills the gap:

> It follows that if the donor grants a reversionary lease within 7 years of acquiring the freehold interest, FA86/S102A may apply to the gift depending on how the remaining provisions of that section apply in relation to the circumstances of the case - for example, if the donor pays full consideration for the right to occupy or enjoy the land, that would not be a significant right in view of FA86/S102A(3), so the reservation of benefit rules cannot apply and a POA charge arises instead.
>
> But, despite this, and irrespective of when the freehold interest was acquired, the reservation of benefit provisions may apply if the lease contains terms currently beneficial to the donor - see *Buzzoni v HMRC*.[10]

10 See now [2012] UKUT 360.

IHTM44108 - Pre-owned assets: specific avoidance schemes: chattels - lease carve-out scheme [Mar 2012]
Although the use of a lease to carve out an interest in property is more commonly used with land (IHTM44100) it can also apply to chattels. In effect, the owner of the chattels carves out a lease for themselves and then makes a gift of the chattels. Although FA86/S102A is aimed at ensuring such a transaction with land is now subject to the reservation of benefit provisions, that section only applies to interests in land and so does not apply to similar transactions involving chattels.
The transaction is a disposal by the chargeable person and they will be liable to the POA charge under FA04/Sch15/Para6(2)....

76.2.3 *Home loan schemes*

The IHT Manual explains:

IHTM44103 - Pre-owned assets: specific avoidance schemes: land - home loan or double trust scheme [March 2012]
This is a scheme whereby the individual seeks to put the value of their home outside their estate and avoid the reservation of benefit provisions, whilst still continuing to occupy the property. The steps in a typical scheme were:

- the individual creates an interest in possession trust under which they are the life tenant; the trustees have the power to allow the life tenant to use the trust property,
- the individual then sells their house to the trust, usually at the open market value; but because the trustees have no funds, they agree to leave the purchase price outstanding by way of loan,
- the individual creates a second interest in possession trust under which (usually) their children are the life tenants and excludes the taxpayer from any benefit,
- the individual transfers the benefit of the loan to the trustees of the second trust.

The HMRC analysis is as follows:

The Inheritance Tax consequences are intended to be as follows

- there is no loss to the estate on the sale of the property to the first trust as the individual enjoys a life interest in the trust property. On their death, the trust fund forms part of their estate, but the value of the property is largely or wholly covered by the debt now owed to the trustees,
- the transfer of the debt to the second trust is a PET (since the taxpayer is wholly excluded from benefiting under this trust), so that on

> survival for 7 years, the value of their home is not charged to Inheritance Tax.
>
> [The Manual comments on SDLT aspects and continues] The requirements of FA04/Sch15/Para3 are met in that the individual is occupying land which they owned and has now disposed of, so the POA charge applies. However, the property still forms part of their estate as the life tenant of an interest in possession trust, and so the exemption in FA04/Sch15/Para11(1) applies. To bring this scheme within the POA charge, the concept of excluded liabilities is contained in FA04/Sch15/Para11(6) which states that only the value of the property in excess of an excluded liability is treated as forming part of the individual's estate and therefore qualifies for the exemption under FA04/Sch15/Para11(1).
>
> ...
>
> But, this assumes that the scheme succeeds in avoiding the reservation of benefit provisions. HMRC does not accept that the scheme succeeds and is litigating the point. A brief analysis of HMRC's view and the consequences for the POA charge are at IHTM44104 onwards.

The GWR aspect of home loan schemes is an interesting story, but is not discussed here.

76.2.4 *Width of POA provisions*

The POA provisions are widely drafted. This may be because they are aimed at three distinct schemes with nothing in common. Alternatively, with hindsight, one might see the provisions as adopting a style of anti-avoidance provisions under which:

(1) The gateway conditions for the operation of the rules are extremely wide and it is only a slight exaggeration to say that they potentially catch (more or less) everything.
(2) There are a large number of exemptions to the provisions some of which are also very wide.[11]

So the POA provisions apply in situations which have nothing to do with the three schemes at which they were targeted. They need consideration whenever one person provides funds to another to purchase a home, which includes any case where a home is held by a trust or a company. This will often be the case for the home of foreign domiciliaries; my guess is that any effect on foreign domiciliaries is entirely accidental; no-one at all had

11 A good example of this style of drafting is the disguised remuneration rules (not discussed in this book, but I hope to do so in a future edition).

worked it out in the short time available as the provisions were frantically amended and re-amended as the FA 2004 passed through Parliament.

76.3 POA land charge

Para 3(1) Sch 15 FA 2004 provides:

> This paragraph applies where—
> (a) an individual ("the chargeable person") occupies any land ("the relevant land"), whether alone or together with other persons, and
> (b) the disposal condition or the contribution condition is met as respects the land.

In the discussion below the "chargeable person" is called "T" and the land T occupies is called "land occupied by T" (rather than "the relevant land").

76.3.1 *"Occupation"*

"Occupation" is a technical legal concept extensively discussed in rating cases. The IHT Manual provides:

> **IHTM44003 - Pre-owned assets: property in charge: land** [March 2012]
> ...
> The meaning of the word ‹occupies' should be taken quite widely. It goes wider than the chargeable person being physically present at the property concerned. Case law suggests that the word ‹occupy' requires some element of control. So a visitor may not be in occupation (even someone who stays for an extended period of time due to illness) but someone who has a key and can freely enter and leave premises as they please is more likely to be in occupation; even if they are absent for significant periods. It does not necessarily mean the place you reside which implies a greater level of permanence so a lower threshold is required to satisfy the occupation condition.
> A person may be in occupation if they are storing possessions in a property - but only if they also had the right of access to the property to use it as they wished - or if they were the only person with the means of access and used the property from time to time. Storing possessions on its own is not occupation, but may be evidence of occupation. The chargeable person would not be regarded as occupying a property from which they were receiving rental payments from the person(s) actually in occupation.
> If the chargeable person's use of the property is only very limited in its nature or duration, they may not be in ‹occupation' for the purposes of

the POA charge. Each case should be decided on the facts and circumstances relating to it. The guidance at IHTM14333 contains some examples where limited use or occupation of land does not gives rise to a reservation of benefit and are unlikely, on their own, to be ‹occupation' for the POA charge.
Where the chargeable person was occupying part of their former property and was entitled to, and did, use the rest of the property from time to time, you should regard them as being in occupation of the whole of the property for the POA charge. On the other hand, if the chargeable person occupies a self-contained part of their former property and has no access to the remainder which is occupied by others, you should regard the relevant land as limited to the self-contained part. You should consider occasional visits to the remainder of the property in the same manner as social visits mentioned in example 2 at IHTM14333.[12]

76.4 The disposal conditions

Para 3(2) Sch 15 FA 2004 provides:

> The disposal condition is that—
> (a) at any time after 17 March 1986 the chargeable person owned an interest—
> (i) in the relevant land, or
> (ii) in other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the relevant land, and
> (b) the chargeable person has disposed[13] of all, or part of, his interest in the relevant land or the other property, otherwise than by an excluded transaction.

This is best regarded as two conditions depending on whether (a) (i) or (ii) applies. I call them **"disposal conditions (i) and (ii)"**. Only one of them needs to be satisfied for the "disposal condition" to be met.

76.4.1 *Disposal condition (i)*

The essence of disposal condition (i) is that:

> (a) T owned an interest in the land occupied by him.... and
> (b) T has disposed of all, or part of, his interest in the land ...

What if T enters into a contract to purchase land and then assigns that

12 See 63.6.3 ("Virtually" to the entire exclusion).
13 "Disposal" is defined in para 3(4) Sch 15 FA 2004.

contract to a trust or company? The contract is an interest in land. However, on completion the contract ceases to exist. That will normally be before the valuation date. Since the asset cannot be valued on the valuation date, it is tentatively suggested that disposal condition (i) does not apply in this situation.

The disposal condition is satisfied by a disposal of land for full consideration. However, in such a case the exclusion for arm's length transactions may apply.

76.4.2 *Disposal condition (ii)*

The essence of disposal condition (ii) is that:

> (a) T owned ... other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the land occupied by T, and
> (b) T has disposed of all, or part of, his interest in the ... other property ...

Disposal condition (ii) is probably intended to deal with the situation where:

(1) T disposes of land to A.
(2) A sells the land and uses the proceeds to purchase other land occupied by T.

However, it may apply where:

(1) T disposes of any property (not land or cash) to A; and
(2) A disposes of that property and uses the proceeds to purchase land occupied by T.

This overlaps with the contribution conditions. The overlap matters because the excluded transaction defences to the contribution and disposal conditions are not the same.

The IHT Manual provides:

> **IHTM44004 - Pre-owned assets: property in charge: the disposal condition - land** [March 2012]
> ...
> **Example** (Trevor and Paul)
> T gives The Paddocks to P. P then sells The Paddocks and buys Whiteacre with the proceeds. T then occupies Whiteacre. The disposal condition is met.
> So the disposal condition will apply to the chargeable person's occupation or use of the property even if that property was never actually owned by them. If they give away other property (it does not

have to be land, but see the contribution condition IHTM44005) if the gift is of cash) to another person who then sells such property and uses the proceeds to buy the relevant land, the disposal condition is satisfied, unless it qualifies as an excluded transaction.

A disposition that creates a new interest in land out of an existing interest is taken to be a disposal of part of the existing interest, FA04/Sch15/Para 3(4).

The disposal condition will be met whether the sale or gift is of the whole or part of land and whether or not the sale is at less than the full market value. See IHTM44031 where the disposal is of the whole of the land for full consideration.

FA04/Sch15/Para 3(2)(a)(ii) applies where the proceeds of sale are used to acquire land that is subsequently occupied by the chargeable person. So, in the example above, if P exchanged The Paddocks for Whiteacre, on the face of it the disposal condition is not met; but see IHTM44005

76.5 The contribution conditions

Para 3(3) Sch 15 FA 2004 provides:

> The contribution condition is that at any time after 17 March 1986 the chargeable person has directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of—
>
> (a) an interest in the relevant land, or
>
> (b) an interest in any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the relevant land.

This is best regarded as two conditions, depending on whether (a) or (b) applies. I call them **"contribution conditions (a) and (b)"**. Only one of them need be satisfied for the "contribution condition" to be met.

76.5.1 *Contribution condition (a)*

The essence of contribution condition (a) is that:

> T has directly or indirectly provided…any of the consideration given by another person for the acquisition of ... the land occupied by T …

This envisages that:

(1) "another person" (which may be a company or trustee) acquires for consideration land occupied by T; and

(2) T has provided that consideration directly or indirectly.

76.5.2 *Contribution condition (b)*

The essence of contribution condition (b) is that:

> T has directly or indirectly provided … any of the consideration given by another person for the acquisition of … any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of ... the land occupied by T.

This applies where:

(1) "another person" ("A") acquires "other property" for consideration.
(2) T has provided that consideration directly or indirectly.
(3) A disposes of the other property.
(4) The proceeds are (directly or indirectly) applied by "another person" (presumably either A himself or another person, "B") towards the acquisition of the land occupied by T.

The drafter may be considering a situation where:

(a) T transfers funds to A who purchases a property; and
(b) A sells that property and uses the proceeds to buy another property occupied by T.

or

(a) T transfers funds to A (eg trustees);
(b) A transfers the funds to B (eg a company held by A);
(c) B uses the funds to purchase a property occupied by T.

In both those cases I would have said that T had indirectly provided consideration given for the land and contribution condition (a) was already satisfied. I cannot think of a situation which falls within condition (b) and which does not fall within condition (a). But it does not much matter.

The IHT Manual provides:

> **IHTM44005 Pre-owned assets: property in charge: the contribution condition - land** [March 2012]
>
> ...
>
> **Example** (Trevor and Paul)
>
> T gives P the funds to buy Blackacre. P then sells Blackacre and buys The Paddocks with the proceeds. T then occupies The Paddocks. The contribution condition is met.
>
> You do not need to show that when the contribution was made, the individual intended to occupy the land purchased by another; if the chargeable person occupies land that they have, as a matter of fact, indirectly contributed to the purchase of, the contribution condition is met.

The contribution condition does not only apply to cash contributions. So in the example at IHTM44004, where P exchanges The Paddocks for Whiteacre, the gift of The Paddocks from T to P is a contribution to the acquisition of the property that T subsequently occupied and so the contribution condition is met.

However, the contribution condition is not met where the chargeable person resides in property purchased by another with money loaned by the chargeable person. This is because the outstanding debt will form part of the lender's estate for Inheritance Tax purposes, and the lender cannot be said to have provided a contribution to the purchase of that property when that money has to be repaid to them, even if the loan was interest free. It follows that the 'lender', in such an arrangement, is not subject to a POA charge.

76.5.3 *Width of contribution conditions*

The contributions conditions apply whenever one person gives funds to another for the purchase of a home. For instance, if H gives funds to W so H and W can purchase a home jointly; but if H and W are spouses, the POA spouse exemption may apply;[14] if H and W jointly occupy the property, the GWR exemption may apply.[15]

76.5.4 *Purpose of contribution conditions*

It is hard to see the purpose of the contribution conditions. *Ingram, Eversden* and home loan schemes would be caught by the disposal conditions. Perhaps it was meant to catch schemes set up on the occasion of purchase of a new property where the settlor would provide cash to a trust. But this was never done in the past; it would have been better to frame more targeted anti-avoidance provisions than this blunderbuss approach.

76.6 "Provide"

"Providing" is the fundamental concept in the contribution conditions and it is not an easy one. Some guidance can be found in cases on the meaning of "settlor" where the statutory language is similar.[16]

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14 See 76.10.3 (Inter-spouse transfer).

15 See 76.19 (GWR exemptions).

16 Some guidance ought to be found from comparable wording in Stamp Duty and SDLT group relief: s.27 FA 1967; para 2(2) Sch 7 FA 2003. Unfortunately the SD/SDLT position is even more obscure than the POA: SP 3/98; Tax Bulletin 70.

It is considered that "provide" implies an element of bounty. So if T lends money on arm's length terms to A, who uses the money lent to buy the property, T has not "provided" the consideration and the contribution condition is not satisfied.

What if T lends interest-free to A, who uses the money lent to buy the property? At first sight T has provided the consideration. But it might be argued that A provides the consideration himself (by A's promise to repay T) and that T provides nothing.[17] In practice HMRC now[18] accept this.

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17 One might say that T has provided the interest foregone on the loan, but (1) interest foregone does not exist, and it is difficult to see how one could provide something which does not exist; see 80.19 (Interest-free or back-to-back loan); (2) the interest foregone is not the consideration given for the acquisition of the land.

18 This reverses the view taken in the CIOT Statement:

"6.2 The meaning of the ‹provision' of ‹consideration' in the context of the contribution condition needs to be clarified. On the basis of the case law the word provided suggests some element of bounty.

On this basis our view is that if there is a transfer of Whiteacre by A (or another asset) to his son at full market value which is then sold by son and the sale proceeds used to purchase Blackacre for A to occupy this is a breach of the disposal but not the contribution condition because it lacks the necessary element of bounty.

Similarly the provision of a loan on commercial terms by A to his son to enable son to purchase a house which A then occupies in our view does not fall within the contribution condition.

Question 32

Do HMRC agree with this analysis?

HMRC answer to question 32

In our view, it is arguable that the contribution condition does not depend on a degree of bounty for its application. If, on the contrary, a degree of bounty was necessary, might not the operation of the contribution condition provisions in paras 3(3) and 6(3) of Schedule 15 be circumvented by the relatively simple expedient of A, in your example, providing the wherewithal for the purchase of a house by his son by way of a loan, ostensibly on commercial terms, which is then left outstanding indefinitely?

Having said that, we have considered further the sort of case where a loan is made **and operated** on commercial terms eg a commercial rate of interest is specified and paid and there are provisions for repayment of the loan over the sort of period one would expect to find in a truly commercial loan. Having regard to paras 4(2)(c) or 7(2)(c) of Schedule 15, the chargeable amount would depend on the value of DV in R (or N)×DV/V: that's to say on ‹such part of the value of the land/chattel as can reasonably be attributed to the consideration provided by the chargeable person'. In the case where the loan is on truly commercial terms and conducted in a truly commercial way, we would accept that the attributable amount is nil or de minimis.

In determining ‹reasonable attribution' for the purposes of para 4(2)(c), it is the terms on which the loan is made and operated that are relevant, as indicated above.

The IHT Manual provides:

> **IHTM44005 - Pre-owned assets: property in charge: the contribution condition - land** [March 2012]
> ... However, the contribution condition is not met where the chargeable person resides in property purchased by another with money loaned by the chargeable person. This is because the outstanding debt will form part of the lender's estate for Inheritance Tax purposes, and the lender cannot be said to have provided a contribution to the purchase of that property when that money has to be repaid to them, even if the loan was interest free. It follows that the ‹lender', in such an arrangement, is not subject to a POA charge.

What if:
(1) T lends interest-free to A,
(2) A purchases the property, and
(3) T later releases the loan (or makes a gift to A which A uses to repay the loan, which comes to the same thing)?

Alternatively, more simply, what if:
(1) A purchases the property
(2) T makes a gift to A, or reimburses A for the expense (without being obliged to do so).

If T has not provided the consideration at the time that A purchases the property, T cannot provide it later. However if the steps form part of a single arrangement, it can probably be said that A has provided the consideration indirectly, even if slightly belatedly.

What if T subscribes for shares on arm's length terms? Probably T has provided funds to the company

76.6.1 *Arrangements involving third parties*

The position becomes more complex where more than two persons are involved.

Suppose T provides funds to A, an individual, who gives them to B, an

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In that context, the period over which the loan is repaid as well as whether a commercial rate of interest is charged is relevant.
Thus, where an interest-free loan is repaid over a typical ‹commercial' period, it would be reasonable to regard the interest foregone as attributable to the consideration provided by the chargeable person. In cases where the principal of the loan was left outstanding indefinitely, such principal could reasonably be regarded as attributable to the consideration provided."

individual, and B purchases the property. It is suggested that T has not provided the consideration if the "clean break" test is satisfied.[19]

Suppose T provides funds to a trust, who lend them to a company owned by the trust, which purchases the property. It is suggested that T has provided the consideration because the "clean break" test is not satisfied.

What if T gives funds to A and A borrows from a third party on the security of those funds, and uses the borrowed funds to buy the property? It is considered that T has not provided the consideration.

If T provides fund X to a company or trust, which borrows fund Y from a third party, and the company or trust uses both funds to acquire the property, then T has provided fund X but not fund Y.

Commonplace arrangements for a foreign domiciliary's residence will often satisfy the contribution condition, for instance where:

(1) an individual gives to a trust which purchases the home (without a company); or
(2) a foreign domiciliary gifts funds to a trust which lends interest-free to the company which acquires the home.

In most cases one exemption or another will apply but it is possible to fall between the gaps.

76.6.2 *Provision of funds for purpose of acquisition*

What is the position if T provides funds, but not for the purpose of the acquisition of the land? Suppose:

(1) In 1987 T created a trust. At the time T had no plans to move to the UK.
(2) In 2005 the trustees make an interest-free loan to a company which purchases a property which T occupies.

The foreign domiciled individual has directly provided the property for the purposes of the trust. They are probably to be regarded as having indirectly provided the consideration given for the acquisition of the land under the principle in *Muir v Muir*.[20] So contribution condition (a) is satisfied.

But if T gives funds to A, an individual, and A later uses those funds to buy a property, it is suggested that T has not provided the consideration,

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19 See 80.4.1 (When is A an indirect settlor?).

20 [1943] AC 468. This is consistent with para 10(2)(c) Sch 15 FA 2004 which envisages a seven-year gap between the provisions of funds and the occupation of the land. But the contrary view is arguable.

unless the two steps form a single arrangement.

76.6.3 *Guarantees*

Para 17 Sch 15 FA 2004 provides:

> Where a person ("A") acts as guarantor in respect of a loan made to another person ("B") by a third party in connection with B's acquisition of any property, the mere giving of the guarantee is not to be regarded as the provision by A of consideration for B's acquisition of the property.

It is suggested that this applies even if A provides security for A's guarantee or deposits funds with a bank as a back-to-back loan.

What if:

(1) B borrows to purchase property (perhaps with a guarantee by T); and

(2) T later gives funds to B who repays?

If the steps are independent, it is considered that T has not provided the consideration. If, however, the steps form part of a single arrangement, it is suggested that T can be said to have provided the consideration indirectly.

76.6.4 *Secondhand company*

The contribution condition will not be satisfied where:

(1) A has provided funds to a company to purchase a house.

(2) A sells the company to B who occupies the house.

B has not provided the funds for the purchase (unless the two steps form a single arrangement).[21]

76.7 POA chattel charge

Para 6 Sch 15 FA 2004 provides:

> (1) This paragraph applies where—
>
> (a) an individual ("the chargeable person") is in possession of, or has the use of, a chattel, whether alone or together with other persons, and
>
> (b) the disposal condition or the contribution condition is met as respects the chattel.
>
> (2) The disposal condition is that—
>
> (a) at any time after 17 March 1986 the chargeable person had

21 See 28.8.1 (Purchase of secondhand company by individual).

(whether alone or jointly with others) owned—

(i) the chattel, or

(ii) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel, and

(b) the chargeable person disposed[22] of all or part of his interest in the chattel or other property otherwise than by an excluded transaction.

(3) The contribution condition is that at any time after 17 March 1986 the chargeable person had directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of—

(a) the chattel, or

(b) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel.

This follows the form of the POA land charge.

The IHT Manual provides:

IHTM44007 Pre-owned assets: property in charge: the disposal condition- chattels [March 2012]

...

Example (Trevor and Paul)

T gives a painting to P. P then sells the painting and buys a violin with the proceeds, which T then plays. The disposal condition is met.

So the disposal condition will apply to the chargeable person's enjoyment or use of a chattel even if it was never actually owned by them. If they give away another asset (it does not have to be another chattel, but see the contribution condition (IHTM44008) if the gift is of cash) to another person who sells the asset and uses the proceeds to purchase the chattel concerned, the disposal condition is satisfied, unless it qualifies as an excluded transaction.

A disposition that creates a new interest in a chattel out of an existing interest is taken to be a disposal of part of the existing interest, FA04/Sch15/Para 6(4).

The disposal condition will be met whether the sale or gift is of the whole or part of the chattel and whether or not the sale is at less than the market price. See IHTM44031 where the disposal is of the whole of the chattel for full consideration.

22 "Disposal" is further defined in para 6(4) Sch 15 FA 2004.

FA04/Sch15/Para 6(2)(a)(ii) applies where the proceeds of sale are used to acquire a chattel that is subsequently used or enjoyed by the chargeable person. So, in the example above, if P exchanged the painting for the violin, on the face of it, the disposal condition is not met; but see IHTM44008.

IHTM44008 - Pre-owned assets: property in charge: the contribution condition - chattels [March 2012]

...

The contribution condition applies not only where the contribution provided by the chargeable person is directly used to purchase the chattel but also where the contribution is indirect. If the chargeable person provided all or part of the consideration for the purchase of an asset by another person, who then sold that asset and used the proceeds to purchase the chattel used or enjoyed by the chargeable person, the contribution condition is satisfied.

Example (Trevor and Paul)

T gives P the funds to buy a painting. P then sells the painting and buys a violin with the sale proceeds which T then plays. The contribution condition is met.

You do not need to show that when the contribution was made, the individual intended to use or enjoy the chattel purchased by another; if the chargeable person uses or enjoys a chattel that they have, as a matter of fact, indirectly contributed to the purchase of, the contribution condition is met.

The contribution condition does not only apply to cash contributions. So in the example at IHTM44007, where P exchanges a painting for a violin, the gift of the painting from T to P is a contribution to the acquisition of the chattel that T subsequently used or enjoyed and so the contribution condition is met.

However, the contribution condition is not met where the chargeable person uses or enjoys a chattel purchased by another with money loaned by the chargeable person. This is because the outstanding debt will form part of the lender's estate for Inheritance Tax purposes, and the lender cannot be said to have provided a contribution to the purchase of the chattel when that money has to be repaid to them, even if the loan was interest free. It follows that the 'lender', in such an arrangement, is not subject to a POA charge.

76.8 POA intangible property charge

Para 8 Sch 15 FA 2004 provides:

(1) This paragraph applies where—

(a) the terms of a settlement, as they affect any property comprised

in the settlement, are such that any income arising from the property would be treated by virtue of section 624 of ITTOIA (income arising under settlement where settlor retains an interest) as income of a person ("the chargeable person") who is for the purposes of Chapter 5 of Part 5 of that Act the settlor,

(b) any such income would be so treated even if section 625(1) of ITTOIA (settlor's retained interest) did not include any reference to the spouse or civil partner of the settlor, and

(c) that property includes any property as respects which the condition in sub-para (2) is met ("the relevant property").

(2) The condition mentioned in sub-para (1)(c) is that the property is intangible property which is or represents property which the chargeable person settled, or added to the settlement, after 17 March 1986.

In common form settlor-interested discretionary trusts the GWR exemption will apply.

If S lends on favourable terms to a trust from which S is excluded, s.624 applies[23] but para 8 does not apply.[24]

In common form trusts where the settlor has an IIP, the GWR exemption (or for an estate IIP, the estate exemption) will apply.

Accordingly, the POA intangible property charge will not usually affect foreign domiciliaries.

The charge does not apply to intangible property held by a company held by a trust, since that is not property comprised in a settlement, and not caught by s.624, but the shares in the company will be intangible property (except perhaps bearer shares?).

The charge is intended to catch *Eversden* schemes (which will not normally have been carried out by foreign domiciliaries). But it is much wider than that. It applies (in short) to (almost) any settlor-interested trust unless GWR also applies. If A creates a trust to A for life remainder to B absolutely, or to B for life remainder to A absolutely, the charge applies. However, if there is a power of appointment in favour of A, the charge does not apply as in this case there is a GWR. There is no sense in this and in practice HMRC do not take the point. Since s.102ZA FA 1986 stops the *Eversden* schemes, the intangible property charge is an anti-avoidance provision that has lost its purpose[25] and only remains as clutter

23 See 27.3.2 ("Settlor-interested" for IT purposes).

24 Because s.624 only applies because of the loan, and not because of the terms of the settlement (in the IHT sense).

25 Except for *Eversden* schemes carried out before 2003.

in the tax system which will occasionally trap the unwary (if anyone notices or cares). It should be repealed (except for pre-2003 disposals).

The IHT Manual provides:

> **IHTM44009 - Pre-owned assets: property in charge: intangible property** [March 2012]
> ...
> Note that under FA04/Sch15/Para 8(1)(a), income arising from the assets concerned (and not the settlement generally) must be treated as income of the chargeable person. So, if the settled property is partitioned so that the settlor cannot benefit from one part of the fund, the POA charge will only apply to the part of the fund that the settlor can benefit from. If the part the settlor can benefit from contains land - but the settlor does not occupy it - the POA charge on land IHTM44004) cannot apply, and will not apply to the part the settlor cannot benefit from, even if that part contains intangibles.
> You should also note the fact that the settled property may not actually produce any income does not matter, as long as any income that might arise would be treated as income of the settlor, a charge under FA04/Sch15/Para 8 will arise.
> ...
> Note that the intangibles charge does not apply to intangible property which is owned by a company which is in turn owned by a trust since the property owned by the company is not settled property. On the other hand, the shares of the company itself will be settled property and potentially caught by the POA charge subject to any exclusions (IHTM44030).
> **Example** (Andrew and Joan)
> A sets up a trust for his wife J on their marriage in 2005 and as he is excluded from all benefit there is no possibility of a charge under FA04/Sch15/Para 8 arising. If, however, he sets up a trust where J receives the income but he can benefit under, say, an overriding power of appointment or perhaps a remainder interest (although see IHTM44112 in this regard), then a charge under FA04/Sch15/Para 8 arises subject to any relevant exemptions IHTM44040), even though the property forms part of J's estate (being a pre-March 2006 interest in possession).

76.8.1 *"Settlement"*

"Settlement" here has the IHT meaning, not the settlement-arrangement meaning: para 1 Sch 15 FA 2004. See 80.2 (Definitions of "settlement").

The IHT Manual provides:

IHTM44009 - Pre-owned assets: property in charge: intangible property [March 2012]

...

In this context ‹settlement' has the same meaning as it does for Inheritance Tax purposes. The definition of ‹settlement' is in IHTA84/S43(2) (IHTM16042). Unlike the requirement for Income Tax, the fact that there is no element of bounty does not prevent a trust being a 'settlement' for Inheritance Tax - although the legislation does still require the chargeable person to have 'settled' or 'added' property to the settlement. So an arms length sale at full market value to the trust would not be a settlement or addition by the vendor.

...

IHTM44112 - Pre-owned assets: insurance based products: discounted gift trust [March 2012]

A discounted gift trust or plan is where the settlor makes a gift into settlement with certain 'rights' being retained by them. The retained rights may, for example, be a series of single premium policies maturing (usually) on successive anniversaries of the initial investment or on survival, reverting to the settlor, if they are alive on the maturity date; or the settlor carves out the right to receive future capital payments if they are alive at each prospective payment date. The gift with reservation provisions do not apply.

In the straightforward case where the settlor has retained a right to an annual income or to a reversion under arrangements, that right is not property within FA04/Sch15/Para8 as the trustees hold it on bare trust for the settlor. A bare trust is not a settlement for inheritance tax purposes (IHTM16030). The settlor is excluded from other benefits under the policy and so the POA charge does not apply.

There may be more complex cases where the settlor's retained rights or interests are themselves held on trust. But that would normally be construed as being a separate trust of those benefits in which the settlor had an interest in possession. No POA charge will arise where the interest in possession arose before 22 March 2006 by virtue of FA04/Sch15/Para11(1) (IHTM44041).

Where, however, the POA charge does arise, it will be by reference to the value of the rights held on trust for the settlor, not by reference to the value of the underlying life policy. An open market value of those rights will need to be obtained in order to calculate the charge (IHTM44025).

76.9 Excluded transactions

A disposal of property by an excluded transaction is ignored for the

disposal conditions; and the provision of property by an excluded transaction is ignored for the contribution conditions. Para 10(1) Sch 15 FA 2004 defines "excluded transaction" for the disposal conditions and para 10(2) Sch 15 FA 2004 defines it for the contribution conditions. Each sub-paragraph contains five categories of excluded transaction, making 10 in all. Simplicity was evidently not an important consideration to the drafter of the POA rules.

Excluded transactions are not a defence to the POA intangible property charge.

76.10 Excluded transactions: Disposal conditions

76.10.1 *Arm's length transaction: Disposal of whole interest*

Para 10(1) Sch 15 FA 2004 provides:

> For the purposes of ... [the disposal condition], the disposal of any property is an "excluded transaction" in relation to any person ("the chargeable person") if—
>
> (a) it was a disposal of his whole interest in the property, except for any right expressly reserved by him over the property, either—
>
> (i) by a transaction made at arm's length with a person not connected with him, or
>
> (ii) by a transaction such as might be expected to be made at arm's length between persons not connected with each other.

There are two requirements here:

(1) A disposal of the whole interest (except for any rights expressly reserved).

(2) The disposal[26] is (in short) on arm's length terms.

There is no equivalent of this category of excluded transaction for the purposes of the contribution conditions. The reason is that a disposal at arm's length is not likely to amount to "providing" consideration.

The IHT Manual provides:

> **IHTM44031 - Pre-owned assets: excluded transactions: the disposal condition - sale of entire interest** [March 2012]
>
> ...
>
> **Example** (George and Robert)

26 Not the reservation of rights.

G sells his house to his son R for full consideration, but continues to live in the property. As he has not made a gift, there is no reservation of benefit (IHTM14301) and provided the sale falls within FA04/Sch15/Para 10(1)(a)(ii), there will be no POA charge either. The position would be different if G had given R money in the past (IHTM44005).

Example (Robert and James)

R executes an 'Ingram' (IHTM44100) scheme and sells the freehold reversion to J. This would be an excluded transaction, provided that the sale was at arm's length or such as might be expected to be made at arm's length between persons not connected with each other. The reversion is a distinct item of property and R has sold his entire interest in it; he continues to occupy the property by virtue of his leasehold interest which is a separate item of property. There will be a 'marriage' value for the two interests and a truly arm's length transaction must reflect this. In practice, this is likely to be difficult for the taxpayer to show since an independent purchaser would not normally want to pay for marriage value unless he was certain of getting the leasehold interest.

76.10.2 *Arm's length transaction: Part disposal*

Reg. 5(1) POA Regulations 2005 provide a further relief for part disposals:

> Para 3 (land) and para 6 (chattels) do not apply to a person in relation to a disposal of part of an interest in any property if—
>
> (a) the disposal was by a transaction made at arm's length with a person not connected with him;
>
> (b) the disposal was by a transaction such as might be expected to be made at arm's length between persons not connected with each other, and
>
> (i) the disposal was for a consideration not in money or in the form of readily convertible assets[27], or
>
> (ii) the disposal was made before 7 March 2005.

This is wider than Para 10(1) Sch 15 FA 2004 in that it provides relief from the POA land and chattel charges, not just relief where the disposal conditions apply. But it is narrower in that its requirements are more restrictive.

In particular, one might think the word "not" is included accidentally in

27 Defined in reg.5(2).

reg.5(1)(b)(i) but it was deliberate. A written ministerial statement of Hansard 7 March 2005 provides:

> We do not in general think it is appropriate to provide exemption for sales of a part interest which are made otherwise than at arm's length. If one member of a family needs to raise cash, and another member of the family is willing and able to provide it, there are other and more straightforward ways of structuring this than adopting the form of an equity release transaction.

Very few readers will find that satisfactory. But there it is. The statement continues:

> The point was however made in consultation that some intra-family part disposals can arise from patterns of behaviour adopted for good family or business reasons, for example where a child moves in to care for an aged parent and acquires an equitable interest in their shared home as a corollary of that, or where younger members of a family take over the active role in a family partnership, and in doing so acquire an interest from the partners who preceded them.

What is notable is that the drafter seems to have assumed that these are "transactions such as might be expected to be made at arm's length between persons not connected with each other".

The IHT Manual provides:

> **44059. Sale of part share** [March 2012]
> Regulation 5(1)(b)(i))... may also apply where someone acquires their interest in a property by way of an equitable arrangement, rather than for cash, for example where the person has given up work to care for the owner of the property on the understanding that they will acquire a share of the property in return.

The guidance formerly published on the HMRC website was more helpful:

> If Miss B acquired her interest in the property by way of an equitable arrangement rather than for cash – for example, she had given up work to care for Mr A on the understanding that she would receive a share of the property in return – the income tax charge will not apply: Regulation 5
> In considering whether the conditions were satisfied, we would need information about how the essential elements of the transaction had been arrived at. We do recognise that there is a substantial body of case law dealing with the circumstances in which an interest in a house is

> acquired in consequence of a person acting to his detriment. The Ministerial Statement had these sorts of situations in mind and we would interpret Regulation 5 accordingly. In particular, we accept that the requirement that "the disposal was by a transaction such as might be expected to be made at arm's length between persons not connected with each other" would be interpreted with such cases in mind. Where the parties had sought separate advice and acted upon it or had obtained a court order confirming the property entitlement, that would reinforce the claim that the conditions were satisfied. But we would not expect parties to such an arrangement to have done this. We recognise that detriment that the acquirer can demonstrate he has suffered can provide consideration for the acquisition of the interest and prevent the transaction from being gratuitous.

It is straining credulity to describe this as a transaction that may have been expected to have been made at arm's length. But the legislation was not intended to catch this, and HMRC avoid the problem by informal concession dressed up as a statement of practice.

76.10.3 *Inter-spouse transfer*

The second category of excluded transaction is in para 10(1)(b) Sch 15 FA 2004:

> Para 3 (land) and para 6 (chattels) do not apply to a person in relation to a disposal of part of an interest in any property if ...
>
> (b) the property was transferred to his spouse or civil partner (or where the transfer has been ordered by a court, to his former spouse or civil partner),

This applies whether or not the IHT spouse exemption applies on the transfer. The transfer to the spouse need not be by way of gift.

76.10.4 *Transfer to trust where spouse has interest in possession*

The third category of excluded transaction is in para 10(1)(c) Sch 15 FA 2004:

> Para 3 (land) and para 6 (chattels) do not apply to a person in relation to a disposal of part of an interest in any property if ...
>
> (c) it was a disposal by way of gift (or, where the transfer is for the benefit of his former spouse or civil partner, in accordance with a court order), by virtue of which the property became settled property in which his spouse or civil partner or former spouse or civil partner is beneficially entitled to an interest in

possession.[28]

This applies whether or not the IHT spouse exemption applies on the transfer. The disposal to a trust under which a spouse has an interest in possession must be by way of gift if the disposal is to be an excluded transaction. Perhaps the reason is to stop some variants of the home loan scheme, which involves a sale of a house to an interest in possession trust for consideration.

This seems to apply even after 2006, when the interest in possession may not be an estate interest.

The IHT Manual provides:

> **IHTM44032 - Pre-owned assets: excluded transactions: the disposal condition - transfer to spouse or civil partner** [March 2012]
> ...
> The spouse or civil partner must take an interest in possession from the outset, but note that this does not have to be a qualifying interest in possession under IHTA84/S49(1A). The transaction will remain an excluded transaction provided the interest in possession remains in place until the death of the spouse or civil partner. If the interest in possession ends during their lifetime, the transaction ceases to be an excluded transaction, FA04/Sch15/Para 10(3), so the POA charge will arise in the normal way from that point onwards. However, if the spouse or civil partner (or former spouse or civil partner) has become absolutely entitled to the property, you can accept that the benefit of the exclusion is not lost.
> **Example** (Paul and Susan)
> In 2005, P settles his house on qualifying interest in possession trusts for himself for life, then to his wife S with remainders to their children. Both occupy the property. In 2009, the trustees terminate P's life interest; so that S now has a non-qualifying interest in possession, but P continues to occupy the property.
> Initially there would have been no POA charge as the transaction would

28 This is restricted by para 10(3) Sch 15 FA 2004:
"A disposal is not an excluded transaction by virtue of sub-para (1)(c) or (2)(b), if the interest in possession of the spouse or civil partner or former spouse or civil partner has come to an end otherwise than on the death of the spouse or civil partner or former spouse or civil partner."
The former HMRC Website Guidance provided at 1.3.1:
"In cases where the spouse or civil partner or former spouse or civil partner has become absolutely entitled to the property, we would accept that the benefit of the exclusion is not lost."

have been exempt from the charge (IHTM44041). On the termination of the P's life interest, S's interest in possession is **not** an excluded transaction because there is no disposal by way of gift by virtue of which the property becomes settled property in which S has a life interest. So the exclusion under FA04/Sch15/Para 10(1)(c) does not apply and as the exemption no longer applies either, a POA charge arises.

However, as P continues to occupy the property and the termination of his qualifying life interest is deemed to be a gift by the life tenant, FA86/S102ZA IHTM14391), the exclusion under FA04/Sch15/Para 11(3) applies and no POA charge arises.

76.10.5 *Disposition for maintenance of family*

The fourth category of excluded transaction is in para 10(1)(d) Sch 15 FA 2004:

> Para 3 (land) and para 6 (chattels) do not apply to a person in relation to a disposal of part of an interest in any property if ...
>
> (d) the disposal was a disposition falling within section 11 of IHTA (dispositions for maintenance of family).

76.10.6 *Annual exemption and small gifts*

The fifth category of excluded transaction is in para 10(1)(e) Sch 15 FA 2004:

> Para 3 (land) and para 6 (chattels) do not apply to a person in relation to a disposal of part of an interest in any property if ...
>
> (e) the disposal is an outright gift[29] to an individual and is for the purposes of IHTA a transfer of value that is wholly exempt by virtue of section 19 (annual exemption) or section 20 (small gifts).

This will include substantial gifts which qualify for 100% BPR or APR.

76.11 Excluded transactions: Contribution conditions

76.11.1 *Four exclusions*

Para 10(2) Sch 15 FA 2004 provides:

> For the purposes of ... (the contribution condition) the provision by a person ("the chargeable person") of consideration for another's

29 See 76.12 ("Outright gift").

acquisition of any property is an "excluded transaction" in relation to the chargeable person if—

(a) the other person was his spouse or civil partner (or, where the transfer has been ordered by the court, his former spouse or civil partner),

(b) on its acquisition the property became settled property in which his spouse or civil partner or former spouse or civil partner is beneficially entitled to an interest in possession.

These are the equivalent of the exclusions discussed above, see 76.10.3 (Inter-spouse transfer). The spouse trust exclusion here is wider than the spouse trust exclusion for the disposal condition, as the words "by way of gift" do not appear. The last two exclusions in para 10(2) Sch 15 FA 2004 are:

(d) the provision of the consideration is a disposition falling within section 11 of IHTA (dispositions for maintenance of family), or

(e) the provision of the consideration is an outright gift to an individual and is for the purposes of IHTA a transfer of value that is wholly exempt by virtue of section 19 (annual exemption) or section 20 (small gifts).

These are the equivalent of 76.10.5 (Disposition for maintenance of family)) and 76.10.6 (Annual exemption and small gifts).

The IHT Manual provides:

IHTM44035 - Pre-owned assets: excluded transactions: the contribution condition - transfer to spouse or civil partner [March 2012]

...

The spouse or civil partner must take an interest in possession from the outset, but note that this does not have to be a qualifying interest in possession under IHTA84/S49(1A). The transaction will remain an excluded transaction provided the interest in possession remains in place until the death of the spouse or civil partner. If the interest in possession ends during their lifetime, the transaction ceases to be an excluded transaction, FA04/Sch15/Para 10(3), so the POA charge will arise in the normal way from that point onwards. However, if the spouse or civil partner (or former spouse or civil partner) has become absolutely entitled to the property, you can accept that the benefit of the exclusion is not lost.

Example (Jane and Edward)

J has an interest in possession in a trust with remainders to her children. In 2003 her husband E adds £300,000 to the trust. The transfer is

exempt from IHT, although it will initially be subject to the POA intangibles charge if E is a beneficiary (IHTM44009). The trustees purchase a house that J and E occupy. Since, on its acquisition, the property becomes settled property and would otherwise meet the conditions of FA04/Sch15/Para 3(3), the POA charge is excluded by FA04/Sch15/Para 10(2)(b).

If J's interest is terminated during her lifetime, then FA04/Sch15/Para 10(3) prevents the exclusion under FA04/Sch15/Para 10(2)(b) from applying, so the POA charge will arise in the normal way, unless J becomes absolutely entitled to the property, when you can accept that the benefit of the exclusion is not lost. In the event that J's interest comes to an end with her death and E continues to occupy the property, the exclusion will continue to apply.

The timing of such transactions can give rise to very complicated outcomes due to the interaction of FA86/S.102(5A)-(5C) (IHTM14318); FA86/S102ZA (IHTM14391) and changes to the treatment of interest in possession trusts from 18 March 2006 (IHTM16061). Any cases where this mix of circumstances arises should be referred to Technical for advice.

76.11.2 *Outright gift of money*

The remaining exclusion is in para 10(2)(c) Sch 15 FA 2004 where:

> (c) the provision of the consideration constituted an outright gift[30] of money (in sterling or any other currency) by the chargeable person to the other person and was made at least seven years before the earliest date on which the chargeable person met the condition in para 3(1)(a)[31] or, as the case may be, 6(1)(a).[32]

Para (c) applies only to the contribution conditions.

The exemption only applies to gifts of money. I am unable to see any reason for that. The IHT Manual provides:

> **44036 The contribution condition - outright gift of money** [March 2012]
>
> As the earliest date a POA charge can arise is 6 April 2005, any contribution by way of an outright gift of cash made before 6 April 1998 will be an excluded transaction, irrespective of when the person subsequently went into occupation.

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30 See 76.12 ("Outright gift").

31 ie occupies the relevant land.

32 ie has possession of the chattels.

76.12 "Outright gift"

The expression "outright gift" is used in three of the ten categories of excluded transaction:

(1) Outright gifts to individuals within s.19 (annual exemption) or s.20 (small gifts) are excluded transactions for the disposal and contribution conditions.[33]

(2) Outright gifts of money (whether or not to an individual) are excluded for the disposal condition.[34]

"Outright gift" is not defined.[35] Clearly a loan and a subscription for shares is not an outright gift. It is suggested that a gift to a trust from which the settlor is excluded is in principle an outright gift.

It is tentatively suggested that a gift to an irrevocable discretionary trust of which the donor is merely a discretionary beneficiary is an outright gift. It must be envisaged that the donor occupies the land given or the exclusion will not apply.

76.13 POA exemptions

Para 11 Sch 15 FA 2004 provides a set of exemptions from the POA charges which (in my terminology) are as follows:

(1) Estate exemptions

(2) GWR exemptions

(3) Para 11(5)(b) Sch 15 FA 2004 exemptions (charities and other specialist areas) not discussed here

(4) Para 11(5)(c) Sch 15 FA 2004 exemption (jointly occupied property) not discussed here

(5) Full consideration exemption

76.14 "Relevant property"

A key concept in the POA exemptions is "relevant property" defined in para 11(9) Sch 15 FA 2004. The expression has three possible meanings.

In relation to the POA land and chattel charges, "relevant property" means:

> (i) where the disposal condition ... is met, the property disposed of,

---

33 See 76.10.6 (Annual exemption and small gifts); 76.11.1 (Four exclusions).

34 See 76.11.2 (Outright gift of money).

35 The term "outright gift" is partially defined in s.626 ITTOIA; see 73.12 (Income tax planning for mixed marriage), but that definition does not apply here.

(ii) where the contribution condition ... is met, the property representing the consideration directly or indirectly provided.

In a contribution condition case, the relevant property is the property representing the consideration directly or indirectly provided. Since "provided" is a difficult concept,[36] this is also difficult.

If T gives money to A, who uses it to buy a house, the house represents the consideration provided.

What if T subscribes for shares in A Ltd which purchases the house. Is it the shares or the house which represent the property provided? It is suggested that the relevant property is the house, but the shares may be derived property: see below.

What if T lends money to A interest-free, who purchases a house? Is it the house or the benefit of the loan which represents the consideration provided? In this case HMRC accept that T does not provide the consideration so the contribution condition is not satisfied; but if it mattered, it is suggested that the relevant property is the house and the loan may be derived property.

In relation to the POA intangible property charge, "relevant property" has the meaning given in para 8 Sch 15 FA 2004 (in short, the settled property).[37]

76.15 Estate exemptions

76.15.1 *Full estate exemption*

Para 11(1) Sch 15 FA 2004 provides that the POA charges:

> do not apply to a person at a time when his estate for the purposes of IHTA includes—
>
> (a) the relevant property, or
>
> (b) other property—
>
> (i) which derives its value from the relevant property, and
>
> (ii) whose value, so far as attributable to the relevant property, is not substantially less than the value of the relevant property.

I refer to this as "**the estate exemption**" (or "the **full** estate exemption" if necessary to distinguish it from the partial exemption discussed below).

If T transfers funds to a trust under which T has an estate interest in

---

36 See 76.6 ("Provide").

37 See 76.8 (POA intangible property charge).

possession, the estate exemption will apply. Transfers after 2006 will not normally give rise to an estate IIP, so the exemption is of less importance to post-2006 trusts.

The IHT Manual provides:

> **IHTM44042 - Pre-owned assets: exemptions: examples where relevant property remains part of the Inheritance Tax estate** [March 2012]
>
> **Example** (Brian and Julie)
>
> In 2005, B transfers his house to an interest in possession trust with a life interest for himself and then for his wife, J, with remainders to his children. B continues to occupy the house. The disposal condition (IHTM44004) is met and none of the exclusions (IHTM44030) apply.
>
> The property continues to form part of B's estate under IHTA84/S5(1) and so is exempt from the POA charge under FA04/Sch15/Para11(1) whilst his interest in possession exists.
>
> Note that exemption still applies even though on B's death, the property is exempt from Inheritance Tax as the life interest passes to J. However, should the trustees bring B's life interest to an end during his lifetime, the charge under FA04/Sch15/Para3(2) will apply unless B ceases to occupy the property, another exemption applies or he becomes absolutely entitled to the property.
>
> If the trustees brought B's life interest to an end after 22 March 2006, he will be treated as making a PET under IHTA84/S52(1); but - assuming he continues to occupy the property - he will also be treated as reserving a benefit (IHTM14391) in the property in which his life interest ceased by virtue of FA86/S102ZA(2). Because B is treated as reserving a benefit in the property, he continues to be exempt from the POA charge, but under a different exemption (IHTM44044).
>
> **Example**
>
> If, in the example above, B had made the transfer in 2009, the position would have been quite different, as outlined below.
>
> The transfer into the trust is an immediately chargeable transfer (IHTM04067) and tax would be payable at 20% if the value transferred exceeded the nil-rate band. The trust will also be subject to the normal relevant property trust charges (IHTM42070). B's interest in possession is not part of his estate, so the exemption under FA04/Sch15/Para11(1) (IHTM44041) does not apply. The POA charge will therefore apply, unless B reserves a benefit in the property when a different exemption will apply.
>
> B has made a gift of land to the trust, so the provisions of FA86/S102A (IHTM14360) must be considered. If B has retained a significant right

or interest that entitles him to occupy the land, he will be treated as reserving a benefit in the property, FA86/S102A(2). Although the property does not form part of B's estate for Inheritance Tax purposes, his interest under the trust does entitle him to occupy the property and so he will be exempt from the POA charge under FA04/Sch15/Para11(5) (IHTM44044).

76.15.2 *Partial estate exemption*

Para 11(2) Sch 15 FA 2004 provides:

> Where the estate for the purposes of IHTA of a person to whom para 3, 6 or 8 applies includes property—
>
> (a) which derives its value from the relevant property, and
>
> (b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property,
>
> the appropriate rental value in para 4, the appropriate amount in para 7 or the chargeable amount in para 9 (as the case may be) is to be reduced by such proportion as is reasonable to take account of the inclusion of the property in his estate.

I refer to this as "**the partial estate exemption**".

The concluding words "such proportion as is reasonable to take into account of the inclusion of the property in his estate" are somewhat incoherent. One can speak of "a proportion of a property", but not "a proportion of an inclusion". Presumably it means: "such proportion as is reasonable to take into account of the property which is included in his estate".

76.16 Derived property

In the following discussion:

(1) "**Fully derived property**" is property falling within para 11(1)(b) Sch 15 FA 2004.[38] That is property:

(i) which derives its value from the relevant property, and

(ii) whose value, so far as attributable to the relevant property, is not substantially less than the value of the relevant property.

(2) "**Partly derived property**" is property falling within para 11(2) Sch 15 FA 2004. That is property:

(a) which derives its value from the relevant property, and

(b) whose value, so far as attributable to the relevant property, is

38 In para 11 Sch 15 FA 2004 this is simply called "derived property".

substantially less than the value of the relevant property.

Thus there are three steps to decide whether property is "derived property":

(1) Is its value derived from the relevant property (the house)? If so:
(2) Ascertain how far its value is attributable to the house.
(3) Is that value (the value attributable to the house) "substantially[39] less" than the value of the house?

76.16.1 *Derived property: Shares*

Suppose T subscribes for shares in a company which buys a house and has no other assets. The shares are fully derived property since:

(1) the shares derive their value from the house (the relevant property); and
(2) the value of the shares is attributable to the house; and
(3) that value is not substantially less than the value of the house.

Suppose the company owns a house and other assets. The context shows that the shares are still to be regarded as fully derived property since:

(1) they derive their value from the house;
(2) their value is to some extent attributable to the house;
(3) their value to that extent is not substantially less than the value of the house.

One might question whether it is the case that the shares derive their value from the house. They derive their value in part from the house and in part from other assets. However, the context shows that that satisfies the condition of para 11(1)(b)(i) Sch 15 FA 2004. Otherwise the condition in para 11(1)(b)(ii) Sch 15 FA 2004 is never satisfied.

Suppose the company owns only the house and is subject to a substantial debt. The shares are not fully derived property as their value is substantially less than the house. The shares are partly derived property.

Suppose the company owns the house and other assets, and is subject to

---

39 "Substantially" is, obviously, not a precise word. The IHT Manual provides:

"44043. Property in a person's estate that derives its value from the relevant property [March 2012]

... You should normally regard the value of the derivative property as being 'substantially less' than that of the relevant property where the difference in value is more than 20%. Any case where you consider the exemption should apply (or not apply) in full and there is a reduction of more (or less) than 20% should be referred to Technical."

a debt. It is suggested that the shares are fully derived property so long as the amount of the debt is less than the value of the other assets.

The estate exemption applies so long as T retains the shares in T's estate. If T gifts half the shares to T's spouse the estate exemption ceases to apply and POA land charge is due (but with some relief under the partial estate exemption). HMRC agree. The IHT Manual provides:

> **44043 - Property in a person's estate that derives its value from the relevant property** [March 2012]
> *Example (Bruce)*
> B transfers his house to a company wholly owned by him. The value of the shares in the company which are included in B's estate is fully derived from the value of the house and so the exemption in FA04/Sch15/Para 11(1) applies.
> But if B gave the house to a company which was owned 25% by his civil partner then the value of the 75% shares he holds would be 'substantially less' than the value of the house, so although the POA charge would apply, the appropriate rental value should be reduced by a reasonable proportion, perhaps 75%, to reflect the value of the shares in B's estate.

76.16.2 *Derived property: Benefit of loan*

Suppose T lends interest-free to a company which purchases the house and has no other assets. Initially the loan is fully derived property as the shares have no value. The loan derives its value from the house as, if the loan is called in, it could only be paid by the company:

(1) selling the house and using the proceeds of sale, or
(2) borrowing on the strength of the house (in the sense that no lender would lend if the company did not hold the house) and repaying out of that loan.

Can HMRC argue that:

(1) the loan derives its value from the contractual undertaking that obliges the company to repay; and so
(2) the loan does not derive its value from the underlying property (the house).

Point (1) is correct but point (2) does not follow and is not correct. It is the existence of the house which gives value to the contractual obligation to repay.

If the value of the house increases substantially, the shares and loan (taken together) are fully derived property and taken separately they are partly-derived property.

Unfortunately HMRC may disagree. The CIOT Statement provides:

> 6.3 Clarification is requested on the position where a house is owned by a company but the company is funded by way of loan. The concern is over paras 11(1)(b) and 11(3)(b).
>
> **Example 9**
>
> [1] B owns 100 £1 shares in X Limited and otherwise funds it by shareholder loan.
>
> [2] (Or the house is owned by a company held within an interest in possession trust for B and again the funding for the purchase comes by way of loan from trustees to company.)
>
> X Limited buys the house in which B lives. B *prima facie* falls within the para 3 charge.

In fact HMRC accept that case [1] does not fall within the POA land charge because the interest free loan is not providing consideration.[40] The CIOT Statement continues:

> It would appear that para 11(1) protects him. The shares are not themselves property which derive much value from the house because they are worth substantially less than the house (see para 11(1)(b)(ii)) but the shares and the loan together are comprised in B's estate and between them indirectly derive their value from the house. On that basis para 11(1) does offer full protection.
>
> **Question 33**
>
> Do HMRC agree with this analysis or do they consider that the loan derives its value from the contractual undertakings that oblige the borrowing company to repay?
>
> It would be odd if there is a POA problem when the company is funded by way of loan but not if it is funded by way of share capital.
>
> *HMRC*
>
> In our view, the loan, albeit an asset of B's estate, is not property that derives its value from the relevant property. However, our response to Q32 above[41] would no doubt be applicable here in appropriate circumstances.

This is plainly wrong and I would be surprised if HMRC try to defend it if challenged.[42] It is also inconsistent with GAAR guidance.[43]

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40 See 76.6 ("Provide").

41 See 76.6 ("Provide").

42 But one could avoid the issue by avoiding loans, eg subscribe for redeemable shares, which are commercially equivalent to loans.

43 See 65.23.2 (The GAAR: borrowing set against UK property).

The position is more complicated if T lends to a company which purchases the house and has other assets. Suppose, for example, the company's assets and liabilities consist of a house worth £1m, investments of £1m, and a debt of £1m. It is still plainly the case that the benefit of the debt and the shares taken together are fully derived property. It is suggested that if the debt is charged on the house it derives its value from the house, and if it is not charged then it does not do so (but the shares do derive their value from the house).

What if T lends to a trust which purchases a house? If the loan is on limited recourse terms[44] the loan is fully derived property. It is suggested that the same applies even if the trustees are personally liable for the loan.

76.16.3 *Derived property: Equitable interests*

If T transfers property to a trust for A for life, remainder to T, T has a reversionary interest which is derived property. The interest is part of T's estate so the full (or partial) estate exemptions apply (depending on whether the value of the reversionary interest is equal to 80% or more of the value of the trust fund).

It T transfers property to a trust for T for life, remainder to A, T's life interest is derived property but it does not form part of T's estate (after 2006) so the estate exemption does not apply.

76.17 Excluded liability rule

Para 11(6) Sch 15 FA 2004 provides a restriction on the estate exemptions:

> Where at any time the value of a person's estate for the purposes of IHTA is reduced by an excluded liability affecting any property...

I call this "**the excluded liability rule**". The effect of the rule if it applies is:

> ... that property is not to be treated for the purposes of sub-para (1) or (2) as comprised in his estate except to the extent that the value of the property exceeds the amount of the excluded liability.

The excluded liability rule only applies for the purposes of the estate and

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44 ie the trustees' liability to repay is restricted to the trust assets or their value.

partial estate exemptions. The question of to what extent debts may limit the GWR exemption is discussed at 63.18 (GWR property subject to debt).

76.17.1 *"Excluded liability"*

The term "excluded liability" is defined in para 11(7) Sch 15 FA 2004:

> For the purposes of sub-para (6) a liability is an excluded liability if—
> (a) the creation of the liability, and
> (b) any transaction
> [i] by virtue of which the person's estate came to include
> [A] the relevant property or
> [B] property which derives its value from the relevant property or
> [ii] by virtue of which the value of property in his estate came to be derived from the relevant property,
> were associated operations, as defined by section 268 of IHTA.

This is odd because the liability within (a) must relate to the acquisition of the property (within (b) so it appears at first sight that every liability is an excluded liability within this definition. It is suggested that a liability is an excluded liability only if the creation of the liability and the acquisition of the property form part of a single scheme or arrangement.[45]

76.17.2 *"Affecting" property*

The rule only applies to a liability which "affects" property. It is suggested that a liability of an individual or company does not affect property of the individual or company unless secured on that property. A liability of a company does not affect the shares of the company (even if it may reduce their value). A liability of a trust does affect the trust property since the trustees have a lien over the trust fund to meet the liability.

76.18 Value of estate "reduced" by liability

The excluded liability rule only applies if the value of a person's estate is "reduced" by the liability. In what circumstances does a liability reduce the value of an estate? Plainly it does not do so if it is disallowed for IHT.[46]

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45 See *Reynaud v IRC* [1999] STC (SCD) 185.

46 See 65.2.3 (Disallowed debts).

76.18.1 *Trustees borrow from trust company*

Suppose:
(1) T is the life tenant of an estate IIP trust.
(2) The trustees borrow from a company held by the trust and purchase land occupied by T.

It is considered that the debt does not reduce the life tenant's estate since the benefit of the debt increases the value of the company's shares: the two cancel each other out. So the debt is not an excluded liability. (In addition, if T is the settlor, the GWR exemption will usually apply.)

76.18.2 *Bank borrowing*

Suppose:
(1) T is the life tenant of an estate IIP trust.
(2) The trustees borrow from a bank or third party, and purchase land occupied by T.

It is considered that T's estate is not "reduced" by the liability, since T's estate is not reduced by the transaction: the liability is matched by the receipt of the borrowed money.[47]

Otherwise the excluded liability rule would apply whenever anyone borrows on the security of T's house, which would be absurd.

The CIOT Statement provides:

> 2.5 A common scenario (both for foreign and UK domiciliaries) is where cash is settled into an interest in possession trust for the donor life tenant. The trustees then buy a house for the donor to live in using the gifted cash plus third party barrowings. Although not a home loan scheme, the legislation appears to affect such arrangements.
>
> **Example 4**
>
> E settles cash of £200,000 into an interest in possession trust for himself in 2003. The trustees purchase a property worth £500,000, borrowing £300,000 from a bank. There are other assets in the trust which can fund the interest but the borrowing is secured on the house which E then occupies.
>
> In these circumstances, one would not expect a POA charge. There is no inheritance tax scheme since the property is part of E's estate and the borrowing is not internal. One would argue that E's estate still includes

47 Admittedly s.162(5) IHTA applies and uses the word "reduced" in connection with the same liability. But the question is not whether the value of an *asset* is reduced, but whether the value of the *estate* is reduced.

the house and therefore protection is available under para 11(1). The difficulty is that on one view the loan is an excluded liability within para 11(7) reducing E's estate, albeit it is a loan on commercial terms with a bank.

We would argue that the relevant property for the purposes of para 11 is simply the value of the property net of the commercial borrowing. As this is part of E's estate there is no POA charge.

Question 13

Is the above analysis correct?

HMRC

We agree with your analysis in para 2.5.

It is correct that one would not expect a POA charge, as there is no IHT saving. However, what is the correct analysis of the provisions in this situation? It is wrong to say that the *property* for the purposes of para 11 Sch 15 FA 2004 is its *value* net of the liability, because that confuses two different things: property and the value of property. It is also wrong to say that the asset for the purposes of para 11 Sch 15 FA 2004 is the asset net of the liability; if one said that, the legislation would not work at all. The solution is to say that the liability does not reduce the estate of the individual, E, because E's estate is increased by the proceeds of the loan (as well as being reduced by the liability; the two cancel each other out). So the loan is not an excluded liability.

76.18.3 *Company borrows from individual*

Suppose:

(1) T lends to a company (owned by T).

(2) The company purchases a property occupied by T.

The liability is an excluded liability as defined, but so long as T retains the benefit of the debt the excluded liability rule does not apply because the debt does not reduce T's estate. What if T gives away the debt? The excluded liability rule does not apply unless the debt is secured because the debt does not affect the property.

76.18.4 *Home loan schemes*

The excluded liability rule was intended to catch home loan schemes. Suppose:

(1) T sells T's home to a trust under which T has an interest in possession in return for a debt.

At this point the excluded liability rule does not apply. The liability is an

excluded liability as defined.[48] However, the benefit of the debt is in T's estate. It is considered that the value of T's estate is not "reduced" by the liability.

(2) T gives the benefit of the debt to T's children or to a trust for their benefit.

Is the value of T's estate is now reduced by the liability? One can argue that it is reduced by the gift of the debt, not by the liability. But a purposive construction suggests that this cannot be right.

The provision works as intended.

The IHT Manual provides:

> **IHTM44051 - Pre-owned assets: exemptions: relevant property remains part of the Inheritance Tax estate: excluded liabilities** [March 2012]
>
> ...
>
> **Example**
>
> Duncan sets up a home loan scheme in 2004 where the property is sold to the trust for £500,000. In April 2005, the property is worth £650,000 and the amount of the loan, together with interest accrued at the same date is £550,000. Exemption under FA04/Sch15/Para11(5)(a) applies to the excess of £100,000 and the proportion of the annual rental value that is referable to £550,000 is subject to the POA charge. If the annual rental value was £20,000, the POA charge is 20,000 × (550,000 ÷ 650,000) = £16,923
>
> At the next revaluation date (IHTM44011), the loan should be quantified at that time, taking into account the interest/indexation that has accrued to that date and adding it to the amount of the loan. In the event that part of the loan has been repaid (this is unlikely with a home loan scheme), the reduced amount of the loan - plus accrued interest/indexation - may be taken into account when it occurs and the POA liability recalculated for the tax year in question and subsequently.
>
> It is possible that the property concerned may be sold, some of the proceeds reinvested in a smaller replacement property and the balance retained in the trust as intangibles. This then raises the question of how the loan, which is a general debt of the trust, should be treated. For the sake of simplicity, you should apportion the amount of the loan, at the date the trust assets change, between the two categories of asset and then work out the POA charges in the normal way - although it may now be

48 The transaction by which the person's estate included the house was its purchase not the sale to the trust. The creation of the liability is an associated operation because it affects the same property even if the purchase was many years earlier.

the case, with a smaller property and smaller annual rental that the amount of the POA charge is below the de minimis limit (IHTM44056).

76.19 GWR exemptions

76.19.1 *Full GWR exemption*

Para 11(3) Sch 15 FA 2004 provides:

> (3) Paras 3, 6 and 8 do not apply to a person at a time when—
> (a) the relevant property, or
> (b) any other property—
> (i) which derives its value from the relevant property, and
> (ii) whose value, so far as attributable to the relevant property, is not substantially less than the value of the relevant property,
> falls within sub-para (5) in relation to him.
> ...

The main sub-para (5) case is GWR property. Para 11(5) Sch 15 FA 2004 provides:

> Property falls within this sub-paragraph in relation to a person at a time when it—
> (a) would fall to be treated by virtue of any provision of Part 5 of the 1986 Act (inheritance tax) as property which in relation to him is property subject to a reservation,

In short, the POA charges do not apply to property subject to a reservation. ("**GWR property**"). I refer to this as "**the full GWR exemption**".

Thus in this context it is in the taxpayer's interest to argue that property *is* GWR property, and HMRC's interest is to argue that it is not! The question of whether property is GWR property (subject to a reservation) is considered at 63.4 (Terminology).

Note that property may be GWR property even though it is excluded property. Suppose:

(1) T transfers funds to a discretionary trust under which T is a beneficiary (a GWR).[49]
(2) The trustees lend the funds to a company which purchases a house occupied by T.

The shares and the benefit of the loan are derived property, and are subject

49 The position is the same for a non-estate IIP trust if T is the object of a wide power of appointment (so there is a GWR).

to a reservation. This is so even if they are excluded property. So the GWR exemption applies.

A complication arises if T becomes UK domiciled: see 76.25 (Former foreign domiciliary).

The other sub-para (5) cases are which would be GWR property but for one of nine sets of exemptions. Para 11(5) Sch 15 FA 2004 provides:

> Property falls within this sub-paragraph in relation to a person at a time when it ...
>
> (b) would fall to be so treated but for any of paras (d) to (i) of subsection (5) of section 102 of the 1986 Act (certain cases where disposal by way of gift is an exempt transfer for purposes of inheritance tax),
>
> (c) would fall to be so treated but for subsection (4) of section 102B of the 1986 Act (gifts with reservation: share of interest in land), or would have fallen to be so treated but for that subsection if the disposal by way of gift of an undivided share of an interest in land had been made on or after 9 March 1999, or
>
> (d) would fall to be so treated but for section 102C(3) of, and para 6 of Schedule 20 to, the 1986 Act (exclusion of benefit).

76.19.2 *Partial GWR exemption*

Para 11(4) Sch 15 FA 2004 provides:

> Where any property which falls within sub-para (5) in relation to a person includes property—
>
> (a) which derives its value from the relevant property, and
>
> (b) whose value, so far as attributable to the relevant property, is substantially less than the value of the relevant property,
>
> the appropriate rental value in para 4, the appropriate amount in para 7 or the chargeable amount in para 9 (as the case may be) is to be reduced by such proportion as is reasonable to take account of that fact.

I refer to this as the "**partial GWR exemption**". It is the equivalent of the partial estate exemption discussed above (except that the words at the end of the subsection are grammatical).

76.19.3 *Tracing rules*

For this purpose para 11(8) Sch 15 FA 2004 tinkers with the GWR tracing rules:

> In determining whether any property falls within sub-para (5)(b), (c) or

(d) in a case where the contribution condition in para 3(3) or 6(3) is met, para 2(2)(b) of Schedule 20 [FA 1986] (exclusion of gifts of money) is to be disregarded.

See 63.20.2 (Property received in substitution for gifted property). This extends the GWR tracing rules and so extends the scope of the POA GWR exemption.

The IHT Manual provides:

IHTM44049 - Pre-owned assets: exemptions: cash gifts and exclusion of reservation of benefit provisions [March 2012]
Example (Andrew)
A gives his daughter £150,000 in 2006. In 2008, they decide to buy a property together worth £300,000. The contribution condition (IHTM44005) will be met and A has not made a gift with reservation as the gift was of cash. A has not made a gift of an undivided share of land, so the exemption at IHTM44047 does not apply. So on the face of it, A is subject to the POA charge.
However, the effect of FA04/Sch15/Para 11(8) is to allow the normal tracing rules that apply to substitutions for the reservation of benefit provisions to apply. Therefore the property the donee acquired with cash is treated as being comprised in the original gift. So, as the original gift is treated as a gift of an undivided share of land, the exemption from the POA charge for such gifts (IHTM44047) does apply.
One consequence of this will be that if the donee ceases to occupy the property, the exemption from the POA charge will cease.
If the daughter had purchased the property in her own name and A had given his daughter the money before 6 April 1998, or if he had not moved into the property within 7 years of the gift being made, the exclusion for outright gifts of money (IHTM44036) will apply.

76.20 Reverter to settlor restriction

76.20.1 *The purpose of the rule*

Para 11(11)(12) Sch 15 FA 2004 set out a restriction to the estate and GWR exemptions which I call the "**reverter to settlor restriction**". It is helpful first to explain the problem which the reverter to settlor restriction is intended to address.

EN FB 2006 explains:

17. [The POA] income tax charge was designed to discourage disposals done in a contrived way to avoid IHT. The income tax charge does not therefore apply

> [a] when the original owner has the property back in their estate for IHT purposes (para 11(1) Schedule 15 – for example, because it has been given back to them), or
> [b] when it is treated as back in their estate (para 11(5) – for example, because the original transaction is caught by the IHT "gift with reservation" rules).

This explanation of the estate exemption is correct.

The explanation of the GWR exemption is in essence correct, though strictly speaking, GWR property is not in the individual's estate; it is however taxed as though it is. I stress this point as it will be relevant in the discussion below.

The EN continues:

> 18. There is a mismatch between this relief and an existing IHT exemption for the settled property in "reverter-to-settlor" trusts. The property in such a trust is treated as part of the trust beneficiary's [ie life tenant's] estate for IHT purposes, but it is not actually charged when their interest ends.
> 19. In particular, section 54(1) IHTA provides that, when a person who is beneficially entitled to an interest in possession in settled property dies while the settlor is still living, and the property reverts to the settlor, its value is left out of account in determining the value of the person's estate. [The EN summarises ss.53 and 54 IHTA and continues:]
> 20. This can be used to side-step both IHT and the pre-owned asset income tax charge. For example:
> • B owns an asset, say a house, which he wants to carry on using. B gives it to S, who would otherwise inherit on B's death;
> • S then settles an interest in possession in the house back on B for life, with the condition that it reverts to S on B's death [ie S settles the property on B for life with remainder to S];[50]
> • for IHT purposes, B is therefore treated as owning the house by virtue of section 49 IHTA and so para 11(1) Schedule 15 disapplies the "pre-owned asset" charge;
> • however, although the house is part of B's estate for IHT purposes, there is no IHT charge on B's death by virtue of the exemption in section 54(1) IHTA.

Avoidance of this kind was in fact quite common between 2004 and 2006, and clearly something had to be done.

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50 Author's Note: This is not generally possible after 2006.

> 21. This clause is aimed at blocking such avoidance by ensuring that the income tax exemption [POA estate and GWR exemptions] does not apply where the property in question (or any derived property) is back in the chargeable person's estate for IHT purposes by virtue of their being beneficially entitled to an interest in possession in it.
> 22. However, the clause also provides that, if the chargeable person does not wish to be subject to the income tax charge, they can elect (like other former owners otherwise liable to the "pre-owned asset" charge) that the property should fall back into their estate for IHT purposes. Thus the clause ensures an effective IHT charge in these circumstances by providing that the [reverter to settlor] exemptions in sections 53(3), 53(4) and 54 IHTA will not apply.

76.20.2 *The reverter to settlor restriction*

Para 11(11) Sch 15 FA 2004 sets out the circumstances in which the reverter to settlor restriction applies:

> (11) Sub-para (12) applies where at any time—
> [i] (a) the relevant property has ceased to be comprised in a person's estate ... , or
> (b) he has directly or indirectly provided any consideration for the acquisition of the relevant property,
> and
> [ii] at any subsequent time the relevant property or any derived[51] property is comprised in his estate ... as a result of section 49(1) IHTA.

In these circumstances, para 11(12) Sch 15 FA 2004 disapplies the estate exemptions and the GWR exemptions:

> (12) Where this sub-paragraph applies, the relevant property and any derived property—
> (a) are not to be treated for the purposes of sub-paras (1) and (2) as comprised in his estate at that subsequent time, and
> (b) are not to be treated as falling within sub-para (5) in relation to him at that subsequent time.

76.20.3 *IIP Trust for settlor from outset*

The condition in para 11[i](b) is a paraphrase of the contribution

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51 Para 11(13) Sch 15 FA 2004 defines "derived property" in terms which repeat the wording of para 11(1)(b) Sch 15 FA 2004 verbatim.

condition. At first sight, wherever the contribution condition applies, the estate exemption is disapplied. For instance, suppose:
(1) T transfers cash to an estate IIP trust; and
(2) the trustees acquire a UK residence.
The condition in para 11(12)[i](b) is met. At first sight the condition in para 11(12)[ii]) is also met: one might think that at *any subsequent time ... derived property is comprised in his estate ... as a result of section 49(1) IHTA.* So the reverter to settlor restriction applies (even though the reverter to settlor exemption does not apply). So it appears that the POA charge applies. But HMRC do not agree. They say that the condition in para 11(12)[ii] is not met. Published correspondence between STEP and HMRC provides:

> **STEP letter**
> Are the following cases caught by POAT ...
> 1. In 1987, A sets up an interest in possession trust for himself into which he gifts his house. If the house is still held by the trustees now there is no POAT charge because nothing has left his estate.

More accurately, there is no POAT charge as the conditions of para 11(11) are not satisfied.

> However assume that the house has since been sold but he retains an interest in possession. The trust holds a mixture of investments and another house that A occupies. Is para 11(11)(b) satisfied on the basis that A has provided consideration for the acquisition of the land which land has subsequently become comprised in his estate. ...
> 3. In June 2006, C, a disabled person, sets up a trust for himself that qualifies as a disabled person's interest within s89B IHTA. C puts in cash and the trustees invest in equities or a house that C occupies. C will pay POAT. ...

These two examples raise the same point: they are both estate IIP trusts (though after 2006 a trust of that kind can only be made for a disabled beneficiary). But HMRC say that the reverter to settlor restriction does not apply, as the condition in para 11(11)[ii] is not met. That provides:

> [ii] at any subsequent time the relevant property or any derived property is comprised in his estate ... as a result of section 49(1) IHTA.

The HMRC response is as follows:

> As I understand your concern, it is that the new para 11(11)(b) in

Schedule 15 FA 2004 will catch someone who has settled, say, cash on interest in possession trusts for themselves (either before 22 March 2006, or afterwards if it is a "disabled person's interest") and subsequently occupies property bought by the trustees; or where the property they settled initially has been sold and replaced by other property, while the settlor has retained their interest in possession.

... In our view, the words "at any subsequent time" should be read as meaning that a POA charge will arise where

[1] the consideration leaves the donor's estate, as a result of which that estate is reduced, and

[2] later property acquired with such consideration becomes comprised in it again because of their interest in possession. This is consistent with the reasons for Schedule 15.

We do not, therefore, consider that there will be a charge in the scenarios numbered 1 and 3 in your letters, because the assets transferred into trust and any derived assets have always been in the settlor's estate for IHT purposes. We believe that also applies if, in your second scenario,[52] B set up an interest in possession trust from the outset before Budget Day [2006]. The taxpayer should self-assess on the basis that no POAT is due and there is therefore no need to put anything about POAT on the tax return or for him to make the election where the settlor has retained an interest in possession throughout and settled the cash or property directly into trust himself (rather than through any other funding vehicle such as another trust). This is because no POAT charge arises under s80 FA 2006 [which inserted para 11(11) -(13) Sch 15 FA 2004].

In summary we do not consider that s.80 FA 2006 has any implications for:

- a settlement of cash on interest in possession trusts for onself made before 22 March 2006, or made by a disabled person on or after that date, after which the trustees purchase a property in which the settlor resides; or
- the settlement of a house in the same way, which is subsequently sold by the trustees and replaced by other investments or another property.

That remains our view, on the basis that the words "at any subsequent time" mean that new para 11(11)(b) Schedule 15 FA 2004 will only be relevant where:

- the consideration in question leaves the donor's estate, as a result of which that estate is reduced; and
- later, property acquired with such consideration becomes comprised in the estate once more by virtue of an interest in possession.

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52 See 76.20.4 (Discretionary trust subsequently becomes IIP trust for settlor).

> We do not agree that this interpretation makes para 11(11)(a) redundant,[53] since that relates to cases where the disposal condition is met and para 11(11)(b) to cases where the contribution condition is met.

This is a purposive construction, but taxpayers will not object.

76.20.4 *Discretionary trust subsequently becomes IIP trust for settlor*

The STEP letter sets out one other example:

> Are the following cases caught by POAT ...
> 2. B is a foreign domiciliary who before 22 March 2006 set up a discretionary trust into which he transferred cash. He remains a beneficiary of the trust. The trust then funds a company which buys a house or possibly holds UK investments (and B will pay income tax under [s720 ITA] in respect of any UK income). The trust was before 22 March 2006 converted into an interest in possession trust. If there are any UK intangibles or UK property occupied by A which are held by the trustees within the interest in possession structure he is now subject to POAT. Even if one reads "subsequent time" to mean some time must elapse between the date when the gift is made and the date the property comes back into B's estate this would still not protect B in this example because the trust was originally discretionary.

HMRC comment on this:

> We accept that a POA charge may arise where someone set up a discretionary trust that has subsequently been converted into an interest in possession trust for the benefit of the settlor. (Scenario 2 in your example). However, it remains possible in those circumstances to elect

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53 This paragraph addresses a point made in the STEP letter in these words: "The potential difficulty with paras 11(11) and 11(12) is that they do not distinguish between reverter to settlor trusts and any trust set up between March 1986 and 22 March 2006 where the settlor has a qualifying interest in possession and would in that event be subject to inheritance tax on his death.
These difficulties arise because paras 11(11) and 11(12) catch not only those transactions where land has been given away and ceased to be comprised in the settlor's estate and then comes back into his estate (condition a above). They also catch transactions where a settlor contributed funds or property to a trust and the trust (or an underlying company) has then used those funds or property representing them to buy the relevant property i.e. the land now occupied (condition b above). There is nothing in the words about "any subsequent time" which suggests that under (b) the property had first to cease to be comprised in his estate before being caught by this provision. Indeed if that was the case the words in (a) would be redundant."

out of the charge. So, take the following example:[54]

- H settles a property on discretionary trusts before 22 March 2006;
- also before that date, the trust is converted into an interest in possession trust for H's benefit, with remainder to his wife, W;
- A POA charge therefore arises because of s.80 FA 2006 but H elects.

As we see it, the effects of the election are:

- the chargeable proportion of the property will be treated as subject to a reservation, but only so far as H is not beneficially entitled to an interest in possession in the property (*para 21(2)(b)(i), Schedule 15 FA 2004*) – i.e. not at all;
- section 102(3) and (4) FA 1986 will apply, but only so far as H is not beneficially entitled to an interest in possession in the property (*para 21(2)(b)(ii)*) – i.e. not at all; and
- the reverter-to-settlor exemptions in s.53(3) and (4) and s.54 IHTA will not apply to the actual interest in possession (*para 21(2)(b)(iii)*).

We do not, therefore, consider that the election affects the availability of spouse exemption on H's interest in possession on his death – or on its termination during his lifetime. That is because, as we have just noted, the election will not cause s.102(3) and (4) FA 86 to apply because of H's interest in possession, so there will be no deemed PET.

It is absurd to expect taxpayers to make an election in this case. It is considered that the condition in para 11(12)[ii] is not satisfied, just as it is not satisfied in STEP examples 1 and 3. The property is in the estate of the settlor as soon as the settlement was made. (The settlor did not have an interest in possession, but it is property subject to a reservation, and one may (loosely) regard such property as being in the estate of an individual. That was the view of the drafter of the provisions.[55]) The statutory words *at any subsequent time the relevant property or any derived property is comprised in his estate* require that the property becomes comprised in the individual's estate by means of a disposition other than the original transfer to the trust by the individual.

In short, the reverter to settlor restriction can and should be construed purposively, so it only applies in cases where the reverter to settlor restriction is actually in point, because that, unquestionably, was the intention when it was enacted.

The IHT Manual provides:

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54 [Author's footnote] The HMRC reply simplifies the facts of STEP example 2 by omitting the company: that allows HMRC to ignore various additional complications.

55 See 76.20.1 (The purpose of the rule).

> **IHTM44050 - Pre-owned assets: exemptions: relevant property remains part of the Inheritance Tax estate: restriction for subsequent ownership** [March 2012]
> ...
> **Example** (Abel and Eve)
> In 1990 A gave his widowed mother E the money so that she could buy her council house. E died in 2005 leaving her house in trust to A for life with remainder to her grandson. A lives in the house as life tenant, so does not pay any rent. Despite the house being treated as part of A's estate, A is not exempt under FA04/Sch15/Para11(1) - unless the de minimis (IHTM44056) applies.
> **Example** (Adam)
> A settled a holiday cottage in trust in 2000 giving his wife an interest in possession only while they are married, with a defeasible life interest for himself thereafter and remainders on discretionary trust for his children. He shares the occupation of the cottage with his wife. The initial transfer is an excluded transaction (IHTM44032) and also exempt from reservation of benefit (IHTM14318).
> In May 2008 they divorce and A's former wife's interest ends. The initial exclusion comes to an end, but A's subsequent qualifying life interest (a TSI under IHTA/S49C (IHTM16061)) is not exempt under FA04/Sch15/Para11(1).

76.21 Full consideration exemption

Para 11(5)(d) Sch 15 FA 2004 provides a POA exemption where (in my paraphrase) the relevant property or derived property:

> would fall to be treated as property subject to a reservation but for s.102C(3) and Schedule 20 para 6 FA 1986.

There is a set of exemptions here:[56]

(1) Where the GWR rule would apply but for s.102C(3) FA 1986(this section is not discussed here.

(2) Where the GWR rule would apply but for para 6 Sch. 20 FA 1986.

Para 6(1) Sch 20 FA 1986 provides two exemptions to the GWR rule. The first is:

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56 Another possible reading is that the exemption only applies if s.102C(3) and Sch 20 para 6 both apply, ie it is not enough that Sch 20 para 6 applies if s.102C(3) does not. But a close reading of s.102C shows that s.102C(3) and para 6 Sch 15 FA 2004 are alternatives. They cannot both apply. *Hansard* confirms this (if it were necessary): HC 7 July 2004 col.881, 900.

> In determining whether any property which is disposed of by way of gift is enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise—
>
> (a) in the case of property which is an interest in land or a chattel, retention or assumption by the donor of actual occupation of the land or actual enjoyment of an incorporeal right over the land, or actual possession of the chattel shall be disregarded if it is for full consideration in money or money's worth ...

I call this the "**full consideration exemption**". This is particularly important in relation to chattels because full consideration would be much less than the deemed income charge. As to the meaning of "full consideration" see 63.7 (Full consideration exemption).

The full consideration exemption only applies if there would otherwise be a GWR. If an individual has carried out an *Eversden* scheme, they will not qualify for the full consideration exemption even if they pay full consideration for use of the land (though the rent paid will reduce the quantum of the POA charge).

The second exemption in para 6(1)(b) Sch 20 is less likely to be important in practice.

76.22 Partnerships

The guidance formerly published on the HMRC website provided:

> The treatment of a share of a partnership interest for Schedule 15 purposes follows that applied for IHT purposes. In other words, we do not regard the partnership interest as transparent, and the disposal of a share is unlikely to give rise to a Schedule 15 charge in any circumstances.

This is not a view which bears much examination. If a partnership holds land, a partnership interest is an interest in land, and a disposal of that interest meets the disposal condition.[57] But the legislation was not intended to catch partnerships and HMRC avoid the problem by informal concession dressed up as a statement of practice. The passage is not in the

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57 Contrast the original HMRC guidance (so called "Technical Guidance" 2004) which took the correct (if worrying) line that the POA rules in principle apply "if C, an existing partner, brings his son D into partnership"; see the 6th edition of this work, para 43.10.1.

IHT Manual but HMRC practice may not have changed.

76.23 Non-resident taxpayer

Para 12(1) Sch 15 FA 2004 provides:

> This Schedule does not apply in relation to any person for any year of assessment during which he is not resident in the UK.

This is straightforward.

76.24 UK resident foreign domiciliary

Para 12(2) Sch 15 FA 2004 provides:

> Where in any year of assessment a person is resident in the UK but is domiciled[58] outside the UK, this Schedule does not apply to him unless the property falling within para 3(1)(a), 6(1)(a) or 8(1)(c) is situated in the UK.

This provides three exemptions:

(1) exemption to POA land charge where T occupies non-UK situate land;
(2) exemption to POA chattel charge where T uses non-UK situate chattels; or
(3) exemption to POA intangible property charge where intangible property is not UK situate.[59]

Para 12 Sch 15 FA 2004 does not provide exemption where T transfers assets to a non-UK company which holds UK land occupied by T. But the GWR or estate exemption will usually apply.

76.25 Former foreign domiciliary

Para 12(3) Sch 15 FA 2004 provides:

> In the application of this Schedule to a person who was at any time domiciled[60] outside the UK, no regard is to be had to any property which is for the purposes of IHTA excluded property in relation to

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58 "Domiciled" is defined in para 12(4) Sch 15 FA 2004:
" For the purposes of this paragraph, a person is to be treated as domiciled in the UK at any time only if he would be so treated for the purposes of IHTA."

59 The exemption (anomalously) does not apply to exempt gilts and AUTs or OEICs which may be excluded property but which are UK situate.

60 See above footnote for definition of "domiciled".

him[61] by virtue of section 48(3)(a) of that Act.[62]

The words "was at any time domiciled outside the UK" refer to a person who was formerly foreign domiciled but who has become UK domiciled. The words do not refer to a person who was and remains foreign domiciled. (The words in isolation could, taken literally, apply in such a case, but the word *was* in para 12(3) Sch 15 FA 2004 is to be contrasted with *is* in para 12(2) Sch 15 FA 2004.)

Suppose:

(1) T (not UK domiciled) creates a discretionary trust of which T is a beneficiary;

(2) The trust holds:
   (a) Non-UK investments.
   (b) A company holding UK property occupied by T.

At this point, the conditions for the POA intangible property charge and the POA land charge are satisfied but the GWR exemption provides relief in both cases.

(3) Suppose T becomes IHT deemed domiciled (or actually UK domiciled).

At first sight T ceases to enjoy the benefit of the GWR and estate exemptions as the trust property is excluded property, so "no regard" is to be had to it.

(1) In relation to the investments, there is still no POA intangible property charge, since the investments are excluded property, so no regard is to be had to them either.

(2) However, the land is not excluded property, so the POA land charge seems to apply.[63] This was certainly not foreseen at the time the legislation was passed. It is suggested that para 12(3) Sch 15 FA 2004 is, like a deeming provision, to be construed to have effect so far as intended but it was not intended to disapply the GWR and estate exemptions. The modern purposive approach to construction

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61 The words "in relation to him" are misconceived. Property is excluded property or not excluded; but it cannot be excluded property "in relation to" any particular beneficiary. It is considered that these words should simply be disregarded.

62 The exemption (anomalously) does not apply to exempt gilts and AUTs or OEICs which may be excluded property, but not under s.48(3)(a) IHTA.

63 A further tax charge would arise if (as some have argued) T is also caught by the GWR rules on his death; see 63.14 (GWR death charge: excluded property rules for settled property).

of tax statutes may on this occasion assist the taxpayer. The 17 March 1986 POA start date supports this view. That date shows that the object of the rules is to prevent GWR avoidance, not other kinds of IHT mitigation.

HMRC agree. The CIOT Statement provides at para 7:

> Para 12(3) states that no regard is to be had to excluded property. In a case where a trust settled by a foreign domiciliary owns a UK house through a foreign registered company the shares in the company (and any loan to the company) are excluded property. Concern has been expressed that since para 12(3) says that no regard is to be had to these assets, this in turn means that the shares and loan have to be ignored in applying para 11 and in particular cannot be taken into account in determining whether there is derived property which is in the taxpayer's estate or GWR property in relation to him (which the shares and loans otherwise are). We think that this argument is misconceived but it has been advanced.
>
> **Question 42**
>
> Can HMRC confirm that they agree para 12(3) does not operate in this way and that para 11 can still work to protect the UK house or underlying assets owned by the offshore company in these circumstances?
>
> *HMRC*
>
> We agree with what you say in para 7.1 about the interaction between paras 12(3) and 11.

The guidance formerly published on the HMRC website provided at 4.1:

> Para 12(3) of the schedule provides that if any property situated outside the UK became comprised in a settlement when the person settling the property was domiciled outside the UK it will not be subject to the charge. Even if that person becomes domiciled in the UK at a later date this property will remain excluded from the charge.
>
> Para 12(3) provides that a charge under this Schedule shall not arise in relation to property regarded as excluded by virtue of section 48(3) IHTA'84. We do not regard this provision as having an impact on para 11 in determining whether there is derived property in the taxpayer's estate, or GWR property in relation to him (see foreign domiciliary example in appendix).

The passage is not in the present IHT Manual, but HMRC practice may not have changed.

The IHT Manual provides:

IHTM44054 - Pre-owned assets: exemptions: foreign element - foreign domiciliaries [March 2012]

Example (Gregor)
G, who is non-UK domiciled but resident in the UK, gives his French house to an offshore company which is 100% owned by him and continues to live there. This is a disposal of land, but there is no POA charge because of the exemption under FA04/Sch15/Para12(2). However G owns the company shares that derive their value from the house, so he is also exempt under FA04/Sch15/Para11(1). If, after a period of time, G becomes deemed domiciled in the UK, this exemption under FA04/Sch15 /Para12(2) will be lost. However, exemption under FA04/Sch15/Para11(1) (IHTM44041) is still available as G's estate includes property (the company shares) which derives its value from the relevant property.
If G had given his UK house to the offshore company and continued to live there, a POA charge potentially arises. The exemption under FA04/Sch15/Para12(2) does not apply because the property is situated in the UK. However, exemption under FA04/Sch15/Para11(1) is still available as G's estate includes property (the company shares) which derives its value from the relevant property.
Note that in the second scenario above, the exemption still applies even though should G die non-UK domiciled the property will not be liable to Inheritance Tax because the shares in the offshore company will be excluded property (IHTM04260).

IHTM44055 - Pre-owned assets: exemptions: foreign element - foreign domiciliaries: settled property exemption [March 2012]
Where a person who is domiciled outside the UK creates a settlement that contains overseas property, that settlement is an excluded property settlement for Inheritance Tax purposes (IHTM27220). No regard is to be had to any such property for the purposes of the POA charge, FA04/Sch15/Para12(3). This provision provides an exemption for individuals who subsequently become domiciled in the UK and continue to benefit from the settled property and who would therefore no longer be able to rely on the foreign domiciliary exemption (IHTM44054).
If, having become domiciled in the UK the person adds property, wherever it may be situated, to the settlement, the added property may be subject to the POA charge in the normal way. If available, the exemptions and exclusions would apply as they would for any person domiciled in the UK.
The definition for excluded property for inheritance purposes includes

interests in UK unit trusts, OEICs and gilts, but this is not extended to the POA charge.

76.26 Loan to trust

The IHT Manual provides

> **IHTM44113 - Pre-owned assets: insurance based products: gift and loan trust** [March 2012]
> A gift and loan trust is where the settlor makes a small gift into trust, possibly by way of an insurance policy and settles it on trusts for the benefit of others and from which the settlor is entirely excluded. They then make a substantial interest free loan to the trustees, repayable on demand. The trustees use the loan to purchase more policies, and make partial surrenders each year to pay off part of the loan.
> This arrangement is not a gift with reservation for inheritance tax. The settlor is not a beneficiary of the trust itself and the making of the loan does not constitute a settlement for the purposes of Inheritance Tax. No POA charge arises as the benefit to the settlor arises as a creditor and not under the trust.

76.27 Quantum of charge: Land

We find the usual cascade of definitions. Para 3(5) Sch 15 FA 2004 provides:

> Where this paragraph applies to a person in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 4 is to be treated as income of his chargeable to income tax.

76.27.1 *The chargeable amount and deductible expenses*

One therefore turns to para 4 Sch 15 FA 2004 to find the quantum of the charge. Para 4(1) Sch 15 FA 2004 provides:

> For any taxable period[64] the chargeable amount in relation to the relevant land is
> [a] the appropriate rental value ... less
> [b] the amount of any payments which, in pursuance of any legal

64 "Taxable period" is defined in a commonsense way in para 4(6) Sch 15 FA 2004:
"In this paragraph—
‹the taxable period' means the year of assessment, or part of a year of assessment, during which para 3 applies to the chargeable person."

> obligation, are made by the chargeable person during the period to the owner of the relevant land in respect of the occupation of the land by the chargeable person.

To obtain a deduction requires good paperwork:
(1) a legal obligation; and
(2) payment to the owner of the relevant land.
This is straightforward in an *Eversden* scheme, but who is the "owner" of the land in an *Ingram* scheme (where there is a lease owned by T and a reversion owned by others)? Who is owner of the land in a home loan scheme (where the land is held by trustees)?

76.27.2 *"The appropriate rental value"*

This is defined in para 4(2) Sch 15 FA 2004. This provides:

> The appropriate rental value is R × (DV ÷ V)

In short, R is the **R**ental value; V is the capital **V**alue. DV ÷ V is (in a sense) the chargeable part of that value. **DV** stands, perhaps, for Disposal Value.

76.27.3 *"Rental value"*

R is the rental value of the relevant land for the taxable period. "Rental value" is defined in the same manner as the income tax benefit in kind rule: it means the "annual value". The "annual value" is in turn defined in para 5 Sch 15 FA 2004. That is copied from s.110 ITEPA, except that s.110(3), (4) are omitted. It is here called "the POA Annual Value". The POA Annual Value is defined as the rent which will be payable *on the assumption that the landlord (rather than the tenant) pays for all repairs and insurance*. The normal market rent will be lower than the POA Annual Value, because market practice is that the *tenant* pays the cost of repairs and insurance. The difference between POA annual value and normal market rent will vary from one property to another. The difference would be greater with large properties which are expensive to maintain and insure. In relation to other benefits in kind provisions, such as s.87 and s.731, beneficiaries have sometimes been given the benefit of living accommodation on terms that they are responsible for maintenance and insurance. If the maintenance and insurance cost is substantial, they argue that the value of the benefit is small or sometimes even nil. It was perhaps to avoid these arguments that the legislation was framed in this way. It seems extraordinary if one thinks that the legislation is intended

to charge income tax on a benefit in kind. However, the object of the legislation is really to penalise taxpayers who have carried out some IHT planning schemes and so it does make sense.

The wording is derived from rating legislation. There is a substantial amount of case law, and to research this the reader should refer to rating law textbooks.

The reader will recall that the annual value for benefit in kind purposes is by concession taken to be the rateable value.[65] There is no reason to think that this concession will be applied for the POA Annual Value. POA Annual Value is (in short) slightly above market rental value.

76.27.4 *The proportion (DV ÷ V)*

The key expression is DV. Para 4(2) Sch 15 FA 2004 provides:

> DV is—
>
> (a) in a case falling within para 3(2)(a)(i),[66]
>
> [i] the value as at the valuation date of the interest in the relevant land that was disposed of as mentioned in para 3(2)(b) by the chargeable person or,
>
> [ii] where the disposal was a non-exempt sale, the appropriate proportion of that value,
>
> (b) in a case falling within para 3(2)(a)(ii),[67]
>
> [i] such part of the value of the relevant land at the valuation date as can reasonably be attributed to the property originally disposed of by the chargeable person or,
>
> [ii] where the original disposal was a non-exempt sale, to the appropriate proportion of that property, and
>
> (c) in a case falling within para 3(3),[68] such part of the value of the relevant land at the valuation date as can reasonably be attributed to the consideration provided by the chargeable person, and
>
> V is the value of the relevant land at the valuation date.

The drafter does not deal with a case falling within the disposal and the contribution condition, eg if the individual disposes of an interest in a contract to purchase land to another person and also provides the purchase price.

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65 See 74.11.1 ("Rental value of the accommodation").

66 ie disposal condition (i), see 76.4.1 (Disposal condition (i)).

67 ie disposal condition (ii), see 76.4.2 (Disposal condition (ii)).

68 ie the contribution condition, see 76.5 (The contribution conditions).

76.27.5 *(DV÷V) and the valuation date*

The valuation date is determined by the POA Regulations 2005. The Consultation Document "Taxation of Pre-Owned Assets: Further Consultation" 16 August 2004 explains:

> 5. In the case of land, the "cash equivalent" of enjoyment in a particular tax year is derived from market rental that would be paid for use of the land over the "taxable period" (that is, the tax year or any shorter period for which the asset is "caught" by Schedule 15). This figure is then scaled down, in cases where the taxpayer's "stake" in the caught asset is less than 100 per cent, in the proportion DV/V, where V is the value of the whole asset on the "valuation date" for the year, and DV is the value reasonably attributable to the taxpayer on that date. In many cases, however, we would expect that taxpayers and their advisors will be able to establish the ratio DV/V from the surrounding circumstances without necessarily establishing the absolute amount of V or DV.

76.27.6 *Non-exempt sale*

Para 4(4) Sch 15 FA 2004 provides a relief for a "non-exempt" sale. Para 4(4) Sch 15 FA 2004 begins with the definition of this term:

> The disposal by the chargeable person of an interest in land is a "non-exempt sale" if (although not an excluded transaction) it was a sale of his whole interest in the property for a consideration paid in money in sterling or any other currency;

The label ("non-exempt sale") is chosen, presumably, because the sale is not an excluded transaction. (Perhaps "non-excluded sale" would have been clearer.)

The relief is given by the method of re-defining "the appropriate proportion" to a smaller amount. Para 4(4) Sch 15 FA 2004 continues:

> and, in relation to a non-exempt sale, "the appropriate proportion" is
> (MV–P) ÷ MV
> where—
> MV is the value of the interest in land at the time of the sale;
> P is the amount paid.

This will not often apply as a sale for full value will usually be an excluded transaction and a sale at an undervalue will probably qualify for the GWR exemption.

76.28 Quantum of charge: Chattels

Para 6(5) Sch 15 FA 2004 provides:

> Where this paragraph applies to a person in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 7 is to be treated as income of his chargeable to income tax.

76.28.1 *The chargeable amount*

Para 7(1) Sch 15 FA 2004 provides:

> For any taxable period the chargeable amount in relation to any chattel is
>
> [a] the appropriate amount (as determined under sub-para (2)),
>
> [b] less the amount of any payments which, in pursuance of any legal obligation, are made by the chargeable person during the period to the owner of the chattel in respect of the possession or use of the chattel by the chargeable person.

This follows the format of the POA land charge.

76.28.2 *The appropriate amount*

Para 7(2) Sch 15 FA 2004 provides:

> The appropriate amount is N×(DV ÷ V)

In short, N is **N**otional interest. DV and V are similar to the POA land charge. In detail:

> N is the amount of the interest that would be payable for the taxable period[69] if interest were payable at the prescribed rate on an amount equal to the value of the chattel [at][70] the valuation date,
>
> DV is—
>
> (a) in a case falling within para 6(2)(a)(i),
>
> [i] the value as at the valuation date of the interest in the chattel that was disposed of as mentioned in para 6(2)(b) by the chargeable person or,

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69 Para 7(5) Sch 15 FA 2004 provides that "the taxable period" means the year of assessment, or part of a year of assessment, during which para 6 Sch 15 FA 2004 applies to the chargeable person.

70 The statute erroneously reads "as".

[ii] where the disposal was a non-exempt sale,[71] the appropriate proportion of that value,

(b) in a case falling within para 6(2)(a)(ii),

[i] such part of the value of the chattel at the valuation date as can reasonably be attributed to the property originally disposed of by the chargeable person or,

[ii] where the original disposal was a non-exempt sale, to the appropriate proportion of that property, and

(c) in a case falling within para 6(3), such part of the value of the chattel at the valuation date as can reasonably be attributed to the consideration provided by the chargeable person, and

V is the value of the chattel at the valuation date.

76.29 Quantum of charge: Intangible property

Para 8(3) Sch 15 FA 2004 provides:

> Where this paragraph applies in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under para 9 is to be treated as income of the chargeable person chargeable to income tax.

76.29.1 *The chargeable amount*

Para 9(1) Sch 15 FA 2004 provides:

> For any taxable period the chargeable amount in relation to the relevant property is N minus T

In short, **N** is **N**otional income; **T** is **T**ax payable. In more detail:

> N is the amount of the interest that would be payable for the taxable period[72] if interest were payable at the prescribed rate on an amount equal to the value of the relevant property at the valuation date, and
>
> T is the amount of any income tax or capital gains tax payable by the chargeable person in respect of the taxable period by virtue of any of the following provisions—
>
> (a) section 461 [ITTOIA],
>
> (b) section 624 [ITTOIA],

---

71 Non-exempt sale is defined in para 7(3) Sch 15 FA 2004 following the form of the POA land charge: see 76.27.6 (Non-exempt sale).

72 Para 9(3) Sch 15 FA 2004 provides:
"'the taxable period' means the year of assessment, or part of a year of assessment, during which para 8 applies to the chargeable person".

(c) sections 720 to 730 [ITA],
(d) section 77 [TCGA], and
(e) section 86 [TCGA],

so far as the tax is attributable to the relevant property.

Setting notional income against tax is penal and bizarre, but then, the POA regime is bizarre and intended to be penal.

There is no provision for carry forward or back if T exceeds N (but that will be rare).

If foreign income is unremitted and no tax is paid because of the s.624 remittance basis, it is considered that the amount of T is nil.

76.29.2 *The valuation date*

Para 9 Sch 15 FA 2004 continues:

> (2) Regulations may, in relation to any valuation date, provide for a valuation of the relevant property by reference to an earlier valuation date to apply subject to any prescribed adjustments.
> (3) In this paragraph—
> ...
> "the valuation date", in relation to a year of assessment, means such date as may be prescribed.

The date is prescribed in the POA Regulations 2005.

76.30 Overlap of land and intangible property charges

Para 18 Sch 15 FA 2004 provides:

> *Persons chargeable under different provisions by reference to same property*
> (1) Where, in any year of assessment, a person ("the chargeable person") is (apart from this paragraph) chargeable to income tax both—
> (a) under para 3 (land) or para 6 (chattels) by reason of his occupation of any land or his possession or use of any chattel, and
> (b) under para 8 (intangible property) by reference to any intangible property which derives its value (whether in whole or part) from the land or the chattel,
>
> he is to be charged to income tax under whichever provision produces the higher chargeable amount in relation to him.
> (2) Where sub-para (1) applies, only the amount under the paragraph under which he is chargeable is to be taken into account in relation to the chargeable person for the purposes of para 13(2).

76.31 Interaction with benefit in kind charge

Para 19 Sch 15 FA 2004 provides:

> Where, in any year of assessment, a person is (apart from this paragraph) chargeable, in respect of his occupation of any land or his possession or use of any chattel, to income tax both—
>
> (a) under this Schedule, and
>
> (b) under Part 3 of ITEPA,
>
> the provisions of that Part shall have priority and he shall not be chargeable to income tax under this Schedule, except to the extent that the amount chargeable under this Schedule exceeds the amount to be treated as earnings under that Part.

76.32 *De minimis* exemption

The Press Release announcing the POA regime promised "a substantial *de minimis* exemption" (*sic*). This turned out to be £5,000 per annum. As this book predicted, the "substantial" £5,000 figure has not been raised in line with inflation.

Para 13 Sch 15 FA 2004 provides:

> (1) This paragraph applies where, in relation to any person who would (apart from this para) be chargeable under this Schedule for any year of assessment, the aggregate of the amounts specified in sub-para (2) in respect of that year does not exceed £5,000.
>
> (2) Those amounts are—
>
> (a) in relation to any land to which para 3 applies in respect of him, the appropriate rental value as determined under para 4(2),
>
> (b) in relation to any chattel to which para 6 applies in respect of him, the appropriate amount as determined under para 7(2), and
>
> (c) in relation to any intangible property to which para 8 applies in respect of him, the chargeable amount determined under para 9.
>
> (3) Where this para applies, the person is not chargeable for that year of assessment under any of the following provisions—
>
> (a) para 3(5) (land),
>
> (b) para 6(5) (chattels), or
>
> (c) para 8(3) (intangible property).

This is significant if annual value is (contrary to my expectation) construed by concession to mean rateable value. It could also be significant where husband and wife entered into IHT planning arrangements jointly, since each have their own separate allowance. The exception applies to the "appropriate rental value", so deductible expenses

are not relevant. Another problem here is that the £5,000 limit must be satisfied every year.

The *de minimis* limit is not time apportioned so the full £5,000 can be set against a much shorter period of deemed income.

It is therefore necessary to ascertain "the appropriate rental value". That takes us to para 4(2) Sch 15 FA 2004:

> The appropriate rental value is R×(DV/V) where
> R is the rental value of the relevant land *for the taxable period*

The "taxable period" is defined in para 4(6) Sch 15 FA 2004:

> "the taxable period" means the year of assessment, or part of a year of assessment, during which para 3 applies to the chargeable person.

Thus it seems clear that if para 3 Sch 15 FA 2004 only applies for part of the year, the taxable period is reduced, so R is reduced, so the "appropriate rental value" is reduced and so (carrying the chain to the end) the *de minimis* exemption may apply. Note that the estate exemption in para 11(1) Sch 15 FA 2004 disapplies para 3 Sch 15 FA 2004: see para 11(1) Sch 15 FA 2004.

76.33 POA election

One can elect out of the POA regime at an IHT cost. Para 21 Sch 15 FA 2004 deals with the POA land and chattels charges. Para 22 Sch 15 FA 2004 deals with intangible property. They are not quite the same but for reasons of space I only cover the former.

76.33.1 *Conditions for election*

Para 21(1) Sch 15 FA 2004 provides

> This paragraph applies where—
> (a) a person ("the chargeable person") would (apart from this paragraph) be chargeable under para 3 (land) or para 6 (chattels) for any year of assessment ("the initial year") by reference to his enjoyment[73] of any property ("the relevant property"), and
> (b) he has not been chargeable under the paragraph in question in

73 "Enjoyment" is defined in para 21(4) Sch 15 FA 2004:
> "For the purposes of this paragraph a person ‹enjoys' property if—
> (a) in the case of an interest in land, he occupies the land, and
> (b) in the case of an interest in a chattel, he is in possession of, or has the use of, the chattel."

> respect of any previous year of assessment by reference to his enjoyment of the relevant property, or of any other property for which the relevant property has been substituted.

If an election is made by mistake (because the POA regime does not in fact apply) it has no effect.

76.33.2 *Effect of election*

Para 21(2) Sch 15 FA 2004 provides:

> The chargeable person may elect in accordance with para 23 that—
> (a) the preceding provisions of this Schedule shall not apply to him during the initial year and subsequent years of assessment by reference to his enjoyment of the relevant property or of any property which may be substituted for the relevant property ...

This disapplies Schedule 15. The price is in sub-para (b):

> ..., but
> (b) so long as the chargeable person continues to enjoy the relevant property or any property which is substituted for the relevant property—
> (i) the chargeable proportion of the property is to be treated for the purposes of Part 5 of FA 1986 (in relation to the chargeable person) as property subject to a reservation, but only so far as the chargeable person is not beneficially entitled to an interest in possession in the property,
> (ii) section 102(3) and (4) of that Act shall apply, but only so far as the chargeable person is not beneficially entitled to an interest in possession in the property, and
> (iii) if the chargeable person is beneficially entitled to an interest in possession in the property, sections 53(3) and (4) and 54 of IHTA 1984 (which deal with cases of property reverting to the settlor etc) shall not apply in relation to the chargeable proportion of the property.

Suppose a former foreign domiciliary makes an election in relation to a discretionary trust of which they are a beneficiary and the property is excluded property. How does s.102(3) apply? See 63.14 (GWR death charge: excluded property rules for settled property).

76.33.3 *The chargeable proportion*

This takes us to the definition of "chargeable proportion" in para 21(3)

Sch 15 FA 2004:

> In this paragraph, "the chargeable proportion", in relation to any property, means DV ÷ V
> where DV and V are to be read in accordance with para 4(2) or 7(2), as the case requires, but as if—
> (a) any reference in para 4(2) or 7(2) to the valuation date were a reference—
> (i) in the case of property falling within subsection (3) of section 102 of the Finance Act 1986, to the date of the death of the chargeable person, and
> (ii) in the case of property falling within subsection (4) of that section, to the date on which the property ceases to be treated as property subject to a reservation, and
> (iii) in the case of property in which the chargeable person is beneficially entitled to an interest in possession, to the date of his death or if his interest comes to an end on an earlier date) that earlier date, and
> (b) the transactions to be taken into account in calculating DV included transactions after the time when the election takes effect as well as transactions before that time.

I do not see the purpose or effect of para 21(3)(b) Sch 15 FA 2004. How does this work in the case of an *Ingram* scheme?

76.33.4 *Time limit for election*

Para 23(3) Sch 15 FA 2004 provides:

> The election must be made on or before—
> (a) the relevant filing date, or
> (b) such later date as an officer of Revenue and Customs may, in a particular case, allow..

The key expression is "relevant filing date" which is defined in para 23(1) Sch 15 FA 2004:

> "the relevant filing date" means 31 January in the year of assessment that immediately follows the initial year within the meaning of para 21 or (as the case requires) para 22.

Time runs from when the Schedule begins to apply. Normally that will be 6 April 2005,[74] because in the future no-one will deliberately enter into

74 Or 6 April 2007 for those caught by the reverter to settlor restriction in the FA 2006; see 76.20 (Reverter to settlor restriction).

arrangements caught by the Schedule. But where a person is non-resident or domiciled, the Schedule may not begin to apply until a later time when they become UK resident or domiciled, and in such a case time for the election starts at that later time; a sensible rule.

76.33.5 *Revocation of election*

Para 23(5) Sch 15 FA 2004 provides:

> The election may be withdrawn or amended, during the life of the chargeable person, at any time on or before the relevant filing date.

This will only be useful in very exceptional circumstances.

76.33.6 *Retrospective effect of election*

Para 23(6) Sch 15 FA 2004 provides:

> Subject to sub-para (5), the election takes effect for the purposes of inheritance tax from the beginning of the initial year within the meaning of para 21 or (as the case requires) para 22 or, if later, the date on which the chargeable person would (but for the election) have first become chargeable under this Schedule by reference to the property to which the election relates.

76.34 Election and *Eversden* schemes

If a client has lost their appetite for IHT planning, it would be better to unwind an *Eversden* scheme than to elect. Unwinding an *Eversden* scheme is straightforward.

By contrast, unwinding home loan schemes needs considerable care. Watch out for Fraud on a Power.

76.35 Election in case of home loan schemes

Suppose:

(1) The client ("H") has entered into a home loan plan: H has sold H's home to a trust (before 22 March 2006) ("the property settlement") in return for a debt, and given away the debt.
(2) Under the terms of the property settlement, income is paid to H for life, and then for H's widow ("W") after H's death.
(3) Suppose first of all that the home has not increased in value, so that the net value of the trust fund of the property settlement is nil.
(4) A POA election has been made.
(5) H is survived by W.

76.35.1 *Effect of election*

The chargeable proportion (here = the whole) of the property:

> is to be treated for the purposes of Part 5 of FA 1986 (in relation to the chargeable person) as property subject to a reservation.

So it is treated as property to which H is beneficially entitled.

However, H is already entitled to the property as H has an interest in possession in it. The property is subject to the debt. Is this taken into account in valuing the estate of H on H's death? If so the debt scheme still works! In *IRC v Ayrshire Employers Mutual Insurance Association* 27 TC 331 the House of Lords notoriously said that the legislation had "misfired". But the modern approach of the Courts is to make sure that legislation does not "misfire" if they can. Indeed this approach is not so modern, and in 1965 Lord Diplock criticised the *Ayrshire* decision:

> If the Courts can identify the target of Parliamentary legislation their proper function is to see that it is hit: not merely to record that it has been missed.

76.35.2 *Spouse exemption on death of H*

The IHT spouse exemption provides that the transfer of value deemed to be made on the death of H:

> ... is an exempt transfer to the extent that the value transferred is
> [a] attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner; or
> [b] so far as the value transferred is not so attributable, to the extent that the estate is increased.

See s.18(1) IHTA 1984.

H does not qualify for exemption within [b]. We have to argue that the value transferred is "attributable to property" (the home) "which becomes comprised in the estate of the spouse or civil partner".

Does it? Only subject to the debt. The Revenue may reply that "property" in s.49(1) IHTA means net property and this is supported by *St Barbe Green v IRC*:

> Section 49(1) IHTA 1984 [deems] the deceased to be beneficially entitled to "the property" in which his life interest subsists. It does not say "net property" (i.e. the value of the property net of trust liabilities) but that is what it must mean, and the parties to this appeal both agree

that in practice that is the effect the Revenue gives to the section.[75]

On the facts of the above example, no net property becomes comprised in the estate of the spouse. A purposive construction supports that view. It does not make sense for the spouse exemption to apply there.

The spouse exemption would apply to the extent that the value of the property exceeds the debt.

If the debt were released, the problem disappears and it is clear that the spouse exemption would apply.

76.36 Unwinding existing structures

What is to be done when an existing structure falls within the POA land charge?

Do nothing and pay the POA tax? A suitable option where the client has a short life expectancy. Mitigate the charge by arranging that maintenance costs are deductible: see 76.27.1 (The chargeable amount and deductible expenses).

Elect out of the POA regime? Generally unattractive: you have the IHT charge on death usually without CGT uplift or spouse exemption on death.[76] Consider it if IHT is a long term problem (middle-aged clients). Perhaps a future government will scrap these rules in a decade or so's time.

It may be sensible to elect and retain the structure where:

(1) IHT is not a problem (eg insurance is inexpensive);
(2) Shadow directorship is not a problem (expect an investigation to follow the election); and
(3) A sale of the company is envisaged in the short or medium term. See 76.6.4 (Secondhand company).

In most cases shadow directorship may be a problem; it will usually be better to liquidate the company if IHT, CGT and SDLT issues permit.

The best solution is usually unwinding, or reorganising so as to fall within the estate exemption.

76.37 Is existing scheme validly created?

In *Wolff v Wolff* [2004] STC 1633, a husband and wife entered into a reversionary lease of the property in favour of their daughters for 125

75 [2005] STC 288.

76 See 63.19 (IHT spouse exemption defence to GWR death charge).

years starting from 2017. Subsequently, they became aware that from 2017 they had no right to stay in the property and were at the mercy of the owners of the lease! The lease was set aside for mistake.

76.38 Human rights

The Parliamentary Joint Committee on Human Rights considered the POA provisions to be HR compliant[77] – except (intriguingly) in relation to the spouse exemptions (which deny relief to cohabitees) but no-one took any notice of that. The prospect of a successful human rights challenge now seems slender.

76.39 Commentary

76.39.1 *Nature of the POA charge*

What is the nature of the POA charge? Although the charge is imposed under the Income Tax Acts, it is not an income tax (in the sense that it is not a tax on income or in any way relating to income). To put it another way, the provisions impose an income tax charge on income which does not exist. Once it is accepted that income tax is not in general charged on an individual who occupies their own property[78] then it is anomalous to charge income tax on the benefit of occupation through a trust or company. And since the POA intangible property charge applies even if the property also produces income subject to income tax, it is obviously not income which Schedule 15 is seeking to tax.

The POA charge might be seen as an *ersatz* annual IHT charge on property which has slipped through the IHT net.[79] However, the quantum of the charge is penal (compared to IHT rates).

The true nature of the POA charge is therefore that it is a penalty for carrying out (and not unwinding) certain IHT planning. Hardly anyone is seriously expected to pay it. The object is to force taxpayers (by electing or unwinding) to bring themselves back into the IHT net.[80] The POA charge takes the clothes or label of income tax, but – looking beyond the label to the content – it is not income tax; indeed, it is not a "tax" at all, as that word is properly understood. It is well established that a fee, levy

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77 *http://www.publications.parliament.uk/pa/jt200304/jtselect/jtrights/93/9305.htm*.

78 See Kay and King, *The British Tax System*, (5th ed., 1990), p.80.

79 It is significant that the pre-owned asset charge is dealt with in IHT textbooks and in the HMRC IHT Manual.

80 And to stop similar arrangements being made in the future.

or toll may in fact be a tax despite its name.[81] Likewise provisions carrying the label of a tax do not necessarily constitute a tax.

This point may be relevant to construction, because the principle of construction that penalty provisions are to be strictly construed may have more force than the principle that clear words are required to impose a tax.

76.39.2 *Retrospectivity*

One controversial aspect of the POA regime is that it is retrospective in effect. (One should avoid semantic – indeed Orwellian – debate about the meaning of "retrospective" and look at the effect.) Retrospective legislation is pernicious when it entails liability for conduct which would have been different if the agent had known of the terms of the retrospective law. The POA rules are unashamedly targeted at taxpayers who carried out *Eversden*, *Ingram* and home loan schemes before these were stopped by anti-avoidance legislation.

Those that carried out *Ingram* schemes were particularly unfairly treated. They entered into a package with an IHT advantage (generally) at a significant CGT cost. Parliament removed the benefit and left them with the cost.

In 2004 I said:

> This is unprecedented in the UK tax system, which has traditionally allowed taxpayers to plan their affairs more securely on the basis of the law of the day. One may approve of this as an attack on tax avoidance, or disapprove as contrary to the rule of law. Views may divide on party political lines.

Since 2004, however, retrospective tax legislation has become a matter of routine, having been applied to a somewhat arbitrary selection of tax avoidance schemes and or simply as second thoughts to (what the need for retrospective legislation shows to be) ill thought out legislation.

An interesting question is to what extent this approach will continue under the coalition government. Only time will tell.

76.39.3 *Assessment*

No doubt the POA rules bring some revenue for the Government, though how much is a matter of speculation. Set against the tax raised (whatever

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81 *Re a By-law of the Auckland City Council* [1924] NZLR 907 at p.911.

it is) and the blow against tax avoidance (however one values or regards that) there are some entries to make on the debit side: the POA rules impose significant costs of compliance and tax planning (for they require taxpayers to incur professional fees in order to rearrange their affairs). They impose the unquantifiable burden of complexity and uncertainty which (combined with unfairness) will lead to an equally unquantifiable loss of taxpayer goodwill. One cannot put a value on that goodwill, but it is essential to successful tax administration.

Back in 2004, I think everyone who understood and cared about the UK tax system was aghast at the conception, enactment process and administration of the POA provisions.[82] Looking back with hindsight it can be seen that the provisions were not an aberration. They are the natural result of a fiscal policy with one and only one priority, the attack on tax avoidance, set against which any other *desiderata* of a tax system count for very little and views of practitioners count for nothing at all.

The HMRC change of view that home loan schemes are caught by the GWR rules is the icing on the cake of poor administration.

It is suggested that

(1) The POA intangible property charge should be repealed except for transactions carried out before the anti-Eversden legislation enacted in 2003. That would be more or less a repeal.

(2) The POA land and intangible property should be repealed and replaced by an IHT charge on the death of the person who carried out *Ingram* or Home Loan arrangements (with credit for POA charges if paid). If this was restricted to death after the new rules comes in, it should not be regarded as offensively retrospective.

That would be a valuable simplification.

82 "The anti-avoidance Pre-Owned Assets regime ... is: retrospective in its effect, disproportionate to the mischief at which it is purportedly aimed, contrary to taxpayers' legitimate expectations, and arbitrary ... ."
CIOT and ICAEW Tax Faculty (October 2004).

CHAPTER SEVENTY SEVEN

JOINT ACCOUNTS

77.1 Introduction

This chapter considers a joint bank or building society account held by two account holders. I refer to money in the account as "account money".

I consider the following topics:

(1) IHT on payments into and out of the account
(2) Who is the settlor on a payment out of the account
(3) Taxation of income arising on the account
(4) Remittances from the account

77.2 The property law background

First one must ascertain the rights of the account holders. It would need a chapter to analyse the relevant case law.[1]

There is an important distinction between:

(1) an account on which either account holder can draw a cheque;
(2) an account on which both account holders must sign a cheque.

This chapter only considers the first type of account.

In outline, three distinct questions arise:

(1) *Beneficial ownership of the account money while in the account.* The possibilities are:
    (a) Entitlement in equal shares (the most common case)

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1 For a summary see *Dymond's Capital Taxes* (looseleaf 1986 onwards), para 10.400; Law Commission, "Cohabitation: the financial consequences of relationship breakdown" Law Com No 307 (2007), para A.46, accessible *http://lawcommission.justice.gov.uk*.
Further consideration is needed for an account not governed by English law (but an English court will assume English law principles apply in the absence of evidence to the contrary). English law principles apply in Ireland: *Lynch v Burke* ITR Vol 5 p.271.

(b) Entitlement in proportion to contributions and withdrawals[2]
(c) One account holder beneficially entitled to the whole.

(2) *Beneficial ownership of money withdrawn from the account* (or assets purchased with that money). The possibilities are:
(a) Individual who withdraws funds becomes beneficial owner (the most common case)[3] or
(b) Same as beneficial ownership of the account money (as to which see above).

(3) *Beneficial ownership of account money on death of an account holder*. The possibilities are:
(a) The survivor is beneficially entitled by survivorship.
(b) The deceased owner's share (as to which see (1) above) passes under their will or intestacy.

The answer to one of these three questions does not determine the answers to the others. For instance, account money may belong beneficially to one of the account holders, eg H and W may hold as nominees for H. Such an account may be held on terms that:

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2 In practice the court will assume this is not the case unless there is evidence, such as appropriate records kept by the account holders. *Sillars v IRC* [2004] STC (SCD) 180 at [11] gives cogent reasons for rejecting this analysis for the parent/child account.

3 See *Re Bishop* [1965] Ch 450 at p.456:
"Where a husband and wife open a joint account at a bank on terms that cheques may be drawn on the account by either of them, then, in my judgment, in the absence of facts or circumstances which indicate that the account was intended, or was kept, for some specific or limited purpose, each spouse can draw upon it not only for the benefit of both spouses but for his or her own benefit. Each spouse, in drawing money out of the account, is to be treated as doing so with the authority of the other and, in my judgment, if one of the spouses purchases a chattel for his own benefit or an investment in his or her own name, that chattel or investment belongs to the person in whose name it is purchased or invested: for in such a case there is, in my judgment, no equity in the other spouse to displace the legal ownership of the one in whose name the investment is purchased. What is purchased is not to be regarded as purchased out of a fund belonging to the spouses in the proportions in which they contribute to the account or in equal proportions, but out of a pool or fund of which they were, at law and in equity, joint tenants. It also follows that if one of the spouses draws on the account to make a purchase in the joint names of the spouses, the property purchased, since it is purchased in joint names, is, prima facie, joint property and there is no equity to displace the joint legal ownership. There is, in my judgment, no room for any presumption which would constitute the joint holders as trustees for the parties in equal or some other shares."

(a) on the death of H, the account money passes to W by survivorship;[4] or
(b) the account money may pass under the will of H.

The permutations are almost endless. Note that joint tenancy/tenancy in common is not a comprehensive categorisation since those two terms alone are insufficient to determine the answers to the three questions which may arise.

The property law position depend on the intention of the account holders. In practice spouses and cohabitees generally operate joint accounts without giving any consideration to the ownership of the money; there is just a general desire to pool resources. A search for intention is unrealistic, and the default position is that:

(1) Account money is beneficially owned in equal shares.
(2) Withdrawals belong to the account holder who withdraws the funds.
(3) Beneficial ownership passes by survivorship.

I refer to this as a **"common form account"**.

The circumstances in which parent/child joint accounts arise are different so the rights of the account holders tend to be different. For instance, the terms of the account may be that:

(a) One account holder ("P") may withdraw up to the whole amount of P's benefit and the others may make no withdrawal at all during P's lifetime.
(b) The balance may pass to the survivor by survivorship.[5]

In this case the fund is in the estate of P for IHT purposes. The funds are not in the estate of the other account holder during the life of P: their rights have no substantial value.

The following analysis applies to a common form account.

Further consideration is needed if one party to the account has lost legal capacity.[6]

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4 As in the parent/child joint account *O'Neill v IRC* 1998 STC (SCD) 110; the apparent breach of the Wills Act 1837, and the possibility that this is a settlement for IHT, are tacitly ignored.

5 This was found to be the case on the facts in *Sillars v IRC* [2004] STC (SCD) 180.

6 According to the British Bankers Association: "If you are the joint account holder and the other joint account holder becomes mentally incapable, you do not automatically have the right to access the account unless you have a Lasting Power of Attorney, Enduring Power of Attorney or an order from the Court of Protection." Banking for people who lack capacity to make decisions England and Wales (2010); *http://www.bba.org.uk/media/article/banking-for-people-who-lack-capacity-to-make-decisions*

77.3 Joint account: IHT

77.3.1 *Account money in estate of both account holders*

In strict law the *whole* of the account money is in the estate of both account holders, under s.5(2) IHTA which provides:

> A person who has a general power which enables him... to dispose of any property other than settled property, ... shall be treated as beneficially entitled to the property ... and for this purpose "general power" means a power or authority enabling the person by whom it is exercisable to appoint or dispose of property as he thinks fit.[7]

Beneficial ownership is therefore irrelevant for IHT and GWR is irrelevant on death of an account holder.

77.3.2 *Payment into joint account by one account holder*

Payment into the joint account by an account holder is not a transfer of value because the estate of the payor is not decreased by the payment. HMRC agree. The IHT Manual provides:

> **15043 Lifetime gifts arising out of a transfer of an account into joint names** [September 2011]
> Where A places money in a joint account (IHTM15042) in the names of A and B as joint tenants (IHTM15082) and retains the right to withdraw the whole of it, as a general rule there will not be a lifetime transfer (IHTM15060) at the time the money is paid into the account.

Payment into the joint account by an account holder is not a GWR. HMRC do not accept that[8] but in practice GWR does not often matter.

I find that somewhat surprising, but it may depend on the documentation of the account.

7 This was accepted without discussion in the Court of Appeal in *IRC v Melville* 74 TC 372 at [36]:
"... the inheritance tax regime produces instances of double taxation ... A clear example is one falling within s 5(2) of the Act, the very common case of a joint bank account which permits any holder to draw on that account. The same property, the moneys in the account, is under s 5(2) taxable on the death of each holder. The Revenue in practice do not strictly enforce that provision and treat each holder as beneficially entitled only to the proportion of monies in the account which he has contributed".

8 The IHT Manual is garbled; so far as relevant it provides:
"15061 Gifts with reservation [September 2011]
An example of a joint ownership arrangements involving a GWR is ... if ... A

77.3.3 *Death of an account holder*

Each account holder is strictly subject to IHT on death on the whole of the account money (subject to exemptions such as the spouse exemption). This rule would result in double taxation but that is undone by concession. The IHT Manual provides:

> **15042 Joint money accounts** [September 2011]
> Applying the Inheritance Tax provisions (IHTM15012) to joint accounts can be particularly difficult. In practice:
> - You should normally regard each account holder as beneficially entitled (IHTM15011) to the proportion of the account which is attributable to their contributions. So - if the deceased provided the whole of the money, the whole of the account at death should be included in the IHT400 (IHTM10021)
> - When calculating this proportion you should assume that any money withdrawn by each person should be set as far as possible against their own contributions, despite the rule in *Clayton's Case* [1816] 1 Mer 572
> - You may want to make enquiries about any withdrawals made from funds the deceased provided by the other joint owner(s) as these are likely to be lifetime transfers (IHTM15043). You should pay particular attention to joint accounts opened shortly before the death.
> - In most cases each joint owner has an unrestricted right to withdraw any part of the amount in credit in the account and keep the funds for their own use (for example, see *Re Bishop* [1965] Ch 450). *You should not use the fact that this right exists to argue that tax is due (for example, by referring to the definition of 'property' in IHTA84/S272 or the 'general power' provision in IHTA84/S5(2)) on a share of the account that is greater than the share provided by the*

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transfers ... a joint money account into joint beneficial ownership of himself and his son, and then A either

- receives (or has the right to receive) all the ... interest for his own benefit or
- has the right to withdraw all the money in the joint account for his own benefit."

Possibly the Manual means to say that there is a GWR if A transfers *his money* into a joint account and has the right to withdraw all the money. This view is supported by *Sillars v IRC* [2004] STC (SCD) 180 (where the taxpayer was not represented by counsel). But it is considered that a payment into an account of this kind is not a disposal by way of gift. If it were a GWR, many difficulties arise which the Tribunal did not consider in *Sillars*. On the death of A, however, since the property is in the estate of the individual, it does not matter whether payment into the account was a GWR.

joint owner.

- When establishing the share based on the deceased's contributions you should note that the true legal position is far from clear so it is important to establish the facts and obtain any relevant documents, such as application forms, withdrawal mandates, passbooks, terms and conditions of account before considering the legal and equitable rules...

77.3.4 *IHT spouse exemption on death of account holder*

This section considers the IHT spouse exemption on the death of an account holder. For the IHT spouse exemption generally see 67.1 (IHT spouse exemption).

There are two possibilities:

(1) The account holders may not qualify for the spouse exemption because:
   (a) They are married but one is, and one is not, UK domiciled.[9] (This scenario is closest to the themes of this book, but one cannot examine it in isolation from the others.)
   (b) They are cohabitees.
   (c) There is some other unmarried relationship, such as parent and child.

(2) The account holders may qualify for the IHT spouse exemption.

In the second case, the IHT spouse exemption applies to the transfer of value on the death of an account holder. HMRC agree. The IHT Manual passage continues:

> Refer to TG (IHTM01081) any case in which the parties dispute the claim. However, there is no need to refer if the deceased's interest passes to an exempt beneficiary, such as a surviving spouse or civil partner (IHTM11032). You should also avoid questions and arguments on this subject unless the amount of tax at stake is substantial.

This is correct, though it needs a slightly purposive construction to say that property "becomes comprised" in the estate of the surviving spouse when the property is already in that estate.

77.3.5 *One account holder pays in and other withdraws*

Suppose:

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9 In this section I ignore the limited IHT spouse exemption and the 2013 election rules.

(1) A transfers A's money into the joint account held by A and B and
(2) B withdraws that money into B's own name.
A's estate is reduced at stage (2).

A does not make a transfer of value at stage (2) within the normal definition, as that requires a disposition. Section 3(1) IHTA provides (in short):

> ... a transfer of value is a disposition made by a person ... as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition...

A does not make a disposition.

One might think that A makes a transfer of value by omission under s.3(3) IHTA. This provides:

> Where the value of a person's estate is diminished, and the value—
> (a) of another person's estate, or
> (b) of any settled property, other than settled property treated by s.49(1) below as property to which a person is beneficially entitled,
> is increased by the first-mentioned person's omission to exercise a right, he shall be treated for the purposes of this section as having made a disposition at the time (or latest time) when he could have exercised the right, unless it is shown that the omission was not deliberate.

But the value of the estate of B, the account holder who withdraws the funds, is not increased so s.3(3) does not apply.

However, s.272 IHTA provides an extended definition of "disposition":

> "disposition" includes a disposition effected by associated operations;

It is considered that A makes a disposition (and hence a transfer of value) by associated operations at stage (2). Section 268(3) IHTA provides:

> Where a transfer of value is made by associated operations carried out at different times it shall be treated as made at the time of the last of them;[10]

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10 For completeness: s.268(3) continues with a proviso:
> "...but where any one or more of the earlier operations also constitute a transfer of value made by the same transferor, the value transferred by the earlier operations shall be treated as reducing the value transferred by all the operations taken together, except to the extent that the transfer constituted by the earlier operations but not that made by all the operations taken together is exempt under s.18 above."

"Associated operation" is defined in s.268(1) IHTA. This provides (so far as relevant):

> (1) In this Act "associated operations" means ... any two or more operations of any kind, being—
>
> (a) operations which affect the same property, or one of which affects some property and the other or others of which affect property which represents, whether directly or indirectly, that property, or income arising from that property, or any property representing accumulations of any such income, or
>
> (b) any two operations of which one is effected with reference to the other, or with a view to enabling the other to be effected or facilitating its being effected, and any further operation having a like relation to any of those two, and so on,
>
> whether those operations are effected by the same person or different persons, and whether or not they are simultaneous; and "operation" includes an omission.

The associated operations are:
(1) A's payment into the account.[11]
(2) B's withdrawal from the account.
HMRC agree. The IHT Manual provides:

> **15043 Lifetime gifts arising out of a transfer of an account into joint names** [September 2011]
>
> Where A places money in a joint account (IHTM15042) in the names of A and B as joint tenants (IHTM15082) and retains the right to withdraw the whole of it, as a general rule there will not be a lifetime transfer (IHTM15060) at the time the money is paid into the account. But if any part is subsequently withdrawn for the benefit of B, the other joint owner, there may be a transfer at that time.
>
> Refer to TG any case where
>
> - there is such a withdrawal
> - it is claimed that there was an immediate gift when the money was paid into the joint account
> - there is evidence that an immediate gift was intended, or
> - the position is more complicated, for example where withdrawals need both signatures
>
> **(This text has been withheld because of exemptions in the Freedom**

But that is not relevant here.

11 It might be argued that the associated operation is A's omission to withdraw from the account; it makes no difference if this is the case.

of Information Act 2000)
15042 Joint money accounts [September 2011]
...You may want to make enquiries about any withdrawals made from funds the deceased provided by the other joint owner(s) as these are likely to be lifetime transfers (IHTM15043). You should pay particular attention to joint accounts opened shortly before the death.....

77.3.6 *IHT spouse exemption on lifetime withdrawal*

The IHT spouse exemption may apply to the transfer of value on the lifetime withdrawal by an account holder. Since HMRC accept the application of the spouse exemption on death, they must also accept its application during the lifetime of the account holders.

The exemption does not of course apply when one spouse is and the other is not UK domiciled because the IHT spouse exemption is restricted. The transfer of value takes place when the funds are withdrawn from the account so that is the point where the conditions for the spouse exemption need to be satisfied. For instance if:

(1) Year 1: H makes a payment into the joint account
(2) Year 2: W makes a payment from the joint account

The IHT spouse exemption applies if the conditions for the exemption are satisfied in Year 2. It does not matter whether or not they are satisfied in Year 1.

77.3.7 *One account holder pays in and same account holder withdraws*

Suppose:

(1) A transfers A's money into the joint account held by A and B.
(2) A withdraws that money into A's own name.

A does not make a transfer of value. What about B? B's estate is reduced at stage (2). But it is considered that B makes no transfer of value. Section 3(3) IHTA does not apply.[12] It might be said that B makes a transfer of value by associated operations, but although B makes an omission, which is an associated operation, B does not make a transfer of value by associated operations, since he does not make a disposition. That is consistent with the policy of s.3(3) IHTA.

77.3.8 *Third party pays into account*

The discussion above assumes that the account money is provided by one

12 See 77.3.5 (One account holder pays in and other withdraws).

or both account holders.

Suppose:

(1) A third party ("C") transfers C's money into a joint account held by A and B.

(2) A dies.

In strictness A is taxed on the whole account, but by concession it appears that A is taxed on half. The IHT Manual provides:

> **15042 Joint money accounts** [September 2011]
> *Example*
> A, B and C share a joint account. They all contribute to it. A dies and his proportion of the account accrues by survivorship to B and C. After A's death, the entitlement of B and C should take into account A's contributions.
> **(This text has been withheld because of exemptions in the Freedom of Information Act 2000)**

Presumably this means that after A's death, B and C are each regarded as entitled to (1) their own contributions to the account and (2) half of the contribution of A.

Suppose:

(1) A third party transfers their money into a joint account held by A and B and

(2) A withdraws that money into A's own name.

It is considered that B does not make a transfer of value; see 77.3.7 (One account holder pays in and same account holder withdraws).

77.3.9 *Payment out of account by way of gift*

If B draws on the account to make a gift to a third party donee, B makes a transfer of value.

If A had paid the account money into the joint account A has also made a transfer of value by associated operations at the time of B's withdrawal.[13] But that is not the case if B, or a third party, has provided the funds. Thus the gift by B gives rise to two transfers of value, a transfer of value by A and a transfer of value by B. It may be in practice HMRC would allow some concession.

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13 A does not make a transfer of value under s.3(3) IHTA because although the estate of the third party donee is increased, it is not increased by any failure to exercise a right. But A does make a transfer of value by associated operations.

77.4 Who is the settlor of trust made from joint account

If a trust is created by a payment from a joint account, it is considered that the account holder who writes the cheque or makes the transfer is the settlor. The other account holder is only the settlor if they have provided the property indirectly for the settlement, which requires some element of arrangement; see 80.4 (Gift from A to B followed by gift to trust by B).

77.5 Scottish joint account

The IHT Manual provides:

> **15050. Special destinations and proof of donation** [September 2011]
> If two or more people purchase an asset jointly there may be a contractual agreement between them which determines how the property passes on death.
> If the title is just in their joint names, such as to A and B, they own an equal share which passes to their executors (IHTM05012) on their deaths and is part of their free estate.
> But if the title is to A and B and the survivor and they have paid equally for the asset, the survivor will be entitled to the whole on the death of the first to die (*Perrett's Trs v Perrett* [1909] 46 SLR 453). This is known as special (or survivorship) destination.
> Both parties do, however, have the right to dispose of their shares in life (*Steele v Caldwell* [1979] SLT 228), which will defeat the operation of the special destination.
> If the price was not provided equally the question of whether the donor has conferred an immediate beneficial interest (IHTM15011) on the other party will depend on their intention. Such a donor can revoke the survivorship destination, explicitly, by Will (IHTM12047) under s.30 Succession (Scotland) Act 1964. But the donee may not do the same to defeat the donor's right to the whole of the asset.
> If the whole of a joint asset was provided by one person they retain ownership of the whole until they put title into joint names, or, by some other act, show they intend to make an immediate gift to the other joint owner.
> - Proof of gift requires evidence of both intention and delivery. Evidence of intention does not need to be in writing and oral evidence is acceptable.
> - Delivery may be:
>   - actual, for example, physically handing over the asset to the donee, or
>   - constructive, for example, handing over one book from a collection.
>
> If there is no immediate gift (by intention and delivery) the asset remains part of the provider's estate and will only pass to the other under the survivorship destination on their death, unless the Will contains a clause that explicitly revokes it and conforms to s.30 Succession (Scotland) Act 1964.
> **15051. Joint money accounts** [September 2011]
> The fact that a bank account is held in joint names and that receipts for deposits into it are issued in joint names does not necessarily mean it is held in equal

shares. Neither does it mean there is survivorship destination. The extent of each owner's interest will be a question of fact depending on

- the extent of their identifiable contributions, and
- if contributions are unequal whether there can successfully be established donation (IHTM15050) by the greater contributor to the other, or alternatively, whether the asset was held in joint names merely for administrative convenience

You should resist any suggestion by the taxpayer or agent that the terms in which the account is held can effect either a lifetime gift - or pass the property to a survivor, unless there is other supporting evidence. Any cases of difficulty should be referred to Technical.

15052. Land [September 2011]

The title to heritage is proof of its ownership, and the owners interests in it – unless there is evidence to the contrary, normally by way of written document. If there is no special destination (IHTM15050) and there is equal provision of the price, each co-owner can dispose of his own share as part of his estate and there is no accretion among them.

If spouses or civil partners (IHTM11032) are the joint owners you should keep the 'related property' (IHTM09731) provisions in view (S.161 IHTA 1984).

If it is claimed the beneficial interests (IHTM15011) vary from those indicated by the title and the absence of gift is claimed, strong proof is required of parties intentions such as a contemporaneous writing. In cases of difficulty refer to TG (IHTM01081).

15053. Which law to apply to joint investments owned by someone domiciled in Scotland [September 2011]

Scottish law applies to shares of a company registered in Scotland. If the IHT400 (IHTM10021) or other account does not indicate whether a company is Scottish or not, you should be able to find this information on the Internet. If the taxpayer is of Scots domicile (IHTM13000) a joint holding in Government Stock may be regarded as subject to Scots law (*Cunningham's Trs v Cunningham* [1924] SLT 502).

15054. Joint money accounts and special destination [September 2011]

Under Scots Law where Bank or Building Society Accounts are held in joint names and the survivor the special (or survivorship) destination (IHTM15050) does not by itself pass the ownership of the money in the account to the survivor. An account with a Bank or Building Society is not a document of title as it is not a Deed of Trust in terms of the Bank Bonds and Trusts Act 1696. It is a contract between the Bank and the customer which regulates the conditions on which the account is to be operated and is for administrative convenience only. See for example *Cairns v Davidson* 1913 SC 1054.

For this reason the ownership of the funds in the account is determined according to the ordinary principles of ownership. The owner of the funds in the account remains the owner unless and until some transfer of ownership occurs.

Example

James and Lucy (who are married) open an account, governed by Scots law, in their joint names and the survivor. James has provided all he funds. James dies and is survived by his wife, Lucy. On his death:

- In the absence of any act of transfer of ownership to Lucy (for example, a separate Deed of Gift) the whole account should be included in the IHT400.
- If the account passes to (say) the children under the terms of James' Will then the asset will be chargeable to Inheritance Tax
- If the account passes to Lucy under the terms of the will (IHTM11032) then exemption under IHTA84/S18 will apply/

This applies to all Bank/Building Society accounts governed by Scots Law. So it will apply to taxpayers living in England, Wales and Northern Ireland who have an account which is governed by Scots Law.

For the Scots law position see Meston, "Survivorship destinations and bank accounts" 1996 SLPQ 315; Kerrigan, "Special destinations – survivorship and bank accounts revisited" 2011 SLT 5; the Trusts Discussion Forum (May 2007) under the thread "Scottish bank accounts".[14]

77.6 Remittances from joint accounts

This section considers remittance aspects of joint accounts.

The RDR Manual provides:

> **33510 Joint Accounts** [July 2010]
> *... Analysing the account*
> Where an individual has a "joint account" with someone else and one or both of them chooses to be taxed on the remittance basis it is necessary to fully analyse the account (with due regard being given to the "exceptions" identified above). You will need to do this in order to apply Step 1 s.809Q(3) ITA 2007 which deals with transfers from mixed funds and requires you to find each of the categories of the remittance basis user's income and gains in the mixed fund. A joint account will almost certainly be a mixed fund.
> Analyse the account by putting each credit to the account into separate columns, divided between each individual.
> Likewise with the debits; transfers out of the account that are clearly made by or for one or other of the individuals and intended to be made out of "their" share of the income should be debited "under" their column.
> "Joint" expenses, for example items such mortgage payments where the debt is held jointly, or council tax bills and so on may, if appropriate, be split equally between each individual. Alternatively, such debits may be fully appropriated to just one of the account holders if that reflects the reality of their joint financial arrangements; for example it may be that only one partner is working and contributes most of the "credits" to the account in the form of their income. In such circumstances it may be more appropriate to attribute all expenditure to that partner in so far as the overall balance of the account permits. When separating the account in this way it is important that the overall balance remains consistent.

14 Accessible *http://www.trustsdiscussionforum.co.uk*

In practice you should try to take the most pragmatic approach that best reflects the reality of both individuals' situations.

Cases where only one account holder is a remittance basis user

Individuals who are not using the remittance basis are liable to tax on the arising basis, so they will, where appropriate, have paid UK tax in respect of their share of the income and gains that have been credited to the joint account in the tax year. Because UK tax has been (or will be) paid by that individual he or she may bring to the UK or otherwise use their share of the funds that are in the account in any way they wish without triggering an additional tax charge.

However, if at any time during the year they bring to the UK or otherwise use amounts in excess of their share of the funds in the joint account at that point in time then they will be regarded as using their partner's income or gains instead.

Example:

An offshore bank account was opened on 20 June. It is held jointly by A and B, who are civil partners. A is a remittance basis user in this year. The account shows:

Date	**Credit (Debit)**	**Balance**	**Attributable to**
20 June	£2,000	£2,000	A – foreign earnings
27 June	£1,000	£3,000	A – relevant foreign income
1 July	(£800)	£2,200	B – cash taken out in London
27 July	£90	£2,290[15]	B – UK rental income

In analysing the account you need to look at what was in the account i**mmediately before** each debit. In this case, the cash withdrawn by B in London on 1 July can only be attributed to A's income credits and, as B is relevant person, A will be regarded as having remitted that £800.

Remember that in most cases the account holders are likely to be relevant persons in relation to each other, so even transfers from the non-remittance basis using individual may be a taxable remittance on the other partner if it is regarded as consisting of or deriving from the other partner's foreign income or gains.

Cases where both account holders are remittance basis users

You will still need to analyse the account in order to determine which transfers from the mixed fund are taxable remittances, and to determine which account holder is liable to pay any tax due. Again, you should try to take the most pragmatic approach that best reflects the reality of the situation.

Once the account has been split between the individual account holders, any taxable remittances of the foreign income or gains that are the property of the remittance basis user are subject to the normal "ordering" rules that apply to remittances from a "mixed fund".

The following example demonstrates the principles of analysing a joint account and then determining whether the "transfers" are a taxable remittance from a mixed fund. You will also need to refer to RDRM35230 Remittances from mixed funds.

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15 I have corrected an arithmetical mistake in the original; the exact figures in this line do not matter.

RDRM33515 - Remittance Basis: Identifying Remittances: Specific Topics: Joint Accounts - example [June 2010]

(Erica and John)

E and J have been married for several years, and currently live in the UK. J is domiciled within the UK. E is not domiciled in the UK. E decides to claim the remittance basis for this year.

Both E and J have employment income that is credited to the account. For most of the year E works in the UK but she also has a separate part-time employment with a foreign employer outside of the UK for part of the year.

E and J have a joint bank account in the Isle of Man. Into this account is paid both of their salaries, and some bank interest. They use the account to pay their household bills, including the mortgage on their jointly owned UK home.

Table to show the amounts credited to the account

Date		**Credit (Debit)**	**Balance**
	Opening Balance		£0
30 April	UK salary (Erica)	£3,000	£3,000
30 April	UK salary (John)	£2,000	£5,000
30 April	Overseas salary (Erica)[16]	£2,000	£7,000
30 April	Bank interest not taxed	£200	£7,200
1 May	Direct debit - UK energy co	(£200)	£7,000
5 May	Cash withdrawal (UK)	(£1,000)	£6,000
10 May	Cash withdrawal (UK)	(£1,000)	£5,000
17 May	Direct debit - mortgage	(£3,000)	£2,000
31 May	UK salary (Erica)	£3,000	£5,000
31 May	UK salary (John)	£2,000	£7,000
31 May	Overseas salary (Erica)	£800	£7,800
1 June	Direct debit - UK energy co	(£200)	£7,600
5 June	Cash withdrawal (UK)	(£1,000)	£6,600
10 June	Cash withdrawal (UK)	(£800)	£5,800
17 June	Direct debit - mortgage	(£3,000)	£2,800

The credits and the debits account can be analysed between E and J with the following results:

		Erica Credit	**Erica Balance**	**John Credit**	**John Balance**	**Joint a/c Balance**	**Note**
30 Apr	UK salary	£3,000	£3,000			£3,000	1
30 Apr	UK salary			£2,000	£2,000	£5,000	1
30 Apr	Overseas salary	£2,000	£5,000			£7,000	
30 Apr	Bank interest	£100	£5,100	£100	£2,100	£7,200	2
1 May	Debit to UK co	(£100)	£5,000	(£100)	£2,000	£7,000	
5 May	Cash to UK	(£1,000)	£4,000			£6,000	3
10 May	Cash to UK			(£1,000)	£1,000	£5,000	3
17 May	Mortgage pay't	(£2,000)	£2,000	(£1,000)	£nil	£2,000	4
31 May	UK salary	£3,000	£5,000			£5,000	
31 May	UK salary			£2,000	£2,000	£7,000	

16 The example adds: *not subject to foreign tax*.

31 May	Overseas salary	£800	£5,800			£7,800	
1 Jun	Debit to UK co	(£100)	£5,700	(£100)	£1,900	£7,600	
5 Jun	Cash to UK	(£1,000)	£4,700			£6,600	
10 Jun	Cash to UK			(£800)	£1,100	£5,800	
17 Jun	Mortgate pay't	(£1,900)	£2,800	(£1,100)	Nil	£2,800	4

Note 1: Earned income is attributed to the employee only

Note 2: Because this is a joint account, the interest arising on it is split equally between E and J.

Note 3: This money is withdrawn in the UK by J and E to meet their own personal expenditure, for example travel, meals and so on.

In this example J's "personal expenditure" can be attributed to his "income" credits into the account.

If instead the withdrawals by J were regarded as coming from E's "portion" of the pot, because J is a relevant person and money has been brought into the UK by a relevant person (so Condition A of s.809L(2)(a) ITA 2007 is met) there might still be a taxable remittance, with the tax due payable by E (see below).

Note 4: The mortgage payment is made to a UK bank. The mortgage is held on J and E's UK home and is a joint debt of E and J, and each contributes half of the cost. To the extent that J has money in the account it can be accepted that he has used his taxed income to pay his share of the mortgage.

Money has been brought into the UK to pay this mortgage, so Condition A of s.809L(2)(a) ITA 2007 is met and there is a "transfer" from a mixed fund.

Because this is a mixed fund s.809Q(2) ITA 2007 is in point. So in order to determine whether this money is regarded as consisting of, or deriving from, a remittance basis users' foreign income or gains (such that there is a taxable remittance under Condition B of s.809L(2)(a) ITA 2007) it is necessary to look at the composition of the fund immediately before the "transfer".

This shows that £2,000 of the mortgage payment made on 17 May must be attributable to E's income or gains in the mixed fund. Similarly, £1,900 of the mortgage payment of 17 June is attributable to E's income in the mixed fund.

So far as E is concerned, her share of the account shows (for the purposes of calculating if and to what extent she has made a taxable remittance of her overseas income) is as follows:

E's share of the account		**Credit (Debit)**	**E's balance**	**Category**
30 April	UK salary	£3,000	£3,000	(a)
30 April	Overseas salary[17]	£2,000	£5,000	(b)
30 April	Bank interest	£100	£5,100	(d)
1 May	Direct Debit (energy co)	(£100)	£5,000	
10 May	Cash	(£1,000)	£4,000	
17 May	Direct Debit (mortgage)	(£2,000)	£2,000	
31 May	UK salary	£3,000	£5,000	(a)
31 May	Overseas salary	£800	£5,800	(b)
1 June	Direct Debit (energy)	(£100)	£5,700	

17 The example adds: *not subject to foreign tax*.

5 June	Cash	(£1,000)	£4,700
17 June	Direct Debit (mortgage)	(£1,900)	£2,800

Applying the rules at s809Q ITA 2007 to the first "transfer" to the UK, which is the payment to the energy company on 1 May. Remember the mixed fund rules require the account to be analysed before every "transfer"

Step 1 – Identify the "amount of transfer" in the relevant year		**£100**
Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer	**Para (a)** Employment income (UK employment income)	£3,000
	Para (b) Relevant foreign earnings (not subject to a foreign tax)	£2,000
	Para (d) Relevant foreign income (not subject to a foreign tax)	£100
Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£3,000

Step 3 If the amount at Step 2 is equal to or more than the amount of the transfer treat the whole of the remaining amount of the transfer as coming from that item of income or gain

So E's transfer of £100 is treated as coming from her UK employment income; it is not thus a "taxable" remittance when brought to the UK.
Then apply the rules at s.809Q ITA 2007 to the next "transfer" to the UK, which is the cash withdrawal.

Apply the rules at s.809Q ITA 2007 to the next "transfer" to the UK, which is the cash withdrawal

Step 1 – Identify the "amount of transfer" in the relevant year		**£1,000**
Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer	**Para (a)** Employment income (UK employment income)	£2,900
	Para (b) Relevant foreign earnings (not subject to a foreign tax)	£2,000
	Para (d) Relevant foreign income (not subject to a foreign tax)	£100
Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£1,900

Step 3 If the amount at Step 2 is equal to or more than the amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain

So E's transfer of £1,000 is treated as coming from her UK employment income; it is not thus a "taxable" remittance when brought to the UK.
Then apply the rules at s809Q ITA 2007 to the next "transfer" to the UK, which is the mortgage payment.

Then apply the rules at s809Q ITA 2007 to the next "transfer" to the UK, which is the mortgage payment

Step 1 – Identify the "amount of transfer" in the relevant year		**£2,000**
Analyse mixed fund to identify the separate amounts of income, capital gains and capital present for each tax year immediately before the date of the transfer	**Para (a)** Employment income (UK employment income)	£1,900
	Para (b) Relevant foreign earnings (not subject to a foreign tax)	£2,000
	Para (d) Relevant foreign income (not subject to a foreign tax)	£100
Step 2 – Identify the earliest paragraph above for the relevant year, which has an amount of income or gain in the mixed fund	**Para (a)**	£1,900
Step 3 Where the amount transferred is greater than the amount identified at Step 2 the amount transferred is treated as reduced by the amount identified in Step 2.		£2,000 -£1,900 £100
Step 4 - Find the next paragraph/amount for that tax year. In the order of preference listed above repeat Steps 2 and 3.		
Step 2 - repeated	**Para (b)**	£100

Step 3 If the amount at Step 2 is equal to or more than the amount of the transfer (the last time step 3 was completed) treat the whole of the remaining amount of the transfer as coming from that item of income or gain

> £1,900 of the transfer is treated as coming from E's UK employment income; it is not thus a "taxable" remittance when brought to the UK. The remaining £100 is treated as a remittance of £100 of E's untaxed overseas earnings.

The HMRC analysis stops here. There are in fact three more debits to analyse, but the reader will have the idea. Note that the incomplete analysis of a bank account with only 15 entries has taken 5 pages. It seems safe to say that these are rules which never have, never can and never will be applied in practice. I expect HMRC will accept any reasonable approximation.

77.7 Income from property held jointly by spouses

Section 836 ITA provides:

> (1) This section applies if income arises from property held in the names of individuals—
>
> (a) who are married to, or are civil partners of, each other, and
>
> (b) who live together.
>
> (2) The individuals are treated for income tax purposes as beneficially entitled to the income in equal shares.

Section 836(3) sets out 7 exceptions, of which the first two are the most important:

> (3) But this treatment does not apply in relation to any income within any of the following exceptions.
> *Exception A* Income to which neither of the individuals is beneficially entitled.
> *Exception B* Income in relation to which a declaration by the individuals under section 837 has effect (unequal beneficial interests).
> *Exception C* Income to which Part 9 of ITTOIA 2005 applies (partnerships).
> *Exception D* Income arising from a UK property business which consists of, or so far as it includes, the commercial letting of furnished holiday accommodation (within the meaning of Chapter 6 of Part 3 of ITTOIA 2005).
> *Exception DA* Income arising from an overseas property business which consists of, or so far as it includes, the commercial letting of furnished holiday accommodation (within the meaning of Chapter 6 of Part 3 of ITTOIA 2005) in one or more EEA states.
> *Exception E* Income consisting of a distribution arising from property consisting of—
> (a) shares in or securities of a close company to which one of the individuals is beneficially entitled to the exclusion of the other, or
> (b) such shares or securities to which the individuals are beneficially entitled in equal or unequal shares.
> "Shares" and "securities" have the same meaning as in section 1117 of CTA 2010.
> *Exception F* Income to which one of the individuals is beneficially entitled so far as it is treated as a result of any other provision of the Income Tax Acts as—
> (a) the income of the other individual, or
> (b) the income of a third party.

77.7.1 *Settlor-interested trust provisions*

The income taxation of joint accounts has been thrown into disarray by the decision in *Bingham v HMRC*.[18] In this case, Mr Bingham ("H") transferred money into an account in the joint names of himself, his wife and his adult children. The object was to ensure that the wife and children had income within their personal allowances. The tribunal held that H

18 [2013] SFTD 689.

remained beneficial owner of the money. H, a solicitor, should have paid more attention to documentation (to declare that his children had the desired interest) and implementation (the children did not hold chequebooks so they could not draw out what was said to be their money from the account). So far this is straightforward.

More intriguingly, even if the children held money in the account beneficially, the tribunal would "likely"[19] have held that H was *still* taxable on all the income under s.624, on the grounds that:

(1) The account was a "settlement" (that is clearly right); and

(2) H had an interest since he could withdraw the funds.

It seems to me that point (2) is wrong. If H draws out money for his own benefit, he only does so with the authority of the joint account holders, and the possibility that a donee may give funds back to the donee does not constitute an interest.[20]

I think it is safe to say that no account has ever been dealt with that way in the history of taxation, and the practical difficulties would be immense. In *Bingham* there was clearly a settlement as H provided all the funds. What if the joint account owners provide funds, but unequally? What if a couple shares an account for ordinary domestic purposes?

The problems would attach to husband and wife accounts: the settlor-interested trust provisions take priority over s.836 ITTOA. The relief in s.626 ITTOIA would not apply. This provides (in short):

> (1) The rule in section 624(1) does not apply in respect of an outright gift—
>
> (a) of property from which income arises,
>
> (b) made by one spouse to the other or one civil partner to the other, and
>
> (c) meeting conditions A and B....
>
> (4) A gift is not an outright gift for the purposes of this section if—
>
> (a) it is subject to conditions, or
>
> (b) there are any circumstances in which the property, ... —
>
> (i) is payable to the giver,
>
> (ii) is applicable for the benefit of the giver, or
>
> (iii) will, or may become, so payable or applicable.

If *Bingham* were right, a payment into a joint account would not be an

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19 at [62]

20 *Glyn v IRC* 30 TC 321 at p.329; *West v Trennery* [2003] STC 580 at [51] (point not discussed on appeal).

outright gift under the definition in s.626(4) ITTOIA.

These arguments were not put to the Tribunal.

77.7.2 *Remittance basis and spouses joint accounts*

How does this interrelate with the remittance basis? Suppose:

(1) Property is held in the names of H and W, but belongs in equity to H alone.
(2) Section 836 applies so that half the income is deemed to be the income of W.
(3) W is a remittance basis taxpayer.

Income of W arising before 2008/09, being merely deemed income, could not be remitted and could not be subject to tax. But income arising from 2008/09 counts as remitted if it is remitted by H, since H is a relevant person in relation to W.

77.8 Income from other joint accounts

Subject to the special rules for spouses joint accounts,

77.9 Planning implications for joint accounts

The best way to avoid the IHT difficulties described in this chapter is that substantial sums should not be put in joint accounts (except where the account holders qualify for the full IHT spouse exemption).

Joint accounts may be useful as a means of probate planning, as the funds in a joint account are immediately available to the survivor; by contrast, funds in a sole account are not available until probate is obtained, which will involve delay and, often, cost as IHT must be paid upfront in order to obtain probate. In this case, the parties should specify carefully the terms on which the account is held, and (if appropriate) keep a record of who provided the funds so the IHT position is clear.

It is recommended that remittance basis taxpayers do not use foreign joint accounts, if the remittance tracing problems discussed above will arise. There will be no problem if:

(1) no substantial interest accrues to the account;
(2) no remittance is made from the account to the UK;
(3) interest is paid to a separate account from which no remittance is made to the UK; or
(4) interest is paid to separate account of each account holder in equal shares.

CHAPTER SEVENTY EIGHT

ESTATES OF DECEASED PERSONS - CGT

78.1 Succession law background

On the death of a person domiciled in England and Wales ("**the deceased**") their property passes to their personal representatives ("**PRs**").[1] The property is known as **"the deceased's estate"** which where the context is clear may be abbreviated to **"the estate"**.

The PRs pay the debts of the deceased, and taxes. Provided that there are sufficient assets available, they pay pecuniary legacies and transfer property which the deceased has specifically gifted. Finally, they transfer the residue of the estate to the residuary legatees Thus on completion of the administration, the residuary legatee becomes entitled to the assets of the estate, and any income which the PRs have not expended in the period of administration. It is possible for PRs to transfer specific assets before completion of administration.

When PRs transfer an asset to a beneficiary, the formal legal terminology is that they "assent to the vesting of the asset in the beneficiary",[2] which may be abbreviated to **"assent"**. But outside formal legal contexts, we prefer the word "transfer". That seems clearer to readers unfamiliar with succession law terminology; there are some differences between an assent and other types of transfer, but they are not relevant here.

During the period of administration, the PRs alone are said to be entitled to the assets which are comprised in the estate. The beneficiaries of the estate have the right to compel due administration of the estate, but it has been repeatedly held by courts of the highest authority that the

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1 Further consideration is needed if a foreign law applies: see 78.12 (Succession governed by foreign law).

2 See s.36 Administration of Estates Act 1925, set out at 79.6 (Income from specific legacy).

beneficiaries have no legal or equitable interest in the assets of the estate.[3]

Special taxation rules apply during this period of administration. The rules produce some curious results where the deceased or a beneficiary is a remittance basis taxpayer or non-resident. There can sometimes be considerable scope for tax planning.

I consider CGT and in the following chapter income tax.

The starting point is that PRs are "persons" (though not "individuals") so they are in principle subject to IT and CGT.

Similar issues arise where charities are beneficiaries of estates, as to which see Kessler & Marre, *Taxation of Charities and Nonprofit Organisations*.[4]

78.1.1 *When is administration of estate completed?*

How long does the administration period last? This is a question of succession law, not tax law, but it often arises in tax contexts, including income tax, CGT, and estate duty, and has given rise to a substantial case law.

In *Sudeley v Attorney-General* [1897] AC 11 the Privy Council said:

> The thing that the legatee was entitled to was one-fourth share of a residuary estate, consisting, it may be, of many things; and I think it was fallacious on the part of [counsel] to say that the residue was very nearly ascertained, because the question is not only of amount – although I think that of itself would not be sufficient if it were only of amount – but it is a question of substance as well as a question of amount. It is uncertain until the residuary estate has been ascertained of what it will consist:...
>
> Until the thing has been ascertained, until the trust fund has been constituted, the thing of which the trustees are the trustees has not been ascertained. Whether you treat them, therefore, as trustees or executors, the same consideration arises. Now, if the only thing that the legatee is entitled to is the fourth share of an ascertained residuary estate, I say that to my mind it is impossible to maintain that the character of any part of that estate can be ascertained so as to make it possess a specific locality until that has happened; it is a condition precedent to know what the

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3 *Sudeley v Attorney-General* [1897] AC 11; this (rather odd) principle was re-affirmed in *CSD v Livingston* [1965] AC 694; for a survey of the cases, see *Re Hemming* [2009] Ch 313. Scots law is the same: *Cochrane's Executors v IRC* 49 TC 299.

4 (9th ed., 2013), Chapters 33 and 34 (Estates of deceased persons), online version *http://www.taxationofcharities.co.uk*.

> residuary estate is, and until that has been ascertained you cannot tell of what it will "consist."

In *IRC v Aubrey Smith* the Court of Appeal cited this and said:

> .... I read all those passages because they appear quite clearly to lay down that until the fact is ascertained, or can or ought to be inferred, that the residue has become defined so that the aliquot portion passing to the beneficiary can also be defined, the beneficiary has not, until that time, a definite interest in the sum which will ultimately fall to him. ... it appears to me as Lord Haldane said in the case I first cited that it is largely a question of fact. ...
> What has to be determined here ... is: Is it clear that the portion of each of the sons is ascertained, or has been ascertained, or is capable of ascertainment, and that ascertainment has been assented to by the executor-trustees?[5]

The important points which emerge from the case law are that PRs continue to hold an asset as PRs until:

(1) they transfer an asset to a beneficiary; or
(2) the administration of the estate is complete (at which point there is an implied assent). For this purpose:
    (a) The estate must be completely ascertained. It remains in the course of administration even though this work is nearly done.
    (b) The fact that debts of the deceased remain unascertained or unpaid is a relevant factor but not decisive.
    (c) The fact that the PRs regard themselves as still administering the estate (producing "estate accounts" and not trust accounts) is a relevant factor but not decisive.
    (d) In a marginal case the issue is said to be one of fact and there is a fairly broad "grey area" in which the courts will not interfere with a decision of the first-tier tribunal.

The TSE Manual provides:

> **TSEM7360 Deceased Persons: Definition Of Period Of Administration** [Dec 2011]
> The period during which the personal representatives are settling the estate is called the period of administration. It starts on the day following the date of death of the deceased person and ends when the personal representatives have taken all the steps necessary to complete

5 15 TC 661 at p.672.

the administration of the estate.

The question of when an administration period ends is essentially one of fact and will depend on individual circumstances. It may in some cases coincide with the date when the residue of the estate can be identified. Sometimes the date of issue of the Inheritance Tax clearance certificate is taken as the date the administration was completed.

You should normally accept that the administration ended on the date the personal representatives tell you it did.

The CG Manual provides:

30700 Period of administration [January 2012]

The period during which the personal representatives are settling the estate is called a period of administration. The period starts with the death of the deceased person. The date on which it ends is a question of fact which is often difficult to resolve. During this period the liability for Capital Gains Tax on sales of assets from the estate falls on the personal representatives unless they have taken specific steps to vest the ownership of the assets involved in legatees in advance of the sale, see CG30910.

When considering when administration is complete the Courts look for a construction of the law that leads to an early conclusion of administration. The leading case in this respect is *IRC v Sir Aubrey Smith* 15 TC 661.

In his judgement Lord Hanworth MR set out a principle of general application when he said, at the bottom of page 675, top of page 676

"The question is, in all cases: has the administration of the Estate reached a point of ripeness at which you can infer an assent, at which you can infer that the residuary estate has been ascertained and that it is outstanding and not handed over merely for some other reason."

On this basis we would normally argue that the period of administration ends when residue has been ascertained, see CG30780+.

30710 Extended period of administration [January 2012]

There are some exceptional cases where all the figures are apparently available to enable residue to be ascertained but it has to be accepted that the period of administration is continuing.

One example is where distributing shares in accordance with legatees' fractional entitlements to residue would result in one legatee receiving a majority shareholding whilst the other legatees would only receive minority holdings. Because of the disparity in values between majority and minority holdings it may be necessary for the personal representatives to apply the rule from *Lloyd's Bank v Duker* [1987] 3 All ER 193. This would require them to sell these shares rather than distributing them in specie.

The period of administration would continue in such a case until the shares were sold and the Capital Gains Tax liability arising to the personal representatives was quantified.

The rule referred to above is of fairly limited application. The fact that a majority shareholding would be broken into minority holdings on distribution should not

be accepted as preventing distribution of shares and thus the ending of the period of administration. Nor should minor valuation differences between minority shareholdings passing to the legatees be accepted as covered by the rule in the *Duker* case.

The period of administration may also be extended where the distribution of the estate is being challenged. The personal representatives may be unable to distribute the estate pending the outcome of litigation.

30720 Confusion over terminology [January 2012]

Even where ascertainment of residue marks the end of the administration period for Capital Gains Tax purposes, assets may remain in the hands of the personal representatives after that date. They may have to carry out administrative acts regarding transfer of assets to legatees. In some cases they may sell assets. If so they will be doing this as bare trustees for the legatees. Personal representatives and their agents sometimes regard these acts as forming part of the period of administration. This may lead to confusion when references are made to the period of administration.

Because of the possible confusion it is important to establish precisely what is meant when a reference is made to a period of administration. From the Inland Revenue's side we can try to avoid this confusion for the majority of cases by referring to events as falling before or after residue has been ascertained rather than simply referring to the period of administration.

30780 Necessary to establish if residue ascertained [January 2012]

There are a number of circumstances where it is important to establish whether residue has been ascertained, see CG30700, because it significantly affects the amount of Capital Gains Tax payable. Depending on the circumstances, the personal representatives and legatees may be arguing for residue having been ascertained at an early date or at a late date.

30781 Early date [January 2012]

If there is a will the personal representatives and legatees may claim that administration has ceased and residue has been ascertained at an early date if:

- the legatees would be liable at a lower rate of Capital Gains Tax than the personal representatives on the disposal of assets in the estate
- have any unused annual exemption that could be used to cover the gains
- the legatee is a charity and any gain on the disposal would be exempt.

You will only see claims under the first two bullet points in cases of intestacy as a charity will not qualify as a legatee under the rules of intestacy.

Applying the rule that assets remain vested in the personal representatives until residue has been ascertained unless specific steps have been taken to vest the assets in advance of ascertainment of residue usually defeats unwarranted claims in this area.

30790 Late date [January 2012]

For the years 2008-09 there will be few cases in which it will be to the taxpayers' advantage to argue that there has been an extended period of administration. This is because the rate of Capital Gains Tax payable by personal representatives is either the same as that paid by the legatees or higher. It cannot be lower. There may be a small advantage if the personal representatives have any unused annual exempt amount and the legatee doesn't or the personal representatives may have

unused losses that will be lost.

Unless it is an exceptional case where there are good reasons for accepting that the period of administration must be extended beyond the date residue is ascertained, see CG30710 – CG30712, you should seek the full facts to enable you to determine when residue became ascertainable. You should then argue that the beneficial ownership of the assets vested in the legatees at that date. As stated in CG30701 the attitude of the Courts is to look for an interpretation that allows administration to be completed at an early date.

Unquantified debts

One claim that is sometimes met is that there is an unquantified debt preventing residue being ascertained. This may not be sufficient to prevent the administration period being treated as at an end. Such a situation was considered in *IRC v Sir Aubrey Smith* 15 TC 661. Lord Hanworth commented at page 674

> 'For my own part I think the question of a mortgage debt or any other debt must take its proper place in perspective. It may be in some cases that that is a factor from which a strong inference may be drawn. It may be on the other hand that the device of leaving a debt unpaid is resorted to in order to pretend that the residue of the estate has not been ascertained and is not ascertainable. If such a device were resorted to in any case it ought to be held ineffective'.

When a Solicitor or other professional person is employed by the personal representatives to deal with the administration of the estate, his or her fees will be one of the estate's debts. Sometimes when personal representatives wish to extend the period of administration they arrange that the Solicitor, etc, does not submit a bill in respect of at least some part of his or her fees. They then argue that this has prevented ascertainment of residue and has caused the period of administration to be extended. Any such claim should be resisted on the basis of the above quotation. It should be contended that the information to quantify the bill must be in the Solicitor's records and that administration should therefore be considered to have ended.

30800 How residue is ascertained [January 2012]

In order to ascertain residue the personal representatives must identify all the assets and liabilities of the estate. They then need to quantify these.

In the case of taxation liabilities this process will start with settling any Income Tax and Capital Gains Tax liabilities to the date of death. If any income arises to the personal representatives or if they realise any chargeable gains during the period of administration they will also need to agree their own liabilities for this period.

As far as Inheritance Tax is concerned the personal representatives will need to agree with HMRC - IHT whether any liability arises and if so in what amount. When seeking a grant of probate or letters of administration (or, in Scotland, a confirmation) the personal representatives have to supply HMRC - IHT with a provisional computation of the Inheritance Tax due. HMRC - IHT will review this and, where necessary, check valuations. When it is either agreed there is no liability to Inheritance Tax or the amount has been quantified HMRC - IHT will issue a clearance certificate. We would not normally accept that residue had been ascertained at a date before the date of issue of a clearance certificate. See

IHTM05001+ for detailed guidance on the Inheritance Tax procedures.

30810 Providing funds [January 2012]

When the assets and liabilities have been quantified the personal representatives have to consider how they can pay

- the estate's liabilities and
- any pecuniary legacies provided for in the will.

If they do not have sufficient liquid funds they will have to sell assets in order to raise funds. (Occasionally they may agree with legatees entitled to pecuniary legacies that the legatee should accept an asset in satisfaction or part satisfaction of the pecuniary legacy).

Disposing of assets may give rise to further Capital Gains Tax liabilities which have to be agreed before residue can be ascertained.

Residue is only ascertained when the personal representatives have both established the net worth of the estate and provided the liquid funds to pay liabilities and pecuniary legacies. Once that point is reached residue is ascertained and it is irrelevant that the assets have not been distributed.

30820 Executor's year [January 2012]

For estates in England and Wales, the personal representatives cannot be compelled to distribute the assets of the estate until at least one year has elapsed from the date of death (Section 44 Administration of Estates Act 1925). This is commonly referred to as the executor's year.

When dealing with a dispute about whether a disposal was by personal representatives in that capacity or in their capacity as bare trustees for legatees we would not normally contend that the disposal was on behalf of the legatees if it took place during the executor's year.

Although personal representatives cannot be compelled to distribute assets during the executor's year there is no bar to them doing so. In a simple estate they may have ascertained residue well before the year ends. If there is evidence that they have done and have then distributed assets to the legatees we can accept that the liability relating to disposals during that year but after the date assets were distributed does lie with legatees.

Scotland

In Scotland the rule is that the personal representatives are entitled to distribute the estate after six months from the deceased's death if they have provided funds for payment of all the estate debts and made reasonable enquiries for claims.

78.1.2 *Importance of assents*

PRs transfer assets to beneficiaries by means of an "assent". The assent is fundamental, since a sale after an assent to a non-resident or a remittance basis taxpayer may in broad terms be free of CGT and a sale before assent may not. (Conversely a sale by non-resident PRs or PRs with losses may be CGT free and a sale after an asset may be taxable.)

An assent of land in England and Wales must be in writing. An assent of other property may be oral or implied by conduct. No formal written assent is required if (say) shares are simply transferred to the name of a

beneficiary by stock transfer form. If shares are registered in the names of PRs (or their nominees), and the legatee wants them to be sold, it may be administratively convenient if an assent is made under which the PRs (or their nominees) become nominees for the legatee. Then the shares can be sold without CGT (assuming a non-resident legatee or if the remittance basis applies) without the formality of a transfer of legal title to the legatee.

78.2 Meaning of "PRs" for CGT

Section 288 TCGA provides:

> "personal representatives" has the same meaning as in the Corporation Tax Acts (see section 1119 of CTA 2010);

Se we turn to s.1119 CTA 2010 which provides a commonsense definition:

> "personal representatives", in relation to a person who has died, means—
>
> (a) in the UK, persons responsible for administering the estate of the deceased, and
>
> (b) in a territory outside the UK, those persons having functions under its law equivalent to those of administering the estate of the deceased.
>
> This is the same as the income tax definition.[6]

78.3 Residence and domicile of PRs for CGT

Section 62(3) TCGA provides:

> In relation to property forming part of the estate of a deceased person
>
> [a] the PRs shall for the purposes of this Act be treated as being a single and continuing body of persons (distinct from the persons who may from time to time be the PRs), and
>
> [b] that body shall be treated as having the deceased's residence and domicile at the date of death.

The residence and domicile of the PRs in their private capacity is irrelevant.

The reference here to domicile is otiose, as there are no provisions where

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6 See 79.3 (Meaning of "PRs" for income tax). If we had a taxes-act-wide definition the repetition would not have been necessary.

the domicile of PRs matters for CGT purposes; though there have been such provisions in the past.

The definition of "residence" for PRs is different for IT.[7]

78.4 Acquisition by PRs

Section 62(1) TCGA provides:

> For the purposes of this Act the assets of which a deceased person was competent to dispose—
>
> (a) shall be deemed to be acquired on his death by the personal representatives or other person on whom they devolve for a consideration equal to their market value at the date of the death, but
>
> (b) shall not be deemed to be disposed of by him on his death (whether or not they were the subject of a testamentary disposition).

This is the so-called tax-free uplift on death.

The expression "assets of which a deceased person was competent to dispose" is given a commonsense definition in s.62(10) TCGA:

> In this section references to assets of which a deceased person was competent to dispose are references to assets of the deceased which (otherwise than in right of a power of appointment or of the testamentary power conferred by statute to dispose of entailed interests) he could, if of full age and capacity, have disposed of by his will, assuming that all the assets were situated in England and, if he was not domiciled in the UK, that he was domiciled in England, and include references to his severable share in any assets to which, immediately before his death, he was beneficially entitled as a joint tenant.

78.5 Transfer from PRs to beneficiaries

78.5.1 *Transfer from PRs to legatee*

Section 62(4) TCGA provides:

> On a person acquiring any asset as legatee (as defined in section 64)—
>
> (a) no chargeable gain shall accrue to the personal representatives, and
>
> (b) the legatee shall be treated as if the personal representatives' acquisition of the asset had been his acquisition of it.

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7 See 79.4 (Residence of PRs for IT).

Section 64(2) TCGA defines legatee:

> In this Act, unless the context otherwise requires,
> [a] "legatee" includes any person taking under a testamentary disposition or on an intestacy or partial intestacy, whether he takes beneficially or as trustee, and
> [b] a person taking under a donatio mortis causa shall be treated (except for the purposes of section 62) as a legatee and his acquisition as made at the time of the donor's death.

78.5.2 *Appropriation of assets to beneficiary*

Section 64(3) TCGA provides:

> For the purposes of the definition of "legatee" above, and of any reference in this Act to a person acquiring an asset "as legatee", property taken under a testamentary disposition or on an intestacy or partial intestacy includes any asset appropriated by the personal representatives in or towards satisfaction of a pecuniary legacy or any other interest or share in the property devolving under the disposition or intestacy.

Thus, if PRs appropriate assets in satisfaction of a pecuniary legacy, the beneficiary acquires as legatee. This is so even if the appropriation needs the consent of the beneficiary.[8]

If the PRs had no power of appropriation, then an "appropriation" could be authorised only on the basis that it was in fact a sale of the asset to a

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8 Although for stamp duty purposes that the transfer of the asset to a legatee amounted to a conveyance on sale where the consent of the legatee is required: *Jopling v IRC* [1940] 2 KB 282. CCAB Statement June 1967 provided:

> "The Revenue stated that in their view [TCGA s.62(4)] does not apply in all cases where assets are transferred to beneficiaries in specie. Where assets are appointed by personal representatives to satisfy a legacy in circumstances where such appropriation requires the legatee's consent, ie where the personal representatives do not have (whether by the terms of the will or under the Administration of Estates Act 1925 s.41) powers of appropriation without consent, the Revenue are advised that the acquisition of the asset has a contractual basis and is not strictly an acquisition qua legatee. In practice, however, the disposal of appropriated assets by the personal representatives to a legatee in these circumstances is not treated as an occasion of charge on the personal representatives provided that both they and the legatee agree that the legatee should be treated as acquiring the assets concerned as legatee for the purposes of [TCGA s.62(4)]."

This was written before the enactment of what is now s.64(3) TCGA (by the FA 1969). This brought the law into line with what was formerly HMRC practice.

beneficiary coupled with a payment of the legacy by way of set-off. In that case, the beneficiary would acquire as purchaser and not as legatee. In practice, PRs will generally have a power of appropriation,[9] so the issue does not arise.

78.5.3 *Appointment to beneficiary by executors under overriding powers*

Where executors exercise a power to appoint trust property to a beneficiary, that beneficiary takes under the appointment "as legatee". This follows from the trust law principle that, for the purposes of the rules relating to perpetuities, where trustees exercise a power of appointment, the deed of appointment is read back into the original trust instrument. It is treated as coming into operation at the date of the instrument that creates the power.[10] This rule has been applied for tax purposes, in a different context, in *Chinn v Collins* the exercise of a power of appointment merely "fills in a blank in the original settlement which left blank how the final distribution of a trust asset was to be made".[11]

Quite apart from that, the beneficiary would take as "legatee" in the general sense of the expression. The definition in s.64(2) is inclusive and not a comprehensive definition. The reason that the beneficiaries take as legatee is that they acquire under an assent. They acquire from the PRs acting in their capacity as PRs.

This conclusion is consistent with the general scheme of the TCGA. A person who acquires under an appropriation acquires "as legatee". It would be anomalous if a person who acquired under an appointment would not. (A power of appropriation is sometimes regarded as a dispositive power: *Re Freeston* [1978] Ch 741, though I would not regard that as an essential point.)

In CG Manual 31432–3 (although one might quibble with the language used) it seems that HMRC accept that an appointee acquires as legatee.

78.5.4 *Transfer to trustees of will trust*

If the will appoints non-resident trustees, the PRs may transfer the assets to the trustees without a CGT charge.

If the will appoints UK resident trustees, the PRs may transfer the assets to the trustees but the trust will be within the charge to CGT. If non-

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9 Section 41 Administration of Estates Act 1925.

10 *Muir v Muir* [1943] AC 468; *Pilkington v IRC* 40 TC 416 at 441.

11 54 TC 311 at p.357.

resident trustees are subsequently appointed, there will in principle be an exit charge.

It should normally be possible to arrange that:

(1) The PRs appoint that the assets are to be transferred to trustees of a new non-resident trust.

(2) The PRs then transfer the assets to the non-resident trustees.

As long as this is done during the administration of the estate, the assets may then become held in a non-resident trust without a charge to CGT.

78.6 Deceased not UK resident

If the deceased was not UK resident at the time of their death (regardless of domicile) the PRs are in principle outside the scope of CGT.[12]

78.6.1 *Is an estate a "settlement" within s.87 TCGA?*

Is a deceased's estate is a "settlement" for the purposes of s.87? The question matters, because if an estate were a "settlement" then:

(1) Gains accruing to non-resident PRs would be s.2(2) amounts (trust gains) for the purposes of s.87 TCGA; so

(2) Capital payments from the PRs to UK resident beneficiaries would in principle be subject to tax under s.87; and

(3) If the will created a will trust, or made a gift to a lifetime trust, unmatched s.2(2) amounts of the PRs would be transferred to the trust on completion of the administration of the estate.[13]

The word "settlement" is used with different definitions; in the terminology of this book:

(1) The **"standard IT/CGT definition"** (a classic settlement).

(2) The "**settlement-arrangement**" definition.[14]

An estate is not a settlement in the standard IT/CGT sense. If the will creates a will trust, a settlement in the standard IT/CGT sense comes into existence when the administration is complete (or if property is transferred to the trustees sooner). However, s.97(7) TCGA provides the settlement-arrangement definition,[15] so the question is whether an estate may be a settlement-arrangement.

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12 See 49.1.2 (CGT residence condition).

13 See 51.32 (Rebasing: transfers between trusts).

14 See 80.2.1 (Terminology) and 80.2.3 (Settlement-arrangement definition of "settlement").

15 This provides: "settlement" has the meaning given by s.620 of ITTOIA.

In *IRC v Buchanan* 37 TC 366 at p.374, Lord Goddard said:

> I do not think for a minute that a will of a testator comes within section 20[16] at all; it is not a settlement to which the Act applies.

Lord Goddard did not actually say that a will is not a settlement-arrangement but if that is what he meant, the comment was *obiter* and surprising. One might have thought that an estate is a "settlement" in the sense of "arrangement". There is an element of bounty in that the deceased decides who should benefit (or by not making a will, decides that the intestacy rules should apply). However, Lord Goddard's comment was loyally followed.[17] Accordingly CG Manual is right to provide:

> **14590 Connected persons: Trustees** [January 2010]
> A will trust cannot be a Settlement for these purposes [for the purposes of the settlement-arrangement definition].

Similarly, the Company Taxation Manual provides:

> **60150 Tests: Associates** [November 2011]
> On the authority of *Willingale v Islington Green Investment Co* 48 TC 547, a settlement [under the settlement-arrangement definition] does not include a will trust.

For this reason an estate is not a "settlement" within s.87.

This is in fact the sensible result. The scheme of s.87 is designed with trusts in mind and would not work well if extended to estates:

(1) Suppose a will left legacies to (UK resident) legatees, and the residue on trust ("the will trust"). It would be odd if the legatees were subject to CGT under s.87 by reference to gains accruing to the estate, or, subsequently, to the will trust. But that would (almost[18]) necessarily follow, if the estate were a settlement-arrangement.

(2) Suppose a testator left their estate for such of their children as attain the age of 30, and one child reaches that age before death, or during the period of administration. The executors would transfer half of the estate to the older child and (on completion of administration) hold

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16 Section 20 FA 1943, the predecessor of s.644 ITTOIA.

17 *Willingale v Islington Green Investment* 48 TC 547 at p.556. (The point was not argued on appeal.)

18 A possible way to avoid this unsatisfactory result might be to say that assent of a legacy is not a "capital payment"; but that is a stretch, given the definition that payment includes the transfer of an asset.

> the other half on trust for the younger child until it reached the vesting age. It would be odd if the older child were subject to CGT under s.87 by reference to gains accruing to estate, or to the younger child's will trust fund.

I have considered one possible argument to the contrary. Section 87(6) TCGA provides:

> For the purposes of this section a settlement arising under a will or intestacy shall be treated as made by the testator or intestate at the time of death.[19]

This wording does *not* deem an estate to be a settlement for s.87 purposes. The wording makes sense if one reads it in the context of original s.87 provisions, in the FA 1981. At that time, "settlement" was not expressly defined; for s.87 purposes (what I call) the standard IT/CGT definition applied. So in 1981 it was clear that an estate was not a settlement, and that a will trust was a settlement. However there would be doubt as to who was the settlor of the will trust, and when that settlement was made. These matters are resolved by (what is now) s.87(6). The provision is still needed: the identity of the settlor and domicile at the time of making the settlement are still relevant for s.87, though the relevance is now for transitional relief only.

Another effect of s.87(6) now is to make it clear that a will trust is a settlement for the purposes of s.87.

78.6.2 *CGT planning for estate of non-resident testator*

The estate of a non-resident testator is in principle a CGT free vehicle.

In principle, it would be desirable to arrange that gains accrue to PRs during the period of administration, and not to beneficiaries subsequently. If the PRs transfer assets to UK residents who sell the assets, the gain on the disposal is chargeable in full or on the remittance basis. If the PRs transfer assets to non-resident trustees, who sell the assets, the gain is a s.2(2) amount (trust gain). If the will creates a will trust, the trust comes into the scope of s.87 when administration of the estate is completed (or when property is transferred to the trust, if sooner).

By contrast, assets with losses should be transferred to beneficiaries of the estate *in specie*.

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19 The wording was previously in s.97(7) TCGA but moved in the 2006 reforms.

It may also be desirable to extend the administration period as long as possible.

If a will creates a will trust, it may be desirable that capital payments are made by the PRs, during the period of administration, not by trustees subsequently. If the trust fund is entirely distributed, no settlement ever comes into existence and s.87 does not operate.

Suppose:

(1) A will creates a discretionary will trust.
(2) The PRs exercise their powers[20] to make a distribution to a beneficiary during the administration period.

There is (at the time) no settlement and s.87 charge. After the completion of administration, the capital payment is not matched to future s.2(2) amounts (trust gains) of the trust. It is considered that s.87(6) TCGA does not retrospectively alter the position. That is not the purpose of the deeming provision.

The position is different if:

(1) A will makes a gift to a separate trust ("the lifetime trust").
(2) The trustees of the lifetime trust exercise their powers to direct the PRs to make a distribution to a beneficiary during the administration period.

That is a capital payment from the trustees of the lifetime trust, which can be matched to trust gains of the lifetime trust and so give rise to a s.87 charge on the beneficiary. An Instrument of Variation may be appropriate.

78.7 Gain accruing to non-resident company held by non-resident PRs

Suppose:

(1) PRs hold a non-resident company.
(2) The company disposes of an asset and realises a gain, which I call "the company gain".

78.7.1 *Position of company and PRs*

The company is in principle not subject to tax on the company gain because it is not UK resident.

The PRs are participators. But if they are not UK resident, they are not treated as if the company gain had accrued to them. The condition in s.13(2)[a] TCGA is not satisfied.

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20 It is assumed that the PRs have power to do this.

78.7.2 *Position of legatee*

Assume that under the terms of the will the shares pass to a legatee. Is it possible that the legatee should be treated as if the company gain accrued to the legatee, so that:

(1) a UK resident legatee would be subject to tax on the gain under s.13(2) TCGA; or

(2) a non-resident trust legatee would be treated as receiving a s.2(2) amount (trust gain) under s.13(10) TCGA?

78.7.3 *Position of legatee during period of administration*

The first question is whether, at the time the gain accrues to the company (while the estate is still in the course of administration) the legatee is a participator. Section 13(12) TCGA provides:

> In this section "participator", in relation to a company, has the meaning given by section 454 of CTA 2010.

A legatee is a participator under this definition.[21]

However s.13(3) TCGA (identifying the part of the chargeable gain which is deemed to accrue to the participator) provides:

> That part shall be equal to the proportion of the gain that corresponds to the extent of the participator's *interest* as a participator in the company.

Residuary[22] beneficiaries of an estate have no legal or equitable interest in the assets of the estate.[23] They have the right to enforce its proper administration but that right is not properly described as an "interest" in the assets. It is therefore considered that during the period of administration the legatee does not have an "interest" as a participator.[24]

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21 See 85.17.5 (Personal representatives and beneficiaries of estates).

22 There is however no difference between residuary beneficiaries and specific legatees. The origin of the principle that a residuary legatee has no "interest" in the estate is historical: until the mid 19th century, estates were administered in the ecclesiastical courts and not the Chancery courts. That reasoning would apply to a specific legatee as to a residuary legatee.

23 See 78.1 (Succession law background).

24 See *Willingale v Islington Green Investment* 48 TC 547 at p.562D.
The expressions used in s.13(3) are partially defined in s.13(13):
In this section—
(a) references to a person's interest as a participator in a company are references to

Thus it does not matter that they are participators because nothing can be attributed to them under s.13.

The context can show that the word "interest" is to be understood in a loose or non-technical sense, in which case it might include the rights of a beneficiary of an estate. But there is no reason here to say the word is used loosely or non-technically. My conclusion is supported by the fact that it is not clear what would be the "just and reasonable" apportionment of the gain as between UK resident PRs and legatees. Also if the will creates a will trust, the trust does not come into existence until completion of the administration of the estate.

78.7.4 *Position of legatee on transfer of the shares*

That is not the end of the matter. Normally, on the completion of the administration of the estate the PRs will transfer the shares to the legatee. What is the position of the legatee then?

The legatee is treated as having acquired the shares on the death.[25] Does this apply for the purposes of s.13 TCGA, so the legatee is retrospectively treated as if the company gain accrued to them?

We first consider the position of a residuary legatee, and consider a specific legatee separately below. For a residuary legatee, it is the old question of how far one carries through the deeming in the TCGA.[26] In principle, one carries the deeming all the way and retrospectivity would then follow. However, several difficulties then arise:

(1) Suppose the PRs were UK resident. They would have been taxed in the first instance on the company gain under s.13 TCGA. There is nothing to give them relief on their subsequently transferring the shares to a legatee. (Section 62(4)(b) TCGA states that the *legatee* shall be treated as if the PRs acquisition had been theirs. It makes no comment about the position of the PRs. Relief might perhaps be

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the interest in the company which is represented by all the factors by reference to which he falls to be treated as such a participator; and

(b) references to the extent of such an interest are references to the proportion of the interests as participators of all the participators in the company (including any who are not resident in the UK) which on a just and reasonable apportionment is represented by that interest.

Section 13(13)(a) does not turn a legatee's right into an "interest" if it is not already an interest.

25 See 78.5.1 (Transfer from PRs to legatee).

26 See App 2.1 (Construction of deeming provisions).

implied, but the approach of the House of Lords in *R v Dimsey & Allen* suggests that it should not.)

(2) Another problem would arise if the PRs receive a dividend from the company, before distributing the shares to the legatee. The legatee would receive the shares but the company at that time may no longer hold funds representing the gain, so it would not be fair that the company gain should be treated as accruing to the legatee. Company distribution relief[27] would not work properly.

(3) There would be an anomalous distinction between:
   (a) an assent of the shares (s.13 applies to the legatee); and
   (b) sale (or liquidation) of the company and assent of the proceeds to the legatee (s.13 TCGA does not apply).

For these reasons it is suggested that the deeming of s.62(4)(b) TCGA does not extend to deem the legatee to receive the company gains under s.13. This construction is also consistent with the limited view of the deeming provision taken in *Marshall* v *Kerr* 67 TC 56.

The arguments are more finely balanced in the case of a specific legacy. In that case, the assent operates retrospectively, as a matter of general law, at least, unless the assent otherwise provides.[28] But it would be anomalous if there were a distinction between a specific legatee and a residuary legatee, and it is suggested that no distinction should be drawn between the two cases.

78.8 Capital payment from company held by estate

Suppose:

(1) An estate holds shares in a non-resident company.[29]

(2) Under the will, the shares are pass to a non-resident trust ("the lifetime trust").

(3) The company makes a capital payment to a beneficiary. This may happen, for instance, if an interest free loan is left outstanding.

The capital payment may be provided directly or indirectly by the lifetime trust, in which case it is potentially subject to tax under s.87 like any other capital payment.

If that is not the case, the capital payment may be deemed to be provided

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27 See 53.23 (Company distribution relief) .

28 See 79.6 (Income from specific legacy).

29 Similar issues could arise for a UK resident company, but in practice a payment from such a company is less likely to be a capital payment.

by the lifetime trust, under s.96(1) TCGA.[30] That will be the case if the company is "controlled" by the trustees, in the defined sense.

78.9 Deceased UK resident

If the deceased was UK resident and domiciled, the PRs are UK resident and domiciled, and so subject to CGT on all chargeable gains (less losses).

78.9.1 *Deceased UK resident, not UK domiciled*

Suppose at the time of death the deceased was UK resident but foreign domiciled. The PRs are treated as UK resident but not UK domiciled. CG Manual provides:

> **30660 Remittance basis not in administration period** [October 2013] If the deceased was resident and/or ordinarily resident[31] but not domiciled in the UK before his or her death, then on disposing of assets outside the UK he or she would have benefited from the application of the remittance basis in S.12 TCGA ... . Although the PRs have the same residence and domicile status as the deceased had, if they realise chargeable gains from disposals of assets situated outside the UK but do not remit those gains to the UK immediately they cannot benefit from this treatment. This is because the remittance basis applies only to individuals but S.65(2) says that the body of PRs is not to be treated as an individual.

This remains valid after the 2008 reforms. At first sight this seems surprising, but on reflection, it is not absurd to draw a distinction between:
(1) a UK resident foreign domiciled individual, taxed on the remittance basis, and
(2) the PRs of that individual, taxed on an arising basis.

A remittance basis makes less sense for PRs whose role is generally short term.[32]

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30 See 51.8 (Capital payment from close company).

31 [Footnote original] For 2013-14 and subsequent years ordinary residence does not need to be considered.

32 It has been argued that the HMRC view is wrong. The argument was largely based on the supposed anomalous position of PRs. Following the 2008 reforms, the anomalies work the other way (for if the remittance basis applied, it would be anomalous that PRs did not pay the remittance basis claim charge). The argument would require the word "individual" in s.12(1) TCGA to be construed so as to include PRs, which is contrary to general statutory usage. So I do not think the argument now merits serious attention (but readers can find further discussion in the 2008/09 edition

Of course, if the PRs are actually outside the UK, especially if they are outside the EU, HMRC may not, in practice, be able to recover the tax.

DTR is in principle available to treaty non-resident PRs, which may solve this problem.

78.10 CGT planning for UK resident PRs

If PRs sell assets in the period of administration, then any gain will be subject to CGT, even though the net proceeds of sale will in due course pass to a remittance basis taxpayer. If, by contrast, PRs transfer an asset *in specie* to a legatee, then the PRs will not realise any chargeable gain but the base cost of the recipient beneficiary will be that of the PRs.[33] Where the legatee is a remittance basis taxpayer (or a non-UK resident, or a charity), they will often be able to dispose of the asset free of CGT.

It is thus a fundamental principle of CGT planning that PRs should generally avoid, wherever possible, making disposals of assets which pass under the will to remittance basis taxpayers, non-residents or charities, if a gain (less losses) arises on the disposal.

Suppose that a remittance basis taxpayer is entitled to a pecuniary legacy of £1m under a will. The estate holds a foreign situate asset which had a value of £600k at the date of the death of the deceased and which is now worth £1m. If the PRs sell the asset in order to pay the legacy, they will be liable to CGT. This liability can be avoided by the PRs agreeing to transfer the property to the legatee in satisfaction of their pecuniary legacy.

Suppose the PRs inherit an asset belonging to the deceased which is the subject matter of a specific gift in their will; that they then sell the asset, the sale giving rise to a charge to CGT, and that they subsequently transfer the whole or part of the proceeds of sale to the specific legatee.[34] So if there is such a sale, the PRs bear the CGT and transferring the proceeds of sale to the remittance basis taxpayer does not confer any exemption.

It may be necessary to sell some assets to pay liabilities of the PRs, and

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of this work).

33 See 78.5 (Transfer from PRs to beneficiaries).

34 Income tax sometimes applies the common law doctrine of relation back; see 79.6 (Income from specific legacy). But this does not apply here. This doctrine would operate only where an asset owned by the deceased is subsequently transferred to the legatee. In any case, the express provisions of the TCGA deal so comprehensively with the situation that any application of the doctrine of relation back to CGT is by necessary implication excluded.

it may be that the assets available for sale will give rise to a chargeable gain.

One solution is as follows:

(1) The PRs transfer the asset to the beneficiary subject to a charge for their liabilities under s.36(10) Administration of Estates Act 1925.
(2) The beneficiary then sells the asset: any gain on the sale accrues to the beneficiary: s.26(2) TCGA.
(3) Under the charge the proceeds are used to pay the PRs' liability.

78.11 CGT planning by IoV

Where there is more than one residuary legatee and some are remittance basis taxpayers, non-residents or charities, it would often make sense for assets with inherent capital gains to be transferred to them rather than to UK resident and domiciled individuals. This can often be done by means of an appropriation under s.41 Administration of Estates Act 1925, but (depending on the terms of the will) an instrument of variation may be necessary. The variation must be made within two years of the death of the deceased.

The basic strategy should be to redirect foreign assets of the estate with inherent capital gains to the remittance basis taxpayer. UK resident and domiciled beneficiaries would instead receive cash or assets without inherent gains. The remittance basis taxpayer might in due course realise the gains free of tax. There would be an overall tax saving, which could be shared between the remittance basis taxpayer and the other beneficiaries by negotiation, or which could be allowed to accrue entirely to the remittance basis taxpayer if the other beneficiaries were so minded.

78.12 Succession governed by foreign law

Further consideration is needed if the succession is governed by a foreign law. Section 62(1) TCGA provides:

> For the purposes of this Act the assets of which a deceased person was competent to dispose—
>
> (a) shall be deemed to be acquired on his death by the personal representatives *or other person on whom they devolve* for a consideration equal to their market value at the date of the death...

In civil law jurisdictions, property devolves directly on the beneficiary without the intervention of PRs during an administration period. *Bentley*

v Pike 53 TC 590 concerned the position under German law (the deceased having died intestate owning a share of land in Germany). The evidence showed:

> ... the principle of *Universalsukzession* ... means that on the death of a person, his or her entire property passes immediately and automatically to his or her heirs. ... No distinction is made between movable and immovable property: on the death of the deceased person both types of property are automatically and without any interval in time or any further outward action of any kind vested in the heirs, whoever they may be, no matter whether they are known or whether it is necessary to take steps to ascertain their identity.

In these circumstances, the ownership of the property devolved on the beneficiary immediately on the death. The gain on the subsequent sale of the property therefore accrued to the beneficiary and not to the German equivalent of PRs.

However the position may be fact sensitive, and one should not assume that all civil law jurisdictions are the same. In Quebec, the executor's seizen has priority over the legatee, and income and gains during the administration period accrue to the executor, not the legatee;[35] so it seems that for UK tax purposes too, gains should be regarded as accruing to PRs and not the legatee.

35 Canadian Revenue Authority, Technical Interpretation 2004-0100621E5, "Application of s. 164(6) in a Civil Law Context" (2006) *https://www.knotia.ca/Login/ViewEmailDocument.aspx?uniqID=167690&productID=649&sGotoStr=2004-0100621E5+E&pageLanguage=en*

CHAPTER SEVENTY NINE

ESTATES OF DECEASED PERSONS: INCOME TAX

79.1 Income taxation of estates: Introduction

This chapter considers the income taxation of personal representatives and beneficiaries of estates of deceased persons. A full discussion needs a book to itself. I try to focus on matters closest to the themes of this book, but that can only be done in the context of a more general discussion of the rules.

I do not consider the equivalent provisions applicable for corporation tax which would apply to corporate beneficiaries.

79.2 *Cross references*

The following points are considered elsewhere:
14.2 (Location of source of income: Territorial scope of It)
78.1 (Succession law background).

79.3 Meaning of "PRs" for income tax

Section 989 ITA provides a commonsense definition of PRs:

> The following definitions apply for the purposes of the Income Tax Acts—
> "personal representatives" in relation to a person who has died, means—
> (a) in the UK, persons responsible for administering the estate of the deceased, and
> (b) in a territory outside the UK, those persons having functions under its law equivalent to those of administering the estate of the deceased.

There is no rule for IT purposes that PRs are a single and continuing body of persons separate from the persons who are actually the PRs. This is anomalous, for such a rule applies to PRs for CGT and applies to trustees

for both taxes.[1] It is suggested that there should be a rule. However it will not often matter.

79.4 Residence of PRs for income tax

One must identify the PR's actual place of residence in their personal capacities, applying the statutory residence test to PRs who are individuals,[2] and the corporate residence test to corporate PRs.

PRs are UK resident for income tax if they are all UK resident in their personal capacity. They are non-resident if they are all non-resident in their personal capacity. HMRC agree. Form SA906(Notes) 2013 (Notes on form SA906 Trust and Estate Non-residence 2012/13) provides:

> ***Deciding the personal representatives' residence status for Income Tax purposes***
> You can find out the personal representatives' residence status for Income Tax purposes by working through Questions 4 to 6.
> 4. Were **all** the personal representatives resident in the UK throughout the year to 5 April 2013?
> If 'YES', the personal representatives as a whole are resident in the UK for Income Tax purposes. Tick box 6.1 [Resident in the UK for Income Tax purposes]. Go to Question 7.
> If 'NO', go to Question 5.
> 5. Were **all** the personal representatives not resident in the UK throughout the year to 5 April 2013?
> If 'YES', the personal representatives as a whole are not resident in the UK for Income Tax purposes. Tick box 6.2 [Not resident in the UK for Income Tax purposes.] Please also complete boxes 6.7 to 6.12 as appropriate. Go to Question 7.
> If 'NO', go to Question 6 [mixed resident PRs].[3]

The position where an estate has both resident and non-resident PRs is governed by s.834 ITA:

> (1) This section applies for income tax purposes if the personal representatives of a deceased person ("D") include one or more persons who are UK resident and one or more persons who are non-UK resident.
> (2) If the following condition is met, the person or persons who are non-UK resident are treated, in their capacity as personal representatives, as

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1 See 78.2 (Meaning of "PRs" for CGT).

2 See 4.2.1 (Residence of trustees and personal representatives).

3 Accessible *http://www.hmrc.gov.uk/worksheets/sa906-notes.pdf*.

> UK resident.
> (3) The condition is that when D died D was UK resident or domiciled in the UK.
> (4) If that condition is not met, the person or persons who are UK resident are treated, in their capacity as personal representatives, as non-UK resident.

Thus it is possible to arrange that PRs are not UK resident for income tax purposes. All of the PRs must be non-resident in their private capacities, (except in the case of a non-resident non-domiciled testator where only one PR need be non-resident).

There are no statutory rules for domicile but the domicile of PRs will not often matter for IT purposes.

The position is different for CGT.[4]

79.4.1 *Death before 2013: 2013 transitional rule*

Prior to 2013, s.834(3) ITA provided:

> (3) The condition is that when D died D was UK resident, ordinarily UK resident or domiciled in the UK.

The underlined words were deleted by para 67(1) sch 46 FA 2013. Para 67(2) provides a transitional rule:

> (2) The amendment made by this paragraph does not apply if D died before 6 April 2013.

79.5 Income taxation of PRs

PRs are "persons" and so pay income tax at the basic rate (or dividend ordinary rate) on the income of the estate if:

(1) the PRs are UK resident, or
(2) the income has a UK source.

79.5.1 *Foreign domiciled testator*

Form SA 906(Notes) 2014 (Notes on form SA 906 Trust and Estate Non-residence 2013/14) provides under the heading "Personal representatives: application to Income Tax":

> [1] If the personal representatives are resident in the UK, their taxable income will depend on the domicile of the deceased, whose estate is

4 See 78.3 (Residence and domicile of PRs for CGT).

> being administered, at the date of death.
> [2] If the deceased was domiciled in the UK, then the personal representatives will be taxable in the normal way on both UK and overseas income.
> [3] If the deceased was domiciled outside the UK, they will only be taxable on UK income. In such circumstances, you should not include such income. Please also tick box 6.6.[5]

Point [3] is not right as a matter of law. UK resident PRs are as a matter of law liable to income tax on foreign income regardless of the domicile of the deceased. (Domicile of the deceased is sometimes relevant to the separate question of whether PRs are UK resident, but it is possible for a foreign domiciled deceased to have UK resident PRs.)

One is nevertheless entitled (perhaps bound) to assume that HMRC mean what they say, in a document as formal as guidance notes to a tax return, unless it is clear that there has been a blunder, that is, if it is clear that they cannot mean what they say. HMRC clearly do mean what they say as they say it more than once and have said it for many years.[6]

There is therefore an informal concessionary practice. A concession is logical where the beneficiary of the estate is non-resident since income tax paid on foreign income would be reclaimed later when the income is paid to the beneficiary. The concession does raise a puzzle where the beneficiary is UK resident and the income is paid to the beneficiary: one might think that the foreign income should not be taken into account in computing the beneficiary's estate income, but that must be too good to be true. I think the effect of the concession should be to treat the PRs as non-resident for IT purposes and that should be followed through for payments made by the PRs (who therefore constitute a foreign estate). Thus a payment of the income to a UK resident beneficiary is taxable under the estate income regime, but a payment to a non-resident (or treaty non-resident) is not.

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5 Accessible *http://www.hmrc.gov.uk/worksheets/sa906-notes.pdf.* The reference is to box 6.6 in form SA906 (Trust and Estate Non-residence) which reads: "Tick box 6.6 if the deceased whose estate is being administered was domiciled outside the UK at the date of death".

6 The point has been made in the equivalent notes going back at least to the 2005 notes. Similar wording is found in form SA904(Notes) (Notes on form SA904 Trust and Estate Foreign 2013/14) under the heading "Special circumstances – Personal representatives."

79.6 Income from specific legacy

This section considers the position where a testator by their Will gives specific assets to a beneficiary.

In the first instance, the PRs will acquire the assets and they will receive the income arising from them. If they do not need to use the assets or income for the purpose of paying debts, taxes, etc., the PRs will in due course transfer the assets and income to the beneficiary (the formal legal terminology is that the PRs "assent to the vesting of the assets in the beneficiary").

In the first instance, the PRs usually pay tax at the basic rate (or dividend ordinary rate) on income arising from the assets. If the PRs asset and its income vesting in the beneficiary, something rather peculiar happens. The beneficiary is deemed to have been the owner of the asset since the death. The assent is said to "relate back" - that is, it operates retrospectively. For personal property this is a common law rule; for land, it is in s.36 Administration of Estates Act 1925 which provides:

> (1) A personal representative may assent to the vesting, in any person who (whether by devise, bequest, devolution, appropriation or otherwise) may be entitled thereto, either beneficially or as a trustee or personal representative, of any estate or interest in real estate to which the testator or intestate was entitled ....
> (2) The assent shall operate to vest in that person the estate or interest to which the assent relates, and, unless a contrary intention appears, the assent shall relate back to the death of the deceased.

This rule operates for income tax purposes: *IRC v Hawley* 13 TC 327. The beneficiary will, retrospectively, be treated as having received the income year by year as it arose and the PRs will be treated as if they had not received it. The PRs may have paid UK tax. This will retrospectively be treated as being paid by the PRs on behalf of the beneficiary. Thus a beneficiary who is a remittance basis taxpayer can reclaim tax paid by UK resident PRs on unremitted foreign income. A non-resident beneficiary can also reclaim tax (it is not necessary to rely on ESC A14).

TSE Manual provides:

> **7490 Beneficiaries of estates: legacies** [December 2011]
> *Tax rules for specific legacies.*
> A legacy may take the form of an asset that does not produce income – for example a picture or a piece of jewellery. The beneficiary does not receive income and has no tax liability in respect of the legacy.

Other assets can produce income – for example a bank account, shareholding or land. The general rule is that the beneficiary is entitled to the income arising to that asset from the death of the deceased person. Sometimes however the personal representatives may by law be entitled to use the income for some other purpose.

If the beneficiary gets the income it should be treated as his income for the year in which it arises. The authority for this is *IRC v Hawley* 13 TC 327. The beneficiary cannot however be taxed on or given repayment on income that he did not receive.

79.7 Income from residuary estate

During the period of administration, the PRs alone are entitled to the assets in the residue of the estate and its income. On completion of the administration, the residuary legatee becomes entitled to the assets which at that time form part of the estate, and any income which the PRs have not expended in the course of administration. It is possible for PRs to transfer specific assets to a beneficiary before completion of administration.

In order to appreciate the income tax law it is helpful to understand its history. In *R v Special Commissioners, ex p. Dr Barnado's Homes* 7 TC 646, the residuary legatee was a charity. Income arose to the PRs during the period of administration on which the PRs paid income tax. The residuary legatee was not entitled to the income of the residuary estate as it arose during the period of administration, so it could not at that time reclaim income tax paid. Instead it sought to recover the tax when it actually received the income, on completion of administration. The House of Lords held that although the sum received by the charity represented (or was derived from) the PR's income, it was received by the charity as a capital receipt (like accumulated income of a trust). The payment on the completion of administration did not operate retrospectively, the PR's income could not be treated as arising to the residuary legatee. So income tax paid by the PRs could not be recovered by the charity. The rule that an assent of a specific legacy relates back to death was not extended to gifts of residue. The reader may think that the charity had the better argument.[7] But that is now of academic interest: the law is settled.

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7 See Nitikman, "The Forgotten Law of Assent" Trusts & Trustees, Vol. 18, No. 7, August 2012, p.672. Perhaps the House of Lords was motivated by the (unmentioned) policy argument that any other decision would be inconvenient to the point of unworkable in practice. If so they were right, as the tax rules which have

That was a victory for the Revenue, who were no doubt unperturbed about the unfairness to the charity. But subsequently, predictably, individual residuary legatees successfully contended that they were not liable to super-tax (which became surtax in 1927 and is now higher rate tax) on the income of a residuary estate arising during the administration period.[8] The Revenue then realised they had made a rod for their own back. Legislation was therefore brought in which is now to be found in Chapter 6 Part 5 ITTOIA.

79.8 Absolute/limited/discretionary interest in residue

The legislation distinguishes absolute/limited/discretionary interests in residue.

79.8.1 *Absolute interest in residue*

Section 650(1) ITTOIA provides a fairly commonsense definition:

> A person has an absolute interest in the whole or part of the residue of an estate for the purposes of this Chapter if—
>
> (a) the capital of the residue or that part is properly payable to the person, or
>
> (b) it would be so payable, if the residue had been ascertained.

79.8.2 *Limited interest in residue*

Section 650(2) ITTOIA provides a fairly commonsense definition:

> A person has a limited interest in the whole or part of the residue of an estate during any period for the purposes of this Chapter if—
>
> (a) the person does not have an absolute interest in it, and
>
> (b) the income from it would be properly payable to the person if the residue had been ascertained at the beginning of that period.

In practice the usual example of a limited interest is a life interest.

79.8.3 *Discretionary interest in residue*

Section 650(3) ITTOIA provides a fairly commonsense definition:

> A person has a discretionary interest in the whole or part of the residue

---

replaced their decision do not work: see 79.22 (Reforming the income taxation of estates: Commentary).

8 eg *Corbett v IRC* 21 TC 449. There are several income tax cases on the issue of whether administration was completed.

of an estate for the purposes of this Chapter if—

(a) a discretion may be exercised in the person's favour, and

(b) on its exercise in the person's favour any of the income of the residue during the whole or part of the administration period (see section 653) would be properly payable to the person if the residue had been ascertained at the beginning of that period.

Section 650(4), (6) ITTOIA defines "properly payable" and s.650(5) deals with the situation where PRs have an interest in another estate.

79.9 "UK estate" and "foreign estate"

The legislation distinguishes "UK estates" and "foreign estates". The distinction matters for two purposes:

(1) Computation of the basic amount.

(2) Source of income (relevant to remittance basis taxpayers and non-residents).

These terms are defined in s.651(1) ITTOIA:

> "UK estate", in relation to a tax year, means an estate[9] which meets conditions A and B, or condition C, for that year, and
> "foreign estate", in relation to a tax year, means an estate which is not a UK estate in relation to that year.

I refer below to "**estate conditions A to C**". Unfortunately these conditions are in a tangle.

An estate may be a UK estate in one year and a foreign estate in another year. The question must be addressed each year.

79.9.1 *Estate conditions A and B*

Section 651 ITTOIA provides:

(2) Condition A is that all the income of the estate either—

(a) has borne UK income tax by deduction, or

(b) is income in respect of which the personal representatives are directly assessable to UK income tax for the tax year.

(3) Condition B is that none of the income of the estate is income for which the personal representatives are not liable to UK income tax for

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9 Section 649(2) ITTOIA provides a commonsense definition of "estate":
In this Chapter—
"estate" means the estate of a deceased person (whether a UK estate or a foreign estate).

the tax year because they are not UK resident.

79.9.2 *Disregarded income and estate condition C*

Section 651(4) ITTOIA provides:

> For the purposes of conditions A and B sums within section 680(3) or (4) (sums treated as bearing tax) are ignored.

The list of disregards in s.680 ITTOIA is as follows:

> (3) The following sums are treated as bearing income tax at the dividend ordinary rate—
>
> (a) a sum charged under Chapter 3 of Part 4 (dividends etc. from UK resident companies etc.), or
>
> (b) a sum that is part of the aggregate income of the estate because of falling within—
>
> (i) section 664(2)(c) (stock dividends), or
>
> (ii) section 664(2)(d) (release of loan to participator in close company where debt due from personal representatives).
>
> (4) A sum that is part of the aggregate income of the estate because of falling within section 664(2)(e) (gains from life insurance contracts etc) is treated as bearing income tax at the basic rate.

It is convenient to have a term to describe these categories of income, so I call it "**disregarded income**".

Why is this income disregarded? Prior to 1996, s.233(1) ICTA 1988 (repealed) provided:

> *Where in any year of assessment the income of any person, not being a company resident in the UK, includes a distribution in respect of which that person is not entitled to a tax credit*
>
> *(a) no assessment shall be made on that person in respect of income tax at the basic rate on the amount or value of the distribution ...*

Thus non-resident PRs who received dividend income would not be assessable and so would count as a foreign estate.

Section 651(5) ITTOIA provides:

> Condition C is that the aggregate income of the estate for the tax year consists only of sums within section 680(3) or (4).

79.9.3 *Examples*

If the PRs are UK resident:

(1) Estate condition A is satisfied (the PRs are directly assessable to IT).

(2) Estate condition B is satisfied[10]

so the estate is a UK estate.

If the PRs are UK resident but the testator was foreign domiciled, it appears that the estate is by concession treated as a foreign estate.[11]

If the PRs are non-resident, and have some foreign source income:

(1) Estate condition A is not satisfied (some of the PR's income is not taxable).
(2) It does not matter whether estate condition B is satisfied
(3) Estate condition C is not satisfied

so the estate is not a UK estate.

If the PRs are non-resident but have only UK source taxable income,

(1) estate condition A is satisfied (they are assessable)
(2) Estate condition B is satisfied (no foreign income) so the estate is a UK estate.

If the PRs are non resident and have some UK income which qualifies for exemption (eg gilts) the estate is a foreign estate.

It is easy to procure that an estate with non-resident PRs qualifies as a "foreign estate" by arranging that there is some foreign income or FOTRA securities.

79.10 "Payment"

The legislation uses the word "payment" but (like "capital payment" for s.87) this is widely defined. Section 681 ITTOIA provides:

> (1) For the purposes of this Chapter—
> (a) a transfer of assets, or
> (b) the appropriation of assets by personal representatives to themselves,

---

10 It takes more than one reading to comprehend the triple negative in condition B (the source legislation was clearer before the ITTOIA rewrite). Suppose PRs are not UK resident and receive foreign source income. The position is that condition B is not satisfied because:

(1) The PRs are not liable to IT on that income
(2) The reason they are not liable is that they are not UK resident: had they been UK resident, they would have been liable.
(3) Thus it is not the case that "none of the income of the estate is income for which the personal representatives are not liable to UK income tax for the tax year because they are not UK resident".

The same applies if non resident PRs receive income from exempt gilts.

11 See 79.5.1 (Foreign domiciled testator).

is treated as the payment of an amount equal to the assets' value at the date of transfer or appropriation.

(2) The set off or release of a debt is treated for the purposes of this Chapter as the payment of an amount equal to it.

(3) If at the end of the administration period—

(a) there is an obligation to transfer assets to any person, or

(b) personal representatives are entitled to appropriate assets to themselves,

an amount equal to the assets' value at that time is treated as payable then for the purposes of this Chapter.

(4) If at the end of the administration period—

(a) there is an obligation to release or set off a debt owed by any person, or

(b) personal representatives are entitled to release or set off a debt in their own favour,

a sum equal to the debt is treated as payable then for the purposes of this Chapter.

79.11 Charge to tax on estate income

Beneficiaries are subject to tax on estate income. There are essentially three parts to the legislation:

(1) The charge to tax on estate income.

(2) The definition of when estate income arises.

(3) The quantification of the amount of estate income.

Section 649(1) ITTOIA provides the charge to tax:

> Income tax is charged on estate income.

Section 659 ITTOIA identifies the person liable:

> (1) If the estate income is from a person's absolute interest or limited interest, that person is liable for any tax charged under section 649 unless subsection (3) or (4) provides that another person is liable.
>
> (2) If the estate income is from a discretionary interest, the person in whose favour the discretion is exercised in making the payment in question is liable for any tax charged under section 649.

Section 659(3)(4) (not set out here) deal with successive interests.

79.12 Estate income

Estate income is a label which brings in different sets of rules for the different types of interest in residue.

Section 649(2) ITTOIA provides:

> (2) In this Chapter—
> "estate income" means the income treated under this Chapter as arising from an absolute, limited or discretionary interest in the whole or part of the residue of an estate ...
> (3) Estate income is treated as income for income tax purposes.
> (4) If different parts of an estate are subject to different residuary dispositions, those parts are treated for the purposes of this Chapter as if they were separate estates.

The circumstances in which estate income is treated as arising depend on the type of interest in residue. These are set out in ss.652–655 ITTOIA. These provisions state *when* estate income is treated as arising. The question of the *amount* of estate income is addressed separately.

79.12.1 *When estate income arises: Absolute interest in residue*

Section 652 ITTOIA provides:

> (1) Income is treated as arising in a tax year from a person's absolute interest in the whole or part of the residue of an estate if—
> (a) the person has an assumed income entitlement for the tax year in respect of the interest (see sections 665 to 670), and
> (b) condition A or B is met.
> (2) Condition A is that a payment is made in respect of the interest in the tax year and before the end of the administration period (see section 653).
> (3) Condition B is that the tax year is the final tax year (see section 653).
> (4) Income treated as arising as a result of this section is estate income for the purposes of this Chapter.

The key term here is "assumed income entitlement;" see 79.15 (Assumed income entitlement).

For completeness, s.653 ITTOIA provides commonsense definitions of "administration period" and "final tax year":

> (1) In this Chapter "the administration period", in relation to the estate of a deceased person, means the period beginning with the deceased's death and ending with the completion of the administration of the estate.
> (2) In the application of subsection (1) to Scotland, the reference to the completion of the administration is to be taken as a reference to the date at which, after discharge of, or provision for, liabilities falling to be met out of the deceased's estate, the free balance held in trust for the residuary legatees or for the persons with the right to the intestate estate

has been ascertained.
(3) In this Chapter "the final tax year" means the tax year in which the administration period ends.

79.12.2 *When estate income arises: Limited interest in residue*

Section 654 ITTOIA provides:

(1) Income is treated as arising in a tax year from a person's limited interest in the whole or part of the residue of an estate in cases A, B and C.
(2) Case A is where—
(a) the interest has not ceased before the beginning of the tax year, and
(b) a sum is paid in respect of the interest in that year and before the end of the administration period.
(3) Case B is where—
(a) the tax year is the final tax year,
(b) the interest has not ceased before the beginning of that year, and
(c) a sum remains payable in respect of the interest at the end of the administration period.
(4) Case C is where—
(a) the tax year is a year before the final tax year,
(b) the interest ceases in the tax year, and
(c) a sum is paid in respect of the interest in a later tax year but before the end of the administration period, or remains payable in respect of it at the end of that period. ...
(6) Income treated as arising as a result of this section or section 674 is estate income for the purposes of this Chapter.

79.12.3 *When estate income arises: Discretionary interest in residue*

Section 655 ITTOIA provides:

(1) Income is treated as arising in a tax year from a person's discretionary interest in the whole or part of the residue of an estate if a payment is made in the tax year in exercise of the discretion in that person's favour.
(2) Income treated as arising as a result of this section is estate income for the purposes of this Chapter.

79.13 Amount of estate income

There are two aspects to the rules: quantifying the "basic amount", and grossing up.

79.13.1 *UK estate*

Section 656(1) ITTOIA provides:

> In the case of a UK estate, tax is charged under section 649 on the amount of estate income treated as arising in the tax year.

Section 656 defines the amount of estate income:

> (2) That amount is the basic amount of that income for the tax year (see subsection (4)) grossed up by reference to the applicable rate for that year (see section 663).
> (3) The gross amount is treated as having borne income tax at that rate.

The applicable rate is not discussed here. The key term is the "basic amount" of estate income.

79.13.2 *Foreign estate*

Section 657(1) ITTOIA provides:

> In the case of a foreign estate, tax is charged under section 649 on the full[12] amount of estate income treated as arising in the tax year.

The section goes on to specify the amount:

> (2) That amount depends on whether the estate income arising in the tax year is paid from sums within section 680(3) or (4) (sums treated as bearing income tax).
> (3) So far as the estate income is paid from such sums, that amount is the basic amount of that income for the tax year grossed up by reference to the applicable rate for that year (see section 663).
> (4) That gross amount is treated as having borne income tax at that rate.
> (5) So far as the estate income is not paid from sums within section 680(3) or (4), the amount of estate income treated as arising in the tax year is the basic amount of that income for that year.

The difference between UK and foreign estates is that in the latter case there is no grossing up.

We turn at last to the key concept "basic amount".

79.14 "Basic amount of estate income"

The quantum of the "basic amount of estate income" depends on the type

12 Section 657 refers to the "full amount" and s.656 refers only to the "amount", but the word "full" is clearly otiose: there is no difference in meaning.

of interest in residue, ie whether there is an absolute, limited or discretionary interest.

79.14.1 *Basic amount of estate income: Absolute interest*

Section 660 ITTOIA provides:

> (1) The basic amount of estate income relating to a person's absolute interest in the whole or part of the residue of an estate for a tax year before the final tax year is the lower of—
>
> (a) the total of all sums paid in the tax year in respect of that interest, and
>
> (b) the amount of the person's assumed income entitlement for the tax year in respect of it.
>
> (2) The basic amount for the final tax year is equal to the amount of the person's assumed income entitlement for that year in respect of that interest.

The next key term is "assumed income entitlement".

79.14.2 *Basic amount of estate income: Limited interest*

Section 661(1) ITTOIA provides:

> (1) The basic amount of estate income relating to a person's limited interest in the whole or part of the residue of an estate for a tax year is the total of the sums within section 654(2)(b), (3)(c) and (4)(c) for that year.

79.14.3 *Basic amount of estate income: Discretionary interest*

Section 662 ITTOIA provides:

> The basic amount of estate income relating to a person's discretionary interest in the whole or part of the residue of an estate for a tax year is the total of the payments made in the tax year in exercise of the discretion in favour of the person.

79.15 Assumed income entitlement

The key term "assumed income entitlement" is relevant to computation of the basic amount. For absolute interests, this is (in brief) calculated as follows.

79.15.1 *"Aggregate income of the estate"*

First one calculates the "aggregate income of the estate". This has a

broadly commonsense definition in s.664 ITTOIA:

> (1) For the purposes of this Chapter the aggregate income of the estate for a tax year is
>
> [a] the total of the income and amounts specified in subsection (2), but
>
> [b] excluding the income specified in subsection (5).
>
> (2) The income and amounts are—
>
> (a) the income of the deceased's personal representatives in that capacity which is charged to UK income tax for the tax year,
>
> (b) the income of the deceased's personal representatives in that capacity on which such tax would have been charged for the tax year if—
>
> (i) it was income of a UK resident, and
>
> (ii) it was income from a source in the UK,[13]

Paragraphs (c) to (e) deal with somewhat specialist topics:

> (c) any amount of income treated as arising to the personal representatives under section 410(4) (stock dividends) that would be charged to income tax under Chapter 5 of Part 4 if income arising to personal representatives were so charged (see section 411),
>
> (d) in a case where section 419(2) applies (release of loans to participator in close company: loans and advances to persons who die), the amount that would be charged to income tax under Chapter 6 of Part 4 apart from that section, and
>
> (e) any amount that would have been treated as income of the personal representatives in that capacity under section 466 if the condition in section 466(2) had been met (gains from contracts for life insurance).

Section 664(3)(4) deal with deductions:

> (3) In calculating the amount of the income within subsection (2)(a), any allowable deductions are to be taken into account.
>
> (4) In calculating the amount of the income within subsection (2)(b), any deductions which would be allowable if the income had been charged to UK income tax are to be deducted from the full amount of the income actually arising in the tax year.

---

13 I cannot see the point in (ii). If it is income of a UK resident, why does the source matter?

Section 664(5) identifies two categories of income not included in "estate income". The first is income from specific legacies:

> (5) The excluded income is—
> (a) income to which any person is or may become entitled under a specific disposition[14]

That is excluded from estate income as the income is deemed to accrue to the legatee.[15]

> (5) The excluded income is ...
> (b) income from property devolving on the personal representatives otherwise than as assets for payment of the deceased's debts.

That would include property which vests in the PRs under the obsolescent settled land act regime.

79.15.2 *"The residuary income of the estate"*

Armed with the figure for "the aggregate income of the estate", one next computes "the residuary income of the estate". This brings in rules for "allowable estate deductions". Section 666(1) ITTOIA provides:

> For the purposes of this Chapter the residuary income of an estate for a tax year is
> [1] the aggregate income of the estate for that year, less
> [2] the allowable estate deductions for that year.
> This is subject to section 669 (reduction in residuary income: inheritance tax on accrued income).

There are four categories of deductions. Section 666(2) ITTOIA provides:

> The allowable estate deductions for a tax year are—
> (a) all interest paid in that year by the personal representatives in that capacity (but see section 233 of IHTA 1984: exclusion of interest on unpaid inheritance tax),

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14 Defined in subsection (6): "In subsection (5)(a) 'specific disposition' means a gift of specific property under a will, including—
(a) the disposition of personal chattels by section 46 of the Administration of Estates Act 1925 (c 23) (succession on intestacy), and
(b) any disposition which under the law of another country has a similar effect to a gift of specific property by will under the law of England and Wales,
but excluding real property included in a residuary gift made by will by a specific or general description of it or, in Scotland, heritable estate included in such a gift."

15 See 79.6 (Income from specific legacy).

(b) all annual payments for that year which are properly payable out of residue,[16]
(c) all payments made in that year in respect of expenses incurred by the personal representatives in that capacity in the management of the assets of the estate,[17] and
(d) any excess deductions from the previous tax year.[18]

This is subject to subsections (3) to (5).

Subsections (3)(4) prevent double allowances:

(3) No sum is to be treated as an allowable estate deduction if it is allowable in calculating the aggregate income of the estate.
(4) No sum is to be counted twice as an allowable estate deduction.

79.15.3 *"Assumed income entitlement"*

Armed with the figure for the residuary income of the estate, we are at last in a position to compute the assumed income entitlement. Section 665 ITTOIA provides:

(1) Whether a person has an assumed income entitlement for a tax year in respect of an absolute interest in the whole or part of the residue of an estate depends on the results of the following steps.
Step 1 Find the amount of the person's share of the residuary income of the estate that is attributable to that interest for that tax year and each previous tax year during which the person had that interest (see sections 666 to 669).
Step 2 If the estate is a UK estate in relation to any tax year for which an amount has been found under step 1, deduct from that amount income tax on that amount at the applicable rate for that year (see section 670).
Step 3 Add together the amounts found under step 1 after making any deductions necessary under step 2.
Step 4 Add together the basic amounts relating to the person's absolute

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16 Para (c) should be deleted, as annual payments are not generally allowable; but it does no harm.

17 Section 666(5) restricts this to income expenses: "Payments in respect of expenses are only allowable estate deductions if they are properly chargeable to income (ignoring any specific direction in a will)."

18 This is defined in s.666(6):
"In this section 'excess deductions from the previous tax year' means so much of the allowable deductions for the previous tax year as exceeded the aggregate income of the estate for that year."
This allows unused expenses to be carried forward.

interest in respect of which the person was liable for income tax for all previous tax years (or would have been so liable if the person had been a person liable for income tax for those years).
(2) For the purposes of this Chapter the person has an assumed income entitlement for the tax year if the amount resulting from step 3 exceeds the amount resulting from step 4.
(3) The assumed income entitlement is equal to the excess.
(4) [This deals with successive interests].

79.16 Beneficiary a trustee of a discretionary trust

Section 483 ITA provides:

(1) This section applies if, during or at the end of the administration period for an estate—
(a) the personal representatives pay the trustees of a settlement a sum representing income of the personal representatives, and
(b) if this Chapter had applied to personal representatives, income tax would have been charged on that income at the dividend trust rate or at the trust rate.
(2) The sum is treated as—
(a) being paid as income, and
(b) having borne income tax at the applicable rate.

Lastly we have some definitions by reference (which would have been unnecessary had there been taxes-act-wide definitions):

(3) In this section—
"administration period" has the meaning given by section 653 of ITTOIA 2005, and
"the applicable rate" means the rate referred to in section 663(1) of ITTOIA 2005 (the applicable rate for grossing up basic amounts of estate income).

The drafter has failed to incorporate the extended definition of "payment" but perhaps that may be implied.

79.17 Beneficiary a remittance basis taxpayer

Section 658 ITTOIA brings in the remittance basis:

(1) The charge to tax under section 649 on the amount of income arising in a tax year is subject to Part 8 (foreign income: special rules).
(2) For the purposes of section 830(1) (meaning of "relevant foreign income") amounts charged to tax under section 649—
(a) are treated as arising from a source outside the UK if the estate

is a foreign estate, and

(b) are treated as not arising from such a source if the estate is a UK estate.

The section uses the words "treated as" because the income (being fictional income) does not have a source.[19]

If a beneficiary is a remittance basis taxpayer, it is important to ensure that the estate is a "foreign estate" and not a "UK estate" because the remittance basis only applies to a foreign estate.

Since the estate income is deemed income, not real income, it cannot be remitted. There is no rule that the PRs income or the beneficiary's actual receipts are is deemed to be derived from the estate income.

79.18 Non-resident beneficiary of UK estate: DT relief

International Manual provides:

> **367510 Claims by beneficiaries of a UK estate** [June 2007]
> A distribution made to a beneficiary of income received by a UK estate during its administration period is considered to be a source of income in its own right.[20]
> Where a beneficiary receives a distribution of income that has arisen during the administration of a UK estate, that beneficiary may be entitled to relief on the income under a Double Taxation treaty. Relief will be available in one of two ways:
> • Other Income article: where an other income article of a treaty does not exclude income paid out of a UK estate, that income is considered as other income. ...
> The beneficiary is entitled to full relief from the total tax deemed to have been paid on the income.
> • Extra Statutory Concession A14: where it is not possible to relieve the income under an other income article, Extra Statutory Concession A14 allows us to look through to the underlying sources of income received by an estate and allow relief as if the beneficiary owned the sources of income in their own right.[21] ...

International Manual para 367530 sets out a list of countries where relief is available under the Other Income article on distributions made by UK estates. For this list see 25.11.1 (DTAs with OECD model "other income"

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19 See 14.6 (Location of source of income when there is no source).

20 Author's footnote: That is, the estate is not considered to be transparent.

21 See 79.19 (Non-resident beneficiary of UK estate: concessionary relief).

article).

> **367540 How to give relief by 'looking through'** [April 2007]
> A repayment claim will be supported by an R185 (Estate Income) (or an R185E) tax certificate prepared by the personal representative(s) showing the rate(s) at which the sources of income have been taxed.
> It should be possible to identify the sources of income from the R185 (Estate Income). If so, you should apply relief at the treaty rate for the type of income. It may not be possible to identify the sources of income on an R185E; if so you will need to find out what they are. Remember that you will have to open an SA enquiry to ask for the information you need. See INTM331200 for guidance on how to open an enquiry. You should ask the claimant or their representative for a breakdown of the underlying sources of income arising to the estate.
> (This text has been withheld because of exemptions in the Freedom of Information Act 2000)

79.19 Non-resident beneficiary of UK estate: Concessionary relief

ESC A14 provides:

> **Deceased person's estate: residuary income received during the administration period**
> A beneficiary who for a year of assessment is not resident or not ordinarily resident in the UK, and is deemed under ITTOIA ss.657, 658(2) and 830(1) to have received income from a UK estate in that year, may claim to have their tax liability on that income from the estate adjusted to what it would be if such income had arisen to them directly and as a result they—
> [1] could claim relief under TA 1988 s.278 (claim to personal reliefs by certain non residents); or
> [2] could claim entitlement to exemption in respect of FOTRA Securities issued in accordance with ITTOIA s.714; or
> [3] could claim relief under the terms of a double taxation agreement; or
> [4] would not have been chargeable to income tax.

The ESC goes on to specify the conditions for the relief.

> Relief or exemption, as appropriate, will be granted to the beneficiary only if the personal representatives of the estate—
> – have made estate returns for each and every year for which they are required, and
> – have paid all tax due and any interest, surcharges and penalties arising, and

– keep available for inspection any relevant tax certificates, together with copies of the estate accounts for all years of the period of administration showing details of all sources of estate income and payments made to beneficiaries.

Relief or exemption, as appropriate, will be granted to the beneficiary on a claim made within five years and ten months of the end of the year of assessment in which the beneficiary is deemed to have received the income.

No tax will be repayable to the beneficiary in respect of income they are deemed to have received where the basic amount of estate income, if received by a UK resident beneficiary of an estate, is paid sums within ss.657(3), (4) and 680(3), (4) ITTOIA.

This is the equivalent of ESC B18 for trusts.[22]

79.20 Time limits for claims and assessments

Section 682 ITTOIA provides:

(1) This subsection applies if after the administration period ends it is apparent that a person is liable for income tax on estate income for any tax year who previously appeared not to be so liable or to be liable for tax on a lesser amount.

(2) If subsection (1) applies—

(a) the person may be assessed and taxed for the tax year, and

(b) any relief or additional relief to which the person may be entitled for the tax year is to be allowed if a claim is made.

(3) This subsection applies if after the administration period ends it is apparent that a person who previously appeared to be liable for income tax on estate income for any tax year is not so liable or is liable for tax on a lesser amount.

(4) If subsection (3) applies—

(a) all necessary adjustments and repayments of income tax for the tax year are to be made, and

(b) if the person has been allowed relief which exceeds the relief that could have been given by reference to the amount actually charged for the tax year, income tax is charged on the person for that year under this subsection on the excess.

(4A) The excess charged under subsection (4)(b) is treated as an amount of income for income tax purposes, except so far as it represents a tax reduction given effect at Step 6 of the calculation in section 23 of ITA

22 See 25.9 (Discretionary trusts treated as transparent to allow beneficiaries reliefs).

2007.

(5) An assessment or adjustment made for the purposes of this Chapter or a claim made as a result of this Chapter may be made after the end of the period otherwise allowed if it is made on or before the third anniversary of the normal self-assessment filing date for the tax year in which the administration period ends.

International Manual provides:

367560 Statutory time limit for claims by beneficiaries [April 2007]
It is possible that a beneficiary may receive a distribution from an estate which includes income received by the personal representative outside the normal statutory time limit. However, Section 700(3) ICTA 1988 allows beneficiaries until 3 years from 31 January following the year in which administration was completed to make their claims. This means that a beneficiary is not prevented from claiming relief from UK tax because of the time taken to complete the administration of the estate.
For example, a death occurs during 1994/95. In the normal course of events, the time limit for a beneficiary to claim on administration period income arising in that year would have expired on 5 April 2001. However, if the administration of the estate is not completed until 2002/03 the time limit is extended and the beneficiary has until 31 January 2007 to make the claim.

79.21 HMRC practice (the conventional basis)

The statutory rules are too complicated, and in practice no-one usually takes much notice of them. The TSE Manual first outlines the law:

7655. Statutory - conventional basis of taxation [March 2009]
The statutory basis
The statutory basis is provided in ITTOIA/Ss654, 656 and 661. This requires all sums paid during or payable on completion of the administration period to be taxed over the course of the administration period. The amounts are allocated to tax years as follows:-
1. where
   - the interest has not ceased before the beginning of the tax year
   - the administration period continues after the end of the tax year

   then the amount is the sum paid in the tax year
2. where
   - the interest has not ceased before the beginning of the tax year
   - the administration period ends in the tax year

   then the amount is the total of
   [a] any sum paid in the tax year before the end of the administration

period plus

[b] any amount still due to the beneficiary at the end of the administration period...

The amounts allocated to each year are then deemed to be the net income of the beneficiary for that year. The amount concerned is grossed at the applicable rate...

The TSE Manual then provides a concession:

The conventional basis

The beneficiary is treated as if he had been entitled to the income of the estate (or an appropriate part of the estate) as and when the income arose to the personal representatives. The basis applies for all purposes including repayments.

It is unlikely that there will be cases where it is worthwhile insisting on the statutory basis. If the beneficiary asks for the statutory basis to be applied, you should ask for a computation on that basis. If you have any problems with such a computation, ask HMRC Trusts Edinburgh for advice.

In other words, the estate is treated as transparent for IT purposes. That will normally suit remittance basis taxpayers.

79.22 Reforming the income taxation of estates: Commentary

There could hardly be a stronger condemnation of the current rules than the statement in the Manual that *It is unlikely that there will be cases where it is worthwhile insisting on the statutory basis.* The entire code needs to be rethought and replaced with something simpler. But that is outside the scope of this book.

CHAPTER EIGHTY

WHO IS THE SETTLOR?

80.1 Why does it matter who is the settlor?

The identity of the settlor(s) of a settlement is important for many tax purposes. It is not practical to compile a full list, but the rules include the following:

(1) Rules taxing a settlor on trust income and gains.[1]

(2) Rules taxing trustees (or beneficiaries) if the settlor is UK domiciled or resident. The tax status of the settlor is an appropriate connecting factor for the taxation of trustees and beneficiaries. The most important example is the IHT excluded property rule.[2] So the question of the identity of the settlor often arises in matters concerning foreign domiciliaries.

(3) Connected person rules, which apply if a person is connected with a settlor.

(4) Reverter to settlor rules.[3]

Subsidiary questions may also arise:

- Where a settlement has two settlors, what property each has settlor provided
- Whether a settlor provides additional property
- When a settlor provides property

The person named as "the settlor" in a trust document is not necessarily a settlor, or the only settlor, for tax purposes.[4]

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1 See 27.1 (Settlor-interested trusts) and 50.2 (Fundamental s.86 conditions).

2 See 62.1 (Excluded property for IHT)..

3 See s.54 IHTA.

4 On nominal settlors see Kessler, *Drafting Trusts and Will Trust*s, (12th ed., 2014), para 10.14 (Nominal Settlor).

80.2 Definitions of "settlement"

Before discussing "settlor" we need to discuss "settlement".

80.2.1 *Terminology*

There are three distinct definitions of "settlement". When discussing statutory provisions it is usually best to use the statutory terminology, but that will not do here. We need labels to distinguish the definitions. I use the following terms:

(1) ***Classic settlements***

(a) ***Standard IT/CGT definition of "settlement"***

This definition applies in the Income Tax Acts, and TCGA unless the context otherwise requires.

It also applies for the CT Acts, so the label should perhaps be "standard IT/CGT/CT definition" but that seems too clumsy; I refer to IT/CGT only as that is the focus of this book.

In some cases the context does "otherwise require" because the settlement-arrangement definition is applied. I cannot think of any other case where the context would "otherwise require".

(b) ***IHT definition of "settlement"***: the definition for IHT purposes. For present purposes (identifying the settlor) the IHT definition is effectively the same as the standard IT/CGT definition, there is no need to distinguish between them.

The term "**classic settlement**" is used to describe a settlement within the standard IT/CGT and IHT definitions.[5] For most purposes the words "settlement" and "trust" are interchangeable[6], so I use **"trust"** as a shorthand to refer to a classic settlement.

(2) ***Settlement-arrangement***

This is the definition which applies for the purposes of the IT settlement provisions. It is also applied in various other contexts.[7]

Equipped with this terminology we can now consider the various

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5 This convenient term was first used in *Chinn v Collins* 54 TC 311 at p.339, and adopted in *Jones v Garnett* 78 TC 1 HL at [43].

6 See Kessler & Sartin, *Drafting Trusts and Will Trusts* (12th ed., 2014), p.*lix* (Terminology).

7 In earlier editions I called this "the IT definition of Settlement". But that terminology became inappropriate following the introduction of the standard IT/CGT definition in 2006; also the settlement-arrangement definition is adopted for several purposes for CGT.

definitions of "settlement".

80.2.2 *Standard IT/CGT definition of settlement*

Section 466 ITA provides:

> (1) This section applies for the purposes of the Income Tax Acts, except so far as, in those Acts, the context otherwise requires.
> (2) "Settled property" means any property held in trust other than property excluded by subsection (3)...
> (4) References, however expressed, to property comprised in a settlement are references to settled property.[8]

This is formally a definition of "settled property" not "settlement" but, as subs.(4) illustrates, the definition also governs the meaning of the word "settlement".

The exemption in s.466(3) relates to nominees or bare trustees, see 84.5 (Bare trusts/nomineeships).

CGT has equivalent provisions: s.60, 68 TCGA.

The same definition applies for CT: s.1169 CTA 2010.

80.2.3 *Settlement-arrangement definition of settlement*

Section 620(1) ITTOIA provides:

> In this Chapter "settlement" includes[9] any disposition, trust, covenant, agreement, arrangement or transfer of assets...

This is an outstandingly bad definition, because, taken literally, it covers every conceivable transaction. It has been left to the Courts to define the term. In *Jones v Garnett*, Lord Hoffmann explains:

> Not every transfer of property is a settlement for the purposes of [the settlement-arrangement definition]. There has to be an "element of bounty" in the transaction. This old-fashioned phrase, apparently derived from the judgment of Plowman J in *IRC v Leiner* 41 TC 589 and approved by the House of Lords in *IRC v Plummer* [1980] AC 896, conjuring up the image of Lady Bountiful in *The Beaux' Stratagem*, is perhaps not the happiest way of describing a provision for a spouse or

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8 The legislation is set out in full in ITA and TCGA, but there are no significant differences, so I give the text of ITA only. The CGT equivalent is in ss.60, 68 TCGA.

9 The context shows this is an exhaustive definition, ie the word "includes" really means "means".

> minor children. ... It is nevertheless exactly the kind of thing at which the anti-avoidance provisions are aimed. In *Chinn v Hochstrasser* [1981] AC 533 Lord Roskill cautioned against treating the word "bounty" as if it had been included in the statute. It seems to me that the general effect of the cases is that, under the arrangement, the settlor must provide a benefit which would not have been provided in a transaction at arms' length.[10]

The expression "bounty" was criticised by Lady Hale in the same case, but it is likely to continue in use as a technical term. It is short, accurate, and memorable if archaic.[11]

The bounty requirement is not quite the same as a "commercial" requirement, but the concepts overlap. In *IRC v Levy* the judge stated that "a commercial transaction devoid of any element of bounty is not within the definition". In that case an interest-free loan to a company wholly owned by the lender was held to be a *simple case of a commercial transaction devoid of any element of bounty* and hence not a settlement-arrangement.[12]

By contrast, the standard IT/CGT and IHT definitions of "settlement" do not include a bounty requirement.

It is unfortunate that statute uses the word "settlement" as a label for this concept, but there is nothing to be done about that.

Is an estate of a deceased person, or a trust under a will or intestacy a settlement-arrangement? This question does not arise for the purposes of the IT settlement provisions. Even if it is a settlement-arrangement the settlor, that is, testator (being dead) will not be subject to tax. The

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10 78 TC 1 at [7]. HMRC agree. The TSE Manual provides:

> "**4110 Restrictions to the definition of settlement** [August 2010]
>
> ...A purely commercial transaction at arms length is outside the meaning of 'settlement'.
>
> Settlement must include an element of bounty, as decided in the tax case of *IRC v Plummer* (54 TC 1). Bounty is the provision of value without any corresponding quid pro quo, usually a gift or a transfer at less than full value."

11 Lord Neuberger agreed in *Jones v Garnett* 78 TC 1 at [76]:

> "The word 'bounty' rings slightly uncomfortably, at least to my ears. … However, in the light of the judicial decisions on these provisions, it seems to me that the law is now tolerably clear and sensible, and, particularly given the need for clarity and the room for difficulties in this area, it would be inappropriate to risk introducing uncertainty or new complications by redefining the principles, even if only linguistically."

12 56 TC 68 at p.87.

settlement-arrangement definition is used in other contexts where the issue does arise: see 78.6.1 (Is an estate a "settlement" within s.87 TCGA?).

80.2.4 *IHT definition of settlement*

The IHT definition of "settlement" is different again. However for the purposes of this chapter (who is the settlor) it is equivalent to the standard IT/CGT definition.[13]

80.3 Definitions of "settlor"

80.3.1 *Terminology*

There are four distinct definitions of "settlor". We need labels to distinguish them, and I use the following terms:

(1) ***The standard IT/CGT definition of settlor***. This definition applies in the Income Tax Acts and TCGA "unless the context otherwise requires". In some cases the context does "otherwise require" because one of the other definitions of settlor is applied. I cannot think of any other case where the context would "otherwise require". The standard IT/CGT definition does not apply for the IT settlement provisions or for s.86 TCGA, so it is not the most important.

(2) ***The settlement-arrangement definition of settlor***. This is the definition which applies for the purposes of the IT settlement provisions. It is applied by reference in various other contexts.

(3) ***The CGT s.86 definition of settlor****:* the definition for the purposes of s.86 TCGA.

(4) ***The IHT definition of settlor****:* the definition for the purposes of IHT.

Equipped with this terminology we can now consider the various definitions of settlor.

80.3.2 *Standard IT/CGT definition of settlor*

Section 467(1) ITA provides:[14]

> In the Income Tax Acts (except where the context otherwise requires) "settlor", in relation to a settlement, means the person, or any of the

13 The differences matter for issues relating to categorisation of foreign institutions; the IHT definition is discussed in 84.3 (Definition of "IHT-settlement").

14 The legislation is set out in full in ITA and TCGA, but there are no significant differences, so I give the text of ITA only. The CGT equivalent here is s.68A TCGA. This definition also applies for CT: s.1169 CTA 2010.

persons, who has made the settlement.

Section 467 ITA sets out various circumstances in which a person is treated as having made a settlement:

> (3) A person ("S") is treated for the purposes of the Income Tax Acts as having made a settlement if—
>
> (a) S has made or entered into the settlement (directly or indirectly), ...

There are four possibilities here:

(1) S is treated as having made a settlement if S has made the settlement directly. This is a tautology.

(2) S is treated as having made a settlement if S has made a settlement indirectly. I am unable to see how one can make a settlement indirectly.

(3) and (4) S is treated as making a settlement if S has entered into it (directly or indirectly). These words have been lifted from the settlement-arrangement definitions of settlement and are not apt here.

I conclude that s.467(3)(a) achieves nothing, but it does no harm. One might take from it a general intent that "making a settlement" is not to be construed narrowly.

Section 467 ITA continues:

> (3) A person ("S") is treated for the purposes of the Income Tax Acts as having made a settlement if ...
>
> (b) the settled property, or property from which the settled property derives, is or includes property within subsection (4).
>
> (4) Property is within this subsection if—
>
> (a) the settlement arose on S's death (whether by S's will, on S's intestacy or in any other way), and
>
> (b) immediately before S's death, the property was property of S—
>
> (i) which was disposable property (see section 468), or
>
> (ii) which represented S's severable share in any property to which S was beneficially entitled as joint tenant.

This is necessary because an intestate does not "make or enter into" a trust arising on intestacy; and it might perhaps be argued that a testator does not "make or enter into" a trust arising under their will.[15]

Section 467(5) ITA provides:

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15 See 78.6.1 (Is an estate a "settlement" within s.87 TCGA?).

> In particular, S is treated for the purposes of the Income Tax Acts as having made a settlement if—
>
> (a) S has provided property for the purposes of the settlement (directly or indirectly), or
>
> (b) S has undertaken to do that.

This definition of settlor is almost the same as the settlement-arrangement definition, the only differences are that the wording is recast in the plain legal English drafting style, and will trusts are included.

Section 467(6) ITA deals with reciprocal arrangements:

> If a person ("A") makes or enters into a settlement in accordance with reciprocal arrangements with another person ("B")—
>
> (a) B is treated for the purposes of the Income Tax Acts as having made the settlement, and
>
> (b) A is not to be treated for the purposes of the Income Tax Acts as having made the settlement just because of the reciprocal arrangements.

80.3.3 *Settlement-arrangement definition of settlor*

Section 620 ITTOIA provides the settlement-arrangement definition:

> (1) In this Chapter ...
>
> "settlor", in relation to a settlement, means any person by whom the settlement was made.
>
> (2) A person is treated for the purposes of this Chapter as having made a settlement if the person has made or entered into the settlement directly or indirectly.
>
> (3) A person is, in particular, treated as having made a settlement if the person—
>
> (a) has provided funds directly or indirectly for the purpose of the settlement,
>
> (b) has undertaken to provide funds directly or indirectly for the purpose of the settlement, or
>
> (c) has made a reciprocal arrangement with another person for the other person to make or enter into the settlement.

One can identify five parts of the definition. A person is a settlor if and only[16] if they have:

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16 "Means" in s.620(1) is the term used for an exhaustive definition. The context shows that the words "is treated as" in s.620(2)(3) also constitute an exhaustive (not inclusive) definition.

(1) made the settlement directly or indirectly;
(2) "entered into"[17] the settlement directly or indirectly;
(3) provided funds directly or indirectly for the purpose of the settlement;
(4) undertaken to provide funds directly or indirectly for the purpose of the settlement;[18] or
(5) made a reciprocal arrangement with another person to make or enter into the settlement.

80.3.4 *IHT definition of settlor*

Section 44(1) IHTA provides the IHT definition:

> In this Act "settlor", in relation to a settlement, includes[19]
> [a] any person by whom the settlement was made directly or indirectly,
> [b] and in particular (but without prejudice to the generality of the preceding words) includes any person who
> [i] has provided funds directly or indirectly for the purpose of or in connection with the settlement or
> [ii] has made with any other person a reciprocal arrangement for that other person to make the settlement.

The IHT definition expands "for the purpose of the settlement" into "for the purpose of *or in connection with* the settlement". It is considered that the words make no difference, for if something is provided "in connection

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17 The words "entered into" are not found in the CGT s.86 or IHT definitions of "settlor". The reason is that (in the context of the settlement-arrangement definition) the word "settlement" includes an agreement or arrangement. One is said to "enter into" an agreement or arrangement even though it is not normal usage to say that one "enters into" a settlement (in the classic sense).
The drafter of the standard IT/CGT definition did not realise this, so they included the words infelicitously, though no harm is done.

18 In practice HMRC may ignore this. TSE Manual formerly provides at 4120: "In practice if someone has undertaken to provide funds, but actually does not, we would not seek to apply s.624 or s.629 ITTOIA." The passage was quietly deleted in February 2011, but with no announcement of a change of practice. Undertakings to provide funds are not found in practice so this has no practical relevance. The IHT and CGT s.86 definitions omits this, presumably it was thought to be unnecessary. The drafter of the standard IT/CGT definition included the words; if they had thought about this they would probably have omitted them, but no harm is done.

19 The IHT definition (unlike the other definitions) uses the non-exhaustive "includes". Perhaps the drafter of the IHT provision had in mind a case where a person was the "settlor" of a settlement in the natural sense of the word but was not within the IHT definition. I cannot think of such a case.

with" a settlement it must be provided "for the purpose of" the settlement; one must bear in mind that "purpose" does not need to be a very focussed or intense purpose.[20] The attraction of this view is that it makes the "who is the settlor" area of tax law more coherent if (so far as possible) the same test applies for all the taxes.[21]

There are specific IHT provisions which may affect the identity of the settlement and settlor for IHT. So sometimes a person who is the actual settlor in the general sense is not regarded as the settlor for IHT. This chapter considers the general sense of settlor; for the IHT provisions see 64.1 (IHT consequences of transfers between trusts).

80.3.5 *CGT s.86 definition of settlor*

TCGA Schedule 5 paras 7, 8 provide the CGT s.86 definition:

> *Meaning of "settlor"*
> 7 For the purposes of section 86 and this Schedule, a person is a settlor in relation to a settlement if the settled property consists of or includes property originating from him.
> *Meaning of "originating"*
> 8– (1) References in section 86 and this Schedule to property originating from a person are references to—
> (a) property provided by that person;
> (b) property representing property falling within para (a) above;
> (c) so much of any property representing both property falling within para (a) above and other property as, on a just apportionment, can be taken to represent property so falling.
> ...
> (3) Where a person who is a settlor in relation to a settlement makes reciprocal arrangements with another person for the provision of property or income, for the purposes of this paragraph—
> (a) property or income provided by the other person in pursuance of the arrangements shall be treated as provided by the settlor, but

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20 See 80.27 (Purpose: minor settlor).

21 Why did the drafter use a different form of words, if they wanted the same result? Perhaps the reason is that "settlement" for IHT is sometimes narrower than settlement-arrangement. The drafter may have considered cases where it may have been argued that A is a settlor of a settlement-arrangement (providing property for the purpose of the *arrangement*) but A is not a settlor for IHT purposes (not providing for the purposes of the IHT-settlement). For instance in *Crossland v Hawkins* 39 TC 493 the taxpayer accepted that (if there were an arrangement) he would be the settlor of the "arrangement"; but he argued (unsuccessfully) that he was not the settlor of the classic settlement. To anticipate such arguments, perhaps, the drafter added the words "or in connection with".

> (b) property or income provided by the settlor in pursuance of the arrangements shall be treated as provided by the other person (and not by the settlor).
>
> ...
>
> (6) For the purposes of this paragraph references to property representing other property include references to property representing accumulated income from that other property.
>
> (7) For the purposes of this paragraph property or income is provided by a person if it is provided directly or indirectly by the person.

The CGT s.86 definition does not have the words "for the purpose of the settlement". Instead what is provided must be the "settled property". This is slightly narrower. What is provided must necessarily be for the purpose of the settlement (or it would not become settled property).

Very similar to this definition is para 9(3) sch 5 TCGA, which sets out one of the trigger conditions which may bring a pre-1991 trust within the scope of s.86 TCGA:

> The first condition is that on or after 19th March 1991 property or income is provided directly or indirectly for the purposes of the settlement;[22]

HMRC guidance on para 9(3) (which is quite extensive) is therefore relevant to the definitions of settlor more generally.

80.3.6 *Person ceasing to be settlor*

Section 469 ITA provides for someone to cease to be a settlor:

> (1) A person ("S") who is a settlor in relation to a settlement ceases to be so when the following condition is met.
>
> (2) The condition is that—
>
> (a) no property of which S is the settlor[23] is comprised in the

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22 See 50.5.1 (First s.86 trigger condition: provision of property).
For completeness, para 9(3) continues with two exceptions (arm's length transactions and administrative expenses) but that is not relevant for the purposes of this chapter.

23 Section 467(2) ITA provides a commonsense definition of this expression:
"In the Income Tax Acts (except where the context otherwise requires) a person is a settlor of property if—
(a) the property is settled property because of—
(i) the person's having made the settlement, or
(ii) an event which leads to the person being treated by this Chapter as having made the settlement, or
(b) the property derives from settled property within paragraph (a)."

settlement,

(b) S has not undertaken to provide property (directly or indirectly) for the purposes of the settlement in the future, and

(c) S has not made reciprocal arrangements with another person for that other person to enter into the settlement in the future.[24]

This section is not expressed to apply only to the standard IT/CGT definition of settlor, so it is considered that it also applies to the settlement-arrangement definition.

This has no equivalent in the IHT definition of "settlor", though (if it mattered) it might, perhaps, be implied.

The CG Manual provides a straightforward example:

> **33245 Settlor: from 6 April 2006: Basic principles** [October 2007] [The Manual paraphrases s.469 ITA and continues:] For example A and B execute a deed of variation under which property left to them by their father's will is resettled on behalf of their children. Broadly speaking half the income and capital is held for the children of A and the other half for the children of B. From the time the variation is made, A and B are settlors of the settlement (see CG 33248). In due course the share relating to A's children has been wholly distributed. In this case we should say that A was no longer a settlor.

80.3.7 *Relevance of case law and HMRC statements*

In keeping with the patchwork nature of UK tax law, the three definitions of settlor are based on a common framework but they each have slight differences to the others. The settlement-arrangement definition originated in 1936 and is the ancestor of the other definitions. In IHT there has been a little tidying up of the settlement-arrangement definition; the CGT s.86 definition is perhaps an attempt to extract its essence. There is a single concept underlying all the definitions which also represents the normal meaning of "settlor" in trust law.[25] In most cases the differences in wording between the definitions do not matter.

Cases on one statutory provision will generally be relevant to them all.

This expression is defined for the purposes of the IT Acts, but it is only used here in s.469 apart from the (unimportant) IoV provisions.

The CGT equivalent is s.68A(1)(b) TCGA.

24 The CGT equivalent is s.68A(6) TCGA.

25 Contrast the definition in Article 1 Trusts (Jersey) Law 1984: "'settlor' means a person who provides trust property or makes a testamentary disposition on trust or to a trust").

Similarly, HMRC statements made in connection with one provision are generally applicable to the other provisions.

There is also a link between the concept of bounty which is a requirement of a settlement-arrangement and the concept of providing property for the purposes of a settlement, so cases discussing "settlement-arrangement" can also be relevant to the question of who is the settlor.[26]

There are circumstances where a person is a settlor of a settlement-arrangement but not the settlor of the classic settlement[27] but this is not because of differences in the definitions of "settlor": it is because of differences in the definitions of "settlement".

80.3.8 *Tainting*

It does not generally matter if a person provides a trivial amount of property to a trust (whether the settlor adding to the trust or a person adding to a trust made by another.) But occasionally penal tax rules apply if even trivial value is added. This is known as "**tainting**" a trust.

The most common examples are:

(1) A post-1991 provision of funds to a pre-1991 trust, and a post-1998 provision of funds to a pre-1998 trust, may lose the benefit of 1991 and 1998 transitional reliefs for s.86 TCGA.[28]

(2) A provisions of funds by a UK domiciled person will lose the benefit of 1998 transitional relief for s.87 TCGA.[29]

(3) A provision of funds by a UK-linked person may lose a beneficial mixed resident trustee rule for trustee residence.[30]

In these cases, the question of when funds are provided may also arise.

80.3.9 *Multiple definitions of "settlor": Commentary*

Three definitions of "settlement" seems complicated, but there are material differences between them and each definition is appropriate in its own context. However, four definitions of "settlor" is extravagant, for there is little difference between them.

A rational tax system would have one standard definition of settlor, which would apply for all taxes. Until 2006 we had a number of

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26 See 80.2.3 (Settlement-arrangement definition of "settlement").

27 See 80.12.2 (Beneficiary assigns interest to individual).

28 See 50.5 (Pre-1998 protected trusts); 50.7 (Pre-1991 protected trusts).

29 See 51.20 (1998 transitional relief).

30 See 5.7 (Trustee residence condition C).

definitions of settlor in different contexts, which had developed piecemeal as the tax system evolved. The FA 2006 introduced the standard IT/CGT definition but only applied it for some (not all) purposes of IT and CGT. It has therefore increased the number of definitions of "settlor" and made a complex situation rather more complex. This is curious because the authors of the proposals were emphatic that the two former definitions of trustee residence (a CGT and an IT definition) should be replaced by a single definition. We live in bad times for UK tax policy, but eventually, perhaps, someone will tidy up this mess. It would not be very hard to introduce a single definition.

80.4 Gift from A to B followed by gift to trust by B

Suppose:
(1) A gives property to B unconditionally;[31] and
(2) B gives the same[32] property to a trust.
Two "settlor" questions arise:[33]
(1) In what circumstances does one say that the A is the settlor of the trust, having provided the property indirectly? That is, what is the meaning of "providing indirectly"?
(2) If A is the settlor (having provided property indirectly), can one say that B is not a settlor, perhaps on the grounds that A is the "real" settlor?

One might expect to find guidance to these questions in *Hatton v IRC*.[34] The facts were as follows:
(1) Mrs Cole ("the mother") made a settlement ("the first settlement")

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31 The position is different if the gift from A to B is made on terms which require B to transfer the property to the trust. In that case, clearly:
(1) A would be the settlor,
(2) B would not be a settlor.
It is also different if the gift from A to B is made by instrument of variation: see 80.33 (Trust made by instrument of variation).

32 Similar points arise if B gives other property (not the property given by A) if this is part of an arrangement between A and B.

33 Other issues may also arise. If A is a beneficiary of the trust, A's gift to B may become a gift with reservation: see 63.6.2 (Gift from A to B followed by gift to trust by B). Note that even if A is a settlor of the discretionary trust, A has not made a chargeable transfer and no IHT is payable by A on the gift to the trust by B.

34 67 TC 759. For another aspect of this decision see 80.28 (Purpose: advisers and agents of settlor).

conferring on Mrs Hatton ("the daughter") a valuable equitable interest.

(2) The daughter transferred her interest to a new settlement ("the second settlement").

So this was in essence a case of a gift to B followed by gift to trust by B. It is important to note the background facts:

> Once the first settlement had been executed ... it was a virtual certainty that the second would be made on the following day provided that [the mother] was then still living.[35]

80.4.1 *When is A an indirect settlor?*

The Special Commissioners held:

> [the mother] was a settlor of the second settlement having directly or indirectly provided the only funds which were subjected to it.[36]

The judge held (67 TC at p.789):

> The Special Commissioners ... held that [the mother] was properly to be treated as a settlor of the second settlement on the ground that, by making the first settlement, [the mother] was a person who had provided funds directly or indirectly for the purpose of or in connection with the second settlement; and so, in relation to the second settlement, fell within the definition [of settlor]. In my view, they were entitled to reach that conclusion on the facts.

Hatton represents a relatively clear case of providing funds indirectly because the two gifts (from A to B, and from B to the trust) were part of an arrangement and it was a "virtual certainty" that the second gift would follow the first. Are these essential requirements? The Special Commissioners, and the court, did not address this important point.

It is clearly not sufficient that B's funds are historically derived from A. Something more is required, but what? It might be said that all paraphrases are suspect and the court must return to the words of the statute. But when the words are so vague, some gloss is necessary to

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35 67 TC at 771. The Special Commissioners added:

> [The daughter] was content to leave the details to [the mother's advisers]. There was no real likelihood that she would reject the suggestion that she should make the second settlement when Mr Willcox [her adviser] put it to her.
>
> But nothing turns on that.

36 At p.768G.

avoid hopeless uncertainty. At first sight, the concept of a "clean break" seems a useful one for determining whether property is provided indirectly. That is, if there is a clean break between A's gift to B, and B's gift to the trust, A has not provided property indirectly. But "clean break" is only a metaphor which itself needs elucidation. It is not much more than a colourful label.

It is suggested that A is a settlor (having provided property indirectly) only if (like *Hatton*) there is an arrangement under which:

(1) A makes a gift of property to B, and intends that B should promptly make the gift to the trust.
(2) B gives the property to a trust in fulfilment of the wishes of A.
(3) It is virtually certain that B's gift will be made.

Of course, this formulation will not solve all problems, since the factual questions may arise as to whether there is an "arrangement", what is A's intention and whether B makes a gift in fulfilment of A's wishes. But this is probably the best that can be done. It is consistent with the "conscious association" comments in *Fitzwilliam*.[37] It might be said that this is too narrow a test and it favours the taxpayer as it allows tax planning of the kind considered in 80.36 (Planning to create trust with foreign domiciled settlor). However, the planning is not all that easy! No looser test can be applied without considerable uncertainty. Moreover (see below), the consequences of A being an indirect settlor is that B is not a settlor; this strongly suggests a narrower test is appropriate for if B is a genuinely independent agent B should be the settlor.

80.4.2 *If A is indirect settlor, is B also the settlor?*

In *Hatton* the Special Commissioners held that the daughter did not provide the funds for the second settlement.[38] The reason was, it appears, that the mother had provided the funds indirectly and this excluded the possibility that the daughter had provided them.

The judge held on the appeal that it was immaterial (for the purposes of the IHT provisions being considered) whether the daughter was also a

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37 See 80.6 (Appointment from old trust to B followed by gift to new trust by B).

38 Page 768H. Confusingly, the Special Commissioners also say that the daughter *was* a settlor within the IHT definition. The reason, presumably, is that, although she did not provide property, she was a person by whom the second settlement was made. But nothing turns on that.

settlor of the settlement.[39] The judge did suggest that the daughter might also be a settlor.[40]

Approaching the matter as one of principle, untrammelled by authority, it is respectfully suggested that the Special Commissioners' approach is to be preferred. While as a matter of logic it is possible for A to provide property indirectly, and B to provide it directly, the legislation is framed on the basis that trust property can have only one "provider". This is clearly the case for the IT and CGT settlor-interested trust provisions.[41] It is suggested that the IHT definition should be construed in the same way. If property is provided indirectly by A, it should not be regarded as provided by B at all.

A similar issue arises in relation to the definition of capital payment (receipt of a benefit directly or indirectly from the trustees) where a similar analysis applies.[42]

80.4.3 *HMRC views*

TSEM 4300 [May 2014] provides:

> **Indirect gift of shares from parent**
> Mr J owns 60 of the 100 issued £1 shares in J Limited. Mr J is the sole company director and is the person responsible for making all the company's profits because of his knowledge, expertise and hard work. On starting up the company, Mr J allowed his mother to subscribe £40 for 40% of the shares but *shortly afterwards* she gifted them to her grandchildren. The circumstances are such that the decision to issue 40 shares at par is a bounteous arrangement (as were the shares in Jones v Garnett). ...

This is essentially a case of:

(1) A gift from Mr J to the grandmother; and

(2) A gift from the grandmother to the grandchildren.

The Manual's tax analysis is as follows:

> The true settlor here is Mr J *rather than the children's grandmother*. Section 629 [ITTOIA] therefore applies and attributes the dividends

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39 Page 791B.

40 The conclusion that the mother was a settlor "did not lead, necessarily, to the further conclusion that [the daughter] was not also a settlor". See p.791B.

41 See 81.4.1 (Direct and indirect settlors).

42 See 51.7.1 (Indirect receipt from trustees).

received by the children to Mr J for tax purposes.

The words in italics suggest that HMRC accept the views set out above: if J is the settlor then the grandmother is not.

Similarly Helpsheet 270 (Trusts and settlements – income treated as the settlor's) 2013/2014:

> **Example 1**
> Sue gives £1,000 to her brother Roger to put into trust for her children. Roger sets up a trust with this money and although he is the named settlor in the trust deed, Sue is treated as the real settlor because it was she who indirectly provided (or settled) the funds

It is clearly assumed that Roger is not the settlor.

Similarly, the CG Manual provides:

> **CG33246 - Basic terms of trust law as applied to CGT: settlor: from 6 April 2006: anti-avoidance** [January 2010]
> ... If A and B enter into 'reciprocal arrangements' under which A provides property for B's settlement in return for B providing property for A's settlement, then B, *and not A,* is the settlor of B's settlement, and vice versa.

A reciprocal settlement is just another way of providing property indirectly.

80.5 Trust created by B at request of A

> Suppose that a man owing a debt of honour or of gratitude to a friend, without any legal obligation proposed to discharge it by paying £1,000 to the friend, and that the latter asks that the sum be paid not to him but to the trustees of a settlement, which is done. The payment of the money to the trustees would obviously be a provision of funds for the settlement. On a purely objective view the payer could be said to have made that provision, but I think that the friend should properly be regarded as the person making this provision. It would be just as if the money had been first paid to him and then paid by him to the trustees. *The payer would have acted at his behest.*[43]

This *obiter* comment is right if (as Buckley LJ assumes) the payer agrees (albeit without legal obligation) to make the payment at the direction of the friend so that the friend has *de facto* (though not *de jure*) power of

43 *Mills v IRC* 49 TC at 387 (Buckley LJ).

disposition of the funds. The situation is different if a father proposed to make a gift to his son, and the son merely *asks* that the sum be paid to trustees of a settlement for himself and his family. For a father will feel moral obligations to his grandchildren as well as to his son; the father has no (even non-binding) obligation to make a payment to his son; the son has no *de facto* power of disposition over the funds; in such circumstances the father (not the son) is the settlor. The son has not provided funds even indirectly.

If A asks B to transfer a nominal sum as an initial trust fund, and B does so, not because B wishes to benefit the beneficiaries by the payment, but because A has asked B to, as a favour to A, then applying this principle, A is the (indirect) settlor.

80.6 Appointment from old trust to B followed by gift to new trust by B

Fitzwilliam v IRC concerned an arrangement under which:

(1) Trustees of a will trust exercised their power of appointment ("step 3") to confer a valuable equitable interest on Lady Hastings.

(2) Lady Hastings transferred this interest to a new trust shortly afterwards ("step 5").

So this was a relatively simple case of an appointment from the will trust to B followed by a gift to a new trust by B. The question was who was the settlor of the new trust: Lady Hastings or the testator of the will trust (or both). Lord Keith said:

> The argument for the Crown is that, by virtue of the appointment contained in step 3, property was provided to Lady Hastings directly or indirectly for the purpose of or in connection with the settlement which Lady Hastings later made under step 5. The person who provided that property is said to be Earl Fitzwilliam [the testator], because the appointment by the trustees falls to be read back into his will, under the principle of *Muir v Muir* [1943] AC 468 and *Pilkington v IRC* [1964] AC 612. These cases decided that for the purposes of the Scottish rule against successive liferents and the English rule against perpetuities the exercise of a power of appointment must be written into the instrument creating the power. Earl Fitzwilliam is, therefore, to be treated as the settlor so far as concerns the trust purposes contained in the appointment made by his trustees under step 3, but he cannot reasonably be regarded as having provided property directly or indirectly for the purpose of or in connection with the settlement made by Lady Hastings under step 5. The words "for the purpose of or in connection with" connote that there must *at least be a conscious association of the provider of the funds*

> with the settlement in question. It is clearly not sufficient that the settled funds should historically have been derived from the provider of them. If it were otherwise anyone who gave funds unconditionally to another which that other later settled would fall to be treated as the settlor or as a settlor of the funds. It is clear that in the present situation there cannot possibly have been any conscious association of Earl Fitzwilliam with Lady Hastings' settlement.[44]

It seems therefore that if:

(1) a trust ("trust 1") exists and A is its settlor;
(2) there is an arrangement under which:
    (a) the trustees of trust 1 appoint trust property to B;
    (b) B gives the property to a separate trust ("trust 2");

B will be the settlor of trust 2, and A will not be a settlor, unless the creation of trust 2 is envisaged by A at the time that trust 1 is made.

The "conscious association" test is an understandable and generally helpful paraphrase of the statutory words (though of course it does not solve much as the question may arise as to what is a "conscious association". Further, Lord Keith said there must *at least* be a conscious association, suggesting that it is a necessary, but may not be a sufficient, condition). The application of the conscious association test in the context of an appointment followed by a gift really is surprising, but the House of Lords have spoken. The matter is for most practical purposes ended – unless and until the Supreme Court speaks again. For implications for tax planning, see 80.36 (Planning to create trust with foreign domiciled settlor).

80.7 Transfers between trusts: The trust law background

There are (at least) five ways by which property can move between settlements (without a person becoming beneficially entitled to the property in the meantime):

(1) Trustees may exercise a power to transfer trust property to another trust. This is in practice the most common way.
(2) A beneficiary with a power of appointment (typically a general power) may exercise it so as to transfer property to another trust.
(3) (a) A beneficiary who is entitled to a contingent or reversionary interest in the capital of the trust fund of trust 1 may assign that

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44 *Fitzwilliam v IRC* 67 TC 614 at p.732, emphasis added.

interest to trust 2; and

(b) the trustees of trust 2 in due course become absolutely entitled to the trust fund of trust 1.

(4) Beneficiaries (who between them are absolutely entitled to the trust property) may exercise their powers under the rule in *Saunders v Vautier* to direct trustees to transfer the trust property to another trust.

(5) Where beneficiaries are not absolutely entitled to the trust property, the transfer to another trust may be achieved with the consent of the Court on behalf of minor or unborn beneficiaries under the Variation of Trusts Act 1958.

A transfer to a separate settlement needs to be distinguished from the situation where steps take place which vary the terms on which trustees hold trust property, but without giving rise to a transfer to another trust. The distinction is a matter of trust law.

Where there is a transfer from trust 1 to trust 2, the question discussed here is who is the settlor of trust 2. Is it the settlor of trust 1 or the person(s) who brought about the transfer?[45]

80.8 Transfer between trusts by appointment: IT/CGT appointment rules

Section 470(1) ITA provides:

> Section 471 applies in relation to a transfer of property[46] from the trustees of one settlement ("settlement 1") to the trustees of another settlement ("settlement 2") if the transfer—
>
> (a) is not for full consideration,
>
> (b) is not by way of a bargain made at arm's length, and
>
> (c) is not excluded by subsection (2).

The provision set out above applies for IT and the rules are incorporated

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45 Trust law questions also arise: whether a power can be exercised to transfer to another trust, and restrictions on accumulation and perpetuity periods.

46 The expression "transfer of property" is widely defined in s.470(3) ITA:

"In this section 'transfer of property' means—

(a) a disposal of property by the trustees of settlement 1, and

(b) the acquisition by the trustees of settlement 2 of—

(i) property disposed of by the trustees of settlement 1, or

(ii) property created by the disposal.

(4) For the purposes of subsection (3) there is an acquisition or disposal of property if there would be an acquisition or disposal of property for the purposes of TCGA 1992."

by reference for CT.[47] The same rules apply for CGT.[48]

At first sight s.470 seems wide enough to cover every type of transfer between trusts. But the exclusions in subsection (2) are also wide,[49] and in practice s.471 usually applies on a transfer between trusts by exercise of a power of appointment. So I refer to the rules in s.470, 471 (and the CGT equivalent) as **"the IT/CGT appointment rules"**. That label does not completely encapsulate the circumstances where s.471 may apply, but no short label could do that.

The CG manual provides:

> **33247 Settlor: from 6 April 2006: Transfer between settlements** [January 2010]
> TCGA92/S68B
> This section is concerned with the situation where the trustees of Settlement 1 ["S1"] transfer property to the trustees of Settlement 2 ["S2"], including cases where property is created by Settlement 1 on behalf of Settlement 2, such as the grant of a lease by the trustees of Settlement 1 to the trustees of Settlement 2.
> Unless the transfer is for full consideration, or by way of a bargain at arm's length Section 68B TCGA applies. The reason for having these two alternatives is to allow for the possibility that Settlement 1 and Settlement 2 are connected persons (so that any transaction between them is not at arm's length by virtue of Section 18 TCGA 1992), and Settlement 1 sells an asset to Settlement 2 for its full market value. In such a case we do not want section 18 to cause section 68B to apply.

80.8.1 *The IT/CGT appointment rules*

Assuming the conditions for the IT/CGT appointment rules are satisfied, we journey on to s.471(1) ITA:

> If there is a transfer of property in relation to which this section applies, then the following subsections apply for the purposes of the Income Tax Acts, except so far as, in those Acts, the context otherwise requires.

Although the drafter adds the words except "where the context otherwise requires", I cannot think of a case where the context would "otherwise

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47 Section 1169 CTA 2010.

48 The CGT equivalent is s.68B TCGA.

49 See 80.12.1 (Beneficiary assigns interest to new trust); 80.11 (Transfer between trusts under general power of appointment); 80.33.5 (IT and CGT: IoVs from 6 April 2006).

require"; and I expect the drafter has copied without much thought the wording used (appropriately) in s.467 ITA.[50] The IT/CGT appointment rules apply for all IT/CGT definitions of settlor: the standard IT/CGT definition, the settlement-arrangement definition, and the CGT s.86 definition.

> (2) The settlor (or each settlor) of the property disposed of by the trustees of settlement 1 ("the disposed property") is treated from the time of the disposal as having made settlement 2.
> (3) If there is more than one settlor of the disposed property, each of them is treated in relation to settlement 2 as the settlor of a proportionate part of the property acquired by the trustees of settlement 2 on the disposal.
> (4) So far as the disposed property—
> (a) was provided for the purposes of settlement 1, or
> (b) was derived from property so provided,
> the property acquired by the trustees of settlement 2 on the disposal is treated from the time of the disposal as having been provided for the purposes of settlement 2.
> (5) If as a result of subsection (4), property ("the transferred property") is treated as having been provided for the purposes of settlement 2—
> (a) the person who provided the disposed property, or the property from which it was derived, for the purposes of settlement 1 is treated as having provided the transferred property for the purposes of settlement 2, and
> (b) if more than one person provided the disposed property, or the property from which it was derived, for the purposes of settlement 1, each of them is treated as having provided a proportionate part of the transferred property for the purposes of settlement 2.

In short, the settlor of settlement 1 is the settlor of settlement 2.

80.9 Transfers between trusts by appointment: IHT rules

Where there is a transfer from trust 1 to trust 2, by exercise of a power of appointment the question discussed here is who is the settlor of trust 2. Is it the settlor of trust 1 or the person(s) who brought about the transfer?

This section considers the general sense of settlor for IHT purposes. Some special IHT rules apply in particular circumstances: see 64.1

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50 See 80.3.1 (Terminology).

(Transfers between trusts – Introduction).

IHT has no statutory equivalent of IT/CGT appointment rules. Those statutory provisions applies for IT, CGT and CT purposes only. But the IT/CGT appointment rules only codify the general law position, so the same principles apply for IHT. This explains why the statutory provisions (which originated in the FA 2006) were backdated and apply even if the transfer between trusts was made before 2006.

HMRC agree. The CG Manual provides:

> **33247 Settlor: from 6 April 2006: Transfer between settlements** [January 2010]
> ... It is not unusual for trustees to appoint or advance assets to a newly created trust. See for example *Hart v Briscoe* 52 TC 53. Courts have said, see for example *Chinn v Collins* 54 TC 311, that the trustees in such a situation are perfecting the settlor's original gift in settlement. Therefore in such a case section 68B has the effect that it is the original settlor of Settlement 1 who is the settlor of Settlement 2. The property is treated as having been provided for the purposes of Settlement 2.
> It is not considered that section 68B effected any change in the law.

80.9.1 *Transfer from trust 1 to existing trust made by B*

Suppose:

(1) A transfers property ("A's fund") to a trust ("trust 1"). The trustees have the standard power to transfer property to another trust.
(2) B transfers property ("B's fund") to a separate trust ("trust B").
(3) The trustees of trust A transfer A's fund to trust B.[51]

Trust 2 now has two settlors: A has provided A's fund indirectly, and B has provided B's fund directly. The issue was settled in CGT cases before the enactment of the IT/CGT appointment rules. In *Eilbeck v Rawling* 54 TC 101:

(1) A Gibraltar settlement ("Trust 1") made by "Mr A" held £600k.
(2) A Jersey settlement ("Trust 2") made by "Mr B" held £100.
(3) £315k was transferred from Trust 1 to Trust 2 by exercise of the trustees' powers.

Buckley LJ summarised the trust law background:

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51 If there is an arrangement under which (1) A transfers to trust 1 and (2) the trustees transfer to trust 2, ie the transfer to Trust B is in contemplation at the outset, then A is the settlor of Trust B. It is here assumed that the transfer was not in contemplation at the time of the creation of Trust A.

> When [the donee of a special power of appointment] exercises that discretion in making an appointment, he acts as the delegate of the settlor. What the donee does in exercise of a special power of appointment is done vicariously by the settlor. It is also settled law of long standing that, for the purposes of the rule against perpetuities, when a special power is exercised, the limitations created under it are to be written into the instrument which created the power. This association of the interests arising under an appointment in the exercise of a special power with the settlement conferring that power is not, in my opinion, confined to the rule against perpetuities.

The answer is then clear:

> If one asks who was the settlor of the £315,000 appointed by the appointment ... the only possible answer is [Mr A] the settlor of the £600,000 comprised in [Trust 1]. [Mr B] did not settle[52] the £315,000; he settled only £100. The [trustees of Trust 1] did not settle the £315,000; it was not the ... trustee's to settle, and making the appointment the ... trustee was only exercising a fiduciary power conferred on him by the settlor [Mr A], whose delegate he was as donee of the power. The exercise of the power had, in my opinion, precisely the same effect as if the [trustee of trust 1] had appointed the £315,000 in favour of the [trustee of trust 2] to be held upon trusts identical with the trusts of [Trust 2] but set out in extenso in the appointment without reference to [trust 2]. If the appointment had taken that form, there could, I think, be no doubt that the trusts so appointed would be trusts taking effect under [trust 1].

The House of Lords approved this reasoning on appeal.[53]

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52 Buckley is using the word "settle" as a paraphrase of the statutory word "provide".

53 It may be objected that this is not consistent with *Fitzwilliam*: see 80.6 (Appointment from old trust to B followed by gift to new trust by B). There is no "conscious association" between A and Trust 2. However, *Fitzwilliam* was a case where the Court found that an individual beneficiary who assigned an asset to the new trust was the "settlor". The beneficiary displaced the testator from being a settlor by their independent act. There is no equivalent here.
The alternative conclusion that Trust B has no settlor for general tax purposes would have the result, attractive to taxpayers but absurd, that the property in Trust B could be excluded property, as one could not say that "the settlor" was domiciled in the UK at the time that the settlement was made! That can hardly be right.
If (which is doubtful) further authority is needed, see *Trennary v West* [2005] STC 214 at [49].

HMRC agree. The CG Manual provides:

> **33241 Settlor: Up to 5 April 2006** [October 2007]
> Where trustees exercise a special power of appointment, or power of advancement, in such a way as to create a new settlement, see CG33800+, the settlor of the new settlement is the person who was the settlor of the old one. See, for example, *Pilkington v IRC*, 40 TC 416, p.442[54] and *Chinn v Collins*, 54 TC 311, p.351H.[55]

It is considered that the same applies to a transfer for less than full consideration made in exercise of trustees dispositive powers, and to an interest-free loan from trust 1 to trust 2.

80.9.2 *Transfer from trust 1 to new trust created by trustees*

Suppose:
(1) Trustees of a trust made by A ("trust 1") have power to transfer to a new trust.
(2) The trustees transfer the trust fund to new trustees to hold on the terms of a newly created trust, trust 2. All the funds of trust 2 are derived from trust 1.

Who is the settlor (in the general sense) of Trust 2? The trustees of Trust 1 cannot be the settlor as they have merely exercised a fiduciary power. So either A is the settlor or there is no settlor. The answer is that A is the settlor of Trust 2.

80.9.3 *Commentary: Extending IT/CGT appointment rules to IHT*

It was not necessary to enact the IT/CGT appointment rules. But at present we have statutory rules for IT/CGT/CT and case law rules for IHT, the worst of both worlds. It would have been better if the IT/CGT appointment rules had not been enacted. But now we have them, a small simplification would be to extend the statutory rules to IHT. This would not change the law, but would make its explanation slightly easier.

80.10 Transfer between trusts under power of advancement

Suppose:
(1) Trustees of trust 1 have a power of advancement (that is, a power to apply trust property for the benefit of a beneficiary).

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54 [Author's note] See 80.10 (Power of advancement) where this passage is set out.
55 The same point is made again at CG Manual 34802.

(2) They use that power to transfer trust property to a new trust ("trust 2").[56]

The position for IT/CGT is covered by the IT/CGT appointment rules: the settlor of trust 1 is also the settlor of trust 2.

The same applies for IHT. The consent of the beneficiary is not needed and therefore the beneficiary is not the settlor of the new trust.

Pilkington v IRC concerned a proposal to transfer property to a new settlement by exercise of a power of advancement in favour of a Miss Penelope. Lord Radcliffe said:

> When one asks what person can be regarded as the settlor of Miss Penelope's proposed settlement, I do not see how it is possible to say that she is herself or that the trustees are. She is the passive recipient of the benefit extracted for her from the original trusts; the trustees are merely exercising a fiduciary power in arranging for the desired limitations. It is not their property that constitutes the funds of Miss Penelope's settlement: it is the property subject to trusts by the will of the testator and passed over into the new settlement through the instrumentality of a power which by Statute is made appendant to those trusts.[57]

HMRC agree: see CG33241 set out in 80.8 (Transfer from trust 1 to trust 2 by exercise of trustees' power).

If the power of advancement is used to alter the terms of an existing trust, without a transfer to a new trust, then *a fortiori* neither the trustees nor the object of the power are settlors.

In short, as far as the identity of the settlor is concerned, there is no difference between a power of appointment and a power of advancement.

80.11 Transfer between trusts under general power of appointment

Section 470(2) ITA sets out three exceptions to the IT/CGT appointment rules. The second is:

> A transfer of property is excluded for the purposes of subsection (1) if
> ... (b) it occurs only because of the exercise of a general power of appointment

This excludes the operation of (what I call) the IT/CGT appointment rules.

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56 See Kessler, *Drafting Trusts and Will Trusts* (12th ed., 2014), para 11.11 (Power of advancement used to create new trusts).

57 *Pilkington v IRC* 40 TC 416 at p.442.

It does not expressly say who is the settlor: general principles apply. The answer is clear enough.

The CG Manual provides:

> **33247 Settlor: from 6 April 2006: Transfer between settlements** [January 2010]
> ... However there are three specific cases which are excluded...
> [2] Under the terms of Settlement 1 D may have a general power of appointment. If so D is the settlor (or additional settlor) of Settlement 2.

80.11.1 *General powers: The trust law background*

The term **"general power of appointment"** is not defined: it is a term of English trust law and will have its trust law meaning. This section considers that meaning.

I refer to the person who exercises a power of appointment as "the trustees" (if the power is vested in trustees) or **"the powerholder"** (if the power is vested in an individual). The traditional trust law term is "donee" (that is, the person to whom the power is given) or appointor (that is, the person exercising the power)

Powers are either:

(1) general powers or
(2) not general powers: the American terminology **"non general"** is the clearest word. The traditional trust law term is "special power"; one sometimes sees "limited power".

The cases are mostly old trust law cases, as general powers are not much used nowadays. However general powers do crop up in some tax planning contexts so the law is not of merely academic interest.

The Court of Appeal explain the term:

> General powers are such as the donee can exercise in favour of such person or persons as he pleases, including himself.
> Limited powers, which are sometimes also called special powers, are such as the donee can exercise only in favour of certain specified persons or classes.[58]

Powers vested in trustees are not likely to be construed to be general powers, as trustees cannot in principle use their powers to benefit themselves.

The commercial reality is that a general power is equivalent to

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58 *Re Dilke* [1921] 1 Ch 34 at p. 42 citing *Farwell on Powers* (3rd ed.), p. 8.

ownership. There are differences: if the powerholder dies without exercising the power the property will go as in default of appointment, and not under the will or intestacy of the powerholder, and the powerholder may not be entitled to income arising before an appointment. But for many purposes the law recognises the commercial reality and donee is treated in the same way as the owner. Examples are:

(1) The perpetuity period rule. *Re Churston* explains:

> If the powers of appointment are what are commonly known as special powers in which the field of dispositees is plainly limited, then the instrument exercising the power has to be read back into the instrument creating the power for the purpose of applying the rule. ... If the power of appointment is a general power ... then the instrument exercising the power need not be read back into the original settlement for the purpose of applying the rule.[59]

(2) Insolvent powerholder rules
   (a) The holder of a general power must use it to pay their debts before voluntarily using it to benefit others.
   (b) If an insolvent holder of a non-fiduciary power (such as a power of revocation) refuses to exercise the power in their own favour, the courts will appoint a receiver who can exercise the power.

80.11.2 *Consent powers*

The question arises as to the classification of a power to appoint to whoever the powerholder directs, subject to the consent of a second person. I refer to that as **"a consent power"**.

It is considered that a consent power is not a general power. This was decided in *Re Churston* and is clearly right on principle:

> the reason why a general power of appointment in the ordinary sense starts a new settlement, and has not got to be read back into the original settlement, is because the property is treated as vesting in the donee of the general power, though it is not quite strictly accurate to say that it does so; or, in other words, that the test really is: is there somebody who for all practical purposes can be treated as the owner? [60]

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59 [1954] Ch 334 at p. 341. The perpetuity period rule was codified in 1964 (see now s.11 Perpetuities and Accumulations Act 2009) so the English law cases on the perpetuity period rule are all pre-1964 cases.

60 [1954] Ch 334 at p.347.

A consent power is not the equivalent of ownership.

Churston, it seems to me, successfully cleared up a confusion left by three earlier cases: *Watts*, *Dilke*, and *Philips*. It is necessary for completeness to consider these cases to explain that confusion.

In *Re Watts*, a consent power was also held not to be a general power. In this case however the Court laid some stress on particular features of the power concerned:

(1) The consent power was conferred by a settlement made in consideration of marriage.
(2) The consent power was exercisable during the lifetime of the consentor.
(3) The consentor had to consent both to the exercise of the power of revocation and to the exercise of the power of new appointment.

But as *Churston* pointed out, these features have no bearing on the central question of whether the power is equivalent to ownership.

> He said: "… in interpreting the language used in the settlement one must have regard to the fact that it is a settlement made in consideration of marriage." I must admit that I cannot think why. I cannot think that for the purpose of applying the rule against perpetuities a power to appoint as A thinks fit with the consent of B can have a different effect according to whether it is in a marriage settlement or in any other settlement.[61]

Quite so.

> Again, Bennett J. said: "It is also material, in interpreting the language used in the instrument, to have regard to the fact that the power of revocation and new appointment is restricted in point of time to the lifetime of [the consentor] …,". There again, with all respect, I cannot agree. That, of course, does show that the power is limited in duration; but a power to A to appoint to anybody he thinks fit during the life of B would be a general power of the common kind, though it could not be exercised after the death of B; by the terms of its creation it would thereupon cease to be a power at all. Likewise, a power to A to appoint to anybody he might think fit during a period of 21 years would appear to me to be a general power of the common kind, though obviously it could not be exercised after the expiration of the term of 21 years...[62]

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61 [1954] Ch 334 at p.342.
62 [1954] Ch 334 at p.342.

Quite so.

> Then he said that regard must also be had to the fact of "her consent in writing being given both to the exercise of the power of revocation and to the exercise of the power of new appointment." Again, I cannot appreciate the bearing of that. The two things are different things.[63]

So in conclusion:

> I therefore cannot say that I can see any real ground of distinction on those facts between *In re Watts* and *In re Dilke* and *In re Phillips*, neither of which, as far as I can make out, really throws any particular light on the present question.[64]

So the decision in *Watts* was correct; but not on the ground that its consent power was different from powers which *Dilke* and *Phillips* considered to be general powers; but on the ground that those cases were not relevant to the definition of "general power".

What were those two cases? *Re Dilke*[65] concerned a consent power which the powerholder exercised so as to confer a general testamentary power on herself, which did not require a consent.[66] The question was whether the consent power was validly exercised. This was a question of construction, and the exercise of the power was rightly held valid. The court described the power as "a general power of appointment to be exercised with certain consent". The question whether the consent power had to be categorised as a general power did not arise and I do not think that the Court decided it.

Re Phillips[67] concerned the insolvent powerholder rule: the holder of a consent power exercised the power and then died insolvent. The question was whether the appointed funds were available for the disappointed creditor – and it was held that they were. The case could have been decided on the basis that the consent power was a general power; but it could equally have been decided on the basis that the insolvent

63 [1954] Ch 334 at p.342

64 [1954] Ch 334 at p.343

65 [1921] 1 Ch 34.

66 [1921] 1 Ch 34. It seems that this was done because of a concern that the donee may lose mental capacity. I suspect there were death duty implications; but it does not matter.

67 [1931] 1 Ch 347.

powerholder rule applied on the exercise of a consent power even though it was not a general power: "the equity of the creditors is as strong as if it were an unfettered general power which the testator could exercise without consent." The court did not clearly distinguish the two possible analyses, but the consent power was not held, or at least not clearly held, to be a general power.

Churlston was approved in *Re Triffitt's Settlement*, which again concerned a consent power:

> for the purposes of the rule against perpetuities, a power such as I have read must be treated as a special or limited power. That seems to be the effect of *In re Watts* and *In re Churston Settled Estates*.[68]

Churlston also decided that a joint power (a power to appoint to whoever two persons jointly direct) is similarly not a general power.

80.11.3 *General power of appointment merely varies existing trust*

A general power of appointment (whether testamentary or not) may be used:
(1) in a manner which creates a new settlement, or
(2) in a manner which merely varies an existing settlement.
In case (2) it is considered that the powerholder is not in principle the settlor, but is in the same position as a person who consents to the exercise of a power.[69]

80.12 Beneficiary assigns or surrenders equitable interest

80.12.1 *Beneficiary assigns interest to new trust*

Section 470(2) ITA sets out three exceptions to the IT/CGT appointment rules. The first is:

> A transfer of property is excluded for the purposes of subsection (1) if—

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68 [1958] Ch 852 at p.861. For completeness: the Judge continued: "... On the other hand, under the now obsolete Legacy Duty Act, 1796, it would seem that a power in these terms has the character of a general power: see *Platt v Routh* (1841) 3 Beav 257." But *Platt v Routh* did not concern a consent power, but a general testamentary power exercisable by will in favour of anyone in the world other than three named families; so this is not relevant here.
Re Churlston was also approved in *Tasarruf Mevduati Sigorta Fonu v Merrill Lynch Bank and Trust Co* [2011] 4 All ER 704.

69 The position is analogous to 80.14 (Variation or resettlement by beneficiaries).

(a) it occurs only because of the assignment by a beneficiary under settlement 1 of an interest in that settlement to the trustees of settlement 2

This excludes the operation of (what I call) the IT/CGT appointment rules. It does not expressly say who is the settlor: general principles apply. The answer is clear enough. The CG Manual provides:

> **33247 Settlor: from 6 April 2006: Transfer between settlements** [January 2010]
> ... However there are three specific cases which are excluded.
> [1] A beneficiary, B, of Settlement 1 may transfer to Settlement 2 his interest in Settlement 1. In this case it is B who is the settlor (or an additional settlor) of Settlement 2.

A person who assigns an equitable interest under Trust 1 to Trust 2 is the settlor of Trust 2 but does not of course become the settlor of Trust 1.

80.12.2 *Beneficiary assigns interest to individual*

If a person assigns an equitable interest under Trust 1 to another individual there is no "Trust 2". In that case, that person is the settlor for the settlement-arrangement definition[70] so far as they have provided the income, but they are not a settlor of Trust 1 for the IHT definition, the CGT s.86 definition, or the standard IT/CGT definition.

HMRC agree: CG Manual provides:

> **33242 Settlor: Up to 5 April 2006** [October 2007]
> Normally the same person was the settlor for both Income Tax and CGT. But this is not the case where a person has assigned a right to income. Such an assignment could not have affected the identity of the settlor for CGT purposes.

The CG Manual also provides:

> **34801. Meaning of settlor** [October 2007]
> In general if HMRC Trusts Head Office Bootle or Edinburgh, or their predecessors Financial Intermediaries and Claims Office or Claims Branch have advised or ruled that a person is the settlor for Part XV ICTA 1988 or Part 5 Chapter 5 ITTOIA 2005 purposes then the same person should be regarded as the settlor for the purposes of these provisions. In exceptional cases, eg the assignment of a life interest, a

70 *IRC v Buchanan* 37 TC 362.

person may have settled a right to income under an existing settlement without thereby creating a new settlement for CGT purposes. Although the Income Tax Settlements Legislation may apply as regards that income, that person is not thereby a settlor of the main settlement.

The position is similar to a variation of trust by beneficiaries; see below.

80.12.3 *Beneficiary surrenders equitable interest*

If a person surrenders an equitable interest under Trust 1 there is no "Trust 2". In that case, that person is the settlor for the settlement-arrangement definition[71] so far as they have provided the income, but they are not a settlor of Trust 1 for the IHT definition, the CGT s.86 definition, or the standard IT/CGT definition. As far as the identity of the settlor is concerned, there is no difference between a surrender and an assignment.

80.13 Disclaimer

TSEM states at 1840:

> **1840 Deed of disclaimer** [April 2012]
> The person disclaiming is not a "settlor" within [the settlement-arrangement definition] (TSEM4120). Subsequent trusts that result from the disclaimer retain their original settlor.

A disclaimer, if possible, may be preferable to a surrender or assignment. The distinction between a disclaimer and a surrender/assignment is therefore important. This raises questions of property law which cannot be fully discussed here. TSEM provides a brief outline:

> **1840 Deed of disclaimer** [April 2012]
> A person uses a true disclaimer to refuse a gift due under a trust. Effectively the person steps aside. This allows subsequent provisions of the trust to take effect.
> A disclaimer can relate to
> • capital
> • income
> • both.
> A disclaimer has retrospective effect. It applies from the date that the entitlement arose. There may be a lapse of time between the entitlement arising and the disclaimer. This is not conclusive evidence that the deed cannot be a true disclaimer. ...

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71 *IRC v Buchanan* 37 TC 362.

> The person making a disclaimer may still benefit from another part of the trust income or capital. This is irrelevant. If that person seeks to impose new trusts, the deed is not a disclaimer. It is an assignment (TSEM1845).

Where the disposition is governed by foreign law, the disclaimer/assignment distinction may be more difficult to draw.

See too 67.5 (Forced heirship, legitime & Sharia rights).

80.14 Variation or resettlement by beneficiaries

80.14.1 *Variation or resettlement: The trust law background*

Beneficiaries who are adult and absolutely entitled to trust property[72] may:

(1) create a new settlement ("a resettlement") or

(2) (with the consent of the trustees) vary the terms of an existing settlement ("a variation").[73]

The distinction between a variation and a resettlement is crucial, but careful drafting will normally achieve whichever is desired.

HMRC agree. The CG Manual provides:

> **Variations of trusts**
> **37880. By agreement** [February 2006]

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72 If there are minor and unborn beneficiaries, a variation can similarly be made with the consent of the court under the VTA 1958.

73 See s.1(1) VTA 1958 which assumes that beneficiaries have power to vary a trust:

> "Where property...is held on trusts arising...under any will, settlement or other disposition, the court may if it thinks fit by order approve on behalf of [unborn or unascertained beneficiaries] any arrangement ... *varying* or revoking all or any of the trusts, or enlarging the powers of the trustees of managing or administering any of the property subject to the trusts. ..."

The Court only approves on behalf of unborn or unascertained beneficiaries, and adult beneficiaries can make a variation without the approval of the Court. See *Re Holt* [1969] 1 Ch 100 at p.120:

> "Under an arrangement approved by the court [under the Variation of Trusts Act 1958] the trusts may be brought wholly to an end. On the other hand, they may be varied; and there is no limit, other than the discretion of the court and the agreement of the parties, to the variation which may be made. Any variation owes its authority not to anything in the initial settlement but to the statute and the consent of the adults coming, as it were, ab extra. *This certainly seems to be so in any case not within the Act where a variation or resettlement is made under the doctrine of Saunders v Vautier by all the adults joining together*; and I cannot see any real difference in principle in a case where the court exercises its jurisdiction on behalf of the infants under the Act of 1958."

If all the beneficiaries of the trust are 18 or over and agree, they may bring it to an end and share out between themselves (and others) the trust property. (There is an exception to this rule in Scotland in that a person with an alimentary liferent cannot exercise consent in this way.) In these circumstances there is a deemed disposal by the trustees of the whole of the settled property under TCGA 1992, s.71(1).

37881. [February 2006]

It is also possible, with the consent of the trustees, to vary the terms of the trust. There are all kinds of variation possible. Some property may pass absolutely to beneficiaries or existing separate settlements. Clearly this must involve disposals under TCGA 1992, s. 71(1). Other property is held on the same trusts as before and/or on different trusts.

37882. [February 2006]

In such circumstances it is necessary to consider, in the light of the principles set out in the preceding paragraphs and also CG33290-33304, what the correct analysis is. The alternatives are

[1] mere variation of the terms of the existing settlement

[2] continuation of the old settlement as regards part of the property, with the remainder being held on one or more new settlements

[3] termination of the old settlement in its entirety being replaced by one or more new settlements. This last is an unlikely analysis unless a significant part of the property is being distributed absolutely. In such circumstances it may be helpful to refer to *Ewart v Taylor* where one reason for the court holding that a new settlement had come into existence was that it was part of a scheme for winding up the old settlement. See 57 TC 401 at 468, Section I.

...

37883. Under Variation of Trusts Act [February 2006]

The trusts of an existing settlement may be varied (in particular when the interests of unborn or minor beneficiaries are involved) by way of an Arrangement agreed between those parties of full age and approved by a Court Order under the Variation of Trusts Act 1958 (in Scotland Section 1 Trusts (Scotland) Act 1961) on behalf of those unable to give consent.

37884. [February 2006]

If so the principles of CG37880 –CG37882 apply. The degree of variation may exceptionally be such as to involve the termination of the original settlement in whole or in part and the creation of a new settlement. The fact that the courts may only consent to variation of the trusts does not prevent this. (If so then consideration must be given to the identity of the settlor, see CG37900.) A variation may also cause a beneficiary to become absolutely entitled to assets as against the trustees. ...

37886. Instrument of variation of will or intestacy [October 2010]

It is quite common for instruments of variation of wills or intestacies to be executed within two years of the testator's (or intestate's) death. In England & Wales the usual form of the instrument is a deed. The general guidance is at IHTM35011+ and guidance on CGT at CG31600+. If an instrument of variation creates a continuing trust which replaces absolute interests in the original will,

> and there is no statement of intent in the deed or before 1 August 2002 no election, under Section 62(7) TCGA 1992, ... the person who gives up the absolute interest in favour of the trustees is to be regarded as the settlor for the purposes of the annual exempt amount and Section 77 TCGA 1992. His personal position is considered at CG32000+, assuming the variation is gratuitous.

This is clearly correct. The Manual then turns to our situation:

> **37887.** [October 2007]
> If, however, in a case where there is no such election or statement of intent, the will or intestacy provided for property to be held subject to trusts, and these trusts are varied or replaced by the deed of variation, then there are two questions to be answered.
> a. Is there a new separate settlement?
> b. If so, who is the settlor of that settlement?
> If there are only minor variations clearly there is no new settlement and the deceased remains the settlor. Minor variations would include for instance changes in the administrative powers of the trustees, or the provision of an ultimate gift over, that is, a provision saying to whom the property is to pass if the trusts fail, or the appropriation of property to particular funds within the settlement. Otherwise it is necessary to determine whether there is a new settlement in accordance with the principles explained at CG37882, and see CG37889. If there is a new settlement then the identity of the settlor should be determined in accordance with CG37900. ...
> **37889.** [October 2007]
> One situation which is quite common[74] is where there is a life interest trust for the spouse of the deceased. For Inheritance Tax reasons this is partly varied so that there is a discretionary trust up to the amount of the Inheritance Tax nil rate band. In such a case, where the spouse continues to be a beneficiary of the new discretionary trust, it would often be appropriate to regard this, except for the purposes of Inheritance Tax, as little more than a cosmetic arrangement, particularly if the broad intention is that the bulk of the income should be paid to the spouse. So this would be regarded for Capital Gains Tax purposes as a variation of the original will trust, and not as giving rise to a new separate settlement. The deceased remains the settlor.

Para 37889 is correct though not for the reason given (which does not bear examination) but for the reason given in 80.12 (Beneficiary assigns or

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74 [Author's footnote] This ceased to be common after the introduction of transferrable nil rate bands in 2007, but that does not affect the points being made.

surrenders equitable interest).

80.14.2 *Tax consequences of resettlement*

A resettlement (unlike a variation) involves a disposal for CGT, and may lose the benefit of IHT relief for transitional serial interests. It also changes the settlor. The CG Manual provides:

> **37900. Identity of settlor** [February 2006]
> Where there is a variation of a trust of the kind described in CG37880+ [variation by beneficiaries] it is necessary to identify the settlor. If the conclusion taken is that there are no new settlements then for CGT purposes the identity of the settlor is unaffected. However if in effect interests in income have passed from one person to another, the former may well be the settlor of an arrangement for Income Tax purposes.
> **37901. Identity of settlor** [October 2007]
> If however one or more new settlements have come into existence, then the settlors of those settlements are one or more of the parties to the variation. The question should be tackled on a practical basis by determining where each beneficiary's share has gone. ...
> **37903. Example** [October 2010]
> Under a settlement made by X, A and B are each entitled to half the income. On A's death his son P gets half absolutely. On B's death her daughter Q gets half absolutely. The values of their respective interests are, say:
>
> | | |
> |---|---|
> | A's life interest | £60,000 [30% total value] |
> | P's remainder | £40,000 [20% total value] |
> | B's life interest | £75,000 [37.5% total value] |
> | Q's remainder | £25,000 [12.5% total value] |
>
> Under the variation, which is considered to terminate the old settlement:
> A takes 30% of the property.
> 20% goes to a new accumulation and maintenance settlement for P's children.
> B takes 25% of the property.
> The rest [25%] is held for Q for life with remainder to Q's son R.
> P should be regarded as the settlor, for the purpose of the annual exempt amount, of the accumulation and maintenance settlement, because this is how his share has been dealt with.
> B and Q equally should be regarded as the settlors of the other settlement. ...

B and Q are joint settlors: see 81.1 (Trusts with two settlors).

80.15 Variation under Variation of Trusts Act 1958

Where a court approves a variation of trust on behalf of a minor beneficiary, under the VTA, it is considered that the minor beneficiary does not become a settlor. The reason is that the court in giving its approval does not merely act on behalf of the minor: the court has a wider role.[75] The position is analogous to trustees exercising a power of advancement.[76] But HMRC do not agree. CG Manual para 37902 provides:

> **Minor as settlor** [October 2007]
> It is considered that where a court has given consent on behalf of a minor, that minor can be a settlor. The authority lies in *Yates v Starkey*, 32 TC 38, where it was held that a person could be a settlor under compulsion, and *Mills v IRC*, 49 TC 367, where it was held that a minor with very little involvement in the transactions could be the settlor because she provided the property.

Neither of these cases compels a Court to accept the HMRC view.

80.16 Consent to exercise of power

A trust sometimes provides that the trustees can only exercise a power of appointment with the consent of a particular beneficiary (typically the life tenant). If the power of consent is wholly personal (ie proprietary),[77] this raises some intriguing questions. A concise exposition is difficult because of the variety of possible circumstances and taxes. In outline the position is as follows:

(1) A gratuitous consent to an appointment which terminates the consentor's interest in trust income probably makes the consentor the settlor, for the purposes of the settlement-arrangement definition. The consentor has provided income for the purpose of the settlement-

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75 *Re Steed* [1960] 1 Ch 407; *Re Remnant* [1970] Ch 560. This view is consistent with the fact that where a Court approves a variation on behalf of an unborn beneficiary, that beneficiary clearly does not become a settlor. Further consideration is needed if foreign trust laws apply.

76 See 80.10 (Power of advancement).

77 On this terminology and powers of consent generally see Kessler, *Drafting Trusts and Will Trusts* (12th ed., 2014), para 7.33 (Nature of powers of consent and appointment).

arrangement because they have effectively given up their right to the income by their consent.[78]

(2) For similar reasons a gratuitous consent to an appointment which terminates the consentor's contingent interest in trust capital probably makes the consentor the settlor, for the purposes of standard IT/CGT and IHT[79] definitions from the time that the contingency is satisfied. The consentor has provided capital for the purposes of the settlement because they have effectively given up their right to the capital by virtue of their consent.

(3) By contrast, the giving of the consent to an appointment does not make the consentor a settlor (for any purpose) if:
   (a) the consentor had no interest in the trust immediately before giving the consent; or
   (b) the appointment leaves the interest of the consentor in the trust

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78 The position is analogous to an assignment or surrender of a life interest. The analogy is not exact. In one case the arrangement consists of the assignment/surrender alone. In the other case the arrangement consists of the consent and the exercise of the trustees' power of appointment. So in a sense there is an arrangement with two settlors: (i) the consentor and (ii) the (actual) settlor of the classic settlement who conferred the power of appointment on the trustees. But HMRC (or the actual settlor) may plausibly argue that the consentor (not the actual settlor) is the settlor for the purposes of s.624. They may take support from *Braybrooke v AG* 9 HLC 149 at p.165, accessible on *http://www.commonlii.org*. (A case on the Succession Duty Act 1853 whose provisions are analogous to current definitions of settlor. Since Succession Duty was only abolished in 1949, the drafter of the original settlement provisions doubtless had it in mind.) The ground of the decision in *Braybrooke* was:

> "that, although the estate of the son arose under a joint power of appointment made by his father and himself, and although therefore the father was in a sense one of the settlors, yet he was not a settlor from whom the interest or any part of the interest of the son, in his character of successor, was derived. And the decision shews that, in order to ascertain who is the settlor 'from whom the interest of the successor is derived,' we must inquire, not who are the parties by whose conveyance the estate has been created, but who is the conveying party out of whose estate the interest in question has been derived." See *Att-Gen. v Charlton* (1877) 2 Ex D 398 at p.417.

79 It is arguable that the consentor is not a settlor for IHT because the power of consent is a settlement power and so not property for IHT purposes. It is the old question of how far one carries through the deeming provisions. The better view is that one does not carry the deeming that far.

unaffected.[80]

In these cases the consentor has not provided any property by their consent.

(4) The giving of a consent is probably not a disposal for CGT[81] of:
   (a) the right to consent (even if it is extinguished); or
   (b) the consentor's interest in the trust (even if that is extinguished).
   The contrary is arguable but it would not normally matter.[82]

(5) The giving of the consent does not give rise to a gift with reservation since:
   (a) A consent is probably not a "disposal" for the purposes of the gift with reservation rule.[83]
   (b) In any event, a consent is not a disposal of property as the power of consent is a "settlement power" and so not property for IHT.[84]

HMRC do not appear to take any of these points at present; but there is cause for caution. The practical conclusion is that it is in principle better not to make a power of appointment subject to the consent of the life tenant (or any other beneficiary).

80.17 Provision of property for company held by trust

HMRC take the view that provision of property to a company wholly

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80 This is fairly clear from first principles, but some support can be found in two cases. In *Braybrooke* (see fn above) a tenant in tail exercised his power to dispose of the lands entailed, with the consent of the protector. The protector was not the creator of the disposition: "It cannot be argued that a person whose consent is apparently necessary to a disposition, makes that disposition." In *Mills v IRC* the father's consent was apparently thought necessary for the daughter (Hayley Mills) to enter into the arrangements: see 49 TC 367 at p.403. This did not prevent Hayley being a settlor.

81 Under general principles or by virtue of s.24 TCGA (extinction of an asset constituting a disposal).

82 It will matter if the usual CGT exemption on the disposal of an equitable interest does not apply (eg offshore trusts). It could matter if the conditions of TCGA Sch 4A are satisfied, but that would be unusual.

83 See *Baird v Baird* [1990] 2 AC 548 at 557 [the exercise of a power of appointment] "disposes of no property of the appointor". HMRC agreed. The former CTO Advanced Instruction Manual E.91 provided:

> "Nor should you regard the giving of a consent by a limited owner to the exercise of the power of advancement as the making of a disposition."

This passage does is not in the current IHT Manual. But there is no reason to think that HMRC have changed their view.

84 See s.272 IHTA.

owned by a trust is in principle provision of property for the purpose of the trust, and so makes the provider a settlor. SP 5/92 provides:

> 16 The condition in TCGA Sch 5 para 9(3)[85] may be satisfied where property or income is provided to a company in which the trustees are participators.[86]

This is supported by some case law.[87] It is correct for the standard IT/CGT definition, the settlement-arrangement definition and the IHT definition.

However, for the CGT s.86 definition, the question is not whether a person has provided property for the purpose of the settlement. The question is whether a person has provided *settled* property. So if a person only provides property for a company held by a trust, the person is not the settlor under this definition.[88]

80.17.1 *Transactions with wholly owned trust subsidiaries*

SP 5/92 para 18 provides:

> In general, transactions between trustees and companies which they, directly or indirectly, wholly own, or between such companies, are outside the scope of TCGA 1992 Sch 5 para 9(3).[89]

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85 The condition is that property is provided directly or indirectly for the purposes of the settlement; see 80.3.5 (CGT s.86 definition of settlor).

86 The SP continues with an exception:

"Where, however, the transaction is carried out with the sole object of leaving funds within the company for the company's purposes and it can be shown that any indirect benefit to the trust is merely incidental to that object, the transaction is disregarded for the purposes of para 9(3).

17 Examples of transactions which may be so disregarded are—

– where another shareholder waives an entitlement to all or part of a dividend; or

– where a director restricts withdrawals of remuneration voted,

in order to assist the company's cash flow, and no payments are made, directly or indirectly, to the trustees as a result of this. All relevant factors will be considered in determining whether it is appropriate to apply this practice in a particular case."

87 *Obiter* comments in *Crossland v Hawkins* 39 TC at p.506 followed by Goulding J in *IRC v Mills* 49 TC at p.337.

88 This view, expressed in earlier editions of this work, is confirmed by *Coombes v HMRC* [2008] STC 2984.

89 The SP sets out a commonsense definition of "wholly owned" and continues with a qualification:

"This approach may not, however, be taken where, on the facts of a particular case, it appears that the transaction has been entered into solely or mainly for the

This is right. There can be no element of bounty so a wholly owned company cannot "provide" property to its owner, just as shareholders cannot "provide" property to their company.

80.18 Provision of services

80.18.1 *Services envisaged when settlement made*

In two cases (the "film star" cases):

(1) A friendly third party created a trust.
(2) The trust acquired a company.[90]
(3) Well-known actors (Jack Hawkins, Hayley Mills) entered into a contract to provide services to the company at a substantial undervalue, and the company duly received what the earlier case described as an "enviable salary" for their work as artiste.
(4) The company made profits and paid dividends to the trustees.

In both cases:

(1) the classic trust created at step (1) was clearly a settlement-arrangement by itself;
(2) Steps (1) - (4) together constituted an arrangement which was a settlement-arrangement.[91]

The question was who was the settlor. It was held that the actor was the settlor.[92]

Viscount Dilhorne in *IRC v Mills* 49 TC at 408 considered two situations:

(1) Employees of a company held by trustees contribute by their labour to the profits of the company, and so increase the company's dividends and the income of the settlement.
(2) A stockbroker who gives well founded advice to trustees of a settlement increases the income of the settlement.

One might have said that these were not settlors because they provide no

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purposes of obtaining a UK tax advantage."

90 The company was UK resident, so transfer of assets abroad issues did not arise.

91 This was disputed in *Crossland v Hawkins* on the (factually doubtful) grounds that the step (3) was not contemplated at the time of step (2) but the CA rightly found against that on the facts.

92 *Crossland v Hawkins* 37 TC 493 approved *Jones v Garnett* 78 TC 1; *IRC v Mills* 49 TC 367. More accurately, the actor was one of the settlors but the contribution by the third party who created the trust was ignored as insignificant.

bounty but what if they do act with gratuitous intent? For instance, suppose the stockbroker chose not to charge for their services? Viscount Dilhorne rightly[93] did not rely on the bounty point:

> The difference between those cases, on the one hand, and *Crossland v Hawkins* and this case [*Mills*], on the other, is that in *Crossland v Hawkins* and in this case funds which ordinarily would have been received by Mr. Hawkins and by Miss Mills for their acting were diverted to companies which were channels for their transmission to trustees. It is not the provision of services but of funds which comes within the section.

The distinction is not between provision of services and provision of funds, because the actors did provide services; the key feature is the provision of services which yields funds *which would otherwise be received by the provider*. It is considered that the test should be whether one can identify funds which:

(1) would (in the absence of the settlement) have been received by the individual, but
(2) were diverted to the trust.

The settlement provisions do not apply unless one can *identify* the funds which are provided by the settlor. In Viscount Dilhorne's examples of employees and stockbrokers, this condition is not met.

Suppose:

(1) an individual has an opportunity of purchasing land, or shares in a private company;
(2) they allow the trust to take up the offer by advising the trust and not pursuing the opportunity themselves;
(3) had the trust not taken up the offer they would have done so.

In this case the individual is a settlor if one can distinguish the return from the trust's investment from the profit from the advice. A clear case being where the trust only invested a nominal amount in the project. But if the trust provides substantial funds for the development, one cannot identify any income as coming specifically from the adviser. One should not apportion the profits between the adviser's contribution (advice) and the settlement's contribution (finance). It is impractical to do so as there is no sufficiently clear answer to how the apportionment should be made. If

93 It is still a principle (notwithstanding wide exceptions) that trustees should act gratuitously, but no-one suggests that trustees thereby become settlors.

that is right, the *Mills* and *Hawkins* line of cases is effectively restricted to "one-man companies" with no substantial capital (as was the case in both *Mills* and *Hawkins*). It appears that HMRC agree. The TSE Manual provides:

> **TSEM4300 - Settlement For Minor Child Who Is Neither Married Nor In A Civil Partnership** [May 2014]
> **...Indirect gift of shares from parent**
> Mr J owns 60 of the 100 issued £1 shares in J Limited. Mr J is the sole company director *and* is the person responsible for making all the company's profits because of his knowledge, expertise and hard work. On starting up the company, Mr J allowed his mother to subscribe £40 for 40% of the shares but shortly afterwards she gifted them to her grandchildren.

The HMRC analysis is as follows:

> The circumstances are such that the decision to issue 40 shares at par is a bounteous arrangement (as were the shares in Jones v Garnett). The true settlor here is Mr J rather than the children's grandmother. Section 629 [ITTOIA] therefore applies and attributes the dividends received by the children to Mr J for tax purposes.

(Emphasis added.) The example derives from Tax Bulletin 64 Example 9 where HMRC expand on the analysis:

> Since Mr. J
> [1] is the person *responsible for making the company's profits* and
> [2] decides on the level of dividends paid,[94]
> it is Mr. J who is the settlor rather than the children's grandmother.
> The legislation could apply in a similar way if the children had subscribed for shares themselves with money received from a third party or even from bank accounts in their own names.

Suppose a stockbroker who is well disposed to the trust (perhaps a trustee or a beneficiary or a parent of beneficiaries) gives free investment advice to trustees to invest in quoted (easily obtainable) investments, and the trust profits from acting on their advice. There is an element of bounty but the stockbroker has not provided funds and is not the settlor. One cannot identify funds which would ordinarily have been received by the stockbroker. On the contrary, the stockbroker was free (if he or she had

94 It is hard to see the relevance of [2].

the resources) to make the same investments as those recommended to the trustees. This is a clear case.

Suppose a property developer who is well disposed to the trust gives free property market advice to trustees, and the trustees use their own funds invest in land successfully because of the advice. The developer has not provided property and is not the settlor. One cannot identify funds which would ordinarily have been received by them.

Suppose a director of a company held on trust seems reasonably well remunerated but HMRC argue that their remuneration is insufficient. Even if HMRC are right, the individual is not the settlor, because one cannot identify funds which would have been received by the director.

Mills and *Hawkins* were cases where it was intended from the outset that the settlor should provide services at an undervalue. In those cases the settlor contracted to provide services. In *Jones v Garnett*, it was likewise anticipated from the outset that Mr. Jones would provide his services at an undervalue. Here there was no contract, but that made no difference:

> It was the *expectation* of such events and the hope of profit which, together with the absence of any risk attached to the children's ownership of the shares, gives the "element of bounty" to the arrangement constituted by the allotment. What subsequently actually happened was not part of the arrangement.[95]

80.18.2 *Services not envisaged when settlement made*

What is the position if:

(1) a company is up and running and well established;
(2) an individual ("T") *subsequently* provides services at an undervalue (to benefit shareholders).

The question may arise in three circumstances:

(1) shares may be held by a spouse or minor children;
(2) shares may be held by a trust:
    (a) of which some other person is the settlor;
    (b) of which T is the settlor.

In case (1) there is (or may be) no settlement-arrangement before T begins to provide T's services. The question is whether a settlement-arrangement comes into existence.

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95 *Jones v Garnett* 78 TC 1 at [22]. Likewise Lord Walker at [50]:
"A plan which existed when the structure was established."

In case (2) there is a settlement already. The question in 2(a) is whether T becomes the settlor. In case 2(b) T is already the settlor. The question is whether they provide further property (which might taint the settlement).[96] Of course, all the questions are related and they come down to the same question: does T gratuitously provide property for the purposes of the settlement?[97] It is suggested that the answer is, strictly, yes, if one can identify the funds that T has provided: see above. But it appears that HMRC do not take the point. In *Jones v Garnett*, Lord Neuberger envisages a case (1) situation (share held by Mr and Mrs Jones but no settlement-arrangement):

> On that basis, I find it also very hard to see why Mr Jones's decision each year not to take anything like a full salary, thereby increasing substantially the dividend payable to his wife, does not involve an element of bounty. Neither [Counsel for HMRC] (no doubt reflecting the Revenue's policy) nor [Counsel for the taxpayer] (as it would involve his clients losing on this issue) was prepared to adopt this approach. Although it appears to me to be logically attractive, it would be inconvenient in practice, in that it would be difficult to administer, and it might well produce unfair, even arbitrary, results.[98]

80.18.3 *Services provided for full consideration*

In *Mills* in the Court of Appeal, Buckley LJ noted other circumstances why a person who provides services to a trust or company may not be providing property:

(1) A person does not provide funds for a settlement if:
   (a) they are entirely ignorant of the settlement (which would generally be the case for employees of a company held by a trust), or
   (b) they do not have the view of advancing the interests of the trust.

(2) A person does not provide funds for a settlement if they do so for reward in the ordinary course of their professional business.

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96 See 80.3.8 (Tainting).

97 See *Jones v Garnett* 78 TC 1 at [83]:

> "... the definition of settlement in [s.620 ITTOIA] and of the settlor in [s.620 ITTOIA] are closely connected, and it appears to me to be perfectly proper to rely upon observations as to what can be taken into account when considering who is a settlor, when deciding whether there is a settlement."

98 See *Jones v Garnett* 78 TC 1 at [89].

No-one would suggest that these persons providing their services to the company or trust should be regarded as settlors and the only question is why not? It is suggested that one reason is because there is no element of bounty.

80.18.4 *What is the arrangement?*

In *Jones v Garnett* Mr. Jones worked for a company held equally by himself and his wife. Lord Hoffmann gave "settlement-arrangement" a somewhat limited meaning:

> [HMRC's] second argument is that the transfer of the share [to Mrs Jones] was not the whole of the arrangement, which included the provision of services by Mr Jones, the dividend policy and so forth. Again, I think that would be inconsistent with the argument by which the revenue have, in my opinion, succeeded on the first point. The transfer of the share was in my opinion the essence of the arrangement. The expectation of other future events [i.e. provision of services by Mr Jones] gave that transfer the necessary element of bounty but the events themselves did not form part of the arrangement.[99]

80.19 Interest-free or back-to-back loan

A person who lends interest-free (or on favourable terms) is in principle[100] a settlor. HMRC agree. SP 5/92 para 22 provides:

> A loan made, directly or indirectly to a relevant settlement after 19 March 1991 on non-commercial terms, eg at a low or nil rate of interest is regarded as a provision of funds for the purposes of TCGA 1992 Sch 5 para 9(3). This is the case whether the loan is for a fixed period or repayable on demand.[101]

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99 78 TC 1 at [29]. Lord Walker said the same at [54] stressing the absence of a contract of employment.

100 It is assumed that the loan is made with gratuitous intent. The position is different if the loan (though on favourable terms) is made without any gratuitous intent, which is conceivable, for instance, in the case of a loan by a life tenant.

101 As to whether an interest-free loan makes the trust a settlor-interested trust, see 27.3.3 (Beneficial loan or guarantee).

SP 5/92 para 19-21 deal with the CGT implications of loans to trusts before 19 March 1991. This is not now important but is set out here for completeness:

"19 A fixed-period loan made, directly or indirectly, to a relevant settlement prior to 19 March 1991 on non-commercial terms, eg at a low or nil rate of interest is, generally, regarded as a provision of property in pursuance of a liability incurred

Likewise Tax Bulletin 8 provides:

> Our view is that a person making a loan to the trustees on better than commercial terms is ... a settlor and transferor and within the provisions of [Chapter 5 Part 5 ITTOIA] or [s.727 ITA].

The same applies to a back-to-back loan. In *IRC v Wachtel*:

(1) the trustees borrowed from a bank, and
(2) an individual guaranteed the trustee loan and deposited funds equal to the trustee borrowing with the bank. The trustees paid only 1% interest on their loan.

The individual was rightly held to be a settlor.[102]

While a person who lends interest-free is in principle a settlor, what is the property provided, and when is it provided? It is considered that the property provided is the money lent, and property derived from that. It is provided at the time that the interest-free loan is made. If the money lent is spent on expenses, there is no property derived from the loan and the lender ceases to be a settlor.

Suppose:

(1) A settlor while abroad lends money to a trust with mixed resident trustees. The loan is interest-free and repayable on demand.
(2) The settlor later comes to the UK and deliberately leaves the loan outstanding.[103]

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before 19 March 1991, provided the loan remains outstanding on the same terms. As such, it falls within the terms of TCGA 1992 Sch 5 para 9(3)(b) and the first condition set out in para 9(3) is not met.

20 There would, however, be a direct or indirect provision of property for the purposes of the settlement where a fixed-period loan falls to be repaid after 18 March 1991 but repayment is not made and so becomes a repayable on demand loan.

21 An extra-statutory concession D41 ... sets out the position in the case of non-commercial, repayable on demand, loans for the purposes of applying TCGA 1992 Sch 5 para 9(3)."

102 46 TC 543 at p.554I - 555.

103 If the loan is to a company held by the trust, then even if the settlor does provide property by leaving the loan outstanding it did not matter for the CGT rules before 6 April 2007 as the settlor has not provided settled property (so long as company assets are not transferred to the trust). But from 2007 this argument does not apply because the question is not whether the settlor provides settled property, it is whether the settlor provides property for the purposes of the settlement. See 80.17 (Provision of property for company held by trust).

HMRC may contend that the settlor has provided property by deliberately leaving the loan outstanding but it is tentatively suggested that this is not the case: what is the "property" which the settlor has provided? It is not the interest foregone, as that does not exist.[104] Thus the trust continues to be non-resident.

80.20 Indemnities

SP 5/92 provides:

> 34 An indemnity given by the new trustees to retiring trustees is not considered as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3).

This is right because there is no element of bounty. (Also the benefit of the indemnity is held by the *former* trustees so it is not property comprised in the settlement.)

> Other types of indemnity are considered in light of the facts of a particular case.

The standard form indemnity given by a beneficiary who receives trust capital is not the provision of funds, it is made in consideration of the trustees not exercising their trustee lien.

80.21 Guarantees

SP 5/92 continues:

> 35 The giving of a guarantee is regarded as an indirect provision of funds under the terms of TCGA 1992 Sch 5 para 9(3).[105]

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104 Contrast *Re Marshall* [1965] NZLR 851 where the New Zealand Court of Appeal held that where interest on a debt is payable if demanded, but the right to call for payment is not exercised, there is no gift of the interest foregone. Also see 76.6 ("Provide").

105 SP 5/92 goes on to deal with the CGT implications of guarantees to trusts before 19 March 1991. This is not now important but is set out here for completeness:
"Payment of an obligation under a guarantee given before 9 March 1991 is, in general, regarded as a payment in pursuance of a liability incurred before 19 March 1991 and within para 9(3)(b). This may not, however, apply where-
- the contingent liability under the guarantee cannot be quantified with a sufficient degree of accuracy, eg where the guarantee is open-ended or the contingency is remote; or
- the guarantor does not take reasonable steps to pursue his rights against the debtor."

It is not possible to identify the funds which a guarantor provides. So while a guarantee (if made with gratuitous intent) may amount to tainting a trust, it does not give rise to a charge under s.624 or s.86, unless there is not merely a guarantee but also a back to back arrangement of the kind found in *Wachtel.*

80.22 Repayment of loan made by trustees

SP 5/92 para 23 provides:

> The repayment of any loan made, directly or indirectly, to any person by the trustees is not generally regarded as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3). This does not, however, apply where
> [1] more is repaid than is due under the original terms of the loan or,
> [2] in the case of loans made after 19 March 1991, where the interest charged under the terms of the loan exceeds a commercial rate.

This is clearly correct (apart from point [2] but in practice that is not likely to arise). There is no element of bounty.

80.23 Sale or share issue at on favourable terms

A sale to a trust at a conscious undervalue is the provision of property: the seller is a settlor. Likewise a purchase from a trust at a conscious overvalue: the purchaser is a settlor.

Likewise a person is a settlor if they hold all the shares in a company and consent or procure the company to new shares to a trust at a conscious undervalue.[106] The TSE Manual provides a straightforward example of this:

> **TSEM4120 Definition Of Settlor** [December 2011]:
> ***Example 1***
> X is the director and owns all the 150 issued ordinary £1 shares of X Ltd.
> X Ltd issues 100 new ordinary £1 shares which are acquired for £100 by the X Family Trust.
> The trust has been established for the benefit of X's family by his father, X Senior, who created the trust by settling cash of £100.
> Shortly after the issue of the new shares, a dividend of £100 per share

106 This proposition is self evident but if authority is needed, see *Crossland v Hawkins* 39 TC 493 at pp.506–507.

> is declared and paid and the trust receives dividends of £10,000. X controlled the arrangement for the issue of the shares at par followed by the dividend.

On these facts, HMRC conclude:

> X is therefore the true settlor of the settlement from which income of £10,000 arose. The original settlement of £100 by X Senior is usually disregarded on de minimis grounds.[107]

A sale at market value is not the provision of property. HMRC agree. The CG Manual provides:

> **34891. Multiple settlors** [April 2010]
> Where property is acquired as a result of an arms length transaction the third party is not to be regarded as providing property for the purposes of the settlement, thereby becoming a settlor. Instead the property is regarded as representing the cash previously held.

A bargain at arm's length (at a price regarded by both sides as market value) is not the provision of property even if the parties have mistaken the value and the property is sold at an undervalue.[108]

Similar issues arise in multi-party transactions where the trust is one of the parties. For instance, a company acting at arm's length may issue loan notes and shares, in a transaction where an individual subscribes the loan notes and the trust subscribes to the shares. The question then arises how to apportion the total subscription price between the loan notes and the shares. An under apportionment to the trust would make the individual a settlor. A valuation reached honestly and bona fide between the parties binds HMRC: See *Stanton v Drayton Commercial Investment* 55 TC 286 at p.317.

80.23.1 *Market value adjustment clause*

If the trust participates in a transaction where values are uncertain, the parties may be in a quandary, as if the trust pays too little, the vendor is a settlor and makes a transfer of value; if the trust pays too much, there will

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107 [Author's footnote] The issue of shares would also have been a transfer of value for IHT, but it is not necessary to pursue that here.

108 This is consistent with the principles that a settlement-arrangement must have an element of bounty: see 80.2.3 (Settlement-arrangement definition of "settlement"), and that arm's length sales confer no "benefit": see 30.4.1 (Arm's length transaction).

be a capital payment to the vendor. In some cases a market value adjustment clause may be a solution. SP 5/92 provides:

> 13 Solely for the purposes of TCGA 1992 Sch 5 para 9(3)(a), a provision in the document governing the transaction for an appropriate adjustment to the consideration where the value agreed by the Revenue differs from the original consideration arrived at by an independent valuer and specified in the sale document is, in general, regarded as falling within the terms of the above definition of an arm's length transaction. The arm's length value of the transaction is to be determined in accordance with the principles set out in para 12 above. This will usually correspond to the value for capital gains tax purposes except, for example, where TCGA 1992 s 19 would apply.
> 14 It would also be necessary for the terms of the contract to provide for compensating interest at a commercial rate to be paid in either direction once the arm's length value is determined. For this purpose, the official rate of interest for [employment-related loans] purposes will usually be regarded as equivalent to a commercial rate of interest, although a different rate may be accepted as so equivalent if the circumstances of a particular case warrant this treatment.
> 15 This practice is, however, subject to the consideration passing on sale being realistically based, ie on a third party valuation by a qualified valuer, all the other terms of the transaction being at arm's length and the compensating interest being timeously paid. The position in a particular case depends on all the facts and circumstances.

Although the SP is said to be "solely for the purposes para 9(3)(a) Sch 5 TCGA", the same practice ought to apply for other purposes.

80.24 Failure to exercise right of reimbursement

SP 5/92 para 24 provides:

> [1] Failure, by or on behalf of any relevant person, to exercise statutory rights to reimbursement e.g. under [s.646 ITTOIA], may be regarded as the provision of funds for the purposes of the settlement under TCGA 1992 Sch 5 para 9(3).[109]

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109 For completeness, Tax Bulletin 8 correctly qualifies this:
"Para 24 of the Statement of Practice [5/92] points out that failure to exercise statutory rights to reimbursement against non-resident trustees may be regarded as the provision of funds for the purposes of the settlement under para 9(3) of Schedule 5, TCGA 1992. This will not, however, apply in respect of a settlor's non-exercise of statutory rights to reimbursement out of the trust income account

Point [1] only applies to a failure to exercise rights which is both deliberate and gratuitous (ie with an element of bounty). This is the reason for the exceptional case which para 24 then addresses:

> [2] The settlement could remain outside the terms of para 9(3) where the exercise of the right to reimbursement is unsuccessful, provided it could be shown that there had been a genuine attempt to enforce rights to reimbursement.

The exception is stingily worded (here as in several other points, SP 5/92 gives the impression that it was intended to make life as difficult as possible for offshore trusts). It is not necessary to show "a genuine attempt to enforce rights to reimbursement". It is sufficient to show that such rights are not enforceable, or that a decision not to obtain reimbursement is a commercial one or that enforcement would not be cost-effective.

80.25 Payment of administrative expenses

SP 5/92 specifies two cases where payment of capital expenses out of a life tenant's income does not make the life tenant a settlor:

> 29 An expense on capital account paid out of trust income is not treated as a provision of income by a beneficiary for the purposes of TCGA 1992 Sch 5 para 9(3) provided that either—
>
> [1] the trust deed permits payment of capital expenses from income and the beneficiary is entitled only to net income after such payments;[110] or

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where the settlor has a life interest in all the assets of the trust. In such circumstances, failure to exercise the right to reimbursement would, effectively, not add funds to the trust since all income would, in any ease, either be paid to the settlor under the terms of the trust deed or be used to meet expenses chargeable against income.

But even in such cases the settlor may have rights to reimbursement out of the trust capital account, eg in relation to accrued income charges, which if not exercised will be regarded as the provision of funds."

For other issues relating to reimbursement, see 30.4.10 (Reimbursement of tax under statutory indemnity) and 30.22 (Relevant income used to pay expenses).

110 For completeness, Tax Bulletin 8 expands on this:

"Para 29 of the Statement of Practice concerns, inter alia, trust deeds which permit capital expenses to be paid out of the income account. Neither the existence nor the exercise of this power would cause the trust to lose an interest in possession status for IHT purposes."

> [2] the trustees borrow money from the income account which is subsequently restored, along with interest over the period of the loan. The appropriate rate of interest is considered to be that which a Court of Equity would order on the replacement of trust income.[111]

The question, more analytically, is whether the life tenant has provided intentional and gratuitous benefit to the trust. Clearly, in the two cases mentioned, the life tenant does not do this and so does not become a settlor.

Where a trust has no income, someone (typically a beneficiary) may voluntarily pay the expenses. In this case there may also be no gratuitous element. It may be in the beneficiary's interest to make the payment. Subject to that, the SP tacitly suggests that the intentional and gratuitous payment of trustees' expenses *does* make the payor a settlor. But this is not correct. First, in some cases, the payment of expenses may be a provision of services to the trust rather than the provision of property.[112] Secondly, if a non-settlor pays trustees expenses, or pays a sum to the trustees which are immediately consumed in payment of expenses "no property of which S is the settlor" is comprised in the settlement, so the payor of expenses is not the settlor.[113]

HMRC agree. The STEP/CIOT questions[114] consider the IHT problems that arise when:

(1) a person (after 2006) adds property to an estate IIP trust and

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111 For completeness, Tax Bulletin 8 expands on this. The bulletin sets out para 29[2] and continues:

> "The appropriate rate of interest is considered to be equal to the rate payable on the Basic Account administered by the Court Office of the Supreme Courts of Justice. Such interest will constitute taxable income in the hands of the income beneficiary (either when it is credited in the case of a life tenant, or when it is paid or applied for the benefit of a discretionary beneficiary). It may also be treated as 'relevant income' for [s.731 ITA] purposes.
>
> Income beneficiaries will only be liable on the net amount of income available after deduction of any income which has been applied to meet expenses on capital account. Only when the income account is made good will that income become taxable on the beneficiary."

112 See 80.18 (Provision of services).

113 See 80.3.6 (Person ceasing to be settlor).

114 Accessible at *http://www.tax.org.uk/Resources/CIOT/Migrated%20Resources/0-9/521412013-october-2008-version-sch-20-fa2006-letterdoc.pdf*

(2) the property is spent on trust expenses.

Question 37(2)
... if an addition of cash was made which was then spent by the trustees and HMRC regard this addition as within the relevant property regime (eg an addition to pay expenses or improve properties), how would the proportion of the settled property subject to the new rules be calculated? Would a valuation be needed of the property before and after the improvement?
HMRC Answer
If a payment of cash was made and then spent immediately on, say, a tax liability or another administration expense, then that short period will be the extent of its time as "relevant property" and there will be no question of having to consider what proportion of the existing settled property represents it going forward.
If a payment was made towards the improvement of a property, then this would appear to require "with" and "without" valuations when there is a chargeable event.[115]
Note added 6 August 2008: HMRC have indicated that they are actively reconsidering this response with a view to producing further guidance shortly.[116]

80.26 Trust retains life tenant's income

SP 5/92 para 33 provides:

A life tenant is not regarded as having provided income or property for the purposes of the settlement merely because there is an administrative delay in paying out the income that has vested in that beneficiary. If, however, the beneficiary directs the trustees to retain this income on the terms of the settlement, this is regarded as a provision of funds within TCGA 1992 Sch 5 para 9(3).

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115 The question goes on to ask: In HMRC's view, do all subsequent post Budget additions need to be kept physically segregated? HMRC say no, which is just as well as money spent can hardly be regarded as segregated:
"It is clearly up to trustees to decide whether to keep post-Budget additions separate from the rest of the trust fund. We think that it may be sensible to do so—or, at least, to keep good records of additions. (The trustees of discretionary trusts already need to do this, of course, in order for the 10-year anniversary value of each addition to be identified correctly in light of the relief in s 66(2) IHTA for property that has not been 'relevant property' for a full 10-year period)."

116 No such guidance has been produced, presumably the issues have been filed as too difficult.

This is fairly obvious.

80.27 Purpose: Minor settlor

In *Mills v IRC* 49 TC 367, the funds of the settlement were derived from acting work of Hayley Mills, then aged 14. She was supposedly[117] unaware of the settlement to which at her direction her earnings were paid. The argument was that she had not provided funds for the *purpose* of the settlement. Viscount Dilhorne said:

> [1] I do not agree with Lord Denning MR that the word "purpose" in this section connotes a mental element or with Buckley LJ that there must be a motivating intention. I do not myself think that it assists to consider whether the question he posed is to be answered objectively or subjectively. I do not consider it incumbent, in order to establish that a person is a settlor as having provided funds for the purpose of a settlement, to show that there was any element of mens rea.
> [2] Where it is shown that funds have been provided for a settlement a very strong inference is to be drawn that they were provided for that purpose,
> [3] an inference which will be rebutted if it is established that they were provided for another purpose.

It is difficult to see what point this sloppy passage is trying to make.[118] It is not that purpose is irrelevant: see [3]. That seems to contradict the sentence at [1], but it is obviously right. "Purpose" and "provide" inescapably connote a mental element. The best explanation of this passage is that it is considering the situation like the facts in *Mills* where Hayley Mills *did* intend to provide funds for the purpose of her trust (as

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117 The actual evidence recorded that she was "not very interested", which is not the same. The case should have been decided on the simple factual basis that Hayley Mills *did* intend to provide funds for the purpose of the settlement, even if she did not trouble to think very much about it. The judge made this point at p.378:
"The case was put on a factual assumption that Hayley Mills did not subjectively intend to provide funds. This was factually incorrect, and not even conceivable, because it was completely inconsistent with the view that the contract she signed was valid. If Hayley had not thought about it at all, the contract which she signed would be void under the rule *non est factum*."

118 Dilhorne, who took a third in law, was "not in the highest flight of English lawyers" (DNB).

shown by her signing a contract which had that effect) but she took almost no interest in the matter. That is, the comment is restricted to the facts of that particular case.

The legislation sometimes refers to purpose of the settlement (in the singular) and sometimes purposes (in the plural) but there is no distinction.[119]

80.28 Purpose: Advisers and agents of settlor[120]

It is considered that in ascertaining purpose one may have regard not only to the mind of the settlor, but also the mind of those acting for him or her. Agency principles may be applied. See *Crossland v Hawkins* 39 TC 439 at p.508:

> The mere fact that he did not concern himself with some of the 'steps' in the legal machinery involved does not make it any the less his arrangement within the section. A man does not avoid the incidence of [the income tax settlement provisions] by merely being absent from and leaving to his solicitors and accountants certain parts of the legal machinery if he is aware of the proposals for an 'arrangement' or a settlement and actively forwards them by personally carrying out and assisting in the vital parts in which his performance and co-operation are necessary. Nor can he avoid liability by merely giving his solicitors carte blanche to effect some scheme for the benefit of his family and refusing to concern himself with its precise form.

On this analysis many apparent difficulties fall away.

In *Mills*, the father acted on behalf of the daughter.[121] The purpose of the father was to provide the daughter's funds for the purpose of the settlement. That suffices to make the daughter the settlor if she had no purpose of her own. Likewise in *Hatton*[122] the purposes of Mrs Cole's attorney was to provide funds for the settlement, and this purpose should be regarded as the purpose of Mrs Cole.

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119 "The statute seems to me to use the word 'purpose' and 'purposes' indiscriminately"; *Crossland v Hawkins* 39 TC 493 at p.507.

120 See 32.15 (Purpose: advisors and agents of transferor).

121 See 49 TC 367 at p.382 and p.385.

122 See 80.4 (Gift from A to B followed by gift to trust by B).

80.29 Settlement made by court for person lacking capacity

The court has power to make a settlement for a person lacking capacity "on his behalf". It is considered that the person lacking capacity is the settlor.[123] The Court of Protection agree:

> Trusts set up by an order of the Court of Protection will take the form of a settlement, with the patient being the settlor. ... in the case of trusts set up by an order of the Court of Protection, provision can be made for income to be accumulated, if appropriate, for the lifetime of the patient as section 164(1)(a) Law of Property Act 1925 applies.[124]

80.30 Settlement made by compromise of claim of minor or person lacking capacity

Parties to litigation may make a settlement under a compromise on behalf of a claimant who is a minor or person lacking capacity.[125] The Court of Protection say:

> An award of damages can be settled, by consent, in trust for the patient as part of the terms of compromise of the action between the plaintiff and the defendant, with the approval of the High Court, in circumstances where the award never becomes the absolute property of the patient.
> Trusts set up following an order of the High Court can only be done in the form of a declaration of trust by the trustees ... . The period over which income can be accumulated by the trustees is restricted to 21 years.[126]

This assumes that the minor/person lacking capacity is not a settlor for trust law purposes. The first sentence (which is probably the basis for the conclusion) is unsound. While the *award* never becomes the absolute property of the patient, the award represents the claim, which is the property of the claimant.[127]

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123 Sections 16, 18(h) Mental Capacity Act 2005. The tax position is the same for settlements made under the Mental Health Act 1983.

124 Court of Protection Practice Note, 15 November 1996, para 4.

125 See Kessler, *Drafting Trusts & Will Trusts*, (12th ed., 2014), Chapter 26 (Trusts of damages).

126 Court of Protection Practice Note on the settlement of personal injury awards to patients, 15 November 1996, paras 2 and 4; set out in the White Book (Civil Procedure) para 6B-119.

127 *Zim Properties v Proctor* 58 TC 371.

But HMRC accept in practice that there is no settlor.[128] It would follow that the trust fund is excluded property, eg if it is an AUT, an OEIC, or not UK situate.

80.31 Trust under Criminal Injuries Compensation Scheme

An award under the Criminal Injuries Compensation Scheme (or the may be transferred to a trust.[129] The applicant under the Criminal Injuries Compensation Scheme is not the settlor of such a trust.[130] That is consistent with the position under the VTA. However, HMRC have apparently expressed the view that the claimant is the settlor, and in practice this view may well favour the taxpayer (as s.624 ITTOIA reduces the IT charge if the settlor is not a higher rate taxpayer).

The same applies to the Victims of Overseas Terrorism Compensation Scheme.[131]

80.32 Trust made in divorce settlement

In *Harvey v Sivyer* 58 TC 569 a separated husband made payments to his minor children under a deed of separation. The payments were not voluntary; they were pursuant to an obligation to maintain the children and contained no element of bounty.[132] The taxpayer argued that for this reason that there was no "settlement" within the settlement-arrangement definition. The argument was rejected and the taxpayer was held to be the settlor. The judge tentatively reconciled his decision with the bounty requirement because "the natural relationship between parent and young child was one of such deep affection and concern that there must always

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128 Private correspondence.

129 Para 106 Criminal Injuries Compensation Scheme 2012.

130 The drafter of Part 2 Chapter 4 FA 2005 assumed this, though one needs to dig a little into the provisions to see why this is so:

(1) CICS trusts are within the provisions: s.35 FA 2005.

(2) Settlor-interested trusts are outside the scope of the provisions: see s.25(3) and 30 FA 2005. (In relation to CGT this was clearer before s.77 TCGA was repealed in 2008).

(3) The claimant under the CICS would always be a beneficiary, so if he was the settlor the trust would be settlor-interested.

So the drafter must have assumed that the claimant was not the settlor, or the provisions made no sense.

131 Para 99 Victims of Overseas Terrorism Compensation Scheme 2012.

132 58 TC 569 at p.572.

be an element of bounty by the parent, even when the provision is on the face of things made under compulsion".[133] This is romantic nonsense, as any family lawyer will attest. The better way to justify the decision is to note that the bounty requirement is not statutory, and not to be applied unthinkingly. The Court of Appeal noted in an earlier case, "if the legislature had set a limit to the extent to which a taxpayer may divest himself for tax purposes of income by voluntary means, I see no reason why the same principle should not be applied to income of which the taxpayer is compulsorarily divested".[134] So this is simply an exception to the bounty requirement. On this analysis, *Harvey v Sivyer* was correctly decided, though not for the right reasons.

80.33 Trust made by instrument of variation

80.33.1 *The usual situation*

Suppose:
(1) B inherits property absolutely from the estate of a deceased, D.
(2) B varies the will so as to create a settlement of that property; and s.142 IHTA and s.62 TCGA apply.

B is clearly the settlor in the general sense: see 80.4 (Gift from A to B followed by gift to trust by B).

80.33.2 *Settlor for IHT*

For inheritance tax purposes, the effect of s.142 IHTA is probably to override the general sense; the settlor is D and not B. HMRC agree. (The contrary view is arguable but it will not usually be in the taxpayer's interest to argue it.) IHT Manual provides:

> **35151 - IHT implications of an Instrument of Variation: effect of coming within s.142** [February 2006]
> When a variation satisfies the requirements of s.142(1) IHTA and there is a valid election or, on or after 1 August 2002, a valid statement of intent
> • the variation is not a transfer of value, and
> • the IHTA applies as if the deceased had effected the variation
> Consequently, for example ...
> [1] if a variation sets up a non-interest in possession trust, the deceased

133 58 TC 569 at p.577.
134 *Yates v Starkey* 32 TC 38 at p.53.

is treated as the settlor, and

[2] the GWR rules in s.102 FA 1986 cannot apply to a disposition which is accepted as a variation within s.142(1) IHTA.

This is because the effect of s.142(1) IHTA is that the deceased is treated as the donor.

Point [1] states that the deceased is the settlor if a variation sets up a non-interest in possession trust. The same rule must in principle apply if the variation sets up an interest in possession trust (but with the added complication of s.80 IHTA rules, if applicable). Likewise Tax Bulletin 15 provides:

> Our view is that, as the relevant IHT legislation differs from the CGT provisions which were considered in *Marshall v Kerr*, that decision has no application to IHT. Variations which meet all the statutory conditions will continue to be treated for IHT purposes as having been made by the deceased.

80.33.3 *Settlor for IT: Variation before 6 April 2006*

B is the settlor for IT purposes in the case of variations made before 6 April 2006.

80.33.4 *Settlor for CGT: Variation before 6 April 2006*

The identity of the settlor for CGT is an unresolved question.[135] The issue is whether s.62 TCGA overrides the general sense of settlor. The House of Lords held in *Marshall v Kerr* 67 TC 56 that for CGT the settlor is the beneficiary making the variation, not the testator. However, the reasoning relies on the fact that the beneficiary settled a share in an unadministered estate. The position is therefore different if:

(1) the IOV is made after administration of the estate has been completed; or

(2) the will or intestacy is governed by the law of a jurisdiction (such as a civil law jurisdiction) which (unlike common law jurisdictions) does not recognise personal representatives and an administration period; or

(3) the disposition varied is a joint tenancy (because, as in (2), there is no administration period in respect of property passing by survivorship).

In the following discussion cases (1) to (3) above are called "non-

135 See Sokol "*Marshall v Kerr* Revisited", Taxation, 3 May 2001.

administration" cases, and cases where the estate was in administration (like *Marshall v Kerr*) are called "administration cases".

The reasoning of the House of Lords suggests that the law is as follows:

(1) In non-administration cases whenever the IOV is made, it is considered that the deceased is the settlor.

(2) In administration cases:

  (a) If the IOV is made before 31 July 1978 (the passing of the FA 1978) the beneficiary is the settlor: that, at least, is clear from *Marshall v Kerr*.

  (b) If the IOV is made after 31 July 1978, it is suggested that the deceased is the settlor. *Marshall v Kerr* has been reversed by (what is now) s.62(9) TCGA: this subsection was not in force in the tax years relevant to *Marshall v Kerr*.

To distinguish between administration and non-administration cases is highly anomalous, so this view of s.62(9) TCGA brings welcome consistency into the law. It also brings CGT into line with IHT.

It appears to be the HMRC view that the beneficiary is the settlor even in cases (2) and (3). CG Manual 37888 [October 2010] provides:

> The Revenue had always considered that Section 62(7) was concerned with computational matters only, and had no effect on the question whether a new settlement had come into existence or the identity of the settlor. The majority of the House of Lords, in Marshall v Kerr, 67TC56, preferred slightly different reasoning in holding that a residuary legatee, who had executed an instrument of variation so that her 50 per cent share of the estate was settled, was the settlor for the purposes of Section 87 TCGA 1992 (charge on beneficiaries of non-resident settlements). It may be noted that the case was concerned with the pre-1978 version of the relevant legislation and it is considered that the Revenue's arguments in that case are stronger under the later legislation.
>
> Where the instrument was executed before 6 April 2006 this decision should be applied for the purposes of Section 77 TCGA 1992 & Section 86 TCGA 1992 (charge on settlors of certain settlements) and TCGA 1992/SCH1 (annual exempt amount for trustees).[136]

136 Likewise TSEM 1815 [January 2013]:

> "The settlor of a trust created by a deed is not the deceased, unless it's a disclaimer (TSEM1840). It is the person who was entitled to the gift that has now gone into trust. The gift can be capital or income or both. The case of *Marshall v Kerr* (67 TC 56) is relevant. There may be more than one settlor."

The author has been expecting further litigation on this aspect since 1994, but it has not happened yet. In view of the 2006 reforms, HMRC may not dispute the position for variations before 6 April 2006.

80.33.5 *IT and CGT: IoVs from 6 April 2006*

Section 470(2) ITA sets out three exceptions to the IT/CGT appointment rules. The third is:

> A transfer of property is excluded for the purposes of subsection (1) if ... (c) section 473(4) applies in relation to it.

This excludes the operation of (what I call) the IT/CGT appointment rules. Instead the position is governed by s.472, 473 ITA. Section 472 ITA provides:[137]

> (1) This section applies if—
>
> (a) a disposition of property following a person's death is varied, and
>
> (b) section 62(6) of TCGA 1992 applies in relation to the variation.
>
> (2) [i] If property becomes settled property because of the variation [ii] and would not, but for the variation, have become settled property),
>
> a person within subsection (3) is treated for the purposes of the Income Tax Acts (except where the context otherwise requires)—
>
> (a) as having made the settlement, and
>
> (b) as having provided the property for the purposes of the settlement.
>
> (3) The persons within this subsection are—
>
> (a) a person who immediately before the variation was entitled to the property, or to property from which it derived, absolutely as legatee,[138]

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137 The CGT equivalent is s.68C TCGA.

138 Section 472 provides:

> "(4) For the purposes of subsection (3)—
>
> (a) 'legatee' includes a person taking property—
>
> (i) under a testamentary disposition or on an intestacy or partial intestacy, whether beneficially or as trustee, or
>
> (ii) under a donatio mortis causa, and
>
> (b) a person who is a legatee as a result of para (a)(ii) is treated as acquiring the property when the donor dies.

(b) a person who immediately before the variation would have been so entitled if that person had not been an infant or otherwise lacking legal capacity,
(c) a person who, but for the variation, would have become so entitled, and
(d) a person who, but for the variation, would have become so entitled if that person had not been an infant or otherwise lacking legal capacity.

Section 472 (and its CGT equivalent, s.68C TCGA) applies in the usual situation, where a beneficiary absolutely entitled to property under a will varies the will so as to create a settlement. Section 68C TCGA enacts the HMRC view that the beneficiary is the settlor for CGT. Section 472 confirms (which no-one ever doubted) that the beneficiary is the settlor for IT.

This applies not just for the standard IT/CGT definition, but for all purposes of IT and CGT. Although the drafter adds the words except "where the context otherwise requires", I cannot think of a case where the context would "otherwise require"; and I expect the drafter has copied without much thought the wording used (appropriately) in s.467 ITA.

Section 473 ITA provides:

(1) This section applies if—
(a) a disposition of property following the death of a person ("D") is varied, and
(b) section 62(6) of TCGA 1992 applies in relation to the variation.
(2) If—
(a) property would have become comprised in a settlement within subsection (3), but
(b) as a result of the variation, the property, or property derived from it becomes comprised in another settlement,
D is treated for the purposes of the Income Tax Acts (except where the context otherwise requires) as having made the other settlement.
(3) A settlement is within this subsection if—

---

(5) For the purposes of subsection (4)(a) property taken under a testamentary disposition or on an intestacy or partial intestacy includes any property appropriated by the personal representatives in or towards satisfaction of—
(a) a pecuniary legacy, or
(b) any other interest or share in the property devolving under the disposition or intestacy."

(a) it arose on D's death (whether by D's will or on D's intestacy or in any other way), or
(b) it was in existence immediately before D's death (whether or not D was a settlor in relation to it).

(4) If—
(a) immediately before the variation property is comprised in a settlement and is property of which D is a settlor, and
(b) immediately after the variation the property, or property derived from it, becomes comprised in another settlement,

D is treated for the purposes of the Income Tax Acts (except where the context otherwise requires) as having made the other settlement.

(5) A settlement treated as made by D as a result of this section is treated for the purposes of the Income Tax Acts as made by D immediately before D's death.

(6) But subsection (5) does not apply in relation to a settlement which arose on D's death.

Section 473 applies in the highly unusual situation where property settled by will is re-settled by beneficiaries.[139] Here the opposite rule is enacted: the beneficiaries are *not* settlors for IT or CGT.

Where s.472 applies, s.472(2) imposes two rules:

(a) the beneficiary ("B") is deemed to have made the settlement;
(b) B is deemed to have provided the property for the purposes of the settlement.

By contrast, where s.473 applies, we only have rule (a): the deceased is deemed to have made the settlement. By implication, rule (b) must also apply: the deceased must be deemed to have provided the property.

CG Manual 37888 [October 2010] provides:

> Where the instrument was executed on or after 6 April 2006 and notice is given under Section 62(7) Section 68C TCGA 1992 applies with these consequences.
>
> - Where under the will or intestacy property was to pass absolutely to an individual, and a variation is executed settling that property (or property deriving from that property), then the person to whom the property would have passed is the settlor with regard to that property.
> - Where under the will or intestacy property was to be settled, but the variation is such that a new settlement is created (see CG37887) then the deceased is the settlor.

139 See 80.14 (Variation or resettlement by beneficiaries)).

- Where under the will or intestacy property was to be settled, but the variation is minor, then the deceased would be the settlor without the new legislation in FA 2006 and therefore this case is not provided for specifically.

80.33.6 *Settlor of IoV: Commentary*

What is the reason for s.473? Perhaps because it can be hard to identify settlors on variations of settlements. Perhaps because, if the will actually settled the property, there is little need or scope for tax planning by IOVs. In practice s.473 is not important. It appears to be dead letter tax law (not the only dead letter tax law enacted under the banner of trust modernisation). Does it matter to have on the statute book complex provisions that never apply and no-one need take notice of? I think it does, and maybe some day some reformer will sweep it away, and bring CGT and IHT into alignment. The IHT rule is a sensible one, for it fits the object of the IOV rules, which is to allow beneficiaries to avoid the tax unfairnesses of badly drafted wills.

80.34 Pension trusts and employee benefit trusts

80.34.1 *Is a pension trust or employee benefit trust a settlement?*

Employers generally create pension trusts and employee benefit trusts for commercial reasons. There is normally no element of bounty on the part of the employer. Nor is there any bounty on the part of the employee, who is not in a position to negotiate or reject the arrangements. Such a trust is here called "**a commercial trust**".

A commercial trust is a settlement under the classic settlement definition. However, a commercial trust is not a settlement under the settlement-arrangement definition.

HMRC agree. CG Manual 14596 provides:

> **Pension funds** [January 2010]
> ... It is considered that for the purposes of Income Tax[140] a pension fund, certainly an approved one, is not a settlement, because of the absence of 'bounty'; (see *Berry v Warnett*, 55 TC 92 for a discussion of the bounty test). Accordingly transfers of assets to Pension Funds are not connected persons transactions and there is no restriction of availability

140 The author means, for the purposes of the settlement-arrangement definition of "settlement".

of losses under section 18(3) TCGA 1992.

80.34.2 *Who is the settlor of a commercial trust?*

Since a commercial trust is not a settlement-arrangement, the question of who is the settlor does not arise when the settlement-arrangement definition of settlement is applicable. However the question arises as to who is the settlor of the commercial trust where a classic definition of settlement is applicable.

The answer depends on which definition of settlor applies.

80.34.3 *Settlor of commercial trust: Standard IT/CGT & IHT definitions*

Let us look first at the standard IT/CGT definition and the IHT definition of settlor. Under these definitions "settlor" includes (1) the person who provides property and (2) the person who makes the settlement. It is considered that the position is as follows:

(1) "Providing" property requires an element of bounty, and no-one can be said to "provide" property to a commercial trust.
(2) To "make" (or perhaps to "enter into") a settlement does not require an element of bounty.

HMRC agree. The CG Manual provides:

> **33245. Settlor: from 6 April 2006: Basic principles** [October 2007]
> ...Basically under Section 68A(1) to (3) [TCGA] a person is a settlor if:
> [1] he made or entered into the settlement. This describes the person who has had the deed drawn up on his behalf. The property may come from elsewhere; or the transfer of property to the settlement may be without 'bounty' (see next bullet),
> [2] he has provided property for the purposes of the settlement. On the basis of *IRC v Leiner* 41 TC 589 these words are regarded as applying only where there is 'bounty'.
> [3] the property is settled as a result of his will or intestacy.
> **34800 - Settlor trusts: meaning of settlor** [October 2007]
> For the purposes of TCGA92/S77 a person is a settlor in relation to a settlement if the settled property consists of or includes property directly or indirectly provided by him. ... The word 'provided' is regarded as importing the 'bounty' test.

The employer normally "makes" a commercial trust (normally the employer is a party to the trust deed and the deed is drawn on his behalf) and so the employer is a settlor under the standard IT/CGT definition and the IHT definition. HMRC agree. CG Manual provides:

> **33240 Settlor: Up to 5 April 2006** [October 2007][141]
> ... There is no judicial guidance on the precise meaning of "made" and "entered into" although they have been present in the Income Tax legislation for many years. They would appear to be descriptive of anyone who can reasonably be described as settlor in accordance with the relevant legislation but also anyone who has created a settlement as a formality or put property into a settlement other than for full consideration....
> Because a person who has 'made' or 'entered into' a settlement is within the definition of settlor it is not considered necessary for 'bounty' to have been provided. Therefore employee trusts have a settlor. See CG33580 and CG35020+. ...
> **33580. Trusts for employees** [February 2012]
> Except where specific rules provide otherwise, trusts set up for the benefit of employees are subject to the normal rules relating to settled property. For the purposes of determining the annual exempt amount the settlor is the person who made or entered into the settlement, generally the employer. ... In addition any individual or company which adds property to the settlement is also a settlor. ...

If the employer is the settlor, and is a company, it follows that excluded property status depends on the domicile (ie place of incorporation) of the company. That is a relatively sensible rule. IHT cannot normally operate on the basis that employees are the settlors of an EBT, since they are normally a large and fluctuating body. It would be odd if an EBT had no settlor for IHT purposes.

80.34.4 *Settlor of commercial trust: s.86 definition*

The CGT s.86 definition of "settlor" is different and does *not* include the person who makes or enters into a settlement. So the employer is not a settlor for the purposes of s.86. HMRC appear to agree. This can be inferred from comments in the CG Manual on s.77 TCGA. That section was repealed in 2008 but the comments are relevant because the definition of settlor for s.77 was (in short) the same as for s.86 TCGA. The CG

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141 This passage is considering Sch 1 TCGA before the 2006 amendments. At that time the Sch 1 applied a classic definition of settlement (so an employee benefit trust was a settlement), and it applied the settlement-arrangement definition of settlor (so someone who made or entered into a settlement was a settlor). The point made here therefore applies to the standard IT/CGT and IHT definitions of settlor which contain similar wording.

Manual provides:

> **34804 Corporate Settlors** [October 2007]:
> Companies frequently create settlements. These are generally settlements for employees, see CG35020, or other commercial arrangements, see CG35023. Such settlements are usually excluded from TCGA Section 77 because of the bounty test.

More analytically, a commercial settlement was a "settlement" for the purposes of s.77 (which applied the IT/CGT definition, not the settlement-arrangement definition). However s.77 did not apply because the company was not within the s.77 definition of settlor. The CG Manual formerly provided:

> **33580. Trusts for employees** [June 2003]
> ... CG35020+ shows that in many circumstances the employer is not the settlor for TCGA 1992 Section 77.

Similarly:

> **35020. Settlor trusts: Share option schemes: Trusts for employees** [February 2006]
> There is nothing in Section 77 [TCGA] itself to prevent it being applied to a company.[142] In particular, where a company has set up a settlement for its employees, the deed may provide that if all the trusts fail, the property may revert to the company. The most common cases are share option schemes and unapproved pension schemes. In the latter case it can also be argued that the employees themselves are also settlors.
> The Revenue Booklet entitled 'The tax treatment of Top-Up Pension Schemes', Para 2.7.5, states:
>
> > 'The 'benefit to settlor' rules in [s.624] and [TCGA 1992, Sections 77–79] can apply to top-up pension schemes. But this is not likely to be the case where the structure and operation of a scheme are broadly similar to an approved pension scheme.'
>
> **35021. Settlor trusts: Share option schemes: Trusts for employees** [February 2006]
> The legal basis of this is that a person is a settlor under Section 79 [TCGA] to the extent that that person has provided property for the purposes of the settlement. The courts have indicated in dealing with similarly worded Income Tax legislation that this means that is necessary for the settlor to have provided 'bounty', and that a commercial

142 This sentence is debatable, but the issue is now of historic interest only.

> transaction does not normally contain bounty. Therefore if a settlement can fairly be regarded as part of an employer's normal commercial arrangements for the remuneration of his employees, neither the employer nor the employees should be regarded as settlors.
>
> **35022. Settlor trusts: Share option schemes: Trusts for employees** [February 2006]
>
> The absence of approval for a share option scheme or a top-up pension scheme does not prevent it from being 'normal'. Cases should only be challenged if the benefits are provided for a very small number of employees, particularly directors and/or shareholders.
>
> **35023. Settlor trusts: Other commercial arrangements** [February 2006]
>
> In exceptional circumstances trusts may be set up for commercial reasons other than to benefit employees. In general Section 77 should not be applied to genuine commercial arrangements, where the main beneficiaries are members of the public, and it is not intended that funds should revert to the person setting up the trust. On the other hand it is possible that the main beneficiary is the settlor, in which case the application of Section 77 should be contended for.

The passage was deleted in February 2012 but there is no reason to think that HMRC have changed their view.

If the company is a close company, see 80.35.1 (Trust made by company: s.86 definition of settlor).

80.34.5 *Could employees be settlors of an employee benefit trust?*

CG Manual para 35020 [February 2006] states in relation to unapproved pension schemes:

> ... it can also be argued that the employees themselves are also settlors.

Similarly, the comment that employers and employees are not settlors is said in the passage set out above to apply only to "normal commercial arrangements".

Why are employees not settlors in normal cases? There may be two reasons:

(1) The employee may not have provided anything as they normally gave up no rights when the employer made the transfer to the trust. The trust is created at the discretion of the employer and these employees play no part in it.

(2) Common form employee benefit trusts benefit a wide class of beneficiaries, so one may not be able to identify any particular part of

the trust fund as provided by any particular employee (even if it is the case that a class of employees have jointly provided the trust property). That would preclude any charge to tax on any employee.

Employees may be settlors where these factors are both absent.

The TSE Manual provides:

> **5355 Summary for FURBS/EFRBS non-resident trustees** [April 2013]
> ***...The Settlements Legislation***
> **Information** The Settlements legislation in Chapter 5 Part 5 ITTOIA will not apply if the scheme is operating on normal commercial lines as part of an employment package. But in certain circumstances you may consider whether the Settlements legislation applies to charge the FURBS/EFRBS trust's income and gains on a director.
> **Action** The Settlements legislation provisions can apply if the trust is apparently not genuinely to provide retirement benefits and/or the beneficiary of the trust has directly or indirectly provided funds for the settlement (see TSEM4120). Apply the following guidelines when examining trust returns and accounts and liaise with the tax office for the company and the employment income tax office, or submit to HMRC Trusts & Estates Technical Edinburgh, as necessary.
> - The Settlements legislation will not apply where only the employer makes contributions - unless the contributions are
>   - made by a close company which the member controls and
>   - unrealistically large by normal commercial standards.
>   - For example, if there is only one director who is also the sole shareholder of the employing company, and substantial contributions are made into the FURBS/EFRBS, you may consider whether the Settlements legislation applies to treat the director/shareholder as the settlor. If you think this may be the case, you must liaise with the tax office for the company. They will consider whether to deny a deduction for the contributions.
> - The Settlements legislation will not apply if the member makes contributions and these are reasonable compared with the member's salary. However, if the member makes **any** contributions, refer the case to the Divisional Technical Adviser.
>
> If you consider the Settlements legislation may apply, submit your papers to HMRC Trusts & Estates Technical Edinburgh...

80.34.6 *Trust of pension scheme death benefits*

The IHT Manual provides:

> **17085. The identity of the settlor** [May 2013]

> The settlor of a discretionary trust created to receive death benefits paid from a pension scheme is the pension scheme member.
> Property settled on the trusts of an employer-financed retirement benefit scheme (EFRBS) (IHTM17027) on or after 6 April 2006 is treated in the same way as settled property in any other discretionary trust. So it is liable to the ten-year anniversary charge and exit charges (IHTM04096). In this case the scheme member is a settlor for Inheritance Tax (IHT) purposes. This applies to:
> - contributions made by the member as an individual, and
> - contributions made by their employer (even where this is non-contributory for the employee (member) and is wholly financed by the employer). This is because pension rights and benefits are derived from payments by the employer as deferred or delayed remuneration for the employee's current work. This principle was established in *Parry v Cleaver* [169] 1AER 555 and *The Halcyon Skies* [1976] 1 AER 856
>
> In this way, the scheme member has provided funds directly or indirectly and is the settlor for IHT purposes.

A member is clearly the settlor if he or she has a general power of appointment over the death benefit and creates the trust by exercise of that power.

In other cases the position is less clear. It is well-settled that:

> ... pensionable employment is more valuable to a man than the mere amount of his weekly wage. It is more valuable because by reason of the terms of his employment money is being regularly set aside to swell his ultimate pension rights whether on retirement or disablement. His earnings are greater than his weekly wage. [Where the wage is £20 with total contributions to the pension fund of £4 per week] his employer is willing to pay £24 per week to obtain his services, and it seems to me that he ought to be regarded as having earned that sum per week. The products of the sums paid into the pension fund are in fact delayed remuneration for his current work. That is why pensions are regarded as earned income.[143]

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143 *Parry v Cleaver* [1970] AC 1 at p.l6C. Similarly, *Imperial Group Pension Trust v Imperial Tobacco* [1991] 1 WLR 589 at p.579:

> "Pension scheme trusts are of quite a different nature to traditional trusts. The traditional trust is one under which the settlor, by way of bounty, transfers property to trustees to be administered for the beneficiaries as objects of his bounty. Normally, there is no legal relationship between the parties apart from the trust. The beneficiaries have given no consideration for what they receive. The

The non-tax cases cited in the IHT Manual do not address the issue of who is the settlor for IHT purposes. The fact that a pension is delayed remuneration does not answer the tax issue. If the member was not the settlor of the pension trust before the transfer to the death benefit trust, how can they become the settlor? At first sight the transfer from a pension trust to the trust of the death benefit should not alter the identity of the settlor.[144] It may be said that the pension trust represents earning of all the members but the death benefit trust isolates or represents earnings of one particular member. But the required element of bounty is missing.

80.35 Trust made by company: Are shareholders settlors?

The position here is made more complicated by differences in the definitions of settlor.

80.35.1 *Trust made by company: s.86 definition of settlor*

The s.86 definition of settlor is unique in that it makes express provision to treat shareholders and other participators as settlors, where a close company is a settlor. Para 8(4) sch 5 TCGA provides:

> For the purposes of this paragraph—
> (a) where property is provided by a qualifying company[145] controlled[146] by one person alone at the time it is provided, that person shall be taken to provide it;
> (b) where property is provided by a qualifying company controlled by 2 or more persons (taking each one separately) at the time it is provided, those persons shall be taken to provide the property and

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settlor, as donor, can impose such limits on his bounty as he chooses ... a pension scheme is quite different. Pension benefits are part of the consideration which an employee receives in return for the rendering of his services. In many cases, ... membership of the pension scheme is a requirement of employment. In contributory schemes ... the employee is himself bound to pay for his or her contributions. Beneficiaries of the scheme, the members, far from being volunteers have been given valuable consideration. The company employer is not conferring a bounty."

144 See 80.8 (Transfer from trust 1 to trust 2 by exercise of trustees' power).

145 Para 8(5) sch 5 TCGA provides: "For the purposes of sub-paragraph (4) above a qualifying company is a close company or a company which would be a close company if it were resident in the UK." For a note on this terminology, see 85.22.1 (Non-resident close company).

146 See 50.3.2 ("Control" and "participator").

each one shall be taken to provide an equal share of it;

(c) where property is provided by a qualifying company controlled by 2 or more persons (taking them together) at the time it is provided, the persons who are participators in the company at the time it is provided shall be taken to provide it and each one shall be taken to provide so much of it as is attributed to him on the basis of a just apportionment;

but where a person would be taken to provide less than one-twentieth of any property by virtue of paragraph (c) above and apart from this provision, he shall not be taken to provide any of it by virtue of that paragraph.

The wording is based on s.96(3)-(5) TCGA; see 51.9.2 (Consequence of capital payment to company).

Why does the s.86 definition have this provision which is not found in any other definition of settlor? The answer may be because the s.86 definition is narrower than the others, lacking the rule that someone who makes a settlement is a settlor.[147]

If para 8 applies (so that a participator is "taken to provide" the trust property) it is considered that the company should be taken not to provide the property, ie, it is not the settlor.

80.35.2 *Trust made by company: Other definitions of settlor*

Where a company makes a settlement, the individual controlling shareholder(s) will be settlor(s) if they can be said to provide property indirectly.[148] In relation to companies with only one or two shareholders, this may well be the case, if there is an element of bounty, though it depends on the facts. The CG Manual para 34804 [October 2007] provides:

> Companies frequently create settlements. These are generally settlements for employees, see CG35020, or other commercial arrangements, see CG35023. Such settlements are usually excluded from Section 77 TCGA 1992 because of the bounty test. Exceptionally it may be appropriate to argue that TCGA Section 77 applies to the particular settlement. *Although there is no specific provision comparable to TCGA Schedule 5 Para 8(4), nevertheless it may be appropriate in such a case to consider whether the property entering*

147 See 80.34.4 (Settlor of commercial trust: s.86 definition).

148 Contrast 29.3.2 (Transfer procured by individual).

the settlement has been provided indirectly by the shareholders, both for the purposes of TCGA Section 77 and for the purposes of Section 619 ITTOIA [the settlement-arrangement definition].
(Emphasis added)

80.36 Planning to create trust with foreign domiciled settlor

The "who is the settlor" question may arise in a tax planning context where it is desired to create a foreign domiciled trust by transferring property to a foreign domiciled settlor. These arrangements are always challenging and sometimes impossible to carry out in practice, for it depends ultimately on intention, and that cannot be manufactured to suit the circumstances.

Example 1
(1) H (UK domiciled) gives property to H's wife W (not UK domiciled); and
(2) W gives it to a trust.
Who is the settlor: H or W or both?

The success of schemes involving a transfer to a foreign domiciliary who creates a settlement depends on how the transaction is carried out. Does W have a genuine and wholly independent role?[149] It is suggested that W should retain the property for at least one year; that no decision be made as to whether or not to create a settlement at the time of the gift from H to W; *a fortiori* no decision should be made on the terms of the trust; and W should receive independent legal[150] advice on any proposed gift to a settlement.

Example 2
(1) Trustees of a trust (with a UK domiciled settlor) appoint property to a beneficiary ("B") (not UK domiciled); and
(2) B gives the property to a new trust.
In principle, the settlor of the new trust will be B, not the settlor of the old trust.[151] But it is different if B is acting at the behest of the settlor.[152]

Watch the trust law rule of fraud on a power, and the GAAR. It would

149 See 80.4 (Gift from A to B followed by gift to trust by B).
150 W may also need tax advice, but what matters here is that W has independent advice on the property law aspects of the gift.
151 See 80.6 (Appointment from old trust to B followed by gift to new trust by B).
152 See 80.5 (Trust created by B at request of A).

be better if the terms of the new settlement are different from the terms of the old. For an (almost unbelievable) example of botched execution of this scheme, see *Anker-Petersen v Christensen* [2002] WTLR 313.

CHAPTER EIGHTY ONE

TRUSTS WITH TWO OR MORE SETTLORS

81.1 Trusts with two settlors: Introduction

This chapter considers the IT and CGT position where a settlor-interested trust has more than one settlor. I deal with this in one chapter as the IT issues and CGT issues overlap.

81.1.1 *Cross references*

For settlor-interested trusts with only one settlor, see 27.1 (IT) and 50.1 (CGT).

For IHT aspects of trusts with two or more settlors, see 64.1 (Transfers between trusts and adding to trusts: Introduction).

Similar s.720 issues arise with multiple transferors: see 28.7.2 (Income arising must be identifiable).

81.2 Two settlors of settlor-interested trust: IT

81.2.1 *Position where multiple settlor provision does not apply*

In *Herbert v IRC* 25 TC 93, the facts (in short) were:

(1) Property was held on trust for L for life, remainder to R.

(2) L and R directed that the property should be transferred to a new trust, which was revocable (and so settlor-intested).

L and R were joint settlors of the new trust. The Revenue assessed R on the income of the new trust under a provision equivalent to s.624 ITTOIA.[1] The judge observed:

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1 I guess that they did not assess L because he was non-resident.

> [R] is not the only settlor. [L] is also a settlor... The Section provides that the income "shall be treated as the income of the settlor and not as the income of any other person". [L] is admittedly a "settlor" and, therefore, the income must be treated as his income and not as the income of any other person: [R] is another person and, therefore, the income cannot be treated as his. If [L] were assessed, the same argument could be raised. If there is no flaw in the argument and the words of the Section are imperative, as they seem to be, the result is that where there is more than one settlor the provisions of the Section become inapplicable.
> ...the Act does not prescribe what is to happen when there is more than one settlor ... It is not suggested that all the settlors can all be assessed in respect of all the income. That, indeed, would seem to be an extravagant proposition. Nor is it suggested by the Crown that the income should be distributed between them....
> The interpretation of the Section put forward on behalf of the Respondents was that where there are two or more settlors the Crown has the option to assess any one of the settlors to the exclusion of the other, and that, in the case of an assessment to Income Tax ... the option must be exercised by the local Inspector of Taxes and that there was no right of appeal by the taxpayer against the Inspector's choice. ... I find myself unable to accept that interpretation. It seems to me fantastic to suppose that Parliament has conferred upon Inspectors of Taxes, or even upon the Special Commissioners, a choice as to whether A, or B, or C should be liable to Income Tax ... .

81.2.2 *Multiple settlor provision*

Section 644 ITTOIA now makes provision for a settlement with multiple settlors:

> (1) In the case of a settlement where there is more than one settlor, this Chapter has effect in relation to each settlor as if that settlor were the only settlor.
> (2) This works as follows.
> (3) In this Chapter, in relation to a settlor—
> (a) references to the property comprised in a settlement include only property originating from the settlor, and
> (b) references to income arising under the settlement include only income originating from the settlor....
> [Subsections (4) and (5) deal with ss.629, 631 and 632 ITTOIA - settlements for minor children of the settlor - not discussed here.]

Section 645 ITTOIA[2] defines "property originating from a settlor":

> (1) References in section 644 to property originating from a settlor are references to—
>
> (a) property which the settlor has provided directly or indirectly for the purposes of the settlement,
>
> (b) property representing property so provided, and
>
> (c) so much of any property which represents both property so provided and other property as, on a just and reasonable apportionment, represents the property so provided.
>
> (2) References in sections 627 and 644 to income originating from a settlor are references to—
>
> (a) income from property originating from the settlor, and
>
> (b) income provided directly or indirectly by the settlor.
>
> (3) In this section references to property or income which a settlor has provided directly or indirectly—
>
> (a) include references to property or income which has been provided directly or indirectly by another person under reciprocal arrangements with the settlor, but
>
> (b) do not include references to property or income which the settlor has provided directly or indirectly under reciprocal arrangements with another person.
>
> (4) In this section references to property which represents other property include references to property which represents accumulated income from the other property.

Thus on the facts of *Herbert*, the income of the new trust would in principle be treated as the income of L for his life, under s.624, and as the income of R after the death of L.

Section 644 applies where there is *one* settlement with more than one settlor. In some IT cases one might say that there are two settlement-arrangements. Eg if S creates a trust and (subsequently and independently) X adds to it, one might say that there are two distinct settlement-arrangements (even if there is only one classic settlement) and S and X are the (sole) settlors of their settlement-arrangement. However s.644 is another route to the same destination, so it does not matter which analysis one takes, and s.644 seems a clearer solution.

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2 Flagged by s.644(6).

81.3 Two settlors of settlor-interested trust: CGT

The s.86 charge applies to disposals of settled property "originating from the settlor".[3] This wording incorporates rules similar to the IT rules discussed above.

The CG Manual contains guidance which relates to s.77 TCGA (repealed 2008) but which would still be applicable to s.86:

> **34893. Multiple settlors** [April 2010]
> Section 79 provides that trust gains are only to be attributed to each settlor to the extent that those gains accrue on property originating from that person. Where the assets provided by two or more settlors are managed as separate funds, there should be no difficulty in determining to which settlor the gains on the disposal of particular items of property should be attributed. Where the assets provided by different settlors are not appropriated into separate funds, the legislation provides for a just apportionment as between the settlors.
> **34894. Multiple settlors** [April 2010]
> If HMRC Trusts Head Office Bootle or Financial Intermediaries and Claims Office (formerly Claims Branch) have given advice on apportionment for Income Tax purposes, this should be followed for CGT. Otherwise, if settlors together make the settlement, the gains in such a case should be apportioned according to the amounts each put in. If a settlor adds to a settlement, then the amount put in should be compared with the value of the settlement at that time. Trust Offices should endeavour to reach a fair and easily worked solution.
> **34895.** [April 2010]
> If one settlor is within Section 79 and the other is not, the gains are apportioned on the lines suggested, but those relating to the settlor who is outside Section 79 are assessed on the trustees in the normal way after deducting the trustees' annual exempt amount.
> **34900. Example 1** [April 2010]
> A and B each settle ordinary shares in X Limited on a trust under which both Mrs A and Mrs B have an interest as defined by the new provisions. A settles 500 such shares and B 1500. It is accepted that there is only one settlement for CGT purposes and the shares are not appropriated into separate funds.
> In 1988-89 there is a gain of £2,000 on the sale of some of the shares,

3 See 50.10 (Section 86 trust gains condition). The expression "originating from the settlor" is defined in TCGA Sch 5 para 8: see 80.3.5 (CGT s.86 definition of "settlor").

> [there is] a loss of £400 on the sale in 1989/90 of further shares and in 1990-91 a gain of £500 on the sale of shares in Y Limited acquired with the sale proceeds of the shares in X Limited.

The HMRC analysis is as follows:

> In 1988-89, as A and B settled property in the proportion 1:3, there is, on a just apportionment, a chargeable gain of £500 (2000×1/4) accruing to A.
> Similarly a gain of £1500 is treated as accruing to B. Each is assessed as appropriate.

That is straightforward. The example then turns to consider the loss in the next year and the gain in the following year:

> The loss of £400 in 1989-90 is apportioned £100 to A and £300 to B.
> The gain of £500 in 1990-91 is apportioned £125 to A and £375 to B.
> The loss of £100 in respect of the property provided by A is set against the gain of £125, leaving a net gain of £25 to be attributed to A. Similarly the loss of £300 in respect of the property provided by B is set against the gain of £375 on the property provided by him, leaving a net gain of £75 assessable on B.

This is not correct. The losses are not attributed to A or to B (either under the former s.77 or under the existing s.86.) They are carried forward and set against future gains of the trustees. The net gains in 1990/91 is £100 which is apportioned £25 to A and £75 to B. But although the analysis is not correct, the end result is the same.

> **34901. Example 2** [April 2010]
> The facts are as in Example 1 except that by a deed executed during 1988-89 Mrs B irrevocably excludes herself from the class of beneficiaries.

The HMRC analysis is as follows:

> The gains of that year are apportioned and attributed as before because Mrs B had an interest in the settlement at some time during the year.

This is straightforward.

> The losses of 1989-90 and the gains of 1990-91 are apportioned in the same way, and the net gains of £25 for 1990-91 are attributed to A.

This is not correct. The losses are set against the trustees gains; but it is correct that of the net £100 gains, £25 is attributed to A on a just and

reasonable apportionment.

> There can be no attribution to B in 1990-91 because neither he nor his spouse [this should read: neither she nor her spouse] has an interest in the settlement in that year. Accordingly the gains on the assets deriving from the property provided by B are assessable on the trustees and the trustees can claim the annual exemption due to them...[4]

81.4 Multiple settlors: Cases where apportionment not possible

The multiple settlor provisions are straightforward if two individual ("A" and"B") directly transfer property to a trust. A and B are both settlors and the property originating from A and B can be identified.

81.4.1 *Direct and indirect settlors*

Suppose there is an arrangement under which:
(1) A makes a gift of property to B, and
(2) B gifts the property to a trust.
A is a settlor (having provided property indirectly) and it seems at first as if B is also a settlor (having provided the property directly).[5] But A and B have provided the *same* property. There is no provision how to apportion trust income or gains between A and B and, since the income and gains cannot be subject to tax twice, it is considered that s.624 and s.86 do not apply at all; see 81.2.1 (Position where multiple settlor provision does not apply). The solution to the problem is that A is the "real" settlor, and B is not to be regarded as the settlor.

This issue sometimes arises in the context of failed tax planning of the kind discussed at 80.36 (Planning to create trust with foreign domiciled settlor)).

81.4.2 *Beneficial loans, guarantees, payments of trust expenses*

Similar issues arise where:
(1) S makes a settlement; and
(2) X provides further funds indirectly to the settlement, for instance by way of beneficial loans, guarantees, or payments of trust expenses.
X may be a joint settlor, but (even if the trust is settlor-interested) s.624 still does not apply to X unless it is possible to identify the income

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4 The Manual continues with some (I think erroneous) comments on the interaction of the annual exemption and loss relief; but it is not necessary to pursue that here.

5 See 80.4 (Gift from A to B followed by gift to trust by B).

provided by X, ie arising from X's act of bounty. In some cases one may say that all the income originates from S, so that s.624 applies to S but not to X. In other cases the contribution of S may be nominal, and one may be able to say that all the income originates from X.

CHAPTER EIGHTY TWO

SITUS OF ASSETS FOR IHT

82.1 Concept(s) of situs

Situs[1] of assets matters for many tax and some non-tax purposes. It is not possible to draw up a full list; the most important are IHT excluded property and the CGT remittance basis.[2]

Situs (like domicile) is a concept of private international law (or conflict of law) which has been adopted whenever statutes (usually tax statutes) refer to the location of property (typically referring to property "in" or "within" or "outside" a state). The rules are laid down by the common law.[3] The common law rules apply for tax, except so far as modified by specific rules in tax legislation. Thus one might refer to these rules as common law rules, private international law rules, or IHT rules.

IHT situs is almost entirely based on the common law rules. These are discussed in this chapter. Some IHT double tax treaties override the usual IHT situs rules.[4]

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1 A note on terminology. The IHTA and TCGA generally refer to the "situation" of assets though the heading to s.275 TCGA refers to "location". Section 59 Stamp Act 1891 (repealed) used the term "locally situate" and some of the older cases referred to the "local situation". The concept in each case is the same. "Situs" has become adopted into legal English usage and should not be written in italics.
Some old cases (unhappy with the concept of situs of intangible property) used the term "quasi locality" but this has not been adopted and situs is the current term.

2 Other tax issues where situs matters include (1) the ITA remittance basis (2) foreign IHT and CGT credit relief (3) stamp duty; see s.14(4) Stamp Act 1891.
In most cases the issue is whether or not the asset is situated in the UK, and if outside the UK it does not matter where. However in cases of foreign IHT and CGT credit relief, it may be necessary to identify the state where assets are situated.

3 I use the term "common law" here to mean judge-made law, including the pre-1857 ecclesiastical law from which the present law is derived.

4 See 69.6 (Treaty-situs); 70.9; (Dual-situate assets).

CGT has statutory situs rules which cover most situations, and the common law is only needed to fill a few gaps. So CGT situs is best regarded as a separate subject, though in a few cases the common law/IHT rules still apply for CGT. Situs for CGT is discussed in the next chapter.

The rules which determine the location of a source of income for income tax purposes are distinct from the rules which determine the situs of assets. For instance, the source of dividends is the place where the company is resident, but the situs of shares is the place where the shares are registered. Situs of assets only occasionally matters for IT, but where it does, the common law rules discussed in this chapter will apply.

As there are diverse statutory situs rules, one should (strictly speaking) not refer to situs in the abstract, but to situs for a specific purpose (CGT, IHT, or whatever). However context may supply the reference, and in this chapter, situs means situs as determined by the common law rules which apply for IHT purposes.

Dicey takes the view that "situs for tax purposes" may be different from situs for the purpose of conflict of law/international law. But this expression conceals a muddle or a mistake. One may correctly refer to situs for *specific* tax purposes, such as CGT, or IHT DTAs, which have statutory situs rules. But in the absence of contrary intention, references in a tax statute (or any statute) to the location of property are taken as references to the common law/international law concept of situs. The law does not distinguish between situs "for (general) tax purposes" and situs for conflict/international law purposes. *AG v Bouwens* (the leading tax case) adopts the situs rules which were developed "to prevent conflicting jurisdictions between different ordinaries".[5] Non-tax situs cases[6] routinely cite and follow tax cases, and vice versa. In a stamp duty case, Lord Lindley referred to situs "for *legal* purposes" (not *tax* purposes) and added:

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5 See the quote at 82.13 (Simple contract debt). The argument that situs rules should be limited to their original context of probate cases was rejected in *English, Scottish & Australian Bank v IRC* [1932] AC 238 at p.257 ("It was suggested that the doctrine just enunciated was peculiar to probate cases. Apart from the illustrations of its application in other departments of the law which Mr. Greene adduced, I venture to express my agreement with Lord Lindley, who said: "The authorities which bear upon the locality of incorporeal personal property for purposes of probate appear to me to afford the best guides for the solution of the case before us.")

6 Such as *New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101.

> It may perhaps be true that property which has no physical existence may, if necessary, be treated for some purposes in one locality, and for other purposes in some other locality. But, until the necessity for so treating it is apparent, I see no justification for introducing confusion by judicially holding the same property to be legally situate in two different places at one and the same time. But this confusion would be introduced if your Lordships were to decide that the analogy of probate cases was to be no guide in dealing with liability to stamp duty.[7]

It would of course be possible for the common law to develop different situs rules for different purposes. But (except for statutory provisions) a distinction between situs for one purpose and situs for another purpose should be avoided so far as possible, and in practice the common law has not gone down this path.[8]

Scots situs law is the same as English law,[9] except where situs law depends on concepts of property law which are different in Scotland.[10]

Northern Ireland situs law is the same as English law.

For completeness: para 21B Sch 24 FA 2007 authorises regulations to determine situs for the purpose of penalty provisions. That really is unnecessary, and the Treasury presumably agreed, since no regulations have been made. It should be repealed.

82.1.1 *Cross references*

For the situs of intermediated securities (depositary receipts) see 40.3 (Situs of transparent intermediated security for IHT).

82.1.2 *History and terminology of situs law*

To understand the old case law one needs to know some of its history and historic terminology.[11]

As mentioned above, the common law has adopted situs rules which were originally developed "to prevent conflicting jurisdictions between

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7 *IRC v Muller & Co.'s Margarine* [1901] AC 217 at p.237.

8 Except for a narrow line of Canadian case law concerning expropriation, which requires a lot of explanation, but which does not affect the point being made here.

9 For instance, *Laidlay v Lord Advocate* (1890) 15 App Cas 468 followed the Scots case *Commissioner of Stamp Duty v Salting* [1907] AC 449; see 82.34 (Situs of partnership share).

10 See 82.18.2 (Situs in Scots law).

11 For a discussion of this interesting corner of legal history; see Outhwaite, *The Rise and Fall of the English Ecclesiastical Courts, 1500-1860.*

different ordinaries".[12]

The **"ordinary"** was the judge of an ecclesiastical court with jurisdiction to grant probate for personal property situate in his province or diocese.

Blackstone explains:

> If all the goods of the deceased lie within the same jurisdiction, a probate before the ordinary, or an administration granted by him, are the only proper ones; but if the deceased had *bona notabilia,* or chattels to the value of a hundred shillings in two distinct dioceses or jurisdictions, then the will must be proved, or administration taken out, before the metropolitan of the province, by way of special prerogative; whence the court where the validity of such wills is tried... is called the prerogative court."[13]

The term ***"bona notabilia"*** in the wider sense meant "such goods and debts of a deceased person as require administration being taken thereto, [ie which require a grant of probate or administration] and are therefore denominated *notable.*" The term was more often used to mean "goods and debts belonging or owing to any person at the time of his death, in any other diocese or peculiar jurisdiction, within the province... besides the goods in the diocese or peculiar jurisdiction where he dwelt".[14] The detailed rules of what counted as *bona notabilia* (and so required probate)

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12 See the quote at 82.13 (Simple contract debt).

13 Commentary on the Laws of England, Book 2 p.509. There were about 250 local courts, and two prerogative courts, in Canterbury and York.
The Solicitor-General said in argument in *AG v Bouwens* (1838) 4 M & W 171 accessible *http://www.commonlii.org* at p.189: "that doctrine [bona notabilia] has no application as between goods in one province or diocese, and out of the kingdom. The defendants must establish that these instruments have no value in the kingdom." In order to understand this, one needs to understand what the Solicitor-General meant by the doctrine of bona notabilia. The Solicitor-General is *not* referring to the set of rules which determine where assets are situate. He is referring to the rule that where the deceased had bona notabilia in more than one diocese, the will must be proved in the prerogative court. Obviously that rule has no application in tax cases such as *Bouwens* where the issue is whether property is situate in the UK or outside the UK. This comment does not cast any doubt on the application of the situs principles developed in the old ecclesiastical probate cases and now adopted in the common law. I mention this because the comment has sometimes been misunderstood.

14 Lawton, *A Brief Treatise of Bona Notabilia* (1825) p.2. Comyn's Digest (Administration, B6): "If the testator had *bona notabilia*, the administration belongs to the archbishop of the province... If the testator had not *bona notabilia*, it belongs to the bishop of the diocese...".

need not be considered here.

In 1857 the jurisdiction of the ecclesiastical courts passed to the Court of Probate. The concept of bona notabilia (in the sense of assets not in the diocese where the deceased was resident) then became obsolete, though the term continued to be used: "bona notabilia in" a certain place became a traditional way of referring to the assets of the deceased situate in that place.

In 1875 the jurisdiction passed to the Chancery Division of the High Court.

82.2 Intangible property has a situs

In *R v Williams* the Privy Council said:

> Shares in a company are "things in action" which have in a sense no real situs, but it is now settled law that for the purposes of taxation ... they must be treated as having a situs which may be merely of a fictional nature.[15]

There are two points here:

(1) Shares (and other choses in action) have a situs.[16]

(2) That situs is "fictional".[17]

The first point is straightforward. The second is more doubtful. It is of course true that an asset with no corporeal existence, such as a debt, shares, or other chose in action, has no material position in the material world. Nevertheless a better analysis is to say that "situs" (of a chose in action) is a term describing an abstract concept. The situs of a chose in action is not "fictional", but perfectly "real" (or at least as real as other legal concepts such as "residence" or "domicile" or indeed "chose in action"). The concept may be described as technical. It might be described as metaphorical (at least in origin), or as "artificial" (though that has pejorative tones which are not apt here). Lawyers are entitled to use ordinary words in special senses and to call a situs (of a chose in action)

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15 [1942] AC 541 at p.549.

16 Similarly, *English Scottish and Australian Bank v IRC* [1932] AC 238 at p.244 ("it is desirable that [debts] should possess a locality..."; at p.248 ("the legal conception of property involves the legal conception of existence somewhere"); at p.251 (" it is not easy to form a conception of property having no local situation").

17 Similarly, in *New York Life Insurance v Public Trustee* [1924] 2 Ch 101 at p.119 the situs rules for choses in action were described as "legal fictions"; also *English Scottish & Australian Bank v IRC* [1932] AC 238 at p. 248 ("fictionem legis").

a "fiction" is inapt and misleading.[18]

Similarly, for conflict of law purposes, choses in action are categorised as movable or immovable property; but I am not aware of anyone describing that as a fiction.

Once one accepts that intangible assets (shares, debts, etc) have a situs, the law must choose connecting factors to identify the situs, in short, to link the asset to a jurisdiction. There is a large choice of possible connecting factors, and the selection of the determining factor must sometimes be arbitrary:

> probably any system of rules for determining the constructive locality of intangible property must be more or less arbitrary.[19]

One might think that it would not matter much what the rule was, as long as there is some rule and its application is clear. But sometimes choices have to be made between more formal rules (easy to apply) and more substantive rules (which aim to track the economic realities more closely).[20] The desirable rule (at least from the HMRC viewpoint) is one which minimises the scope for persons to chose the situs of their assets, as that would allow tax planning. The common law rules do not achieve that. Inasmuch as they were devised for conflicts purposes, there is no reason why they should. There is no objection to parties being able to chose a situs and it may be convenient if they can do so. The common law situs rules are not so well suited to serve as a territorial limitation for tax. It is not surprising that the common law rules have been modified for CGT. The role of situs in private international law has also decreased, though for different reasons,[21] and sometimes it is still important.

82.3 Every asset has one situs

Under the common law rules, every asset is situate in a jurisdiction and only in one jurisdiction. In *R v Williams* [1942] AC 541 at p.559 the Privy

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18 See Baker, *The Law's Two Bodies* (2001), Lecture 2 ("Legal Fictions"); MacCormick, *Institutions of Law* (2007), p.136.

19 *Royal Trust Co v Provincial Secretary-Treasurer of New Brunswick* [1925] SCR 94 at p.99.

20 A similar distinction arises in determining the location of a source of income: see 14.5 (Formal v. substantive source rules: the policy background).

21 The role of situs of intangible property in the conflict of laws is criticised in Rogerson "The Situs of Debts in the Conflict of Laws - Illogical, Unnecessary and Misleading" [1990] CLJ 441.

Council said:

> Property, whether movable or immovable, can ...[22] have only one local situation.[23]

This rule is self-evidently necessary if situs rules in private international law are to achieve their object, which is to resolve conflicts of jurisdiction, and if situs rules in tax law are to achieve the object of avoiding double taxation.

It is also implicit in the word situs: a physical object (let us ignore quantum physics) can be situate in only one place.

I stress this as some old cases considered assets could be dual situate. They no longer represent the law.

An asset must be situate in a single legal jurisdiction. The expression "**UK situate**" is in a literal sense inapt because an asset must be situate in England, Scotland or Northern Ireland. It is, however, universally used to describe an asset which is situate in England, Scotland or Northern Ireland. For tax purposes it usually makes no difference where in the UK an asset is situate, though for non-tax purposes that is occasionally important.

82.4 Inconsistent case law

As in any large body of case law – and the body of situs case law is very large – it is sometimes possible to find cases or dicta supporting inconsistent views. It may be possible to reconcile some inconsistent cases by saying that there is one situs for tax and another for conflicts; or that an asset may be dual situate. But where inconsistency exists it would be better to grasp the nettle and prefer one body of authority to the other.

82.5 Situs of shares: General principle

In *Brassard v Smith* the Privy Council said:

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22 The omitted words are "... for the purposes of determining situs as among the different provinces of Canada in relation to the incidence of a tax imposed by a provincial law upon property transmitted owing to death". These words do not qualify the general principle as there is only one common law situs concept and (subject to statute) that applies for all purposes.

23 Likewise *Laidlay v Lord Advocate* (1890) 15 App Cas 468 at p.483: "locality cannot be both England and India—the choice has to be made between the two". Likewise *Toronto General Trusts Co v The King* [1919] AC 679 at p.684: "it is plainly impossible to hold that [the debts] were situate in both provinces at once."

> This is, in their Lordships' opinion, the true test. Where could the shares be effectively dealt with?[24]

In *R v Williams* the Privy Council approved this passage and said:

> It may be useful here to make some general remarks on the meaning and effect of the principle laid down in *Brassard v Smith* and in the *Erie Beach* case. The first observation is that the phrase used in laying down the principle clearly means "where the shares can be effectively dealt with as between the shareholder and the company, so that the transferee will become legally entitled to all the rights of a member," e.g., the right of attending meetings and voting and of receiving dividends. If the phrase only meant "effectively dealt with as between transferor and transferee of shares," the test would obviously be almost completely useless, since the rights of a shareholder as between himself and a transferee can, speaking generally, effectively be transferred in any part of the world.[25]

These cases concerned registered shares, but the principle is not so restricted and apply to bearer shares also.

The question which follows from this test is: How to identify the place where shares can be dealt with?

82.6 Situs of registered shares

82.6.1 *Place-of-register rule*[26]

The IHT Manual provides:

> **27121 Usual location** [January 2014]
> For the purposes of Inheritance Tax an inscribed[27] and registered security[28] (a shareholding in a Company, for example) is located at the place where the title of ownership must be registered – see *AG v Higgins*.[29]...

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24 [1925] AC 371, page 376.

25 [1942] AC 541, pages 557-558.

26 See Venables, "The Situs of Registered Shares", PTPR Vol 9 p.115, accessible *http://www.khpplc.co.uk/reviews*

27 Author's footnote: "Inscribed" securities are those whose legal owners are inscribed in a register; the term is, as far as I can see, only an old-fashioned synonym of "registered".

28 Author's footnote: "Securities" here includes shares as well as debt securities.

29 (1857) 2 H & N 339 accessible on *http://www.kessler.co.uk/tfd-archive*. This was approved in *AG v Winans (No. 2)* [1910] AC 27.

> It makes no difference that the business of the company is totally administered outside the country in which the register is kept: see *Baelz v Public Trustee* [1926] Ch 863.

I call this "**the place-of-register rule**".[30] This is a straightforward application of the general principle that shares are situate where they can be dealt with.

It is necessary for completeness to mention *Macmillan v Bishopsgate Trust (No. 3)* [1996] 1 WLR 387. This concerned a company incorporated and with its share register in New York. Auld LJ adopted the place-of-register rule: see p.411E. Alarmingly, Aldous LJ stated without discussion that the situs is the place of incorporation: p.423F. Staughton LJ inclined to the same view but expressed himself more cautiously: p.405E. However, this was a case where the court did not have to decide between place-of-register and place of incorporation as rival situs rules. The court's attention was not on the point and the relevant cases were not discussed. In the circumstances, it is suggested that no weight whatsoever should be given to these dicta. The IHT Manual tactfully ignores this case. Thus the Court of Appeal have accidentally introduced into the law if not an uncertainty at least an inconsistency which needs to be explained away. But there it is.

82.6.2 *Overseas branch register*

Multiple registers raise a problem for a place-of-register rule. If there is only one register applicable to the shares in question, that is where the shares can be dealt with. The IHT Manual provides:

> **27122 Branch registers** [January 2014]
> If a company has more than one register, and any changes must be recorded on one of the registers, the relevant securities are sited in the place where that register is required by law to be kept – not in the place of the head office of the company.

This requires an examination of company law to identify which of the two registers is applicable. The IHT Manual summarises the company law background:

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30 A "register" is only a record of stockholders and their assignees: see *Ramsay v IRC* 54 TC 101 at p.133.

> **27124 Overseas branch registers of UK companies** [January 2014]
> Under UK law a share cannot, at one and the same time, be registered on more than one register.
> The rule applies even to overseas branch registers (these are branch registers of members resident in the country to which the register relates). Under [s.132 CA 2006], a company that maintains an overseas branch register has to keep a duplicate of it at the place where its principal register is kept.
> And 'no transaction with respect to any shares registered in an overseas branch register shall, during continuance of the registration, be registered in any other register' – see [s.133 CA 2006].
> So, shares on the overseas branch register of a UK company are situated, for Inheritance Tax purposes, in the country where the register is kept.
> Under [s.129 CA 2006] a company may maintain an overseas branch register. The countries and territories in which overseas branch registers may be kept are specified in enable the provisions for overseas branch registers to be extended by Order in Council to countries within the jurisdiction, or under the protection, of the Crown.

This view is confirmed by s.133(3) CA 2006:

> An instrument of transfer of a share registered in an overseas branch register—
> (a) is regarded as a transfer of property situated outside the UK.

82.6.3 *Transfer office*

Another solution may be that the company has only one register and merely a "transfer office" elsewhere. The IHT Manual provides:

> **27125 Duplicate or multiple registers of non-UK companies** [Jan 2014]
> Some overseas company laws allow a shareholder to use duplicate (or multiple) share registers to record the transfer of their securities.
> The South African Companies Act, for example, authorises South African companies to maintain branch registers in any foreign country. Shares can be transferred on any register, but no transfer of shares passing on death can be registered in the UK until any death duty claimed by South Africa on the shares has been paid.
> Remember that some registers merely record information about transfer of securities without providing the legal basis for the transfer. These registers do not affect the locality of the security (IHTM27071)
> Details of transfer arrangements given in the Stock Exchange Year-

Book[31] do not always make the position clear and, if necessary, you must ask the taxpayer to explain.

82.6.4 *Two effective registers*

If that fails one must look for a tie-breaker test:

> **27125 - Duplicate or multiple registers of non-UK companies** [January 2014]
> Where there are many registers the register upon which the shares would normally be dealt with in the ordinary course of business is the register that determines the situs of the security – see *Treasurer of Ontario v Aberdein* [1947] AC 24.

But which is the register which would normally be used? The Manual explains:

> If the share certificates are in the UK, one of the alternative registers is in the UK, and transfers can be effected here the shares will normally be regarded as legally situated here (*Re Clark, McKechnie v Clark* [1904] Ch 294.)

R v Williams [1942] AC 541 is another example: the location of a (signed and endorsed) share certificate acted as a tie-breaker between two competing jurisdictions (each with a share register).[32] The Manual continues:

> This is only an assumption and can be rebutted by the particular circumstances of the case (see *Standard Chartered Bank v IRC* [1978] 1 WLR 1160). But if tax is offered on shares in a foreign company with transfer facilities in the UK, you can assume that the register in the UK is the one on which the shares would normally be dealt with in the ordinary course of business.

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31 Author's note: The Stock Exchange Official Year Book has long ceased publication; it was first published in 1876 and the most recent edition I have been able to trace was 1994.

32 IHT Manual para 27150 [January 2008]:
"If the company has more than one register on which the holding could be effectively transferred, and the share certificates are found at the material time at a place where a register is located, the holding is for Inheritance Tax purposes situated at that place – see *R v Williams* [1942] AC 541. Cases where none of the effective registers is located where the certificates are found must be referred to TG or your Team Leader, in Scotland."

82.6.5 *Company without register*

The place-of-register test does not work if there is no company register. The IHT Manual provides:

> **27123 Effectiveness of register** [January 2014]
> If shares are entered on a list which does not affect the legal holding of the security (even though the list could be called a register) the location of the list does not affect the situs of the security.
> In *Erie Beach v AG for Ontario* [1930] AC 161, certain shares (on the view that they could, under the Ontario Companies Act, be effectively dealt with only in Ontario) were held to be situated in Ontario for the purposes of Ontario Succession Duty, although they had in fact been entered on a 'register' opened elsewhere.
> It was explained however, in *R v Williams*, that the *Erie Beach* decision was based on the finding that the particular shares in question could be dealt with effectively in Ontario only. In this case it was explained that the decision was 'not an authority for holding that any company subject to the Ontario Companies Act is precluded from establishing registers outside Ontario on which effective transfers can be made, and Ontario companies like other Canadian companies may establish branch registers kept by 'transfer agents' which are equivalent to duplicate or multiple registers (IHTM27125)'.

82.6.6 *Register of share transfers*

The IHT Manual provides:

> **27127 Transfer agencies** [January 2014]
> Many companies incorporated under Canadian law keep a register, or branch register, of transfers kept by one of the company's duly appointed 'transfer agents', not a register of shareholders as with UK companies.
> When considering the question 'where could the shares be effectively dealt with?' (*Brassard v Smith*), to find out where the shares can be taxed we must find out where the company has established transfer agents to operate a register, or branch register, of transfers. There is usually more than one transfer agent to which the shareholder could transfer their holding, regardless of where the share certificate was issued. Some (but relatively few) companies have transfer agents in the UK. These equally available transfer arrangements in various places are said to be 'interchangeable'. For the purposes of situs in relation to Inheritance Tax they can be taken as equivalent to duplicate or multiple registers (IHTM27125).

This applies:

- to shares registered in the name of the taxpayer or their nominee (including marking names),
- whether or not the share certificates are endorsed in blank (*Treasurer of Ontario v Aberdein* [1947] AC 24).,
- whether the company in question was incorporated under Canadian dominion or provincial law.

82.6.7 *Miscellaneous*

The IHT Manual provides:

> **27128 Branch registers of British Colombian and Newfoundland companies** [January 2014]
> Branch registers of companies in these two provinces of Canada can be kept outside the province, so the location of the shares will be determined by the location of the branch register.
> In certain circumstances shares registered on a branch register in the name of a deceased member can be transferred only on a duplicate register kept at the registered office of the company. This restriction does not affect locality for Inheritance Tax purposes on the deceased's death.
> **27129 - Canadian companies: Nova Scotia companies** [January 2014]
> Every company incorporated under the laws of Nova Scotia must keep a duplicate of any branch register kept outside the province at its registered office in the province. In respect of lifetime transfers, we understand that there is a distinction between:
> - Companies incorporated under the Nova Scotia Companies Acts, in which case a lifetime transfer on a branch register appears to be valid and effective. Accordingly if the securities are registered on a branch register in the UK they must be treated as situated in the UK.
> - Companies incorporated under other Acts, in which case no transfer on a branch register is effective until entered in the principal register. In this case , registered securities may be regarded as situated in Nova Scotia, even though they may be registered on a branch register in the UK.
>
> This restriction does not affect locality for Inheritance Tax purposes on the deceased's death.

82.7 Registered debt securities

The rules for registered debt securities[33] are, in general, the same as for

33 I use the term "debt securities" to mean securities which are not shares.

registered shares; the passage from the IHT Manual set out above refers to securities, generally meaning both shares and debt securities.

A UK company is not required by company law to keep a register of debentures, but if it does, it must kept the register in the UK.[34] But the planning by converting registered securities into bearer securities may be possible.[35]

82.7.1 *Place-of-register rule v specialty situs rule*

Shares are not "specialties" so the specialty situs rule cannot apply to them.[36] A debenture may be a specialty so the question arises as to the priority between the place-of-register rule and the specialty situs rule. The IHT Manual formerly provided:

> ***27079 Bonds and debentures under seal*** *[February 2006]*
> *Debentures if under seal, are specialty debts, locally situated where the document is found. So, also, are debts due from the Crown, or under a statute, whether under seal or under hand, and even when they are secured by registered bonds.*

Thus for debentures HMRC accepted that the specialty situs rule overrides the place-of-register rule. For HMRC views as to which securities are "specialties", see 82.15.1 (Situs of specialty).

The Manual has since been amended to reflect HMRC's (untenable) view denying the specialty situs rule:

> **IHTM27079 Specialty debts: bonds and debentures under seal** [January 2014]
> [The Manual outlines the meaning of the term "specialty" and continues:]
> In the past, HMRC's approach to the situs of specialty debts has been that this depends on where the relevant document is found. We now believe this may not be the correct approach in all cases involving specialty debts; specifically that many such debts are likely to be located where the debtor resides, or where property taken as security for the debts is situated. Any cases involving situs and a specialty debt must be referred to Technical. For example, any claim that a debt secured on UK assets is not UK situs property must be sent to Technical.

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34 Section 743 Companies Act 2006.

35 See 82.8.2 (Bearer shares and securities).

36 See 82.15 (Specialty obligation).

HMRC currently say this guidance is under review.[37]

82.8 Bearer documents and negotiable instruments

82.8.1 *The general law background*

Bearer shares or securities are transferable by delivery, so that the person who holds the document has legal title to them.[38]

An instrument is **"negotiable"** if legal title to it is transferable by delivery or by endorsement and delivery; a transferee who takes bona fide and for value has full legal title including the right to sue in his own name all parties to the instrument.[39] Bills of exchange and promissory notes are typically (though not necessarily) negotiable.

Thus bearer instruments and negotiable instruments are distinct but overlapping categories: bearer instruments are negotiable but negotiable instruments are not necessarily bearer.

Negotiable instruments (other than shares) may be made by deed, and so specialties, in which case situs is governed by the specialty situs rule. But they may not be specialties, in which case the specialty situs rule does not apply.

82.8.2 *Bearer shares and securities*

The place-of-register rule cannot apply to bearer shares or debentures as there is no register of shareholders or debenture holders.

The situs of bearer shares and bearer debt securities is where the document is to be found.

The IHT Manual provides:

> **27076 Bearer securities**[40] [January 2014]
> A bearer security is one where the ownership passes by delivery of the document of title. An example would be a security or bond which is not listed on a register. A bearer security is situated, for Inheritance Tax

37 See 82.15.3 (HMRC view(s)).

38 Bearer shares are possible in UK company law, though that is likely to change: see Discussion Paper "Transparency & Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business" (2013). *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/212079/bis-13-959-transparency-and-trust-enhancing-the-transparency-of-uk-company-ownership-and-increaing-trust-in-uk-business.pdf*

39 *Byles on Bills of Exchange and Cheques* (29th ed., 2013), para 1-06 (Negotiability).

40 Author's note: This passage applies to both shares and debt securities.

> purposes, in the place where the document of title is found at the material time. Special rules apply to securities listed on a register (IHTM27121)
> *Att Gen v Bouwens* [1838] 4 M & W 171, *Winans v Att Gen* [1910] AC 27. This does not apply to certain qualifying international securities (IHTM27141).

Dicey agrees:

> For taxation purposes, bonds, bills of exchange and other securities which can be validly and effectively transferred by delivery with or without endorsement are situate in the country where the paper representing the security is itself from time to time to be found.[41]

This is consistent with the general principle that shares are situate where legal title can be transferred.[42]

Situs of UK registered shares can under current law be changed by converting them into bearer shares and taking the document outside the UK. Similarly, foreign shares could be made UK situate. Stamp duty needs consideration. This planning has been described as tax mitigation, not avoidance,[43] though views on that may differ.

AG v Bouwens concerned foreign government bonds (not specialties) which were bearer instruments so it was not necessary to do any act outside England in order to transfer them. The Court said:

> No ordinary in England could perform any act of administration within his diocese, with respect to debts due from persons resident abroad, or with respect to shares or interests in foreign funds payable abroad, and incapable of being transferred here; and therefore no duty would be payable on the probate or letters of administration in respect of such effects. But, on the other hand, it is clear that the ordinary could administer all chattels within his jurisdiction; and if an instrument is created of a chattel nature, capable of being transferred by acts done here, and sold for money here, there is no reason why the ordinary or his appointee should not administer that species of property. Such an instrument is in effect a saleable chattel, and follows the nature of other

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41 *The Conflict of Laws* (15th ed., 2012), para 22-044. Dicey cites: *AG v Bouwens*; *AG v Glendining* (1904) 92 LT 87; *Winans v AG (no 2)* [1910] AC 27; *Provincial Treasurer of Manitoba v Bennett* (1937) 2 DLR 1; *Re Moore* [1937] 2 DLR 746; *Lunn v Barber* [1949] OR 34; *Favorke v Steinkopff* [1922] 1 Ch 174.

42 See 82.5 (Situs of shares: general principle).

43 See 32.31.2 (Is the transfer for tax avoidance?).

chattels as to the jurisdiction to grant probate.[44]

82.8.3 *Negotiable instruments which are not bearer*

The IHT Manual gives guidance on bearer securities but does not consider other negotiable instruments (that is, those which are transferable by endorsement and delivery). But the passage from Dicey set out above states that the same rules apply. The same rule applies in Australia:

> *negotiable instruments and securities transferable by delivery* for taxation purposes, bonds, bills of exchange and other securities which can be validly and effectively transferred by delivery with or without endorsement are situate in the country where the paper representing the security is itself from time to time found.[45]

In *Bouwens* the court stressed that there was an active market in England for the bonds (the Royal Exchange). Some cases suggest that this might be a requirement for situs:

> A negotiable instrument will be situate where the instrument is, *at any rate where there is an available market for its negotiation*.[46]

However I think the general trend of the authorities is that the situs of the instrument prevails and whether or not there is a market (which in modern conditions would be difficult to determine) is not relevant.[47] This is the view of the textbooks cited above. In particular, it would be strange to draw a distinction between bearer instruments (which HMRC accept are situate where the document is, regardless of whether there is a market) and other negotiable instruments.

82.8.4 *Eurobonds*

HMRC have commented specifically on the situs of eurobonds in a passage which I mention for completeness but which adds nothing to the general principles:

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44 (1838) 4 M & W 171 at p.192 accessible *http://www.commonlii.org*. This was approved in *AG v Winans (No. 2)* [1910] AC 27.

45 Taxation Ruling TR 2008/9 *http://law.ato.gov.au/atolaw/view.htm?locid='TXR/TR20089/NAT/ATO/ft20'#ft20*

46 *Kwok Chi Leung Karl v CED* [1988] STC 728 at p.732; the same point is made in *AG v Bouwens* at p.192 (emphasis added).

47 But for a dissenting view, see 82.11 (Letter of allotment of shares).

> ... in the Revenue's view, the *situs* for IHT purposes of Eurobonds and similar fungibles in any issue depends on the terms of that issue and, in particular, where under those terms the bondholder's rights to or rights of action for property exist. Those rights will be determined by reference to general, not Revenue, law principles. So where title to the rights under an issue passes by delivery, the *situs* for IHT purposes of such rights is where the instrument of title is physically.[48]

82.9 CREST

The Law Commission explain the securities law background:

> 2.21 Investment securities constituted under English, Scots and Northern Irish law can take either certificated or dematerialised ('uncertificated') form. CREST is the main securities settlement system in the UK and settles securities in uncertificated form. Unlike system operators in most national settlement systems, CREST does not hold domestically issued securities[49] as a central securities depository for account holders. CREST has no proprietary rights in the securities and is not treated as 'holding' these securities from the issuer on behalf of its participants. Rather, the CREST member is treated as holding directly from the issuer. This CREST member alone is entitled to exercise voting, dividend and other rights attaching to the shares and may do so directly against the issuer.
>
> 2.22 Instead, it is the register operated by CREST which, in the case of UK securities, is actually constituted by statute[50] as the sole legal record of entitlement to the securities. Although the issuer will maintain a regularly reconciled record of what is held in CREST for corporate events purposes, it is the CREST register that confers legal title and which determines the person or entity named in the register as the

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48 [1994] PCB 139. For completeness, the passage concludes:
"There is little we can add to the foregoing guidance. In particular we cannot offer any undertaking about the likely future IHT liability which may arise in respect of rights to particular Eurobond issues currently extant or which may be issued in future. However, in order to be as helpful as possible, we can say that where a Eurobond issue satisfies the terms and conditions of section 124 ICTA 1988, the Revenue will treat for IHT purposes the rights and interests of the beneficiary-investors in such issues as rights to and interests in a bearer security."
A eurobond within s.124 (now repealed) had to be a bearer security, so this does not take matters much further.

49 Footnote original: That is, in the UK, Republic of Ireland, Isle of Man, Guernsey and Jersey.

50 This footnote is set out in the text above.

shareholder for company law purposes.[51]

The first footnote at para 2.22 is important. It provides:

> For UK companies it is the entry in the CREST register that confers legal title on the owner: Uncertificated Securities Regulations 2001, SI 2001 No 3755 reg 24. For Irish, Manx, Guernsey and Jersey securities, the pre-2001 system still operates. Settlement is through CREST but legal title is transferred when the entry is made in the issuer's register.

Registered securities are in principle situate where the register of title is kept; but the position is different for UK companies and for Irish, IoM and Channel Island companies.

For UK companies, the register of legal title is CREST; the situs of the securities is in the UK, assuming (as is no doubt the case) that CREST keeps a UK situate register.

For the non-UK companies, the company law is different: the register of legal title is kept by the issuer. So holding a security through CREST (rather than in certified form) does not make any difference as to situs.[52]

The position is different for intermediated securities held through intermediaries such as Euroclear and Clearstream.[53]

82.10 Share certificate endorsed in blank

The IHT Manual explains the background law and practice as follows:

> **27150 Share certificates endorsed in blank** [January 2014]
> Certificates of many American and Canadian railroads and of certain other companies include a printed transfer form or power of attorney. When this is signed or endorsed by the registered holder it enables the certificates to be transferred by delivery.
> Often these certificates are 'endorsed in blank', This means the endorsement is to be signed by the registered owner as transferor, and the name of the transferee is left blank.
> Dividends are paid by the company to the registered owner, and if these shares have in fact changed hands by delivery, the beneficial owner for the time being recovers their dividends from the registered owner.

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51 Law Com., *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities Further Updated Advice to HM Treasury* (May 2008).

52 Further thought would be needed if the foreign company law were to change from the position which the Law Commission describe in 2008.

53 See 40.1 (Intermediated securities).

> Usually the shares are registered in the name of a recognised broker, bank or discount house. These are known in the UK as a 'good Marking Name' or, in the USA, as a 'Street Name'. This helps to make sure that the purchaser receives their dividends with minimum of trouble and risk.
> A list of good Marking Names recognised by the London Stock Exchange is printed in the Stock Exchange Official Year Book.[54]
> However the beneficial owner can have them registered in their own name, or in the name of some nominee other than a good Marking Name.

I doubt if this is still current practice, but set out the HMRC comments for completeness:

> The local situation of shares for Inheritance Tax purposes is determined as followings:
> [a] If the registered owner is a good Marking Name, the shares are situated where the register is kept, not where the certificates are found. ...[55]
> [b] If the registered owner is the beneficial owner himself, or a nominee of the beneficial owner, or, in the case of settled property, the trustees of the settlement or their nominees, the rules are as at (a) above.[56]

The HMRC view is that one ignores the fact a share transfer form has been endorsed in blank. This is right, because the endorsed certificate does not alter the place where registered shares are dealt with as between shareholder and company: see 82.5 (Situs of shares: general principle). At this point the Manual becomes confused:

> [d] If the registered owner is neither a good Marking Name, the beneficial owner, nor any other of the persons named at (b) above,

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54 Author's note: The Stock Exchange Official Year Book has long ceased publication; it was first published in 1876 and the most recent edition I have been able to trace was 1994.

55 Omitted text set out at 82.6.2 (Overseas branch register).

56 The Manual continues:

> "[c] In such cases it is considered that the legal and only title of the holder consists in his registration as owner. By bringing the certificates to the UK he is in a position to create, in a purchaser, an equitable interest in the shares which would be situated here, but until he does so the beneficial interest has not been severed from the legal interest so as to have a different locality."

This is garbled, or muddled and wrong.

> and the certificates are physically present in the UK at the material time, the shares are locally situated in the UK for Inheritance Tax purposes, (*Stern v The Queen* [1896] 1 QB 211).

I find it hard to see how [d] can apply: the registered owner will always be one of the persons named at [b] (beneficial owner or a nominee).

> Certificates of this kind, not containing any express obligation or promise, are not specialty debts – see the *Williams* case at [1942] AC 556.

That is correct.

82.11 Letter of allotment of shares

A letter of allotment confers the right to an issue of shares. The letter is normally transferable by delivery: it is a bearer security. One would have thought that the bearer security situs rule would apply. However, in *Young v Phillips*[57] a letter of allotment in respect of a company with UK registered shares was held to be situate in the UK, not where the letter of allotment was held. Nicholls J cited the passage in *AG v Bouwens* set out above[58] and said:

> From this it is apparent that for an instrument to be treated as analogous to a chattel for situs purposes more is required of it than mere transferability of title by delivery. A simple contract debt owed by a foreign debtor to a person resident in England and evidenced by a promissory note might be, and normally would be, freely and effectively transferable in England, but such a debt has as its situs the country where the debtor resides, not the place where the creditor lives or currently holds the promissory note. What is required is that in practice the value of the instrument can be realised by a sale of the instrument for money in the country where the instrument is found: the reason being that if an instrument in England could be so sold, the ordinary could properly and effectively administer that asset by selling it here, there being no need in such a case to have recourse to where the foreign debtor lived. When so saleable an instrument is in practice realisable in the same way as a saleable, valuable chattel, and hence, for situs purposes, it falls to be treated in the same way. ...

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57 58 TC 232 This case concerned the common law rules before s.275A TCGA and is still relevant for situs for IHT, and for CGT in the case of foreign incorporated companies.

58 See 82.8.2 (Bearer shares and securities).

This approach requires an investigation into whether a market exists. The judge said:

> In the instant case there are no grounds for concluding that in practice the value of the letters of allotment, *which were issued with a life-span of a little over two months*, could have been realised by a sale of those documents for money wherever they were to be found. The Special Commissioners pointed out that no evidence had been led before them to prove that there existed a market in letters of allotment of shares in private companies. Having regard to the fact that shares in private companies may not be the subject of a public issue, they expressed themselves as being far from prepared to assume the existence of such a market. With that approach I agree. And it is to be noted that the "sales" of the letters of allotment which did take place in Sark were not arm's length transactions but were to purchasers wholly under the control of the vendors, and they had been prearranged even before the letters of allotment were issued. Accordingly, applying the principles I have mentioned to the facts of this case, the renounceable letters of allotment in the UK companies do not fall to be treated as saleable chattels, realisable where they might be found from time to time. They are documents evidencing rights against UK companies, which rights were enforceable in the UK.
> (Emphasis added)

The requirement for "marketability" is not supported in textbooks, or much supported in the cases, nor does it make good sense. A buyer could be found for any valuable asset in any community where private property exists, and one buyer makes a market.[59] Whether a market exists is a question of fact, so application of the marketability test will result in assets moving from one jurisdiction to another as markets come and go. It is conceivable that there was no market in Sark (population 600). But with improved communications markets are no longer local to jurisdictions, as was assumed in *Young v Phillips*. An asset can be sold anywhere, even in Sark.

It seems that *Young v Phillips* stretched the law in order to defeat a tax

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59 This is self-evident, but for an illustration see *FGP v Union of India* 2004 (168) Excise Law Times 289 (Supreme Court of India) accessible *http://www.kessler.co.uk/tfd-archive*. Contrast the sophisticated definition of "asset for which there is a liquid market" in ICAEW Tech 7/03 para 19 (Guidance on the determination of realised profits and losses in the context of company distributions).

avoidance scheme, and in doing so has left something of a mess.

The CG Manual provides:

> **12440 Types of asset (2): Shares and securities etc** [January 2010]
> *Letters of allotment*
> Letters of allotment should be treated as located in the country where the company issuing the letters is registered. In the case of *Young v Phillips* 58 TC 232 bonus shares were issued in respect of registered shares located in the UK. The issue was made in letter of allotment form. The letters were then taken to the Channel Islands and disposed of there. It was held that the letters of allotment were located in the UK because they evidenced rights which were properly enforceable only in the UK.

Thus in the HMRC view *Young v Phillips* is relevant to letters of allotment only, it has no relevance to the situs of bearer debt securities or shares.[60] It is suggested that the reasoning should be restricted to short life assets (such as the letters of allotment in that case which, it was stressed, had a life of only two months).

Even letters of allotment may be situate where the letter is situate, if there is a "market" there (whatever that may require).

82.12 Securities of international organisations

For convenience this section deals with CGT situs as well as IHT situs, as the rules are the same.

82.12.1 *Designated organisations*

Section 126 FA 1984 provides power to designate:

> (1) Where—
> (a) the UK or any of the Communities is a member of an international organisation; and
> (b) the agreement under which it became a member provides for exemption from tax in relation to the organisation, of the kind for which provision is made by this section;
> the Treasury may, by order made by statutory instrument, designate that organisation for the purposes of this section....
> (4) The Treasury may, by order made by statutory instrument, designate

60 In *Mehjoo v Harben Barker* [2013] EWHC 1669 (QB) at [267] ff it was found that HMRC's practice was not to take any *Young v Phillips* point in relation to bearer shares. The point was not considered on appeal.

any of the Communities or the European Investment Bank for the purposes of this section, and references in subsections (2) and (3) above to an organisation designated for the purposes of this section include references to a body so designated by virtue of this subsection.

Section 126(2)(3) set out the consequences of designation:

(2) Where an organisation has been so designated, the provisions mentioned in subsection (3) below shall, with the exception of any which may be excluded by the designation order, apply in relation to that organisation.
(3) The provisions are—
(b) any security issued by the organisation shall be taken, for the purposes of capital transfer tax to be situated outside the UK;

The IHT Manual provides:

27141 List of non-UK situs organisations [January 2014]
Unless they are bearer securities (IHTM27076) and situated physically in the UK[61] securities issued by the following organisations are effectively outside the charge to IHT where:

- they form part of the estate of a person domiciled outside the UK; or
- they are comprised in a settlement and the settlor was not domiciled in the UK at the time the settlement was made:
- ○ the International Monetary Fund:
  - ○ The Bretton Woods Agreement Order in Council, 1946 ((SR & O) 1946 No 36)
  - ○ the International Bank for Reconstruction and Development[62]:
  - ○ The Bretton Woods Agreement, as above
  - ○ the International Finance Corporation:
  - ○ The International Finance Corporation Order, 1955 (SI 1955 No 1954)
  - ○ the International Development Association:
  - ○ The International Development Association Order, 1960 (SI 1960 No 1383)

This list of organisations may not be complete. If you receive a claim for exemption for a security issued by any other international body you should refer the case to Technical.

27142 Designated as non-UK by Treasury [January 2014]
... The following organisations have been so designated.

- The Asian Development Bank: under the International Organisations (Tax Exempt Securities) Order 1984 (SI1984/1215) made on 2 August 1984

61 I do not understand the basis for this exception, but in practice the point may never arise.

62 [Author's footnote] More commonly known as the World Bank.

- The African Development Bank: under the International Organisations (Tax Exempt Securities) (No 2) Order 1984 (SI1984/1634) made on 22 October 1984
- The European Community; The European Coal and Steel Community; The European Atomic Energy Community; The European Investment Bank - under the European Communities (Tax Exempt Securities) Order 1985 (SI 1985 No 1172) made on 25 July 1985.
- The European Bank for Reconstruction and Development - under the International Organisations (Tax Exempt Securities) Order 1991 (SI1991/1202) made on 16 May 1991.

Any security issued by these organisations automatically has a foreign situs for IHT, where the event occurred on or after the date of the order. ...

Section 265 TCGA provides:

(1) Where—
(a) the UK or any of the Communities is a member of an international organisation; and
(b) the agreement under which it became a member provides for exemption from tax, in relation to the organisation, of the kind for which provision is made by this section;

the Treasury may by order designate that organisation for the purposes of this section.

(2) The Treasury may by order designate any of the Communities or the European Investment Bank for the purposes of this section.

(3) Where an organisation has been designated for the purposes of this section, then any security issued by the organisation shall be taken, for the purposes of this Act, to be situated outside the UK.

The CG Manual provides:

12440 Types of asset (2): Shares and securities etc [January 2010]

Securities of International/European Organisations

Special rules are provided for dealing with securities issued by certain designated international organisations.

Section 265 TCGA 1992 allows the Treasury to designate for special treatment certain organisations whose membership includes the UK or any of the Communities of which the UK is a member. Once such an organisation has been designated any securities issued by it are deemed for the purposes of Capital Gains Tax to be located outside the UK. The list of organisations that have been designated under this provision is as follows.

- International Bank for Reconstruction and Development
- Asian Development Bank
- African Development Bank
- The European Economic Community

- The European Investment Bank
- The European Bank for Reconstruction and Development
- The European Coal and Steel Community
- The European Atomic Energy Community

82.12.2 *Inter-American Development Bank and OECD support fund*

Section 131 FA 1976 provides:

> (1) The following provisions of this section shall have effect on the UK's becoming a member of the Inter-American Development Bank ("the Bank").
> (2) A security issued by the Inter-American Development Bank shall be taken for the purposes of capital transfer tax … to be situated outside the UK.

Section 266 TCGA provides a corresponding CGT exemption:

> A security issued by the Inter-American Development Bank shall be taken for the purposes of this Act to be situated outside the UK.

Section 4 OECD Support Fund Act 1975 provides:

> (1) A person not resident in the UK shall not be liable to income tax in respect of income from any security issued by the support fund established by the Agreement if he would not be liable but for the fact that—
>
> (a) the security or income is issued, made payable or paid in the UK or in sterling; or
> (b) the support fund maintains an office or other place of business in the UK;
>
> and such a security shall be taken for the purposes of capital transfer tax and capital gains tax to be situated outside the UK.

82.13 Simple contract debt

A **"simple"** debt is one which is not a specialty (in short, not made by deed).

The basic principles are well established:

> to prevent conflicting jurisdictions between different ordinaries, with respect to choses in action and titles to property, it was established as law, that judgment debts were assets, for the purposes of jurisdiction, where the judgment is recorded; leases, where the land lies; specialty debts, where the instrument happens to be; and simple contract debts,

> where the debtor resides ...[63]

The IHT Manual provides:

> **27091 Debts: contractual** [January 2014]
> In English law, a **simple contract** debt is situated where the debtor resides: *AG v Bouwens*;[64] *English, Scottish and Australian Bank v IRC* [1932] AC 238...

Dicey states:

> Subject to the exceptions set out below, a debt is situate in the country where the debtor resides.[65]

I call this "**the place-of-debtor rule**". Along with the specialty situs rule, this rule can be traced back to Elizabethan times.[66]

There are many cases which state this rule: the most frequently cited, which may be called the two leading cases, are *English, Scottish and Australian Bank* (mentioned above) and *New York Life Insurance Co v Public Trustee* (affirming the passage from *Bouwens* set out above).[67]

A winding-up order against the debtor does not affect the situs of a debt,[68] but judgment against the debtor (turning the debt into a judgment debt) does do so.[69]

82.13.1 *Meaning of "residence"*

In order to apply the place-of-debtor rule one needs to determine where the debtor resides.

For this purpose the definition of residence for a company is neither the common law rule of corporate tax residence (management and control) nor the current statutory rules of corporate tax residence (under which a UK incorporated company is deemed UK resident). The test is where the company carries on business:

> Now, when you are dealing with a corporation, ... you have to examine

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63 *AG v Bouwens* (1838) 4 M & W 171 accessible *http://www.commonlii.org*. The same applies in Australia: *Haque v Haque* (No.2) (1965) 114 CLR 98 at p.137.

64 See above fn.

65 Dicey Morris & Collins, *Conflict of Law* (15th ed., 2012) para 22-026 (Debts).

66 See 82.15.1 (Situs of specialty).

67 [1924] 2 Ch 101.

68 *Wight v Eckhardt* [2004] 1 AC 147. In practice this issue will not usually arise.

69 See 82.22 (Judgment debt).

> the question where the debt can be said to be situate. It appears to me plain that a corporation according to our law is deemed to reside for the purposes of suit in the place where it carries on business in its own name ...[70]

Moreover for this purpose a company is always resident in the place where it is incorporated and has its registered office, whether or not it is carrying on business in any other place.[71]

I refer to the concept as "**jurisdiction-residence**" to distinguish it from tax-residence. It seems surprising to use the term "residence" in a non-tax sense but it is understandable when one bears in mind the history: the situs rule emerged in the context of conflict of laws, not in the context of tax. In practice it may be rare for there to be any difference between tax-residence and jurisdiction-residence.

What is the test of residence of an individual, for the purposes of the place-of-debtor rule? Here jurisdiction-residence adopts and still operates the common law definition of residence which applied for tax purposes until the SRT in 2013.[72] The statutory residence test is intended to achieve (more or less) the same result, so it should come to the same thing. One difference is that for tax-residence, one is resident in the UK; for jurisdiction-residence the question is whether an individual is resident in England or Scotland or Northern Ireland.

82.13.2 *Dual resident debtor*

A company may be jurisdiction-resident in two states. It has been said that an individual cannot be dual jurisdiction-resident.[73] But I do not understand why; an individual could be dual tax-resident under the

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70 *New York Life Insurance v Public Trustee* [1924] 2 Ch 101 at p.120 followed *Kwok Chi Leung Karl v CED* [1988] STC 728 at p.733.

71 *Kwok Chi Leung Karl v CED* [1988] STC 728 at p.733. This may be justified on the basis that a company must be carrying on business where it has its registered office.

72 *OJSC Oil Co Yugraneft v Abramovich* [2008] EWHC 2613 (Comm) (also reported under the name *Yugraneft v Abramovich*) at [461]: "... the courts have sought to give the word [residence] the same 'ordinary' meaning in both tax cases (such as *Levene*) and jurisdiction cases (such as *Abbas*). It makes sense to do so. Resident for jurisdiction purposes but not resident for tax purposes is a distinction to be avoided if possible." For the common law (pre-2013) test, see the 2012/13 edition of this work chapter 3 (Residence of individuals).

73 *New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101 at p.114.

common law definition of residence.[74]

Where the debtor is jurisdiction-resident in two states, the place-of-debtor rule does not provide a solution. A tie-breaker is needed, and the solution adopted in *New York Life Insurance v Public Trustee*[75] is to prefer the state of jurisdiction-residence where the debt is payable.

The position where the debtor is jurisdiction-resident in two states and the debt is payable in a third state has not been considered. Perhaps in relation to a company this cannot happen, as if the debt is payable in a state the company will be carrying on business there, so it must be jurisdiction-resident there.

The position where the debtor is jurisdiction-resident in two states and the debt is payable in both states has not been considered. Some suitable tie breaker must be devised; it is suggested that the proper law of the contract would be the most suitable.

82.13.3 *Place-of-enforceability as rationale of the place-of-debtor rule*

In *New York Life Insurance v Public Trustee* the court said:

> The rule of law with regard to the locality of simple contract debts is that it is determined by the residence of the debtor at the material moment. That has been well settled for a long time, and I think the reason for that is that it is
> [1] the residence of the debtor which determines the place where he may be sued, prima facie at all events, and
> [2] is in general the place where the means of satisfying any judgment may be discovered,
> but whatever the reason is, there is no doubt that this is the rule.[76]

These are not absolutely compelling reasons for the place-of-debtor rule. Even when the rule was first laid down, it was not necessarily the case that the debtor could only be sued in his place of residence, or that his assets were there and not elsewhere. Nowadays these are less safe assumptions than formerly, though even now, they are still the case more often than not. However there is no reason why the debt situs rule must have a compelling reason. In fact any situs rule is bound to be slightly arbitrary

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74 See the 2012/13 edition of this work para 3.13 (Dual residence/dual ordinary residence).

75 [1924] 2 Ch 101 followed *Kwok Chi Leung Karl v CED* [1988] STC 728 at p.733.

76 [1924] 2 Ch 101 at p.114; similarly at p 119.

and any clear rule is better than none.

82.13.4 *Place-of-enforceability as synonym of place-of-debtor rule*

In *Jabbour v Custodian of Absentee's Property of State of Israel* the Court said:

> It is established by the decided cases that not only debts, but also other choses in action, are for legal purposes localised and are situated where they are properly recoverable and are properly recoverable where the debtor resides.[77]

Similarly, Dicey rule 129 provides:

> Choses in action generally[78] are situate in the country where they are properly recoverable or can be enforced.[79]

I think that "properly recoverable" and "can be enforced are synonyms", so Dicey is propounding one test expressed in two different ways. I call this the **"place-of-enforceability test"**.

If this test is synonymous with jurisdiction-residence, it is correct. It is however a confusing and inapt way of expressing the place-of-debtor rule. It would be better to refer to place of residence rather than place of enforceability, and all the leading cases use the term residence;[80] though there are some cases which (under the influence of Dicey) have expressed the rule in this way.[81]

82.13.5 *Place-of-enforceability test as rival to the place-of-debtor rule*

The difficulty with the place-of-enforceability test is that a debt is *not* necessarily recoverable in the place of residence of the debtor, and if that is understood, it is not consistent with the place-of-debtor rule.

The question has been settled in a number of cases which have held that a debt is situate where the debtor is resident, even if the debt is enforceable elsewhere:

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77 [1954] 1 All ER 145 at p.151.

78 I think "generally" is intended to signpost the exceptions for specialties, bearer documents, negotiable instruments and judgment debts.

79 Dicey Morris & Collins, *Conflict of Law* (15th ed., 2012), 22R-023 rule 129.

80 *AG v Bouwens*; *English, Scottish and Australian Bank v IRC* [1932] AC 238.

81 For instance, *Kwok Chi Leung Karl v Commissioner of Estate Duty* [1988] STC 728 at p.732.

> a simple contract debt ... is deemed by English law to be situated in the place where the debtor resides. The reason for assigning this locality to a simple contract debt was that the place where the debtor resides was in nearly every case the place where it was recoverable. Even in earlier times, it might, of course, occasionally have happened that judgment could be obtained against a debtor in a country where he did not reside. But it was probably thought desirable for the sake of uniformity to adopt in all cases the test of residence rather than the test of recoverability. However, whatever the reason may have been, the rule was laid down, was I have stated it, in *AG v Bouwens*, and was recognised by this court as still being the rule in *New York Life Insurance v Public Trustee*. ... In the present case the debt is payable in this country, but the defendant bank was not residing here on Jan. 10, 1920. ...

A debt from a non-resident is recoverable in the UK if (in short) the Court gives permission, but that does not alter situs:

> The debt was also recoverable here ... had the plaintiffs been successful in obtaining leave to serve the defendant bank out of the jurisdiction. But I know of no authority for the proposition that a simple contract debt is situate in this country, at a time when the debtor is not resident here, merely because he can be sued by putting into operation the provisions of R.S.C., Ord. 11. It would be strange if it were so. For it is always in the discretion of the court in cases coming within the rule, to give or refuse leave for service out of the jurisdiction, a discretion depending upon the balance of convenience. A debt due from a debtor resident out of the jurisdiction cannot therefore be deemed to be in this country until an application has been made for service of the writ out of the jurisdiction and that application has been acceded to. If leave were obtained, the question would then arise whether the order granting leave brought the debt into this country for the first time, or established its presence here as from some earlier date. ...But I need not attempt to answer this question, for in my judgment the fact that a simple contract debt can be recovered here from a debtor out of the jurisdiction does not establish an English locality for the debt....[82]

I set this out in detail because unfortunately the contrary view was reached

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82 *Re Banque Des Marchands De Moscou (Koupetschesky)* [1954] 2 All ER 746 at p.752 citing *Deutsche Bank und Disconto Gesellschaft v Banque des Marchands de Moscou* (unreported). The passage was also followed in *Re Helbert Wagg & Co* [1956] 1 All ER 129 at p.137.

in one recent case, *Hillside (New Media) v Baasland*. In this case Baasland ("the creditor") deposited money with Hillside ("the debtor"), creating a debt. The debtor was resident in England. The Court should have held that the debt was situate in England because of the residence of the debtor but it did not. The Judge cited Dicey rule 129 set out above and continued:

> Although at common law this principle led to the general rule that (with some exceptions that are irrelevant for present purposes) debts are situate where the debtor resides (see Dicey, Morris & Collins, at para 22-026[83]), its application in a case such as this, where the debtor is a corporation and the case is covered by the Lugano Convention, depends, as I see it, upon the debtor's domicile. That is the primary ground on which a court takes jurisdiction under article 2 of the Lugano Convention. The domicile of a corporation is determined in accordance with section 42 of the Civil Jurisdiction and Judgments Act, 1982. It depends upon where it has its "seat", and this in turn depends upon where it was incorporated and has its registered or other official address or where its central management and control is exercised.[84]

I do not think any weight should be given to the comments on situs in *Hillside,* as the relevant cases were not cited.[85] *Hillside* illustrates how the place-of-enforcement test can mislead if it is intended to be synonymous with the place-of-debtor rule: it ought to be abandoned.

Although jurisdiction was the historic reason for adopting the place-of-debtor rule, now the rule has been chosen, jurisdiction-residence determines situs regardless of where the debt would actually be enforced. So a debt is situate where the debtor resides even though enforceable elsewhere, eg under an exclusive jurisdiction clause in the debt contract. If the historic reason for the place-of-debtor rule now holds less validity, or even no validity (though I think that would be an exaggeration) the rule is still as good as any other. Well-established precedents are not overturned merely because the historic reason for selecting that rule as against any other has become less compelling.

The place-of-debtor situs rule is in fact better than a place-of-

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83 The text of Dicey has not changed between the 14th edition to which the Judge refers, and the current edition.

84 [2010] EWHC 3336 (Comm) at [33]. The comment may be regarded as obiter as place of residence and place of enforceability were both in England.

85 The creditor (probably insolvent) was not represented.

enforceability rule for several reasons:

(1) It is generally easier to ascertain where a debtor is resident than where a debt may be enforced.
(2) The place of enforcement changes with developments in international law.
(3) A debt may be enforceable in several places against the same debtor.

82.14 Debt enforceable against several persons

Where a debt is guaranteed, the creditor may sue the debtor or the guarantor. This should not affect the situs of the debt, which is the jurisdiction-residence of the debtor, not the guarantor.

Hillside (New Media) v Baasland raised the (perhaps unusual) situation of a debt under a contract with an agent acting for an undisclosed principal. The Judge said:

> [35] ... Hillside... dealt with Mr Baasland in two capacities, (i) as principal in respect of [some funds] and (ii) as agents for an undisclosed principal (or undisclosed principals) in respect of [other funds] In either case, Hillside are liable for the debt represented by the funds ... That chose in action was situate in England
> [36] However, if this analysis is correct, ... Hillside Gibraltar [a Gibraltar company] , as an undisclosed principal of Hillside, would also have been liable to Mr Baasland in debt in respect of [certain funds], and that debt would have been situate in Gibraltar. Similarly, Bet 365 NV [a Netherlands Antilles company] would also have been liable for a debt in respect of [certain funds], and that debt would have been situate in the Netherlands Antilles.[86]

The better analysis of an undisclosed principal case is that the creditor has distinct claims (against the agent and against the undisclosed principal, enforceable in different places) but the claims relate to one single asset. An asset should be regarded as situate in only one place, so here we need a tie breaker between the jurisdiction-residence of the agent and the jurisdiction-residence of the principal. The jurisdiction-residence of the undisclosed agent has the stronger claim as the test of residence. The position of the undisclosed principal is analogous to a guarantor.

There is no authority on the position where a debt is owed by several debtors, whether jointly or severally, who are jurisdiction-resident in

86 [2010] EWHC 3336 (Comm).

different places. Here again some tie-breaker is needed, and the logical one (as in the case of a dual-resident debtor) is the place where the sum is payable.

82.15 Specialty obligation

82.15.1 *Situs of specialty*

If any rule of law can be called established, it is the rule that a debt due under a deed or other specialty is situate where the deed is situate.[87] I call this "**the specialty situs rule**". This rule (along with the place-of-debtor rule) can be traced back to Elizabethan times.[88]

The same rule applies in Australia:

> *specialties* (such as a policy of insurance) - a debt created by deed (a 'specialty') has been held to be located where the deed itself is to be found...[89]

So a debt due from a UK resident can be made non-UK situate for IHT by drafting the debt as a specialty and keeping the document offshore. Conversely a debt, policies, and other specialities can be made UK situate for IHT by bringing the deed here.

82.15.2 *Reason for the specialty situs rule*

What is the reason for the specialty situs rule? In *R v Williams* [1942] AC at 555 the Privy Council offer this explanation:

> [A specialty debt] was for centuries treated as very different from an ordinary debt. Indeed, the act of creating a specialty by deed was at one time possible only to men of the highest rank. Unlike debt, it was

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87 *AG v Bouwens* (1838) 4 M & W 171 accessible *http://www.commonlii.org*. This was approved in *AG v Winans (No. 2)* [1910] AC 27; *Comr of Stamps (New South Wales) v Hope* [1891] AC 476. Dicey Morris & Collins, *Conflict of Law* (15th ed., 2012), para 22-034 (Specialties) cite another half dozen cases.

88 *Byron v Byron* Cro. Eliz. 472: "The debt is where the bond is, being upon a speciality; but debt upon a contract follows the person of the debtor; and this difference has been oftentimes agreed."

89 Taxation Ruling TR 2008/9
http://law.ato.gov.au/atolaw/view.htm?DocID=TXR/TR20089/NAT/ATO/00001&PiT=99991231235958
The Ruling cites: *Shaw v R* (1895) 21 VLR 338; 1 ALR 122; *Haque v Haque (No.2)* (1965) 114 CLR 98 at p.137.

> enforced by an action of covenant.[90] The deed itself was the foundation of the action, the original debt, if any, being merged. The terms of the deed were conclusive. Specialty debts till recent [?] times conferred special rights. They used to rank in the administration of the estate of a deceased person in priority to simple contract debts;[91] and, unlike such debts, were enforceable against the real estate.[92] They were said to be "of a higher nature" than debts by contract. It is, therefore, not surprising that specialty debts by deed were treated from an early date as bona notabilia[93] where the deeds were found at the time of the death, unlike ordinary debts which were said "to follow the person of debtor".

The higher status attributed to a deed made sense several centuries ago. Important legal arrangements were recorded in deeds. Less important or casual legal arrangements would not be. The law's view that a deed was of a higher nature than a simple contract reflected the views of the community and the manner in which business was conducted. The specialty rules mentioned by the Privy Council had (by 1942) long ceased to be valid in English law, but it continues to be the case that a specialty has a higher status, for instance, preferential treatment in the law of limitation. In common law jurisdictions it is still the case, in Blackstone's words, that a deed is "the most solemn and authentic act that a man can possibly perform with relation to the disposal of his property."[94]

None of this justifies the specialty situs rule, but it does show that a distinction between situs rules for a specialty debt and other debts should not be regarded as very surprising or anomalous. Still, one might conclude that the specialty situs rule has no reason but *Commissioner of Stamps v Hope* offers a good explanation:

> ... the distinction drawn and well settled has been and is whether it is a debt by contract or a debt by specialty. In the former case, the debt being merely a chose in action – money to be recovered from the debtor and nothing more – could have no other local existence than the personal residence of the debtor, where the assets to satisfy it would presumably

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90 The Privy Counsel refer to Holdsworth, *A History of English Law* (3rd ed., 1903), vol. iii., p. 417; now Holdsworth, *A History of English Law* (5th ed., 1991), vol. iii., p. 417. This rule was abolished by the Civil Procedure Act 1833.

91 This rule was abolished by the Administration of Estates Act 1869.

92 This rule was abolished by the Administration of Estates Act 1833.

93 See 82.1.2 (History and terminology of situs law).

94 Commentaries Book II (1st ed., 1766), p.297.

> be, and it was held therefore to be bona notabilia[95] within the area of the local jurisdiction within which he resided; but this residence is of course of a changeable and fleeting nature, and depending upon the movements of the debtor, and inasmuch as a debt under seal or specialty had a species of corporeal existence by which its locality might be reduced to a certainty ... it was settled in very early days that such a debt was bona notabilia[96] where it was "conspicuous", i.e. within the jurisdiction within which the specialty was found at the time of death: see *Wentworth on the Office of Executors*, ed. 1763, pp. 45, 47, 60(1).[97]

The reason for the specialty situs rule is not that the specialty has a "species of corporeal existence"[98] though of course the deed does have physical existence. The reason is that the rule is certain and easier to apply than a place-of-debtor rule. There is good sense in that. The specialty situs rule reflects a rational choice in the common tax policy dilemma between formal and substantive rules.[99]

82.15.3 *HMRC view(s)=20 May 2014*

HMRC formerly accepted that the specialty situs rule was correct. The IHT Manual formerly provided:

> ***27091 Contractual*** *[February 2006]*
> *A specialty debt is situated where the instrument happens to be.*

But in January 2013, HMRC announced a change of practice, and the IHTM now provides:

> **IHTM27079 Specialty debts: bonds and debentures under seal** [January 2014]
> ... In the past, HMRC's approach to the situs of specialty debts has been that this depends on where the relevant document is found. We now

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95 See 82.1.2 (History and terminology of situs law).

96 See 82.1.2 (History and terminology of situs law).

97 [1891] AC 476 at p.481. The passage from Wentworth is accessible *http://www.kessler.co.uk/tfd-archive*.

98 That is either tautologous (if "having a species of corporeal existence" means "situate where the deed itself is situate") or metaphysical (if "having a species of corporeal existence" means anything more than "situate where the deed is situate"). It is not, after all, the case that transfer of the deed brings about a transfer of the debt or right to which the deed relates (except in the case of a bearer instrument).

99 See 82.2 (Situs: policy issues and reform).

> believe this may not be the correct approach in all cases involving special debts: especially that many such debts are likely to be located where the debtor resides, or where property taken as security for the debts is situated. Any cases involving situs and a specialty debt must be referred to Technical. For example, any claim that a debt secured on UK assets is not UK situs property must be sent to Technical.

It is very difficult to see any sound basis for the view, which HMRC claim to have been advised, that specialty debts are situate where the debtor resides. The only possible argument is that the Supreme Court should change the law. In the 2012/13 edition of this work I said:

> In tax cases the point should not often arise as HMRC should not argue the point against their own Manual. ... So the UK courts are not likely to have to examine the issue ...

I was wrong about that!

The courts have shown themselves prepared to amend long established common law rules, such as the rule that there is no recovery for payments made under a mistake of law. The Supreme Court has power to do that. But that power is intended to be applied only in a small number of cases in which previous decisions of the House of Lords/Supreme Court were "thought to be impeding the proper development of the law or to have led to results which were unjust or contrary to public policy".[100] That is not the case here. Well-established rules are not overturned merely because the underlying principle is logically unsound. Moreover, situs is a question of international law and it is "of great importance that some fixed common principles should guide the Courts in every country on international questions. In questions of international law we should not depart from any settled decisions, nor lay down any doctrine inconsistent with them".[101] A change would also upset existing wills, which sometimes make different dispositions for property depending on whether it is situate within and outside the UK So it is considered that the rule will remain even if challenged in the Supreme Court. It should be abolished (if at all)

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100 *R v National Insurance Comrs, ex p Hudson* [1972] AC 944; see Lee, "The Doctrine of Precedent and the Supreme Court" (2012) accessible *http://www.innertemple.org.uk/education/lecture-series-2012/previous-lecture-series-speakers*

101 *Udny v Udny* 1 Sc. & Div. 441 at p.452.

by Parliament.[102]

There are a number of objections to what HMRC have done. First, the HMRC view of the law is indefensible. Secondly (but perhaps not unconnectedly) no reason is given to defend it. It is not good enough to say that HMRC have received legal advice and take shelter behind professional privilege. Was the advice given by Counsel? And what are the reasons for overturning a rule set out without qualification in every relevant case, textbook and the HMRC manual? HMRC advocate "transparency, engaging in a co-operative, supportive and professional manner in all interactions ... working collaboratively"[103] though perhaps no-one takes that seriously. Perhaps in the event of a dispute HMRC would disclose their advice, in the interests of the open, frank and transparent enhanced relationship which HMRC say they want to have with their customers.[104]

Thirdly, no thought is given to the transitional problems of a change in practice.

It seems safe to predict that the statement will be withdrawn, in the next decade or so.[105] Altogether, HMRC's customers may think this a

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102 There are precedents for statutory reform: the specialty situs rule was amended for probate duty: s.39 Revenue Act 1862 and it does not usually apply for CGT. Dymond states: "It was formerly considered that s.39 Revenue Act 1862 (which provided that, for Probate Duty purposes, specialty debts owing from persons in the UK, and forming part of the free estate, were to be treated as though they were simple contract debts), was incorporated for Estate Duty purposes... The Irish court, however, decided in *Re Finance Act, 1894 and Deane* [1936] Ir R 556 that [this was not the case] and, accepting this interpretation as correct, such debts are to be regarded as subject to the ordinary rule applicable to specialty debts." See Dymond's Death Duties (15th ed, 1973) p.1267. Of course all this is inconsistent with the current HMRC view.

103 See 87.9 (Above-minimum disclosure for sake of good relations with HMRC).

104 "The minimum amount of openness on the part of revenue bodies that will be necessary for the enhanced relationship to function will include ... a willingness to disclose such information without invoking (except in the very rare case where the public interest requires otherwise) executive and other governmental privileges and immunities to suppress documents and other information reasonably sought by the taxpayer." OECD, "Tax Intermediaries Study Working Paper 6 The Enhanced Relationship" (July 2007), para 43; *http://www.oecd.org/dataoecd/59/61/39003880.pdf.*

105 Contrast the debate over GWR and excluded property where for a decade the IHT Manual instructed inspectors to refer the point to Technical, before finally throwing in the towel and reverting to the original practice.

somewhat unimpressive display of tax administration.

As the statement falls into the category of "clearly wrong" I see no need to disclose to HMRC occasions where a tax charge would arise if their view were right.[106]

In April 2014, HMRC announced:

> The guidance at IHTM27079, IHTM27080 and IHTM27104 is still being reviewed and will be amended again soon.[107]

Perhaps HMRC will back down.

82.15.4 *Commentary: Should we abolish the specialty situs rule?*

There is something to be said for statutory abolition of the specialty situs rule. The change would not bring in any significant amount of tax (as debts could be held by companies whose shares would be non-UK situate) but it would be a simplification. The transitional rules would need thought. Assuming the object is simplification, the new rules should not just apply to new debts. A fair rule would be to apply the new rules after a reasonable delay, say 12 months, to allow taxpayers to review their position. The cost of taxpayers reviewing their affairs ought to be taken into account. After factoring that in, I would not have thought that the improvement was worth the trouble involved in achieving it.

If it could be done as a quid pro quo of a wider review and simplification of the unsatisfactory CGT debt and debenture situs rules[108] the law would be left in a better state. But the best solution is to look at the wider picture altogether: treat all assets other than UK land and securities as non-UK situate for the purposes of IHT and CGT.[109]

82.16 Meaning of "specialty"

"Specialty" is an opaque technical term whose meaning can only be ascertained from the case law. Four categories of asset are "specialties":

(1) Obligations under deeds:
   (a) The paradigm example of a specialty is a debt due under a deed.
   (b) The term also applies to deeds which create or record obligations

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106 See 87.10 (Voluntary (?) disclosure to avoid allegation of misconduct).

107 HMRC, Trusts & Estates Newsletter, April 2014.

108 See 83.8.4 (Commentary); 83.13.5 (UK law rule: Commentary); 83.9 (Debt situs rule); 83.11 (Commentary).

109 See 82.2 (Situs: policy issues and reform).

which are not debts.[110] A life policy, contract for deferred annuity, capital redemption policy and the like are specialties if made by deed. Shares are not specialties.[111]

(2) For completeness the term also includes some liabilities which are not deeds:
   (a) A debt incurred under a statute.[112]
   (b) Certain debts are by statute given the status of a specialty.[113]

So the terms "deed" and "specialty" are not strictly synonymous, but in most cases a deed is a specialty and vice versa.

82.16.1 *What is a "deed"?*

Since a specialty is a deed, the question arises as to what is a deed.

82.16.2 *English law requirements of a deed*

There are different rules for:
(1) individuals
(2) companies incorporated under the companies acts
(3) other types of company
Land Registry Practice Guide 8 – Execution of deeds (March 2013)[114] contains a helpful summary of English law:

> **2.2 Elements of a deed**
> To be a deed the document:
> • must be in writing
> • must make clear on its face that it is intended to be a deed by the person making it or the parties to it. This can be done by the document describing itself as a deed or expressing itself to be executed as a deed 'or otherwise'
> • must be validly executed as a deed by the person making it or one or more of the parties to it (s.1, LP(MP)A 1989). ...
> **3 Execution of deeds by individuals**
> **3.1 The three elements: signature, attestation and delivery**
> **3.1.1 Signature**
> To be validly executed as a deed by an individual, they must sign the document.

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110 In *Aiken v Steward Wrightson Agency* [1995] 1 WLR 1281 the term was applied to a contract by deed to provide services (so a claim for breach of contract was "an action upon a specialty" which qualified for a 12-year limitation period).

111 *R v Williams* [1942] AC 541.

112 *Royal Trust v AG for Alberta* [1930] AC 144.

113 In this category there now remain only a few Victorian antiquities of no practical importance, such as s.14 Metropolitan Fire Brigade Act 1865.

114 *http://www.landregistry.gov.uk/professional/guides/practice-guide-8*

Making one's mark on a document is treated as signing it (s.1(4), LP(MP)A 1989). ...

3.1.2 Attestation by a witness

The individual must sign "in the presence of a witness who attests the signature" (s.1(3), LP(MP)A 1989). ...

3.1.3 Delivery

The document must be "delivered as a deed" by each person executing it or a person authorised to deliver it on their behalf (s.1(3)(b), LP(MP)A 1989). Delivery requires that the person expressly or impliedly acknowledges, by words or conduct, an intention to be bound by its provisions.

Where a conveyancer, in a transaction involving the disposal or creation of an interest in land, purports to deliver a document as a deed on behalf of a party to it, there is a conclusive presumption in favour of a purchaser that the conveyancer is authorised to deliver it (s.1(5), LP(MP)A 1989). In practice, we assume that a document has been delivered as a deed unless there is some indication to the contrary. So if, for example, the words of execution have been modified to provide that delivery has not taken place, or that delivery is not to be presumed until some condition has been fulfilled, we will require evidence that delivery has subsequently taken place.

3.2 Attestation clause

The general law does not require a particular attestation clause. It is sufficient if the clause makes clear that the signatures of the parties to the deed are intended to be by way of execution and that they were made in the presence of the witnesses. The wording should also state that the document has been executed "as a deed". Then, even if it is not clear elsewhere in the document that it is intended to be a deed, the words of execution will make this apparent ...

4 Execution of deeds by companies registered under the Companies Acts

On 6 April 2008 s.44, CA 2006 came into force and applies to deeds executed on or after 6 April 2008 by companies registered under previous Companies Acts and also to companies registered in Northern Ireland.

4.1 Execution by a company under its common seal[115]

Where this form of execution is adopted, the common seal will normally be affixed to the deed in the presence of the company secretary and one director, or two directors, who attest the sealing by countersigning the deed and describing themselves by their respective offices of 'secretary' and 'director' or 'director' and 'director'. ...

Under s.1(2A), LP(MP)A 1989 introduced by the RRO 2005, merely sealing a document will not make it a deed. It must be clear on the face of a document that it is intended to be a deed. ...

This form of execution will also apply to deeds executed by Northern Ireland companies on or after 6 April 2008.

Most companies, however, have articles of association that authorise the affixing

115 [Footnote original] This is the common law method of execution by corporations, preserved for companies registered under the Companies Acts by s.36A(2), CA 1985 and for documents executed on and after 6 April 2008 by s.44(1)(a), CA 2006.

of the company seal to a deed in the presence of people other than a director and the secretary. For example, article 101 of Table A[116] provides that:

"The directors may determine who shall sign any instrument to which the seal is affixed and unless otherwise so determined it shall be signed by a director and the secretary or by a second director". ...

4.2 Execution by a company otherwise than under a common seal

A different method of execution can be used by a company which either has no seal or, having one, chooses not to use it. For deeds executed before 6 April 2008, s.36A(4), CA 1985 provides:

"A document signed by a director and secretary of a company, or by two directors of a company, and expressed (in whatever form of words) to be executed by the company has the same effect as if executed under the common seal of the company." ...

The above form of execution can be used for deeds executed on or after 6 April 2008 by virtue of s.44(2)(a) and (3), CA 2006. This form of execution will also apply to deeds executed by Northern Ireland companies on or after 6 April 2008. In addition for deeds executed on or after 6 April 2008 s.44(2)(b), CA 2006 provides that a company may execute a document under the law of England and Wales or Northern Ireland by a single director if that signature is witnessed and attested. ...

4.3 Delivery

As with other deeds, a deed which has been executed by a company must also be delivered in order to be effective.

A document executed by a company that makes it clear on its face that it is intended by the people making it to be a deed is presumed to have been delivered on execution unless a contrary intention is proved (s.46, CA 2006).

In practice, we assume that a document has been delivered as a deed unless there is some indication to the contrary. So if, for example, the words of execution have been modified to provide that delivery has not taken place, or that delivery is not to be presumed until some condition has been fulfilled, we will require evidence that delivery has subsequently taken place.

4.4 Execution where the director or secretary is also a company

The seal of the executing company needs to be affixed to the deed "in the presence of and attested by" the director and secretary or, from 15 September 2005, two directors (s.74(1), LPA 1925, see 4.1 Execution by a company under its common seal). A corporate director or secretary must act through the agency of a real person. That person is required to be physically present at the affixing of the seal and must then attest the affixing with their signature. We suggest the following words of execution (amended as necessary) be used where the director or secretary is also a company. ...

4.5 Execution by directors/secretaries on behalf of several companies

From 15 September 2005, where a person who is a director or secretary of two or more companies executes a deed on behalf of them all, such person must sign

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116 [Footnote original] That is, Table A in the Schedule to the Companies (Tables A-F) Regulations 1985 (SI 1985/805).

the deed separately for each company (s.36A(4A), CA 1985 and s.44(6), CA 2006). ...

4.6 Execution by Scottish companies registered under the Companies Acts

The question of whether a disposition of land in England and Wales is formally valid must be determined in accordance with the lex situs, that is, the law of England and Wales. It is our view, therefore, that the requirements for an effective transfer etc. of registered land are the same where the disposition is by a Scottish company registered under the Companies Acts as for a disposition by English and Welsh companies so registered.

S.48, CA 2006 provides that "a document signed or subscribed by or on behalf of the company in accordance with the provisions of the Requirements of Writing (Scotland) Act 1995 shall have effect" as if executed by a company affixing its common seal. However, the section begins: "The following provisions form part of the law of Scotland only." It is difficult to see, therefore, how s.48, CA 2006 can be relevant where it is registered land that is being disposed of.

The Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009 includes provisions as to execution by overseas companies, but a Scottish company is not an overseas company.

5 Execution of deeds by unregistered companies

An unregistered company[117] is a body incorporated in and having a place of business in Great Britain, except:

- a body incorporated by or registered under any public general Act of Parliament
- any body not formed for the purpose of carrying on a business that has for its objects the acquisition of gain by the body or its individual members
- any body for the time being exempted by direction of the Secretary of State.

In practice, unregistered companies are usually incorporated either by royal charter or private Act of Parliament and of a local character, although some large companies, such as certain insurance companies, fall into this category. In transfers of registered land and other instruments whose form is prescribed, the attestation clause should be in the form set out in section 4.1 Execution by a company under its common seal where the unregistered company executes using its common seal. We will need to see the statute, charter or other document of constitution of the company when other forms of attestation clause are adopted.

An unregistered company can make use of the same alternative method of execution as a company registered under the Companies Acts.[118] So an unregistered company may execute without using its seal by arranging for a director and its secretary, or two directors, to sign on its behalf. In the case of a transfer of registered land or other instrument whose form is prescribed, the

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117 [Footnote original] The definition which follows is derived from s.1043(1), CA 2006.

118 [Footnote original] Companies (Unregistered Companies) Regulations 2009 (SI 2009/2436). The regulations apply s.44, CA 2006 to unregistered companies, and revoke previous regulations.

attestation clause must be in the form set out in section 4.2 Execution by a company otherwise than under a common seal.

For deeds executed on or after 1 October 2009 an unregistered company may also execute deeds by a single director if that signature is witnessed and attested, using Form D(ii), schedule 9, LRR 2003.

6 Execution of deeds by other corporations incorporated in the UK

6.1 General

A corporation is either a corporation sole or aggregate. A corporation sole is an office, such as 'bishop', that has a legal personality separate from the particular holder of the office for the time being. A corporation aggregate is a body of persons that has a legal personality separate from the particular members of the body for the time being.

This section is concerned with corporations aggregate other than companies registered under the Companies Acts and unregistered companies. So among the corporations this section does cover are those incorporated by or registered under public general Acts other than the Companies Acts; this includes building societies, industrial and provident societies, incorporated friendly societies, higher and further education corporations, the governing bodies of maintained schools and local authorities.

The relaxation of the common law requirement for a deed to be executed under seal, which enables sealing to be dispensed with in the case of deeds executed by individuals, does not extend to corporations sole (s.1(10), LP(MP)A 1989). The statutory provision (s.44(2), CA 2006) allowing companies to execute by a signature on behalf of the company does not apply to the corporations aggregate with which this section is concerned. We will, therefore, require that a corporation sole or aggregate executes under seal except where the applicant is able to point to some specific statutory provision in relation to the corporation concerned.

If the corporation is a corporation aggregate and the attestation clause is in the form set out in section 4.1 Execution by a company under its common seal,[119] we will normally accept the deed without further evidence – s.74(1), LPA 1925 will apply in favour of a purchaser.

The legislation or other document (such as a royal charter) under which the corporation is incorporated will normally provide for it to have a corporate seal and for the use of the seal in the execution of deeds. If the corporation is authorised to execute a deed by affixing its seal other than in accordance with s.74(1), and such a method of execution is adopted, then we will need to see the legislation or document of incorporation or regulating its affairs. If, however, incorporation is under the provisions of a public general Act, we will not require a copy of the legislation to be lodged with the deed, although we would ask that reference is made to the appropriate section or sections of the legislation in a covering letter sent with the deed.

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119 [Footnote original] It will be necessary to adapt this clause if the member of the governing body is not a 'director' or the permanent officer is not the 'secretary': see section 7.1 Execution under common seal.

If a deed is lodged for registration that does not have the common seal affixed and purports to have been:

- executed on behalf of the corporation by signatories
- with descriptions other than as provided for in the relevant statutory provision allowing for execution without a common seal

we will require evidence to be produced to show that the deed has been duly executed. If such evidence cannot be produced we will insist that the deed is executed correctly, either under the common seal or by following the procedure set out in the relevant statutory provision. The same will apply to a deed lodged for registration that purports to have been executed on behalf of the corporation by people who lack any description.

6.2 Limited liability partnerships

... Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009 (SI 2009/1804) applies ss.44-47, CA 2006 to limited liability partnerships, so they may execute deeds as provided by s.44, CA 2006. The regulations modify s.44, CA 2006 so that the references to a director and the secretary, or two directors, of the company are to be read as references to two members of the limited liability partnership (Regulation 4). ...

Paragraphs 6.3 and 6.4 deal with buildings societies and industrial and provident societies which is too specialist to reproduce here.

7 Execution of deeds by foreign corporations

We are concerned here with corporations from outside the UK.

With the coming into effect of the Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009 (SI 2009/1917) an overseas company can execute in one of three ways.[120] The regulations apply s.44, CA 2006 to overseas companies with some amendments. ...

7.1 Execution under common seal

A corporation possessing a common seal may execute deeds using that seal. The points made in section 4.1 Execution by a company under its common seal apply if a deed is executed in this way. ...

A foreign corporation may be able to execute in this way even though it has not hitherto had a seal (perhaps because the sealing of deeds is unknown to the law of its domicile). Provided there is nothing in the corporation's constitution or domestic law to fetter its powers in this respect, it would appear to be open to the board, council or other governing body to adopt a seal for the purpose of executing deeds in relation to property in England and Wales. It could use a wafer seal.[121] The attestation clause in the form set out in section 4.1 Execution

120 [Footnote original] There is a possible fourth way, which is to rely on s.74(3), LPA 1925, but this is much the same as the third way authorised by the regulations with the added requirement that the signature be witnessed.

121 [Footnote original] The Law Commission considered that this should be effective: The Execution of Deeds and Documents by or on behalf of Bodies Corporate (Law Com No 253), 4.33.

> by a company under its common seal should then be used, adapted as necessary (see the previous paragraph).
> **7.2 Execution in a manner permitted by the local law**
> Under Regulation 4 of the Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009 the deed can be executed "in any manner permitted by the laws of the territory in which the company is incorporated for the execution of documents by such a company". ...
> **7.3 Execution by signature of authorised person(s)**
> The Regulations apply s.44(2), CA 2006 amended as follows.
> "(2) A document which:
> (a) is signed by a person who, in accordance with the laws of the territory in which an overseas company is incorporated, is acting under the authority (express or implied) of the company, and
> (b) is expressed (in whatever form of words) to be executed by the company,
> has the same effect in relation to that company as it would have in relation to a company incorporated in England and Wales or Northern Ireland if executed under the common seal of a company so incorporated." ...

For a document to be a "deed" in English law it was formerly a requirement that the document must be sealed but that is not usually now the case. The current rules of what is a deed govern the meaning of "specialty". So a seal is not usually required for an English law document to be a "specialty".[122] No particular form is necessary to be a "specialty" beyond the formalities of a deed.

The same applies in Northern Ireland.[123]

As a shorthand, a deed was formerly referred to as a document "under seal" and a non-deed as a document "under hand". This usage is now out of date (at least in England) but it is still found in HMRC Manuals.

82.16.3 *Which debts are specialties?*

The specialty situs rule requires one to ascertain whether any particular debt is a specialty, which depends on the documentation. The IHT Manual formerly offered a little guidance on some standard categories of securities:

> **27079 Bonds and debentures under seal** [February 2006]
> Debentures if under seal, are specialty debts, locally situated where the

122 The Law Commission took this view in Working Paper No. 85 (1985) and Report No. 253, para 2.12.44. Dicey agrees: *The Conflict of Laws* (15th ed., 2012), para 22-034

123 Article 3 Law Reform (Miscellaneous Provisions) (NI) Order 2005.

document is found. So, also, are debts due from the Crown, or under a statute, whether under seal or under hand, and even when they are secured by registered bonds.

Most UK government securities (e.g. Treasury Loan, Exchequer Stock, War Loan) are registered, so that their locality is determined by the place of registration. However, some bonds issued by the UK government (containing an express obligation to pay) are governed by the general rule that a debt due from the Crown is a specialty debt, situated where the document evidencing the obligation is physically found.

In *Royal Trust v AG for Alberta* [1930] AC 144, the decision related to registered bonds of the Dominion of Canada and their situation for the purpose of Alberta death duties.

27080. Treasury Bills, British Savings Bonds, National Savings Income Bonds [February 2006]

Securities falling within the specialty rule includes Treasury Bills and British Savings Bonds.

Although no actual bonds are in existence holders receive a bond book or, in some cases, a certificate. When the person beneficially entitled to these bonds is domiciled outside the UK, the bonds are regarded for Inheritance Tax purposes as situated outside the UK at any time that the bond book or certificate is situated outside the UK....

The specialty situs rule overrides the place-of-register rule: see 82.6 (Situs of registered shares).

Now the IHT Manual provides:

IHTM27080 Specialty debts: Treasury Bills, British Savings Bonds, National Savings Income Bonds [January 2014]

Treasury Bills, and British Savings Bonds are treated as specialty debts and situs will follow the normal principles (IHTM27079). Any claim that such assets should be regarded as non UK situs at a chargeable event must be referred to Technical.

National Savings Income Bonds are securities registered on the National Savings Stock Register and are situated in the UK.

Any case in which this view is challenged must be referred to Technical.

IHTM27091 Debts: contractual [January 2014]

...Any questions about the situs of specialty debts (IHTM27079) must be referred to Technical.

Corporation mortgages, issued by local authorities under seal, and Northern Irish Land Bonds are examples of specialty debts. You should be careful not to confuse corporation mortgages with corporation stock, which is far more common and which is a registered security, situated where the register is kept.

The Manual text reads confusedly, as it has not been fully rewritten consistently with the new HMRC view that there is no difference between specialty debts and simple debts. HMRC currently say this guidance is under review.[124]

82.16.4 *Isle of Man law requirements of a deed*

The position is as follows:

> While there is no doubt that seals have never been used in the Isle of Man, except by corporations, and that the formality of affixing a seal has never been, and is not now, required in order to constitute a written paper a deed, in my view for a written paper to be a deed there must be some evidence that the parties intended it to be a deed. That will normally be found in the words of the document itself.[125]

82.17 Jurisdictions without "deeds": Channel Islands & Scotland

Common law jurisdictions employ the concept of a "deed", ie

(1) They draw a distinction between:
   (a) a "deed" (a technical term meaning a document which meets some set of formal requirements of execution) and
   (b) an informal document (which does not meet those requirements).
(2) The distinction matters for various purposes, eg certain dispositions of land require a deed; limitation and situs rules differ; etc.

Both the requirements and the consequences of being a deed have varied over the years, but there is a sufficient core to yield a stable and meaningful concept. As far as I know, other jurisdictions do not have this concept or anything very closely comparable.

Jersey and Guernsey do not have the common law concept of a deed and prefer to avoid the word or (if used) to give it an express definition.[126]

Scots law does use the word "deed"[127] but not as a technical term:

> [16]... it is clear that the word "deed" has no technical meaning in Scots

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124 See 82.15.3 (HMRC view(s)).

125 *Aall Trust & Banking Corporation v Samuel McCormick* 2 OFLR 85, Butterworths Offshore Service Cases, Vol 2, p.479.

126 Kessler and Matthams, *Drafting Trusts & Will Trusts in the Channel Islands* (2nd ed., 2013), para 9.1.

127 For instance, "trust deed" (broadly defined) is used frequently in the Trusts (Scotland) Act 1921.

law. In *Henderson's Trs v IRC*, 1913 SC 987, a case dealing with the question of whether a minute of acceptance of office by trustees engrossed upon a trust disposition and settlement was a deed for the purposes of the Stamp Act 1891, ...

Lord Kinnear stated (at 990):

> "I am entirely of the same opinion, and I agree with your Lordship that for the purpose of this case the word 'deed' is a word of ordinary language, because it is not in our system a term of art. I agree also that it is unnecessary to attempt any exact definition of what the word 'deed' means; but I take the definition ... that a deed was any formal instrument which creates a legal relation".

... It is unnecessary for present purposes to attempt any definition of the word "deed". Nevertheless, I take from these cases that the significant characteristics of a deed are first that it should have some degree of formality and secondly that it must demonstrate an intention to create a legal relation.

[17] The minute of the board meeting of a company, duly signed by the chairman, is to my mind clearly a formal document. Section 382 of the Companies Act 1985 [now s.248 CA 2006]... provided ... that every company shall cause minutes of all proceedings at meetings of its directors to be entered in books kept for that purpose. The reason for that provision is that the minutes serve an important purpose in recording the formal decisions of the board, which is of course the body that is responsible for managing the company. Thus board minutes are important documents. Subsection (2) then provides:

> "Any such minute, if purporting to be signed by the chairman of the meeting at which the proceedings were had... is evidence of the proceedings".

That too indicates a degree of formality in the notion of board minutes; they may have to be relied on in future, and it is important to establish precisely what the directors decided on any particular matter. Apart from the provisions of the Companies Act, section 2 of the Trusts (Scotland) Act 1921 states that the expression "trust deed" shall mean and include "any... resolution of any corporation". That again suggests that formal resolutions taken by a company, whether in general meeting or through its board of directors, are to be regarded as documents that have the requisite degree of formality to constitute a deed. ...[128]

In short, Scots law has a concept of "deed" (albeit somewhat vague) but that is not the common law concept. The use of the same word should not

128 *Low & Bonar Pension Trustees v Mercer* [2010] CSOH 47.

be allowed to obscure the difference. Scots law does not have the concept of a "specialty".[129] Accordingly, Scots law cannot have the rule that a specialty is situate where the document is.

82.18 Conflict of law issues on specialties

82.18.1 *Situs in English law*

An English[130] court may have to determine the situs of debt governed by a foreign law. If the foreign law recognises the concept of a deed (in practice, if it is a common law jurisdiction) then it is considered:

(1) The question whether the document is a specialty is governed by the law of the document.[131]

(2) If the document is a specialty under that law, one applies the English law (common law) rule that the situs is where the document is.

It has been suggested that the specialty situs rule may only apply if the document is situate in a jurisdiction which applies the specialty situs rule. So the situs of a specialty debt would be (say) the Isle of Man if the document was there, but it would be the residence of the debtor if the document was moved to (say) Jersey or Scotland. But there is no authority which supports that, and it is clearly wrong on principle. The question of situs in an English court is decided according to English law rules and under English law an asset may be situate in (say) Ruritania even if under Ruritanian law the asset is not situate there. Those who are concerned about the point will keep the documents in a common law jurisdiction, but that is not strictly necessary.

What is the position if a document is governed by a law which does not have the concept of a deed? There is authority that the document will be a specialty if it is executed in accordance with the English law requirements of a deed.[132] But in practice if one wishes to rely on the

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129 This is recognised in former companies act legislation; for instance, s.14(2) Companies Act 1985 provided: "Money payable by a member to the company under the memorandum or articles is a debt due from him to the company, and *in England and Wales* is of the nature of a specialty debt." There is no equivalent in the current companies legislation.

130 The same would apply in Northern Ireland.

131 In practice it would be unusual that a document which is a deed under the governing law does not meet the English law requirements for a deed, so the issue of which law applies for this purpose will not often arise.

132 *Alliance Bank of Simla v Carey* (1880) 5 CPD 429.

specialty situs rule, it is possible to avoid the issue, and chose a common law governing law, which does recognise deeds so the issue need not arise.

82.18.2 *Situs in Scots law*

If one turns to the Scots law textbooks on private international law, one finds no discussion at all on the situs of debts. Scotland did not have the jurisdiction of the Ordinary, where the common law rules arose;[133] and its private international law has managed to develop without reference to the situs of debts. I would be grateful to any reader who could direct me to relevant Scots authority if there is any.

Whatever the rule of Scots law, it seems safe to say that it does not apply the specialty situs rule as Scots law does not recognise that concept. It might apply the place-of-debtor rule: a debt is situate where the debtor resides. I would not have thought that was inevitable. The common law cases are not binding in Scotland. But in the absence of other authority, a solution which is more consistent with foreign jurisdictions seems preferable. This is the view of Dymond's death duties:

> The English specialty rule is unknown to Scottish law, so that debts owing by a person resident in Scotland, whether secured by a document under seal or not, are situate there [under Scottish law].[134]

Take the following examples; assume a specialty debt, and (if it matters) governed by English or IoM law (ie a law recognising deeds):

Case	**Specialty in**	**Debtor resident**	**Situs (Scots law)**	**Situs (English law)**
1	IoM	Scotland	Scotland	IoM
2	Scotland	IoM	IoM	Scotland

The situs of the debt (and whether it is excluded property) can hardly depend on whether the issue is litigated in England or in Scotland. It is suggested that the solution to the conundrum is to say that an asset is situated in the UK if:

(1) it is situate in England according to English law

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133 See 82.1.2 (History and terminology of situs law).

134 *Dymond's Death Duties* (15th ed., 1973), p.1267. The same passage is found in the current Dymond's Capital Taxes with the additional qualification "at any rate if Scots law is the proper law of the debt". *Dymond's Capital Taxes* (looseleaf 1986 onwards), para 30.354. But the authors cite no authority, and have no qualifications to opine on Scots private law. If Scots law follows the common law simple debt cases, the proper law of the debt should not be relevant.

(2) situate in Scotland according to Scots law, or
(3) situate in Northern Ireland according to NI law.[135]

It is situate outside the UK if none of those apply. On that analysis the debt in case 1 is situate in the UK and the debt in case 2 is situate outside the UK. The answer in case 2 is perhaps surprising but the facts of case 2 will not often arise.

The IHT Manual provides:

> **27092 Debts in Scotland** [January 2014]
> In Scotland, the rule that a debt is situated where the debtor resides applies to both to specialty debts (IHTM27079) and to those due on simple contract. For Inheritance Tax purposes debts due from people or companies who are resident or based in Scotland are regarded as situated there.[136]

No reason is given, but the result (although surprising at first sight) is consistent with the analysis of case 1 above.

82.19 Mortgage debt

82.19.1 *The property law background*

This section considers the situs of a debt charged or secured on land (**"a mortgage debt"**). The borrower is **"the mortgagor"** and the creditor is **"the mortgagee"**.

It is not necessarily the case that all mortgage debts should be treated the same way. In English law, mortgages have a long and complex history; in other jurisdictions the nature of a mortgage will vary. The rights of the mortgagee will also depend to some extent on the documentation. However the situs cases have never investigated this, and we can proceed on the basis that all mortgages should be governed by the same situs

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135 See to 3.13 (Child's domicile in Scotland).

136 For completeness, the passage concludes:
"If the taxpayer or agent disputes this rule, refer the case to Technical.
Any case where a Scottish instrument under seal is outside the UK and the locality of the asset determines whether or not Double Taxation Relief under s.159 IHTA applies must also be referred to Technical.
This guidance on this page relates to specialty debts generally. It covers, for example,
[1] mortgages under seal,
[2] policies under seal, and
[3] covenant debts, and
[4] also applies to debts due from the Crown, or due under a statute."

test(s).

A mortgage debt has a twofold character:

(1) It is an interest in land, conferring (at least when the debt is due and unpaid):
   (a) right to possession
   (b) power of sale
   (c) right to foreclose
(2) It is a debt, conferring a right of action against the debtor (like an unsecured debt).

In short, a mortgage debt confers a bundle of different rights. It should however be regarded as a single asset, and not as two assets. The bundle is indivisible:

> If [the mortgagee] sues on the covenant to pay he must reconvey the land on payment.[137] If he has parted with the land, otherwise than in exercise of a power of sale, he would be restrained from suing on the covenant... The result is that a mortgagee cannot assign the mortgage debt effectually without also transferring the security upon the land.[138]

Since rules applicable to land are often different from rules applicable to debts, the question of how to classify a mortgage debt has often arisen, and has been answered in different ways. That is not surprising, as a mortgage debt partakes of both qualities, and the appropriate answer has depended on the context.

At common law, on the death of an individual, real property passed to the heir and only personal property passed to the personal representatives.[139] In *Thornborough v Baker* Lord Nottingham settled that a mortgage debt is personalty, so that on the death of the mortgagee it passed to his personal representatives. The mortgagee's legal title to the land passed to the heir but he held it on trust for the PRs:

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137 [Author's footnote] The equivalent in modern law would be a duty to support an application to the land registry to de-register the mortgage.

138 *Re Hoyles* [1911] 1 Ch 179 at p.184. Although this relates to a pre-1925 mortgage (which took the form of the conveyance of land to the mortgagee subject to a right of reconveyance) the same applies to a modern mortgage (a charge by way of legal mortgage).

139 Hence the name "personal representatives". After s.30 Conveyancing Act 1881, the mortgagee's legal title to the land passed to the PRs; but the point would still arise even now if a will gave real property to A and personal property to B: the mortgage debt would pass to B.

> for in natural justice and equity the principal right of the mortgagee is to the money, and his right to the land is only as a security for the money.[140]

On the other hand, a mortgage debt is an interest in land; a gift by will to a charity was void under the Charitable Uses Act 1735. In *Re Hoyles* the will of a testator domiciled in England gave to charity mortgage debts charged on land in Ontario. The majority of the Court of Appeal held that a mortgage debt was immovable property, at least for the purpose of the conflicts rule that succession to immovable property was governed by the law of the place where the land was. The 1735 Act applied in Ontario, so the gift was void. The principle that a mortgage debt was personal property was limited (or brushed aside):

> It is true that a mortgage is as between mortgagor and mortgagee regarded as personal estate for many purposes; ... but the fact that it is so for certain purposes in questions between our fellow subjects here has no bearing on the question whether such a mortgage should be regarded as movable or not in questions of international law. The mortgage undoubtedly affects the land directly; the mortgagee can enter and take possession at any time after his estate has become absolute at law;[141] he can by foreclosure acquire the full title to the land in fee, and the Legislature has forbidden any devises of land for any estate or interest whatsoever in any way charged or incumbered by any person or persons whatsoever in trust or for the benefit of any charitable use whatsoever and has made them void: 9 Geo. 2, c. 36, ss. 1 and 2.[142]

This was a case where the court decided the answer first and the analysis came second:

> [Counsel] invites us to leave the Mortmain Act out of sight and decide as a preliminary abstract question whether mortgages on land are movable or immovable. But we should fail in our duty if we did not consider that Act and the effect of our decision upon devises within it. We must have regard to the fact that such gifts have been regarded as prejudicial to and against the public utility and a public mischief, and we must accordingly come to such conclusion as will avoid these evils.[143]

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140 (1675) 3 Swans 628 at 630 accessible *http://www.commonlii.org*

141 This is not the case for a mortgage under modern law.

142 [1911] 1 Ch 179 at p.187.

143 [1911] 1 Ch 179 at p.187.

82.19.2 *A principled analysis*

If one accepts (as I think one must) that a mortgage debt is one asset and not two assets, then there are three possible solutions:
(1) The asset is situate only where the land is.
(2) The asset is situate only where the debt is.
(3) The asset is dual situate.
Solution (3) must be rejected if one accepts the view in this book that one asset cannot be situate in two places.[144]

Solution (2) is the rational one. It provides a reasonable result even in a case where the debtor has no assets other than the land, so the debt is paid out of the land. An unsecured debt may be situate in state A even though the debtor's assets used to pay the debt are all in state B.

Solution (1) - that situs depends on location of the land - is not a sensible or workable rule for the following reasons:
(1) One debt may be charged on land in two different countries.
(2) The rule becomes absurd if a large debt happens to be secured on an asset of small value. Would one say a £100m debt is situate in Jersey if it is secured on a property there worth £100,000? But it is not satisfactory to have a rule where the situs depends on relative values of the debt and the security which may fluctuate from time to time.
(3) It has not, I think, been contended that a debt charged on (say) shares is situate where the shares are situate but there is no good reason to distinguish between shares and land.

82.20 Situs of mortgage debts: The case law

All three solutions have support in case law.[145] Some time the Courts will have to review the cases and decide which to prefer.

82.20.1 *Cases supporting view that situs of debt prevails*

These cases in this camp go back at least to *Commissioner of Stamps v Hope* [1891] AC 476. Here:
(1) The testator entered into a contract to sell land in New South Wales for a purchase price payable (in part) by 12 promissory notes falling due at various dates. The contract and promissory notes created

144 See 82.3 (Every asset has one situs).
145 See Hopley, "Reaping the Succession Duty Field: Mortgages and the One Local Situation Rule" (1958) 16 University of Toronto Faculty Law Review 8.

simple contract debts (not made by deed).

(2) Subsequently the purchaser granted a mortgage of the land by deed. This deed included a covenant to pay the promissory notes.

The testator died before the last promissory note was payable, so the question arose as to the situs of the debt. The Revenue argued that the testator held a simple contract debt situate where the debtor was resident (New South Wales). There was some debate about the simple contract debt had merged into the mortgage deed. Under the doctrine of merger, a simple contract debt could merge into a later deed (ie be superceded by the deed) in which case the simple contract debt ceased to exist.[146] Had that happened here then there would only have been a specialty debt. But the Court did not have to decide whether there had been a merger, as even if that had not happened, the debt was a specialty debt:

> The [mortgage] deed contains an express covenant to ... pay the promissory notes; between the same parties it was an existing security under seal, at the time of the testator's death, for the balance then due; it would continue to be a security for a much longer period, and would be attended with advantages not belonging to debt by simple contract. Although it never became necessary to act upon the [mortgage] deed by taking possession or seeking any remedy under it, it was and remained ... of full force and validity. *There is but one debt,* whether in Victoria or New South Wales; and their Lordships fail to see how it can be said that that debt has not become a debt by specialty.[147]

Since the deed was kept in Victoria, the debt was situate there. The Revenue did not argue that the situs of the land in NSW made any difference to the situs of the debt but the Court can hardly have overlooked that fact.

Toronto General Trust Corporation v The King [1919] AC 679 supports the same approach. Here a mortgage debt was represented by two duplicate deeds, one in Ottawa and one in Alberta. In such a case one cannot apply the rule that the debt is situate where the deed is situate. The Court cited *Hope* and distinguished it (there was only one deed in that case) but would otherwise have followed it. Had there been only one deed, the Court would have held the debt to be situate where the deed was.

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146 Merger was important when there were different remedies for simple contract debts and specialties; but now the doctrine is (more or less) obsolete.

147 [1891] AC 476 at p.484

A comment of the Special Commissioner in *Hafton Properties v McHugh* also supports this view[148] and the same view has been reached in India.[149]

82.20.2 *Cases supporting view that situs of land prevails*

The starting point on this side of the fence is the decision of the Privy Council in *Walsh v The Queen* [1894] AC 144. Here there were a variety of debts owed by non-residents secured on property in Queensland. The documents were kept outside Queensland. Whether one applied the place of debtor rule or the specialty rule, the debts were not situate in Queensland. It was held that the debt should be regarded as being in Queensland up to the lower of the value of the debt and the value of the Queensland property.[150]

I have wondered if one could explain *Walsh* on the basis that it did not concern the common law situs rule. The case turned on an income tax statute (the [Queensland] Dividend Duty Act 1890) which could have operated a different situs rule. But the view that *Walsh* only concerned the Dividend Duty Act and was not a common law situs case is difficult to maintain after the probate duty case *Henty v The Queen.* Here a debt was secured on land in New South Wales. In an *obiter* comment the Privy Council said:

> according to the principles recognised by this Board in *Walsh v. Reg*. the security held by [the creditor] is as much an asset in New South Wales as the real estate there which it affects.[151]

If the court was applying the common law situs rule, the Privy Council in should have referred to *Commissioner of Stamps v Hope* (which the taxpayer cited in argument) or to other leading situs cases. Perhaps the PC thought that *Hope* was wrong and chose to ignore it since they could not overrule it. Or perhaps they thought that the debt was dual-situate.

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148 "... the debt was a mortgage debt. Such a debt is regarded for private international law purposes ... as a speciality debt, the situs of which is to be found where the mortgage deed is to be found;" 59 TC 420 at p.426.

149 *Dharanidhar Roy v Sethi AIR* 1933 Cal 379 *http://www.indiankanoon.org/doc/959534*

150 Where the debt was secured on property in Queensland and elsewhere, there was an apportionment.

151 [1896] AC 567 at p.574.

82.20.3 *Cases supporting the view that a mortgage debt is dual situate*

Payne v R [1902] AC 552 concerned a debt charged on land in Victoria. The debtor was resident in New South Wales. The Privy Council held at p.560 (without citing authority) that the mortgage debt was an asset in New South Wales *and* tentatively suggested it was situate in Victoria too:

> The debtor as well as the testator resided in Victoria and was domiciled there. The debt, though a specialty debt in New South Wales, was a simple contract debt in Victoria. That being so, it seems to their Lordships that ... the debt was an asset in Victoria and recoverable under a Victorian probate, although it may well be that in order to discharge the mortgage probate duty would also have to be paid in New South Wales, and the debt, if recovered in Victoria, might be retained in Court until the mortgagees were in a position to discharge the mortgage.[152]

The attraction of this solution is that all the cases adopting the situs of debt approach can be reconciled with those adopting the situs of land approach. But there is only one asset which cannot be dual situate.[153] The comment in *Payne* is *obiter,* and should be dismissed as now overruled.

82.20.4 *Textbooks*

Dicey notes that in practice mortgages on land in England are usually specialties and continues:[154]

> [1] A mortgage of land confers an interest in land and will be held situate where the land is situate,[155]
> [2] but where it is necessary (e.g. for taxation purposes) to distinguish between the situs of the mortgagee's interest in land and that of the mortgagor's personal obligation to repay, then the latter (if in the form of a specialty) will be held situate where the deed is situate from time to time.[156] …
> [3] In the conflict of laws the distinction between the interest in land and the personal obligation is not normally made for the purposes of situs, and the asset is regarded as a unity which is situate in the

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152 [1902] AC 552 at p.560

153 See 82.3 (Every asset has one situs) and 82.4 (Inconsistent case law).

154 Dicey, Morris & Collins, *Conflict of Laws*, (15th ed., 2012), para 22-035.

155 [Dicey's footnote] *Re Hoyles* [1911] 1 Ch 179.

156 [Dicey's footnote] See *Walsh v The Queen* [1894] AC 144; *Payne v R* [1902] AC 552. Also *Henty v The Queen* [1896] AC 567.

country where the land lies.[157]

Dicey's view at [1] and [3] is that the location of the land prevails. This overlooks the authorities cited above. The case cited, *Re Hoyles*, does not support Dicey. It shows that the succession law which applies to a mortgage debt is the law where the land is situate. However, it does not follow from this that the debt should be regarded as situate in that country. This is a case where succession law does not follow the situs of the asset. Situs as such is nowhere discussed in *Re Hoyles*. The suggestion at [2] is that tax law may distinguish between the mortgagee's interest in land and the mortgagees's right to payment. But the distinction is an impossible one: a mortgage debt is a single asset and not two assets.

The IHT Manual passage cited above[158] suggests that the HMRC view is (like mine) that the specialty situs rule prevails, not the location of the land.

82.20.5 *Conclusion*

It is considered that the balance of authority, and principle, both support the view that a mortgage debt is situate where the debt is and not where the land is.

82.21 Debt under letter of credit

The IHT Manual provides:

> **27091 Contractual** [January 2014]
> A debt under a letter of credit has been held to be situated in the place where it is in fact payable against documents (*Power Curber International v National Bank of Kuwait* [1981] 3 All ER 607).

In *Power Curber International*, the bank was resident in Kuwait but the debt payable in Carolina. The majority of the Court of Appeal held the debt was situate in Carolina. The decision on this point was obiter, not fully argued, and the dissenting view was the better one. But the issue will not often arise in an IHT context, as letters of credit are likely to be held by companies, so the situs of the debt will not often matter for tax

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157 [Dicey's footnote] *Re Hoyles* [1911] 1 Ch 179; *Dicey*; cf Falconbridge, *Selected Essays on the Conflict of Laws*, (2nd ed., 1954), pp.573–580 for an acute discussion of the problem raised in this paragraph.

158 82.15.1 (Situs of specialty); note the references to mortgages in the quotation from the IHT Manual.

purposes. If it did arise, the lower courts are likely to follow the majority view of the Court of Appeal, and even the Supreme Court should prefer to maintain the stability which results from following a decision which has been unchallenged for so long. So the law should be regarded as settled.

82.22 Judgment debt

A judgment debt is situate where the judgment is recorded.[159] Obtaining judgment may therefore have the effect of changing situs, for better or worse.

82.23 Bank account

The IHT Manual provides:

> **27093 Debts: Bank accounts** [January 2014]
> A bank account is a debt, and under general law is situated at the branch of the bank where the account is kept: *R v Lovitt*[160] [1912] AC 212...

This is not a special rule for bank accounts: it is an application of the general rule that, in the case of a company carrying on business in two places, a simple debt is situate where payable; see 82.13.1 (Meaning of "residence" and dual resident debtor).

UK bank accounts may qualify for IHT relief.[161] Guidance on what constitutes a branch of a bank can be found in the discussion of branch and PE.[162]

82.24 Building society account

A standard form building society account is not a debt, it is an interest in the society, so corporation situs rules rather than debt rules should be applied.

The IHT Manual provides:

> **27151[Bank or][163] building society accounts in Channel Islands and Isle of Man** [January 2014]

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159 *AG v Bouwens* (1838) 4 M & W 171 accessible on *http://www.commonlii.org*.

160 In the Law Reports the name of this case is: *The King v Lovitt.*

161 See 62.20 (Non-residents foreign currency bank accounts).

162 See 86.2 (Meaning of permanent establishment); 86.14 (Meaning of "branch or agency").

163 The reference to a "bank" in the heading seems to be erroneous since the text only relates to building societies.

Any case in which it is claimed that an account with a UK Building Society must be treated as situated in the Channel Islands or the Isle of Man, so it is exempt from IHT, must be referred to Technical.

82.25 Insurance policy

For the purpose of common law situs rules a policy is treated in the same way as a debt, so the place-of-debtor and specialty situs rules apply.[164] That makes sense if one bears in mind the insurance law background: a policy is in fact just a contingent debt[165] (even though in tax law one would not usually expect the word *debt* to include a policy).

The IHT Manual provides:

> **IHTM27101 Foreign Property: Money From A Life Policy: General Rule** [Jan 2014]
> When a life policy is not made by way of deed the policy monies are situated where the debtor (the company) is resident. This is generally the head office of the company.
> You can find more information on policies at IHTM20000 onwards.
> **IHTM27102 Payment Made At Place Other Than Head Office** [Jan 2014]
> Where under the terms of the policy, payment is to be made at some place other than the residence of the head office the monies are deemed to be situated at the place of payment' (*New York Life Insurance Co v Public Trustee* [1924] 2 Ch 101).
> So, if the policy proceeds are to be paid in the UK the policy proceeds are UK sited and chargeable to Inheritance Tax.
> **HTM27103 Policy Issued At Branch Office** [Jan 2014]
> The proceeds of a policy are usually taxed where they are sited (IHTM27071).
> If a policy:
> - is issued by, or through, a branch office of a UK company that is outside the UK, and
> - no reference is made in the terms of the policy as to the place where the policy monies are to be paid,

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164 *New York Life Assurance v Public Trustee* [1924] 2 Ch 101.

165 *Foskett v McKeown* [2001] 1 AC 102 at p.134: "The word "policy" is here used to describe the bundle of rights to which the policyholder is entitled in return for the premiums. These rights, which may be very complex, together constitute a chose in action, viz, the right to payment of a debt payable on a future event and contingent upon the continued payment of further premiums until the happening of the event."

policy monies are to be treated as situated in the country of the branch office as long as the whole course of business in relation to the policy had been transacted in that country.

The 'whole course of business' means that all the following events must happen in the country of the branch office:

- The policy is issued to a resident in that country from the branch in that country.
- The holder of the policy remains resident and retains the policy there, pays the premiums to the branch there, and dies there.
- The grant of representation to the policy holder's estate is taken out there and the proceeds are collected there.

You should not assume that the policy was situated in the UK without considering all the circumstances surrounding the policy, even if, at the date of the life assured's death:

- the policy is in the UK at the Assurance Company's head office, and
- the life assured has assigned the policy to the assurance company as security for a loan.

Each case must be considered on its own facts. If a small detail prevents the conditions from being fully met this may still mean that the policy is situated outside the UK. But any case where this applies, or where the locality of the policy has to be determined before the policy holder's death must be referred to Technical.

Where a policy not made by way of deed has terms that provide for payment either at its head office or at a branch office, and the 'whole course of business', takes place in the country of the branch office, the monies are also treated as locally situated in that country.

Some of para 27103 is doubtful but the practice will normally favour the taxpayer so the issues will not often arise.

82.25.1 *Policy made by deed*

The IHT Manual provides:

> **IHTM27104 Policies Under Seal** [Jan 2014]
> Policies by way of deed or under seal are specialty debts (IHTM27079) and must be referred to Technical.

It is necessary to investigate whether policies are specialties. The IHT Manual gives a little guidance:

> Most Lloyds policies are embossed with a seal but they are not specialty debts unless they also bear the witnessed personal signature of the General Manager of Lloyds Policy Signing Office. Lloyds policies that

> do not bear this signature are chargeable to Inheritance Tax in the country where the debtor (the company) resides (IHTM27101).

HMRC currently say this guidance is under review.[166]

On IHT treatment of UK situate policies see 33.14 (IHT on policy held by foreign domiciliary).

82.26 Land

The IHT Manual provides:

> **27074 Land and interest in land** [January 2014]
> Immovable property is situated where it is actually located.

That seems self-evident; but if authority is needed, see *Haque v Haque (No 2)* (1965) 114 CLR 98 at p.136. The Manual continues with a discussion of the meaning of "land" though I do not expect that issue will arise very often:

> But, different legal systems may take opposing views as to whether some types of interest in land or relating to land are movable or immovable property.
> These differences are resolved (under Private International Law, and also by specific provision in Double Taxation Conventions where these apply) by the adoption of the view taken by the law of the country in which the land itself is 'situated': *Johnstone v Baker* (1817), 4 Madd 474; *Macdonald v Macdonald* (1932) SLT (HL) 381.
> Land is usually classed as immovable property, so is generally governed by the law of the country in which it is situated ...

82.27 Chattels

The rule is what one would expect. The IHT Manual provides:

> **27075 Chattels** [January 2014]
> ... (chattels) are situated where they happen to be at the relevant time.[167]

It is suggested that this applies even where:

(1) a chattel is moved out of the UK;
(2) the chattel is transferred to another person or trust;
(3) the chattel is returned to the UK.

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166 See 82.15.3 (HMRC view(s)).

167 The text is found twice: IHT Manual paras 21047 [April 2012] and 27075. For a concession on works of art see 62.21 (Works of art).

The temporary removal of the asset at the time of the disposal cannot be ignored, for tax purposes, even if the time spent out of the UK is short.

82.28 Ships and aircraft

The IHT Manual provides:

> **27073 Ships** [January 2014]
> A ship on the high seas is deemed to be situated at its port of registry but when it comes within territorial waters this artificial situs is displaced by the actual situs: *Trustees Executors & Agency v IRC* [1973] Ch 254.

The situs of aircraft for IHT is, surprisingly, undecided. The choice lies between the chattel rule, the ship rule and the place of registration. In *Kuwait Airways v Iraqi Airways (Nos 4 & 5)* [!] [2002] 2 AC 833 no attempt was made even to argue for place of registration. It is suggested that the ship rule is the most sensible solution.

See now *Dornoch v Westminster International* [2009] 2 All ER (Comm) 399.

82.29 Goodwill and intellectual property

Goodwill is situate where the trade or profession is carried on (see *IRC v Muller* [1901] AC 217).

For intellectual property, see *Forster's Australia v CIT* 302 ITR 289 (AAR) 10 ITLR 939.

Because of IHT business property relief, these issues will not often arise.

82.30 Property subject to contract of sale

An interest in English land subject to a contract of sale is still situated in the UK: *Re Clore, IRC v Stype Investments* [1982] STC 625. It is suggested that a contract of sale does not affect situs.

82.31 Interest under bare trust or nomineeship

The interest of a beneficial owner in property held by a nominee or bare trustee is situate where the underlying asset is situate: a nomineeship[168] or bare trust is transparent for situs. In *Re Clore, IRC v Stype Investments* land in England (the Guy's estate) was held by a Jersey nominee (Stype

168 For present purposes the terms "bare trust" and "nomineeship" are used synonymously.

Investments):

> Immediately after the conveyance of the Guy's estate to Stype Investments and the execution of the declaration of trust which acknowledged that the Guy's estate would "continue to remain in the beneficial ownership of Sir Charles," the Guy's estate belonged in equity to Sir Charles in fee simple and his interest constituted property situate in England. Stype Investments was entitled to be paid any outgoings or charges in respect of the estate, but this entitlement did not affect the nature, quality or situation of the interest of Sir Charles in the estate.[169]

The position is different for unit trusts[170] and intermediated securities[171] which are not straightforward bare trusts and best not described as bare trusts at all.[172]

82.32 Equitable interest under a substantive trust

The situs of an equitable interest under a substantive[173] trust is not often relevant for IHT, but it may matter, eg where a reversionary interest is not excluded property for IHT.

82.32.1 *Baker trusts*

An equitable interest under a *Baker* type trust (ie English law or a jurisdiction following English trust law principles)[174] has a twofold character:

(1) It provides rights enforceable against the trustee

(2) It is an interest in the trust property.

There are many connecting factors which might be used to attribute a situs to an equitable interest, and the courts have not had to consider all possible permutations. *Favorke v Steinkopff* [1922] 1 Ch 174 concerned an English law will trust, with English trustees, but German situate property; the equitable interests of an annuitant, life tenant and remaindermen were held to be situate in England. It is suggested that an equitable interest is in

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169 [1982] STC 625 at p.633-4.

170 See 39.5 (Situs of unit).

171 See 40.3 (Situs of transparent intermediated security for IHT).

172 See 84.5.1 (Definition(s) of bare trust and associated terminology).

173 By "substantive" I mean a trust other than a bare trust (nomineeship) or unit trust.

174 For the trust law background, see 26.3 (Taxation of life tenant); 26.8 (Baker or Garland trust jurisdiction?).

principle situate where the trustees are resident. If the trustees are resident in different jurisdictions, situs would be determined by an exclusive jurisdiction clause if there is one, or failing that, by the proper law.[175]

This is consistent with the rule that the equitable interest is classified as moveable (not immovable) property. The High Court of Australia said:[176]

> The mere fact that there is land subject to the trust would not result in the beneficiary's interest in the fund being an immovable in the place where the land is situated. The interest in the fund is situated in the country which is the forum of administration of the trust or whose law is the proper law of the trust: *Ewing v. Orr Ewing* (1883) 9 App Cas 34.

There is a sound basis to say that situs of the assets of the trust fund is not relevant to the situs of the equitable interest. If the trust assets are situate in different jurisdictions it would be impossible to ascertain the situs of the equitable interest (if the equitable interest is regarded as a single asset). An equitable interest such as a life or reversionary interest should not be regarded as several separate interests in as many assets as are held by the trustees. Such an equitable interest is generally regarded as one asset and not as many assets as there are items of trust property.

Where the equitable interest is a power of revocation the position is even clearer. Where the equitable interest is an annuity, it would often be impossible to locate the annuity by reference to the situs of the trust assets, because one cannot identify any particular trust asset and say that asset is (to any fixed extent) the source of the annuity.

82.32.2 *Garland trusts*

An interest under a Scots law or other *Garland* type trust is not an interest in the trust property, so the situs of the trust property is irrelevant to situs.

82.33 Unadministered estate of deceased person

The IHT Manual provides:

> **27072 Unadminstered estates or shares therein** [January 2014]
> In general, a person who takes an absolute interest in the residue of an estate is entitled, not to the assets **of the testator, but to a right of**

175 For a contrary view see Harris, *The Hague Trusts Convention*, (2002), Chapter 9 (Situs of equitable interests) and Dicey *The Conflict of Laws* (15th ed., 2012), para 22-048 (Interests under trusts).

176 *Haque v Haque (No 2)* [1965] HCA 38; (1965) 114 CLR 98 Menzies J at [2].

> **action**, enforceable against the executors. This is the case under English law and many other legal systems.[177]
> This means the executors must administer the estate and transfer the clear residue, or a share of it to the beneficiary. The same rule applies in the case of intestacy.
> This is a similar rule to the **ius crediti** to which a beneficiary is entitled in Scotland.

The chose in action is situate where it is enforced, ie where the executors are. The situs of the assets of the estate is not relevant. See *CSD v Livingston* [1965] AC 694. The IHT Manual continues:

> But, for IHT, the deceased is treated as having a direct interest (in the whole or a share) in the net assets of the residuary estate. See IHTM22031[178]
> For this reason you must consider the situs of each of the underlying assets separately.
> For example, the excluded property provisions in s.6(2) IHTA may apply to qualifying securities included in the unadministered estate (IHTM04260)

82.34 Situs of partnership share

The situs of a partnership share may not matter for IHT, because of BPR, but the issue will sometimes arise.

82.34.1 *Partnerships (except LLPs)*

An interest in a partnership is an asset (a chose in action) distinct from the assets of the partnership.[179] It has its own situs distinct from the situs of the partnership assets.

There are several factors that the court might have used to determine situs. In practice the situs of an interest in a partnership is the place where the partnership business is carried on.[180] I refer to that as **"the place-of-business situs test"**.

The place where the partnership business is carried on is not necessarily

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177 Author's Note: Further consideration will be required for jurisdictions other than England and Wales, especially civil law jurisdictions.

178 See s.91 IHTA.

179 See 11.34.1 (The partnership law background).

180 See *Laidlay v Lord Advocate* (1890) 15 App Cas 468, followed *Commissioner of Stamp Duty v Salting* [1907] AC 449.

the place where the partners reside: there is no concept here of carrying on business by tacit oversight.[181] The law of the partnership is not relevant.

If a partnership is carrying on two businesses in two different places, the place-of-business situs test does not work. This arose in *Beaver v Master in Equity* [1895] AC 251 where the partnership had three businesses, in London, Melborne and Adelaide. The solution adopted was that the partnership businesses were situate in different places; the Melborne business was therefore situate in the state of Victoria. The distinction between one single business and two separate businesses could be somewhat fragile. The issue will not often arise, except, possibly, in some tax planning contexts.

82.34.2 *Situs of share in partnership holding land*

This section considers the position where the partnership assets include land.

Dicey states (tentatively) that "A share in land belonging to the partnership may however be situate where the land is situated."[182] But there is only one case which takes that view. It is unjustified in principle as a partnership share is one asset. "An interest in a partnership is not to be fragmented into as many different interests as the partnership has assets with the consequence that each fragment should be treated as located where the asset with which it is concerned might happen to be".[183] It is also out of line with the authorities. The law is correctly summarised in *Livingston v Commissioner of Stamp Duties:*[184]

> the local situation of the interest in the partnership as a whole being considered in law to be where the business is carried on, so also is the partner's interest in a partnership asset: *In the Goods of Ewing*.[185] In the leading cases of *Laidlay v Lord Advocate*,[186] *Beaver v Master in Equity*[187] and *Stamp Duties Commissioner v Salting*,[188] it occurred to no

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181 See 15.3 (Trading income of UK resident).

182 Dicey, Morris & Collins, *The Conflict of Laws* (15th ed., 2012), para 22-049. Dicey cites: *Boyd v AG for British Columbia* (1916) 54 SCR 532; *Haque v Haque (No. 2)* (1965) 114 CLR 98 but the majority in *Haque* do not support Dicey's view.

183 *Haque v Haque (No 2)* [1965] HCA 38; (1965) 114 CLR 98 Menzies J at [2].

184 High Court of Australia, 107 CLR 411, at [14].

185 (1881) 6 PD 19, at p.23.

186 (1890) 15 App Cas 468.

187 [1895] AC 251.

188 [1907] AC 449.

> one to distinguish for the purposes of locality between the interest in the partnership and the interest in the assets; and indeed in *Beaver v Master in Equity* the emphasis given by the Privy Council to the fact that the business of the partnership in Melbourne was a distinct business from others which the partnership carried on in London and Adelaide indicates that the partner's interest in the Melbourne assets would not have been treated as situate there if there had been only a single business and that had been carried on in London. There is a case in the Supreme Court of Canada in which the contrary view was taken by a majority of the Court, but, with respect, I would prefer the dissenting judgment of Anglin J: *Boyd v AG for British Columbia*.[189]

This is consistent with the rule that even if partnership assets include land, a partnership share is classified as:
(1) moveable (not immovable) property[190] and
(2) personal (not real) property.[191]
If the partnership business is letting land in the UK, it will be a business carried on in the UK and so the partnership interest is UK situate. If that is right, partnerships (unlike companies) cannot easily be used to transfer situs of property outside the UK.

It follows that the existence of a partnership may be important for situs, as the interest of a co-owner of land (in the absence of partnership) is situate where the land is situate.

82.34.3 *Situs of LLP*

A LLP is a body corporate. The situs of a member's interest in a LLP for the purposes of private international law will be determined by the rules applying to companies.

For IHT purposes, however, s.267A IHTA provides:

> For the purposes of this Act and any other enactments relating to inheritance tax—

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189 (1917) 36 DLR 266.

190 *Re Stokes* (1890) 38 WR 535, 62 LT 176, 6 TLR 154; *Haque v Haque (No 2)* [1965] HCA 38; (1965) 114 CLR 98 Menzies J at [2] sets out the majority view.

191 Until 1996 it was clear that a partnership interest was personalty, as there was a common law rule to that effect codified in s.22 Partnership Act 1890. The Trusts of Land and Appointment of Trustees Act 1996 misguidedly repealed s.22 in England, leaving English law confused but probably unaltered. (Section 22 continues to apply in Scotland). But whatever the effect (if any) of the repeal of s.22, it does not affect situs.

> (a) property to which a limited liability partnership[192] is entitled, or which it occupies or uses, shall be treated as property to which its members are entitled, or which they occupy or use, as partners...

A foreign LLP is not a LLP for this purpose[193] and references to a LLP in the discussion here are to a UK LLP.

Section 267A deems the LLP's property to be property to which its members are entitled *as partners*. It does not deem the partners to be directly entitled to the assets: it puts a LLP in the same position as a conventional partnership. The CIOT correctly say:

> The general intention of s.267A IHTA 1984 would appear to be to treat LLPs as though they were general partnerships for IHT purposes, and the wording of the section would seem to be sufficiently clear to achieve this.[194]

It follows that the place-of-business situs test determines the situs of an interest in a LLP as for a general partnership.

The test does not work if the partners are not carrying on a business. In the case of a general partnership, this situation cannot arise. A partnership only exists while partners are carrying on a business. If at any time they do not do so, there is no partnership:[195] the arrangement is classified as joint ownership. A LLP which ceases to carry on a business is still a LLP. It is considered that for IHT purposes the partners are then treated as joint

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192 For the meaning of "limited liability partnership" see 41.8.1 (Definition of LLP).

193 See 41.8.1 (Definition of LLP); 84.19 (Foreign limited liability partnership). HMRC agree: See ICAEW Tax Faculty, CIOT and STEP, "IHT Business Property Relief – Interests in Partnerships/LLPs and Surplus Cash Holdings" (2014) para 15: "We confirm that s.267A IHTA 1984 relates solely to UK LLPs." *http://www.tax.org.uk/Resources/CIOT/Documents/2014/01/140106%20Taxguide%20BPR%20and%20LLPs.pdf?j=577452&e=kessler@kessler.co.uk&l=346_HTML&u=13990635&mid=1062735&jb=0*
ICAEW ref: TECH 01/14 TAX

194 See 41.8.1 (Definition of LLP). HMRC agree: See ICAEW Tax Faculty, CIOT and STEP, "IHT Business Property Relief – Interests in Partnerships/LLPs and Surplus Cash Holdings" (2014) para 15: "We confirm that s.267A IHTA 1984 relates solely to UK LLPs." *http://www.tax.org.uk/Resources/CIOT/Documents/2014/01/140106%20Taxguide%20BPR%20and%20LLPs.pdf?j=577452&e=kessler@kessler.co.uk&l=346_HTML&u=13990635&mid=1062735&jb=0*
ICAEW ref: TECH 01/14 TAX

195 Section 1 Partnership Act 1890.

owners.

The IHT Manual provides:

> **IHTM25094 Limited liability partnerships** [Jan 2008]
> [1] The effect of [s.267A] is that we look through LLPs so that they will be treated in the same way as traditional partnerships. The result of this is that:
> - Where a traditional partnership incorporates itself as a LLP, a partner's period of ownership for the purposes of qualifying for business (or agricultural) relief will not be regarded as being interrupted.
> - The normal reliefs and exemptions available to partners in a traditional partnership will also be available to members of a LLP...
>
> [2] A further change is that an interest in a LLP is deemed to be an interest in each and every asset of the partnership, while an interest in a traditional partnership is a 'chose in action', valued by reference to the net underlying assets of the business.
> [3] This may require you to consider issues of situs of property. In cases of doubt refer to Technical Group (TG) for advice.

Paragraph [2] is terse. It floats the suggestion that a LLP is treated as co-ownership (rather than partnership) for IHT purposes, specifically for valuation, and (logically) for other purposes. But that is wrong and in practice HMRC do not apply that approach in relation, for instance, to BPR (which is considered later in the same paragraph of the Manual). I would be surprised if HMRC seriously argue that the test for situs of an interest in a LLP is different from the test for situs of an interest in a general partnership; I do not think that para [3] should be read as expressing a view on that question, beyond the suggestion to refer difficulties on to TG.

The IHT Manual passage goes on to make some controversial comments on LLPs and BPR, but that takes us too far from the themes of this book to pursue here.

82.35 Situs of pension and death benefits

Death in service benefits payable in respect of service under the Crown, local authorities or overseas governments are generally payable at discretion and so not liable to IHT. However the situs does matter in the exceptional case where the benefit is an asset in the estate of the deceased.

Section 153(2) IHTA provides:

> (2) For the purposes of this Act—

(a) a pension paid under the authority of a scheme made under section 2 of the Overseas Pensions Act 1973 which
  [i] is constituted by the Pensions (India, Pakistan and Burma) Act 1955 or
  [ii] is certified by the Secretary of State for the purposes of this section to correspond to the said Act of 1955
  shall be treated as if it had been paid by the Government of India or the Government of Pakistan (according as the arrangements in pursuance of which the pension was first paid under the said Act of 1955 were made with the one or the other Government);

(b) a pension paid out of any fund established in the UK by the Government of any country which, at the time when the fund was established, was, or formed part of, a colony, protectorate, protected state or UK trust territory shall, if the fund was established for the sole purpose of providing pensions, whether contributory or not, payable in respect of service under the Government be treated as if it had been paid by the Government by which the fund was established;

(c) a pension paid out of the Central African Pension Fund established by section 24 of the Federation of Rhodesia and Nyasaland (Dissolution) Order in Council 1963 shall be treated as if it had been paid by the Government of a territory outside the UK; and

(d) so much of any pension paid to or in respect of any person under—
  (i) the scheme which by virtue of subsection (3) of section 2 of the Overseas Pensions Act 1973 is constituted under that section by section 2 or subsection (2) of section 4 of the Overseas Service Act 1958 or
  (ii) such other scheme made under section 2 of the Overseas Pensions Act 1973 as is certified by the Secretary of State for the purposes of the Taxes Act to correspond to section 2 or subsection (2) of section 4 of the Overseas Service Act 1958
  as is certified by the Secretary of State to be attributable to service under the Government of an overseas territory shall be treated as if it had been paid by the Government of that territory.

(3) ... for the purposes of subsection (2) above—

(a) "pension" includes a gratuity and any sum payable on or in respect of death, and a return of contributions with or without interest thereon or any other addition thereto;

(b) "UK trust territory" means a territory administered by the

Government of the UK under the trusteeship system of the United Nations;

(c) "overseas territory" means any country or territory outside the UK;

(d) references to the Government of any such country or territory as is mentioned in paragraph (b) or (d) of that subsection include a Government constituted for two or more such countries or territories and any authority established for the purpose of providing or administering services which are common to, or relate to matters of common interest to, two or more such countries or territories.

(4) If, by reason of Her Majesty's Government in the UK having assumed responsibility for a pension, allowance or gratuity within the meaning of section 1 of the Overseas Pensions Act 1973 payments in respect of it are made under that section, this section shall apply in relation to the pension, allowance or gratuity, exclusive of so much (if any) of it as is paid by virtue of the application to it of any provisions of the Pensions (Increase) Act 1971 or any enactment repealed by that Act, as if it continued to be paid by the Government or other body or fund which had responsibility for it before that responsibility was assumed by Her Majesty's Government in the UK.

The important effect of this is that the pension (defined to include a death benefit) is not UK situate if it is treated as payable by a foreign government. The IHT Manual provides:

IHTM17058 Pensions: IHT charges: Crown, local authorities and overseas governments [May 2013]

Death in service benefits payable in respect of service under the Crown, local authorities or overseas governments are generally (but not always) payable at the discretion of the pension provider (IHTM17051), so they are not liable to Inheritance Tax.

The following guidance is only general and will not cover every situation. Scheme rules may change and you should check the latest position or ask for advice from Technical. ...

Overseas Service

Sums payable on death to personal representatives by way of return of subscriptions under the regulations of:

- the Indian Military Widows and Orphans Fund;
- the Superior Services (India) Family Pension Fund
- the Indian Military Service Family Pensions Fund; and
- the Indian Civil Service family pension fund

Are not included as part of the estate (IHTA84/S153 (1)).

A lump sum payable on death to personal representatives under a scheme constituted under the Pensions (India, Pakistan and Burma) Act 1955 or a corresponding scheme (a foreign asset by virtue of S153 (2)(a) is part of the estate if the deceased died domiciled (IHTM13000) in the UK. It is excluded property under IHTA84/S6 (1) if the deceased was domiciled outside the UK.

Benefits payable to personal representatives as of right on death of a Colonial Government servant (a foreign asset under S153 (2)(b) are part of the estate if the deceased died domiciled in the UK). They are excluded property under IHTA84/S6 (1) if the deceased was domiciled outside the UK.

Benefits payable under s.1 Overseas Pensions Act 1973 other than 'statutory increases' thereof (a foreign asset by virtue of S153 (4) and S153 (2)(b)) are part of the estate if the deceased died domiciled in the UK. They are excluded property under IHTA84/S6 (1) if the deceased was domiciled outside the UK.

Benefits payable out of the Central African Pension Fund (a foreign asset by virtue of S153 (2)(c)) are part of the estate if the deceased died domiciled in the UK. They are excluded property under IHTA84/S6 (1) if the deceased was domiciled outside the UK.

Lump sum payable on death to personal representatives as of right under a scheme constituted under the Overseas Service Act 1958, or a corresponding scheme (a foreign asset by virtue of S153 (2)(d)) are part of the estate if the deceased died domiciled in the UK. They are excluded property under IHTA84/S6 (1) if the deceased was domiciled outside the UK.

82.36 Reform of IHT/CGT situs rules

Amendment of situs rules for IHT purposes is difficult because of the problem of double inheritance taxation. To the extent that different states adopt the same common law situs rules, they effectively prevent double taxation which otherwise arises if state A regards an asset as situate in state A for IHT purposes and state B regards the same asset as situate in state B. That explains why in 1974 CTT (now IHT) adopted the common law situs rules and not the CGT statutory situs rules. The disparities between CGT and IHT situs are not accidental.[196]

196 It could of course arise that state A regards an asset as situate in state A for CGT purposes and state B regards the same asset as situate in state B; however that is not likely to cause problems in practice, because (in short): (1) a non-resident does not usually pay CGT so double capital gains taxation does not usually arise; (2) a DTA

Two reforms would improve the position:

(1) Treat all assets other than UK land and securities as non-UK situate for the purposes of IHT (and also CGT). That would be a simplification and it is most unlikely that the IHT (or CGT) charge on such assets of foreign domiciliaries brings in any significant tax. There is a precedent in the abolition of stamp duty on UK situate property (other than securities and land).

(2) A counterside would be to introduce a charge on UK private residences held via non-resident close companies.[197]

following the OECD model convention will normally resolve the problem if it does arise.

197 See 75.45.6 (Some ways forward).

CHAPTER EIGHTY THREE

SITUS OF ASSETS FOR CGT

83.1 Situs of assets for CGT – Introduction

This chapter deals with situs of assets for CGT. Strictly one should not refer to situs in the abstract, but to situs for a specific purpose (CGT , IHT, or whatever) but the context may supply the reference, and in this chapter references to situs means situs for CGT purposes.

See 82.1 (Concept(s) of situs).

83.1.1 *Cross references*

The following topics are dealt with elsewhere, see:

39.5.2 (Situs of unit for CGT)
41.7 (Transparency of partnership for CGT)
82.12 (Securities of international organisations)
40.1 (Intermediated securities).

83.2 Meaning of "shares" and "debentures"

The CGT situs rules make specific provision for shares and debentures, so it is necessary to consider the meaning of these terms.

The meaning of debenture is particularly important, because there is an significant distinction for CGT situs between:

(1) Debts which are not debentures, whose situs is generally the residence of the creditor.[1]
(2) Debts which are debentures, whose situs is:
    (a) UK if issued by UK incorporated company, or
    (b) if registered and issued by a non-UK incorporated company, the place of the register.

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1 See 83.9 (Debt situs rule).

There are two statutory provisions which relate to the definitions but they are of very limited scope. It is convenient to mention them first to clear them out of the way.

83.2.1 Company with no share capital

Section 275(2)(a) TCGA provides:

> In subsection (1) above—
>
> (a) in paras (d), (da) and (e), the references to shares or debentures, in relation to a company that has no share capital, include any interests in the company possessed by members of the company, ...

In UK company law the only type of company with no share capital is a company limited by guarantee. There are also foreign entities which are classified as companies for tax purposes which have no share capital, but I cannot think of any to which s.275(2)(a) is likely to be significant.

So far as it concerns *shares* the rule makes sense up to a point. In short, the rule is that "shares" includes the interest of members of a guarantee company. The only puzzle is why the rule is needed. In practice the situs of interests in guarantee companies will rarely if ever arise. A provision of this kind is quite common in tax.[2] The rule was enacted in other areas to prevent avoidance and perhaps the drafter put it in here without much thought as to whether it was actually needed.

I do not understand why the statutory provision refers to *debentures* and suspect the drafter may be under a misapprehension here. A debenture is a right against the company, not an interest in the company. Whether the company has a share capital is (in the absence of the definition) highly relevant in deciding whether an asset is a "share" but it is wholly irrelevant in deciding whether an asset is a "debenture". I would be grateful to any reader who could offer an explanation. In practice it does no harm.

83.2.2 *Securities issued by non-company*

Section 275(2)(b) TCGA provides:

> in paras (d) and (e), the references to debentures, in relation to a person other than a company, include securities.

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2 There are too many to list; see for instance s.135(4)(5) TCGA.

This assumes that (in the absence of this definition) securities issued by a non-company would not be, or may not be, debentures. I think that is doubtful. The term "debenture" is normally used in the context of companies, but the concept is not restricted to companies.[3]

Section 275(1)(d) refers to debentures issued by a government authority.[4] Treasury gilts, though "securities" are not normally called "debentures" so perhaps the provision is useful to avoid doubt.

Similarly, other non-companies, such as trusts or individuals, can in theory create "securities" and if such assets might not be regarded as "debentures" then this provision could be needed (though in practice this does not happen).

While unnecessary, this provision does no harm.

83.2.3 *Change from "securities" to "debentures"*

Before 2005 the legislation referred to "securities" where it now has the word "debentures." HMRC explained the reason for the change:

> The scope of the existing rules in s 275 which apply in relation to securities will be extended so that they apply in relation to debentures - this means, for example, that ... all registered debentures (rather than just those which are securities) of a company which is not incorporated in the UK will be treated as being situated where they are registered ...[5]

HMRC were concerned that there might be a debenture which was not a security. One might have thought that any debenture must necessarily be a security.[6] Perhaps the point is that a "security" in the expression "debt on a security" must be marketable; a debt which is not assignable, or which is repayable on demand, is not a "debt on a security" as it is not marketable. A debenture might be unmarketable and so not a security in that sense, and so perhaps not a security for the purpose of the pre-2005

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3 See Gower and Davies, *Principles of Modern Company Law* (7th ed., 2003), p.806: "The word "debenture" is not restricted to securities of companies or bodies corporate. Clubs not infrequently issue debentures and the name may even be applied to bonds issued by an individual; eg to those issued by the Tichborne Claimant..." This passage is not in the current edition but the point is sound.

4 See 83.4 (Municipal and government securities).

5 BN 36, 16 March 2005.

6 Contrast s.738 CA 2006: "In the Companies Acts "debenture" includes debenture stock, bonds and any other securities of a company..."

situs rules.[7]

The reform raises the question of whether an asset could be a security but not a debenture; if there were such an asset the effect of the 2005 reform was to take it outside the scope of the statutory situs rules applicable to debentures, which was not intended! The better view is that any registered debt security is a debenture so this problem does not arise.

83.2.4 *Meaning of "debenture"*

In the absence of applicable statutory guidance, the word "debentures" should be given its normal meaning. It is a wide and somewhat vague term:

> If we begin by asking what the word "debenture" means, apart from any definition, the reply must be that it has no precise meaning. Chitty J. observed in the case of *Levy v Abercorris Slate and Slab Co.*,[8] that the word "means a document which either creates a debt or acknowledges it, and any document which fulfills either of these conditions is a debenture." ... Sir Nathaniel Lindley had previously stated simply, "What the correct meaning of 'debenture' is I do not know": *British India Steam Navigation Co. v IRC*.[9] In *Lemon v Austin Friars Investment Trust*[10], the same ignorance was professed in the Court of Appeal. Warrington LJ in particular, after observing that it had been said "by a wiser man than himself" that it was impossible to give an exhaustive definition of the word "debenture," went on to remark that he did not propose to incur the reproach of venturing where wise men fear to tread. The textbooks are agreed at least in this that no accurate definition of the word can be found.[11]

Company law draws a distinction between an ordinary debenture and debenture stock:

> Debenture stock is merely borrowed capital consolidated into one mass for the sake of convenience. Instead of each lender having a separate bond or mortgage, he has a certificate entitling him to a certain sum, being a portion of one large loan; and generally debenture stock differs

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7 The concern that a debenture may not be a "security" is also found in s.251(6) TCGA: "... a debenture ... shall be deemed to be a security (as defined in section 132) if..."

8 (1887) 37 Ch D 260.

9 (1881) 7 QBD 165.

10 [1926] 1 Ch 1.

11 *Knightsbridge Estates Trust v Byrne* [1940] 1 AC 613 at p.621.

from a debenture in form rather than in substance.[12]

No-one doubts that debenture stock is within the general meaning of "debentures".

In the following discussion, I use the word **"securities"** to mean either shares or debentures.

83.3 Co-owned assets

Section 275C TCGA provides:

> (1) This section applies for determining for the purposes of this Act—
> (a) the situation of an interest (see subsection (4)) in an asset, or
> (b) whether the situation of an interest in an asset is in the UK.[13]

"Interest" is normally a wide term, but s.275C(4) defines it narrowly:

> In this section "interest", in relation to an asset, means an interest as a co-owner of the asset (whether the asset is owned jointly or in common and whether or not the interests of the co-owners are equal).

I refer to this as **"co-ownership interests"**. Section 275C applies to co-owned assets of all kinds but the most important cases are co-owned securities and debts.

Section 275C goes on to lay down two rules which govern situs of co-ownership interests:

> (2) The situation of the interest in the asset shall be taken to be the same as the situation of the asset, as determined in accordance with subsection (3) below.
> (3) The situation of the asset for the purposes of subsection (2) above shall be determined on the assumption that the asset is wholly-owned by the person holding the interest in the asset.

I refer to these as **"the co-ownership situs rules"**.

At first sight it is hard to see the point of these rules. If an asset is situate in a jurisdiction, one would expect a co-ownership interest to be situate in the same place and a statutory provision to that effect seems unnecessary.

However, s.275 stipulates the situs of shares, debentures, debts, etc and it might be argued that a person who owns a co-ownership interest in a

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12 *Re Herring* [1908] 2 Ch 493 at p.497.

13 Paragraph (b) is otiose since the matter is fully covered by (a); but it does not matter.

share, debenture, debt, etc does not own a share, debenture, debt, etc; so it might be argued that these statutory situs rules do not apply to co-ownership interests. Hence s.275C(2) has a role to play.

Section 275C(3) is needed where situs depends on the residence of the owner and the asset is co-owned. For instance, if a debt or a ship is jointly owned by two persons, one UK resident and one non-resident, the interest of the UK resident is regarded as UK situate and the interest of the non-resident is regarded as non-UK situate.

The CG Manual provides:

> **CG12470 interests of co-owners** [January 2010]
> ...Assets held by a partnership, in which the partners therefore each have an interest, are within the scope of this provision.

83.4 Municipal and government securities

Section 275(1)(d) TCGA provides:

> shares or debentures[14] issued by any municipal or governmental authority, or by any body created by such an authority, are situated in the country of that authority.

The CG Manual provides:

> **12440 Location of assets: Shares and securities** [January 2010]
> [The Manual sets out s.275(1)(c) and continues:] This applies to shares and securities issued by such bodies whether they are in registered form or in bearer form.

83.5 Securities of UK incorporated company

Section 275(1)(da) TCGA provides:

> Subject to para (d) above, shares in or debentures of a company incorporated in any part of the UK are situated in the UK.

This rule prevents CGT remittance basis planning for UK incorporated companies by use of bearer shares and foreign share registers. That was common practice before 2005. The spur to the 2005 reform was probably *Chandrasekaran v Deloitte & Touche* [2004] EWHC 1378 which discussed and raised the awareness of this planning.

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14 For the meaning of "debentures" see 83.2.2 (Securities issued by non-company).

83.6 Registered securities: Non-UK company

Section 275(1)(e) TCGA provides:

> subject to paras (d) and (da) above, registered shares or debentures are situated where they are registered and, if registered in more than one register, where the principal register is situated.

This applies to shares and debentures of foreign incorporated companies but not UK incorporated companies. It (more or less) restates the common law rule.[15]

The CG Manual provides:

> **12440 Types of asset (2): Shares and securities etc** [January 2010]
> *Shares and securities*
> ...Registered shares and securities[16] other than those dealt with in the previous two paragraphs are situated where they are registered. This will normally be in the country where the company was incorporated. If they are registered on more than one register then they are located where the principal register is located, Section 275(1)(e) TCGA 1992. Which register is the principal register is a question of fact.

83.7 Bearer shares

Bearer shares of non-UK incorporated companies are governed by the common law rule.[17] They are situate where the document is situate.

83.8 Bearer debentures: Non-UK company

What is the position for bearer debentures? Unless one of the statutory situs rules applies, the common law rule will apply and the debenture will be situate where the document is situate. Two statutory rules need consideration: the debt situs rule and the UK-law rule.

83.8.1 *Does debt situs rule apply to bearer debentures?*

Section 275(1)(c) TCGA (the debt situs rule) provides:

> subject to the following provisions of this subsection, a debt, secured or unsecured, is situated in the UK if and only if the creditor is resident

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15 See 82.6 (Situs of registered shares).

16 Following the 2005 reforms, the reference to securities should strictly read "debentures" as that is now the statutory term. But it makes no difference.

17 See 82.8 (Bearer documents and negotiable instruments).

in the UK.[18]

Debenture stock is not a debt[19] so the debt situs rule does not apply to debenture stock.[20]

An ordinary debenture (not debenture stock) is a debt in the normal sense of the word. At first sight it seems that the debt situs rule applies, so a bearer debenture is situate where the creditor is resident. If that were right the situs of the document of a bearer debenture would never determine situs. However it is considered that the context of s.275, the reference to a debt in the debt situs rule means a simple debt and not a debenture. The debt situs rule does not apply to any debentures.

HMRC agree. The CG Manual provides:

> **CG12440 Types of asset (2): Shares and securities etc** [January 2010]
> *Shares and securities*
> ... The Companies Acts allow companies to issue 'share warrants to bearer' or 'stock warrants to bearer' provided the company's Articles of Association allow it. These are commonly called bearer shares and securities. The name of the owner of such bearer securities is not recorded in the register of the company. They can be sold without any necessity to notify the company. The holder of the warrant is entitled to receive payment of dividends and, provided certain conditions are complied with, to vote at general meetings.
> The location of bearer securities issued by any body other than
> • a municipal or governmental authority or
> • any body created by such an authority, or
> • a company incorporated in the UK
> is not covered by a specific capital gains rule. Therefore it has to be decided in accordance with general law, see CG12420-CG12421. General law provides that such securities are located where the certificate is located. As for chattels, the location can change if the certificate is moved in or out of the UK.

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18 See 83.9 (Debt situs rule).

19 For the meaning of "debenture stock" see 83.2.4 (Meaning of "debenture"). A person who holds debenture stock is not a creditor: *Re Dunderland Iron Ore* [1909] 1 Ch 446. So the asset is not a "debt".

20 Against this, it might be argued that the co-ownership situs rule applies so the situs of the debenture stock is the situs of the underlying debenture. But it is considered that (1) the co-ownership situs rule does not apply in this case and (2) even if it does, the situs of the underlying debenture is not governed by the debt situs rule as the underlying debenture is not a debt for the purposes of that rule.

83.8.2 *Does UK-law rule apply to bearer securities?*

A debenture is an intangible asset and if it is "subject to UK law" (as widely defined) then in principle it appears that the UK-law rule applies, and the debenture will be UK situate.[21]

The CG Manual does not refer to the UK-law rule. One might argue that the reference to an intangible asset in s.275A means intangible assets other than debentures, in which case a debenture of a foreign incorporated company is not UK situate even if it is subject to UK law. This appears to be the HMRC view since the Manual passage above says that the location of bearer securities "is not covered by a specific capital gains rule".

83.8.3 *Planning implications*

Remittance basis taxpayers will generally avoid investing in debentures which are UK situate for CGT purposes. Non-UK incorporated companies who issue debentures and want their investors to include remittance basis taxpayers will in principle wish to ensure that their debentures should not be UK situate for CGT purposes.

To achieve this:

(1) The debenture could be registered and the register kept outside the UK; in that case the position is clear.
(2) The debenture could be a bearer instrument and
    (a) kept outside the UK and
    (b) not "subject to UK law" (as defined) though that may not be necessary.

83.8.4 *Situs of corporate securities: Commentary*

The combination of statutory and common law rules for securities of non-UK incorporated companies is intricate and sometimes impractical. It has never been thought through. It is suggested that *all* corporate securities should be situate in the place of incorporation of the company. That would be logical, and a simplification, with no loss of tax.

83.9 Debt situs rule

A debt is in some cases a chargeable asset for CGT, so its situs may be relevant for CGT. Section 275(1)(c) TCGA provides:

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21 See 83.13.4 (The UK-law rule).

> subject to the following provisions of this subsection, a debt, secured or unsecured, is situated in the UK if and only if the creditor is resident in the UK.

I refer to this as **"the debt situs rule"**. This reverses the common law rule (under which a simple debt is situate where the *debtor* is situate).

A debt is UK situate if the creditor is dual-resident.

This provision overrides the UK-law rule and common law rules such as the specialty rule and the bearer security rule. However, it is subject to the rules relating to:

(1) debentures;
(2) judgment debts;
(3) bank accounts.

83.10 Judgment debt

Section 275(1)(k) TCGA provides:

> a judgment debt is situated where the judgment is recorded.

The CG Manual explains:

> **12430 Types of asset (1): Land, tangible property and debts** [November 2012]
> Judgment debts, that is, debts created by the judgments, decrees, etc, of courts of record, are located where the judgment is recorded, Section 275(1)(k) TCGA 1992.

Obtaining judgment may have the effect of changing situs.

83.11 Debt rules: Commentary

The effect of the debt situs rule is generally[22] to disapply the CGT remittance basis for debts, because a debt owned by a remittance basis taxpayer is deemed UK situate so the gain from the debt is taxed on an arising basis. That is anomalous, counter-intuitive and a trap for the ill advised foreign domiciliary. I can see no good reason for the rule and it is suggested that s.275(1)(c) should be replaced by a statutory rule that a debt is situate where the debtor is resident (applying the UK tax definition of residence). This would bring CGT and IHT into line.

It is considered that there is no point in a separate rule for judgment debts, and s.275(1)(k) should be repealed. That would be a small but

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22 An exception is if the individual disposes of the debt while temporarily non-resident.

worthwhile simplification. The statutory rule is based on the common law rule, but that is no reason to retain it.

But the best solution is to look at the wider picture altogether: treat all assets other than UK land and securities as non-UK situate for the purposes of IHT and CGT.[23] The debt situs rule and judgement debt rule would fall by the wayside.

83.12 Bank account

A foreign currency bank account is not normally a chargeable asset for CGT[24] so the question of situs does not normally arise.

If it mattered, s.275(1)(l) TCGA provides:

> a debt which—
>
> (i) is owed by a bank, and
>
> (ii) is not in sterling, and
>
> (iii) is represented by a sum standing to the credit of an account in the bank of an individual who is not domiciled in the UK,
>
> is situated in the UK if and only if
>
> [a] that individual is resident in the UK and
>
> [b] the branch or other place of business of the bank at which the account is maintained is itself situated in the UK.

In short, for UK resident foreign domiciled individuals, the situs of a foreign currency account is the situs of the branch. This restates the common law rule for bank accounts; it is needed because without this provision the situs of the account would be the residence of the creditor (ie the account holder). In cases where the conditions (i), (ii) and (iii) are not all satisfied, the usual CGT debt rule applies.

Section 275(1)(l) only applies to individuals' bank accounts. However the situs of a bank account held by a trust or a company does usually matter for CGT.[25]

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23 See 82.36 (Reform of IHT/CGT situs rules).

24 See 55.10 (Foreign currency bank accounts: CGT).

25 If it did matter, the usual CGT debt rule would apply so all accounts held by a non-resident trust or non-resident company would be non-UK situate, as situs would depend on residence of the account holder. This means that UK services relating to the account qualify for foreign services relief under s.809W ITA. That could be important for a bank account held by a non-resident close company, which is a relevant person, but in practice the point will rarely if ever arise as such a company would not normally use a UK account.

83.13 UK-law rule

Section 275A TCGA provides a situs rule for intangible assets which I call"**the UK-law rule"**. It is convenient to deal with some definitions before turning to the rule itself.

83.13.1 *"Intangible asset"*

Section 275A(2) TCGA provides a commonsense definition of "intangible asset":

> In this section "intangible asset" means—
> (a) intangible or incorporeal property and includes a thing in action, or
> (b) anything that under the law of a country or territory outside the UK corresponds or is similar to intangible or incorporeal property or a thing in action.

This includes policies and bonds, futures and options.

83.13.2 *Situs of asset "not otherwise determined"*

Section 275B(1) TCGA provides a commonsense explanation of "not otherwise determined":

> For the purposes of section 275A, the situation of an asset is not otherwise determined if, apart from that section, this Act does not make any provision for determining—
> (a) the situation of the asset, or
> (b) whether the situation of the asset is in the UK.

Thus the statutory rules in s.275 TCGA have priority to the UK law rule. For instance, a debt held by a foreign creditor is not UK situate even if subject to UK law; an option to purchase a non UK situate chattel is not UK situate, even if governed by UK law.

83.13.3 *"Subject to UK law"*

The expression "subject to UK law" is widely defined in s.275B(2):

> For the purposes of section 275A, an intangible asset is subject to UK law at a particular time if any right or interest which comprises or forms part of the asset is, at that time,—
> (a) governed by, or otherwise subject to, or
> (b) enforceable under,
> the law of any part of the UK.

Whether or not an asset is subject to UK law depends on the documentation. That will vary from case to case, but I understand that the position for some standard financial contracts is as follows.[26]

LIFFE FTSE 100 index future contract is subject to UK (English) law.[27]

Eurex contracts and CME contracts are not subject to UK law. They are governed by German law[28] and US law.[29]

83.13.4 *The UK-law rule*

Section 275A(1)(3) TCGA need to be read together to follow the sense:

> (1) This section applies for the purpose of determining whether the situation of an intangible asset ("asset A") is in the UK if the situation of asset A is not otherwise determined (see section 275B(1))...
> (3) If asset A is subject to UK law (see section 275B(2)) at the time it is created, it shall be taken for the purposes of this Act to be situated in the UK at all times.

83.13.5 *UK law rule: Commentary*

The UK law rule was introduced (in accordance with the then practice) without consultation or debate. It should be repealed as:

(1) It is impractical for remittance basis taxpayers who want to know how to invest or what to put on their returns. Only the wealthiest taxpayers with a significant budget for UK tax advice can be expected to research what law governs the assets concerned.
(2) It is contrary to UK legal commercial interests, encouraging the use of non UK law and non UK jurisdictions. (The ill effect may be mitigated by the fact that little notice is taken of the rule in practice.)
(3) It brings in no tax.

But the best solution is to look at the wider picture altogether: treat all assets other than UK land and securities as non-UK situate for the

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26 I am grateful to Lindsay Pentelow of Mazars LLP for his research in this area.

27 See cl 13 of Exchange Contract 29, issue date 3 Sept 2007, *https://globalderivatives.nyx.com/en/products/index-futures/Z-DLON/contract-specification*

28 See *https://www.eurexchange.com/exchange-en/resources/rules-regulations/* Clearing Conditions for Eurex Clearing AG Eurex04e 11.03.2013 para 17. *https://www.eurexchange.com/blob/exchange-en/3138-136778/115100/39/data/clearing_conditions_en_ab_31_05_2013.pdf.pdf*

29 Exchanges' Rule 905 (Choice of Law).

purposes of IHT and CGT.[30] The UK law rule would fall by the wayside.

83.14 Futures/options rules

Section 275A contains three situs rules for futures and options which I call **"the futures/options rules"**.

In the absence of these provisions, remittance basis taxpayers could invest in foreign law futures/options which track the value of UK situate intangible assets (because the underlying assets are UK situate). I surmise that these rules are intended to prevent that.

The drafting makes some formal gestures to the conventions of plain English legal drafting, but its structure is remarkably convoluted. If the Parliamentary Counsel's office held an internal competition for the most obscure drafting, within a plain legal English format, this would be a good contender.

It is convenient to deal with some definitions before turning to the rule itself. The definitions are derived from the corporation tax derivatives code now in part 7 CTA 2009. The definitions of expressions used in the UK law rule are also relevant here.

83.14.1 *"Option"*

Section 275B(3) TCGA provides:

> In section 275A—
> "option" has the meaning given by section 580 of that Act.

So we turn to s.580(1) CTA 2009 for a partial definition of option:

> In this Part "option" includes a warrant.

Section 710 CTA 2009 defines a "warrant":

> In this Part [Part 7]
> "warrant" means an instrument which entitles the holder to subscribe for—
> (a) shares in a company, or
> (b) assets representing a loan relationship of a company,
> whether or not the shares or assets exist or are identifiable.

Section 580 CTA 2009 excludes most cash-settled options:

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30 See 82.2 (Commentary).

(2) References in this Part to an option do not include a contract whose terms—

(a) provide—

(i) that, after setting off their obligations to each other under the contract, a cash payment is to be made by one party to the other in respect of the excess, if any, or

(ii) that each party is liable to make to the other party a cash payment in respect of all that party's obligations to the other under the contract, and

(b) do not provide for the delivery of any property.

(3) Subsection (2) does not prevent an option whose underlying subject matter is currency from being an option.

So cash-settled options do not count, except for currency options; the exception does not matter as currency options are outside the scope of the futures/options rules.

83.14.2 *"Future"*

Section 275B(3) TCGA provides:

In section 275A—
"future" has the meaning given by section 581 of CTA 2009, and

So we turn to s.581 CTA 2009 which defines a "future":

(1) In this Part "future" means a contract for the sale of property under which delivery is to be made—

(a) at a future date agreed when the contract is made, and

(b) at a price so agreed,

but this is subject to subsection (3).

(2) For the purposes of subsection (1)(b), a price is agreed when the contract is made even if—

(a) the price is left to be determined by reference to the price at which a contract is to be entered into on a market or exchange or could be entered into at a time and place specified in the contract, or

(b) in a case where the contract is expressed to be by reference to a standard lot and quality, provision is made for a variation in the price to take account of any variation in quantity or quality on delivery.

Section 581 CTA 2009 excludes most cash-settled futures:

(3) References in this Part to a future do not include a contract whose

terms—

(a) provide—

(i) that, after setting off their obligations to each other under the contract, a cash payment is to be made by one party to the other in respect of the excess, if any, or

(ii) that each party is liable to make to the other party a cash payment in respect of all that party's obligations to the other under the contract, and

(b) do not provide for the delivery of any property.

(4) Subsection (3) does not prevent a future whose underlying subject matter is currency from being a future.

So cash-settled futures do not count, except for currency futures. The exception does not matter as currency futures are outside the scope of the futures/options rules. This is the equivalent of the rule which applies to cash-settled options.

83.14.3 *"Underlying subject matter"*

Section 275B(4) TCGA provides a commonsense definition:

For the purposes of section 275A—

(a) the underlying subject matter of a future is the property which, if the future were to run to delivery, would fall to be delivered at the date and price agreed when the contract is made, and

(b) the underlying subject matter of an option is the property which would fall to be delivered if the option were exercised.

83.14.4 *The futures/options rules*

Armed with these definitions, we can turn to the futures/options rules. Section 275A(4) TCGA provides:

Subsections (5) to (9) below have effect if asset A [the intangible asset]—

(a) is a future or option (see section 275B(3)), and

(b) is not subject to UK law at the time it is created.

The point of (b) is that a future/option which is subject to UK law is UK situate under the UK-law rule and the futures/options rules are not needed. We are therefore only concerned with foreign law futures/options.

One needs to read s.275A(5)(6) together to follow the sense, and it easier to read them in reverse order. Section 275A(6) TCGA provides:

That rule is that where, in the case of any intangible asset,—

(a) the asset is a future or option,[31]
(b) the underlying subject matter (see section 275B(4)) of the asset consists of or includes an asset which is an intangible asset,
and
(c) either—
(i)[A] that intangible asset [the underlying subject matter] is subject to UK law at the time it is created and,
[B] on the assumption that there were no rights or interests in or over that asset,[32] the situation of that asset [the underlying subject matter] would not be otherwise determined, or
(ii) that intangible asset is treated by this subsection as being so subject [ie subject to UK law] at that time,
the intangible asset mentioned in para (a) above [i.e. the future/ option] is to be treated for the purposes of subsection (5) above and this subsection as being so subject [ie subject to UK law] at the time it is created.

This triggers s.275A(5) TCGA:

> If, as a result of the application of the rule in subsection (6) below in relation to asset A or any other asset or assets, asset A falls to be treated as being subject to UK law at the time it is created, it shall be taken for the purposes of this Act to be situated in the UK at all times.

In short, a foreign law future/option over a UK law underlying intangible asset is UK situate.

EN FB 2005 explains the point of s.275A(6)(c)(ii):

> These rules apply recursively. In any case where there is a "nested sequence" of futures or options in which the underlying subject matter of each contract in the sequence consists of or includes the next contract in the sequence, subsection (5) has effect to provide that the first contract is taken for TCGA purposes to be situated in the UK at all times if the [relevant] requirements ... are met in relation to any of the contracts in the sequence.

Suppose:

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31 Para (a) is otiose, since it repeats s.275A(4)(a); but it does not matter.

32 The words "on the assumption that there were no rights or interests in or over that asset" are difficult to understand, as situs of an asset does not depend of whether there are rights or interests in the asset. I think the words are otiose.

(1) Option 1 is a foreign law option over UK intangible property.
(2) Option 2 is a foreign law option over option 2.
Option 1 is UK situate under s.275A(6)(c)(i) and option 2 is UK situate under s.275A(6)(c)(ii).

Section 275A(6) leaves one gap: it does not apply where the situs of the underlying subject matter is "otherwise determined".[33]

Suppose, for instance, a foreign law option over shares in a UK incorporated company. That is not caught by s.275A(5)(6). The gap is filled by the second of the three futures/options rules, which is in s.275A(7)(8). These subsections follow much of the format of s.275A(5)(6) and I need not repeat the drafting points that they have in common.

One needs to read (7) and (8) together to follow the sense and it easier to read them in reverse order. Section 275A(8) TCGA provides:

> (8) That rule is that where, in the case of any intangible asset,—
> (a) the asset is a future or option, and
> (b) the underlying subject matter of the asset consists of or includes an asset—
> (i) which is, by virtue of
> [A] subsection (9) below or of
> [B] any provision of this Act apart from this section,
> situated in the UK at any time, or
> (ii) which is treated by this subsection as being so situated [ie UK situate] at any time,
> the intangible asset mentioned in para (a) above [the future/option] is to be treated for the purposes of subsection (7) above and this subsection as being so situated [ie UK situate] at that time.

This triggers s.275A(7) TCGA:

> (7) If—
> (a) asset A [the future/option] is not taken to be situated in the UK by virtue of subsection (5) above, and
> (b) as a result of the application of the rule in subsection (8) below

33 At first sight there is a second gap: s.275A does not apply where the underlying subject matter of the future/option is a tangible asset. But that is not a gap, as in such a case the future/option is an interest in that asset, and situs is determined by s.275 275(1)(b) TCGA.

> in relation to asset A or any other asset or assets, asset A falls to be treated as being situated in the UK at any time,
>
> it shall be taken for the purposes of this Act to be situated in the UK at that time.

Suppose:
(1) Option 1 is a foreign law option over a UK security.
(2) Option 2 is a foreign law option over option 2.
Option 1 is UK situate under s.275A(8)(b)(i) and option 2 is UK situate under s.275A(8)(b)(ii).
The rules in s.275A(5)(6) and (7)(8) only apply where there is an identifiable underlying asset in existence. A future/option over an asset class (such as gold) rather than any specific asset is not caught. If the underlying asset is currency, say, rather than a specific asset the futures/options rules do not apply. Hence it does not matter that cash-settled currency futures/options are within the definition of futures/options, as they are not within the scope of the futures/options rules.

83.14.5 *Underlying subject matter unissued shares or debentures*

Section 275A(9) TCGA deals with the case where the underlying subject matter is unissued shares or debentures:

> Where—
>
> (a) the underlying subject matter of a future or option consists of or includes shares or debentures issued by a company incorporated in any part of the UK, but
>
> (b) at the time the future or option is created, those shares or debentures have not been issued,
>
> the underlying subject matter of the future or option, so far as consisting of or including those shares or debentures, is to be taken, for the purposes of subsection (8) above, to consist of or include an asset which is situated in the UK at all times.

83.15 Insurance policy

The situs of policies rarely matters for CGT, because of the relief for policies. UK policies will be UK situate under the UK-law rule and for others the common law rule will apply.[34]

34 A policy is not a debt for the purposes of the CGT debt situs rule.

83.16 Land

Section 275(1)(a) TCGA provides:

> the situation of rights or interests (otherwise than by way of security) in or over immovable property is that of the immovable property.

The CG Manual provides:

> **12430 Types of asset (1): Land, tangible property and debts** [November 2012]
> *Land and buildings (Section 275(1)(a) TCGA 1992)*
> Land and buildings are located in the country where they are found. This applies to all rights and interests in the land and buildings. It will therefore apply to leases of land, tenancies etc.

83.17 Chattels

Section 275(1)(b) TCGA provides:

> subject to the following provisions of this subsection,[35] the situation of rights or interests (otherwise than by way of security) in or over tangible movable property is that of the tangible movable property.

Thus an option to purchase a UK situate chattel (even if governed by a foreign law) is a UK situate asset. The CG Manual provides:

> **12430 Types of asset (1): Land, tangible property and debts** [November 2012]
> *Chattels (Section 275(1)(b) TCGA 1992)*
> Items of tangible moveable property (chattels) are located where they are found at any point in time. This applies to all rights and interests over such assets also. Therefore a lease of a chattel can change from being located in the UK to being located elsewhere if the chattel is removed from the UK to another country.

For the position of temporarily exported chattels, see 82.27 (Chattels).

83.18 Ships and aircraft

Section 275(1)(f) TCGA provides:

> a ship or aircraft is situated in the UK if and only if the owner is then resident in the UK, and an interest or right in or over a ship or aircraft

35 This is referring to the special rules for ships and aircraft.

is situated in the UK if and only if the person entitled to the interest or right is resident in the UK.

The CG Manual provides:

> **12430. Types of asset (1): Land, tangible property and debts** [November 2012]
> *Ships and aircraft (Section 275(1)(f) TCGA 1992*)
> ... Contrary to the general rules of international law,[36] for capital gains purposes the location of a ship or aircraft does not depend on its country of registration. Instead the ship or aircraft is located in the UK if and only if the owner is resident in the UK. Similarly any interest or right in or over the ship or aircraft is located in the UK if and only if the owner of the interest or right is resident in the UK.

This generally[37] disapplies the CGT remittance basis since a ship/aircraft owned by a remittance basis taxpayer is deemed UK situate and the gain taxed on an arising basis. If the individual holds the ship/aircraft through a non-resident company the asset is treated as not UK situate which has two advantages:

(1) The s.13 remittance basis is available on a disposal by the company.
(2) Relief is available under s.809W ITA for services relating to the asset.

83.19 Goodwill

Section 275(1)(g) TCGA provides:

> the situation of good-will as a trade, business or professional asset is at the place where the trade, business or profession is carried on.

The CG Manual provides:

> **12450 Types of asset (3): Intangible assets - goodwill, patents, trademarks etc** [January 2010]
> *Goodwill (Section 275(1)(g) TCGA 1992)*
> Goodwill which is an asset of a trade, profession or vocation is located where the trade, profession or vocation is carried on. If the trade etc is carried on in more than one country part of the goodwill appropriate to the part of the trade etc carried on in any one country should be treated as located in that country.

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36 The Manual's view (that under international law ships and aircraft are situate where registered) is erroneous: see 82.28 (Ships and aircraft).

37 An exception is if the individual disposes of the asset while temporarily non-resident.

83.20 Interest under bare trust or nomineeship

The interest of a beneficial owner in property held by a nominee or bare trustee is situate where the underlying asset is situate: s.60 TCGA reinforces the common law rule on this point.[38]

For unit trusts see 39.5.2 (Situs of unit for CGT).

83.21 Equitable interest under a substantive trust

The situs of an equitable interest under a substantive trust only rarely matters for CGT because of the exemption for equitable interests. However it may matter, eg in the case of a purchased interest or an interest in a non-resident trust.

If the trust is "subject to UK law" (as defined) the interest will be situate in the UK. This clearly includes the case of a trust with a UK governing law; it may arguably apply to any trust with UK trustees. In other cases the common law rules will apply.

83.22 Intellectual property

Section 275(1)(h) TCGA provides:

> patents, trade marks, registered designs and corresponding rights are situated where they are registered, and if registered in more than one register, where each register is situated, and licences or other rights in respect of any such rights are situated in the UK if they or any right derived from them are exercisable in the UK,

A different solution must be found for copyright, since such rights do not need registration. Section 275(1)(j) TCGA provides:

> copyright, design right, franchises, and corresponding rights, and licences or other rights in respect of any such rights, are situated in the UK if they or any right derived from them are exercisable in the UK.

"Corresponding rights" has a commonsense definition in s.275(3) TCGA:

> In subsection (1) above, in each of paras (h) and (j), "corresponding rights" means any rights under the law of a country or territory outside the UK that correspond or are similar to those within that paragraph.

This will not often concern remittance basis taxpayers. It is important for non-residents carrying on a trade in the UK through a permanent

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38 See 82.31 (Interest under bare trust or nomineeship).

establishment, who are (in short) subject to CGT on UK situate trading assets.

It seems at first sight that intellectual property is (uniquely) capable of being situate for CGT purposes in more than one jurisdiction. But it is considered that intellectual property exercisable in a number of jurisdictions should be regarded as a number of separate assets, one situate in each jurisdiction. The CG Manual provides:

> **12450 Types of asset (3): Intangible assets - goodwill, patents, trademarks etc** [January 2010]
> *Copyright, design rights, franchises etc (Section 275(1)(j) TCGA 1992)*
> • Copyright, design rights and franchises
> • Any rights or licences to use
> – any copyright work
> – any design in which design rights subsist
> are situated in the UK if they or any right derived from them are exercisable in the UK.

83.23 Unadministered estate of deceased person

If the estate is subject to UK law, it is UK situate for CGT. Other estates are governed by the common law rule.[39]

83.24 CGT planning: Making UK situate property non-UK situate

83.24.1 *Moveable assets in UK*

Moveable assets could in principle be moved offshore prior to a disposal. Consider whether an export licence is needed.

83.24.2 *Unincorporated UK business carried on by foreign domiciliary*

A business could be transferred to a foreign incorporated company under s.162 TCGA and shares later sold. Watch stamp duty. Even if the company were subsequently to become non-resident on emigration of shareholder/directors, no tax would arise except on growth in value since transfer to the company.

83.24.3 *Debts*

There are two ways to deal with a UK situate debt on a security. It may be possible to make the asset non-UK situate. It might be possible to

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39 See 82.33 (Unadministered estate of deceased person).

make the asset a simple debt (not a debt on a security) so it falls within the relief given by s.251 TCGA. It is important to do this by varying the existing debt, and not by ending the existing debt and creating a new one.[40]

83.24.4 *Use of UK resident foreign incorporated company*

It is not ideal for a foreign domiciled individual to hold a UK incorporated company directly, as a disposal of that asset would give rise to CGT. If the foreign domiciliary does not want to go to the trouble and expense of using an offshore trust, what is the alternative? One possibility is to use a foreign incorporated UK resident company. The shares in the company will not be UK situate for CGT.[41]

40 See *Chitty on Contracts*, (31st ed., 2012), para 22-028 (Substituted contract).

41 See 83.6 (Registered securities: non-UK company).

CHAPTER EIGHTY FOUR

FOREIGN ENTITIES

84.1 Foreign entities: Introduction

UK tax law categorises entities (in short) as companies, partnerships or trusts.[1] With more or less difficulty (depending on the similarity of the law of the country concerned) it is necessary to shoehorn foreign entities into these categories; or more accurately, it is necessary to decide whether references to companies, trusts, partnerships, persons, etc in any particular statutory provision include some particular foreign entity. Similarly, it is necessary to decide whether technical terms such as "share capital" or "interest in possession", or less technical terms such as "interest in", are apt to include rights in or under foreign entities.

Memec v IRC explains the general approach:

> When an English tribunal has to apply the provisions of an UK taxing statute to some transaction, arrangement or entity which is governed by a foreign system of law, the tribunal must take account of the rules of that foreign system (properly proved if not admitted) in order to determine the nature and characteristics of the transaction, arrangement or entity. But having informed itself in this way, the tribunal must then apply the taxing statute as part of English law.[2]

Thus in order to decide whether a reference to (say) a trust or trustee, in any particular statutory provision, includes some particular foreign entity or person, one must ask some fundamental questions:

(1) What is the definition, or determinative characteristics, of a trust or trustee (within the meaning of the section), a question of UK law; and

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1 And lastly, PRs but PRs are not discussed in this chapter.

2 71 TC 77 (HC) at p.92 approved *Anson v HMRC* [2013] STC 557 at [70]. Avery Jones "Characterisation of Other States' Partnerships for Income Tax", [2002] BTR 375 is essential reading in this area.

(2) Does the foreign entity or person have those characteristics, a question of the foreign law.

Similar issues arise in the application of DTAs to foreign (and UK) entities, for instance, whether an entity is a "person" or a "body corporate" for the purpose of a DTA. Similar issues arise in non-tax contexts.[3]

Most OECD countries adopt the same approach:

> 11. In most [OECD] Member countries, as a matter of principle, tax laws apply on the basis of the legal relationship deriving from other branches of the law. Thus the tax laws of these countries, when referring to partnerships, will, absent special tax definitions, refer to those entities that constitute partnerships according to domestic civil or commercial law.
>
> 12. Difficulties often arise, however, where income is derived by an entity organised under the laws of another jurisdiction. In that case, the entity will have to be classified for purposes of the application of the tax laws of the country where the income is derived, regardless of whether or not that classification is compatible with the civil or commercial law system of the jurisdiction from which the entity derives its legal status.
>
> 13. For example, if the tax system of a country recognises only individuals, companies and partnerships (but not trusts) as taxpayers and provides for a different tax treatment for these three types of taxpayers, that country will have to 'force' foreign entities in one or the other of these categories (with more or less difficulty depending on the similarity of the civil and commercial law of the countries concerned) for purposes of applying its tax system to domestic income derived by these foreign entities.
>
> 14. In doing so, the practice of most countries is to adopt the same approach as the one they apply in a purely domestic context. They will therefore apply their domestic tax classification to foreign entities on the basis of the foreign law's legal characteristics of the entity. In the previous example, the country, for the purposes of taxing the domestic income of a trust established under the law of a foreign jurisdiction, will typically examine the legal characteristics of the trust as they derive from the trust law of the foreign jurisdiction in order to determine whom it should tax and whether that person should be taxed as an individual,

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3 See for instance s.1208 Companies Act 2006: "partnership" means—
(a) a partnership within the Partnership Act 1890, or
(b) a limited partnership registered under the Limited Partnerships Act 1907,
or a firm or entity of a similar character formed under the law of a country or territory outside the UK.

> company or partnership, which are the only categories recognised under its tax law."[4]

US law adopts the same approach. In *Biddle v Commissioner*[5] the issue was whether tax deducted at source on a dividend by a UK company[6] was regarded as "tax paid by a shareholder" for the purposes of a US statute:

> At the outset it is to be observed that decision must turn on the precise meaning of the words in the statute which grants to the citizen taxpayer a credit for foreign "income taxes paid." The power to tax and to grant the credit resides in Congress, and it is the will of Congress which controls the application of the provisions for credit. The expression of its will in legislation must be taken to conform to its own criteria unless the statute, by express language or necessary implication, makes the meaning of the phrase "paid or accrued," and hence the operation of the statute in which it occurs, depend upon its characterization by the foreign statutes and by decisions under them. ...
> ... The phrase "income taxes paid," as used in our own revenue laws, has for most practical purposes a well understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes. It is that meaning which must be attributed to it as used in § 131.
> Hence the board's finding... that "the stockholder receiving the dividend is regarded in the English income tax acts as having paid 'by deduction or otherwise' the tax 'appropriate' to the dividend" is not conclusive. At most it is but a factor to be considered in deciding whether the stockholder pays the tax within the meaning of our own statute. That must ultimately be determined by ascertaining from an examination of the manner in which the British tax is laid and collected what the stockholder has done in conformity to British law and whether it is the substantial equivalent of payment of the tax as those terms are used in our own statute.

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4 See OECD, "The Application of the OECD Model Tax Convention to Partnerships" (1999) accessible (at a small charge) from *http://www.oecd.org*.
In Ireland this approach was adopted in *Quigley v Harris* [2009] 2 IR 175. In that case the approach was said to derive from the principle of comity of nations, that is, that the courts of one jurisdiction recognise and give effect to rights and obligations relating to foreign entities, in accordance with the law of the state where the entity is established.

5 302 U.S. 573 (1938).

6 Before the introduction of Corporation Tax.

So far as the topic raises issues of foreign law I necessarily rely on secondary material. I would be interested to hear from readers with foreign law expertise if views expressed in this chapter need correction or refinement, and in particular if they disagree with HMRC official views.

A full discussion of the deeply intriguing issues raised in this chapter would require a book to itself.

84.1.1 *Significance of foreign law classification*

If the applicable foreign law is sufficiently similar to UK law, it is considered that a foreign law classification of an entity as, say, a trust, ought to be relevant, though not of course decisive; but in practice that condition is often not satisfied, or at least, in the event of a dispute, the question whether the foreign law is "sufficiently similar" is likely to be contested.

The upper tribunal have said:

> The meaning of the word [dividend] in the tax legislation is a matter of English law not of Cayman law.
> Although Cayman law uses the word "dividend" to cover the distributions made in the present case ... it does not follow that the Preference Dividends are therefore "dividends" with the meaning of the UK tax legislation.[7]

84.2 "Transparent" and "opaque"

84.2.1 *Terminology*

UK tax law categorises entities as **"transparent"** or **"opaque"**.[8] The International Manual explains this terminology:

> **180020 Considerations when using the List of Classifications of Foreign Entities for UK tax purposes** [April 2012]
> ... Entities are described [in the official list set out below] as either fiscally "transparent" or "opaque" solely for the purposes of deciding how a member is to be taxed on the income they derive from their interest in the entity. In the case of a "transparent" entity the member is regarded as being entitled to a share in the underlying income of the

7 *HMRC v First Nationwide* 81 TC 738 at [23]. The point was not doubted on appeal. For another example, see 84.6 (American revocable trust (grantor trust)).

8 The term sometimes used is "fiscally transparent" (and "fiscally opaque") but that is synonymous with "transparent" (or "opaque").

> entity as it arises and is charged to tax in the UK on their share of the profits on that basis. But, in the case of an "opaque" entity the member generally is taxed only on the distributions made by the entity.

The terminology is used similarly for CGT: In the case of a transparent entity the member is regarded as being entitled to a share of the underlying gains of the entity as they arise. In the case of an opaque entity the member is in principle taxed only on distributions made by the entity; the entity itself is regarded as receiving the gains. For instance, a partner is regarded as entitled to a share of the underlying gains of a partnership as they accrue, and is charged to CGT on that basis; so a partnership is said to be transparent for CGT.

Strictly, one should not use the term "transparent" without identifying the tax involved, because an entity may be transparent for one tax and not for another.

Classification of an entity as transparent for IT/CGT in the above sense ought logically to entail that the entity is regarded as *not* entitled to the income/gains (since its members, or those who own or have an interest in the entity, *are* regarded as so entitled). For instance, a partnership is transparent and income/gains accrue to the partners and not to the partnership. Perhaps illogically, this is not always the case. For instance, an IIP trust is transparent, but the trustees may still be taxable on the trust income; likewise a settlor-interested trust within s.624. That state of affairs usually favours HMRC (by offering an alternative person liable for the tax) but in the case of DT exemptions, it may favour the taxpayer (by offering an alternative route to DT relief).

Thus classification as transparent or opaque does not answer all the tax questions which may arise in relation to an entity.

The International Manual provides:

> **180020 Considerations when using the List of Classifications of Foreign Entities for UK tax purposes** [April 2012]
> It should be noted that the expressions "transparent" and "opaque" are not interchangeable with "partnership" and "company" or "body corporate". For example, a fiscally transparent entity is not necessarily a partnership. Likewise an UK company is a "body corporate" and is opaque for the purposes of UK tax on income, but a fiscally opaque entity is not necessarily a "body corporate" or a "company" for UK tax purposes.

Although the expressions are not interchangeable, the issues overlap. A

transparent entity is not necessarily a partnership[9] but a partnership is always transparent for IT and CGT.[10]

The sense explained above is, I think, the paradigm use of the terms transparent/opaque. However the terminology is also used in an analogous way in other contexts; for instance, it may be said that a partnership is not transparent for IHT situs rules. So one should not use the term without identifying the provision or context involved, as an entity may be transparent for one purpose and not for another.[11] Outside the paradigm context, the labels transparent/opaque may be a useful shorthand but it is necessary to focus on the words of the statute and if that is not done, the terminology may mislead. It is better used to summarise a conclusion rather than as the reason for reaching that conclusion.[12]

84.2.2 *How to categorise an entity as transparent or opaque*

The International Manual explains HMRC's approach to categorising an entity as transparent or opaque:

> **180010. Factors to consider in classifying a foreign entity for UK tax purposes** [January 2012]
> ... When considering the classification of a foreign entity (i.e. whether it is either opaque or transparent) for UK tax purposes, due regard is given to the approach of the Court of Appeal in the case of *Memec plc v IRC* (71 TC 77) and the line of case law that precedes it. In particular, the following matters should be considered:
>
> (a) Does the foreign entity have a legal existence separate from that of the persons who have an interest in it?

If the entity does not have a separate legal existence (legal personality) that is the end of the matter. It cannot be opaque (as income cannot be regarded as received by it). On the other hand an entity which does have

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9 For instance, an IIP trust is also transparent: see 26.3 (Taxation of Life Tenant).

10 See 41.4 (Transparency of partnership for IT); 41.7 (Transparency of partnership for CGT).

11 For instance, a partnership is *not* transparent for the purposes of the ITA remittance basis. See 11.34.2 (Non-transparent nature of partnership for remittance basis purposes).

12 The First-tier Tribunal made this point in *Swift v HMRC* [2010] SFTD 553 at [18]: "The issue is whether the UK tax is 'computed by reference to the same profits or income' or whether he is taxable on the equivalent of a dividend. Asking whether SP LLC is transparent or opaque may be another way of asking the same question but we consider that it is preferable to apply the words of the Treaty."

legal personality can be either opaque or transparent. A Scots partnership is an example of a transparent entity with legal personality.

> (b) Does the entity issue share capital or something else, which serves the same function as share capital?
> (c) Is the business carried on by the entity itself or jointly by the persons who have an interest in it that is separate and distinct from the entity?
> (d) Are the persons who have an interest in the entity entitled to share in its profits as they arise; or does the amount of profits to which they are entitled depend on a decision of the entity or its members, after the period in which the profits have arisen, to make a distribution of its profits.
> (e) Who is responsible for debts incurred as a result of the carrying on of the business: the entity or the persons who have an interest in it?
> (f) Do the assets used for carrying on the business belong beneficially to the entity or to the persons who have an interest in it?
>
> Some of those factors may point in one direction; others may point in another. An overall conclusion is reached from looking at all the factors together, though some have more significance than others. Particular attention is paid to factors c. and d.
>
> In considering these factors we look at the foreign commercial law under which the entity is formed and at the internal constitution of the entity. ... The conclusion that is reached is then used in considering the relevant piece of UK tax law.[13]

84.2.3 *Hybrid entities*

"A hybrid entity" is one that is classified as transparent in one state, and non-transparent in another. Such entities may give rise to tax planning or avoidance.[14] They may also give rise to double taxation. HMRC do not regard the latter as objectionable.[15]

In *Columbus Container Services* the advocate-general observed:

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13 This passage is also set out in INT Manual 180010. I deal with the omitted sentence in the following paragraph.

14 See OECD, "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (2012) accessible *http://www.oecd.org/tax/aggressive/HYBRIDS_ENG_Final_October2012.pdf*

15 See 84.25 (US S-Corps and LLCs).

> 40. International tax studies on the problem of the transparency of partnerships have highlighted the incredible complexity of this branch of law, due in particular to the classification of a partnership, which is described as a partnership in one state but as a business corporation in another, and to the bilateral or triangular nature of the relationships to be considered (the state of the source of the income, the state of the partnership, the state of residence of the partner). These difficulties may however be eased by the provisions of taxation conventions between states.
> 41. At the current stage of development of Community law, it does not require member states to recognise in their territory the legal and tax status afforded by the domestic law of the other member states to entities which carry out their economic activities there.

84.2.4 *Significance of foreign law classification as transparent/opaque*

The International Manual adopts a parochial approach:

> **180010. Factors to consider in classifying a foreign entity for UK tax purposes** [January 2012]
> ... How the entity is classified for tax purposes in any other country is not relevant.

If the foreign tax law is sufficiently similar to UK law, it is considered that a foreign law classification as transparent/opaque ought to be relevant, though not of course decisive. An incidental attraction of this course is that it reduces the number of hybrid entities, which give rise double taxation and avoidance. But in practice the condition that foreign tax law is sufficiently similar to UK law is often not satisfied, or at least, in the event of a dispute, the question whether the foreign law is "sufficiently similar" is likely to be contested.

84.3 Definition of "IHT-settlement"

It was noted above that it is necessary to consider the UK tax law definition of terms such as partnership, company and trust before deciding whether a foreign entity falls within the definition. The definitions of "partnership"[16] and "company"[17] are fairly uniform throughout tax law.

However quite different definitions of trusts are used in different taxes.

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16 See 41.2.1 (Partnership).

17 See 84.4 (Meaning of "company").

I discuss terminology in 80.2.1 (terminology); in summary:
"**IHT-settlement**" means a settlement within the IHT definition
"Standard IT/CGT settlement" is a settlement within the standard IT/CGT definition.
"Settlement-arrangement" is a settlement within s.620 ITTOIA, which applies for the purposes of the IT settlement provisions and many other purposes of which the most important is s.87 TCGA**.**

The terms trust and settlement are used (more or less) interchangeably.

Because the definitions are different, it is a mistake to ask if an entity is a trust "for tax purposes". One must ask if it is a trust for IT/CGT, or for IHT purposes, or if it is a settlement-arrangement. An entity may be a trust within one, or two, or all three definitions.

I discuss the IT/CGT and settlement-arrangement definitions elsewhere.[18] Section 43(2) IHTA provides the IHT definition:

> "Settlement" means any disposition or dispositions of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—
>
> (a) held in trust for persons in succession or for any person subject to a contingency, or
>
> (b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income, or
>
> (c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition) with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period,
>
> [d] or would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the UK;
>
> [e] or whereby, under the law of any other country, the administration of the property is for the time being governed by provisions equivalent in effect to those which would apply if the property were so held, charged or burdened.

84.3.1 *Limb [d]: Would be so held if disposition were regulated by UK law*

This limb is present for historic reasons only. The former estate duty

18 See 80.2 (Definition of "settlement").

definition of "settlement" in s.22(1)(i) FA 1894 provided (so far as relevant):

> The expression 'settlement' means any instrument, whether relating to real property or personal property, which is a settlement within the meaning of the Settled Land Act, 1925, or if it related to real property would be a settlement within the meaning of that Act

Dick Taverne, then Financial Secretary to the Treasury, explained the problem posed by this definition:

> The definition is primarily by reference to the Settled Land Act 1925, but it brings in property other than settled land by references to instruments which if related to real properly in England and Wales would be a settlement within the meaning of the Act. We now see that it is arguable that we have done no more than equate an English settlement of personalty with one of realty and that we have not caught foreign settlements.[19]

Hence s.36(5) FA 1969 extended the definition:

> In the enactments relating to estate duty—
>
> (a) the expression 'settlement'— (i) for the avoidance of doubt is hereby declared to include ...
>
> (bb) any disposition regulated by the law of a territory outside Great Britain which would constitute a settlement within the meaning of section 22(1)(i) of the Finance Act 1894 if it had been regulated by the law of England or, as the case may require, of Scotland;

The words now in s.43(2)[d] IHTA are derived from para (bb). Now, the definition of settlement for IHT is not by reference to the SLA 1925 and applies to UK and foreign law trusts, so the words in (bb) were not needed. The drafter of the current definition possibly did not notice, but probably thought the words desirable to preclude an argument that "trust" in s.43(2) IHTA meant a trust governed by a UK law. That argument would not have been very convincing but given the history of the provisions might not have been self-evidently wrong.

Limb [d] therefore has no practical effect.

84.3.2 *Limb [e]: Provisions equivalent in effect to a trust*

The standard IT/CGT definition has no equivalent of s.43(2)[e]. So while

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19 Hansard Standing Committee F, 24 June 1969, col 721.

the IT/CGT definition requires that property is held "in trust" it is (in short) sufficient for IHT that the property is governed by provisions which are equivalent in effect.

Section 43 refers to the *administration* of the property being governed by provisions equivalent in effect. Trust law draws a distinction between administrative and dispositive provisions, but the context here suggests that this is referring to all the provisions which govern the use of the property, and not just administrative provisions in the strict sense.

Two difficulties lie in the short phrase "equivalent in effect":

(1) Equivalent *in effect* presumably requires effective (or substantive) rather than exact equivalence, but where does one draw the line?

(2) Trusts can have the same effect as entails, usufructs, wills, corporations, charges by way of security over assets, and so on, though they are none of those things. A trust is a flexible, protean institution which can have markedly different effects.

In deciding whether a foreign institution is equivalent in effect to a trust, a court should have regard to the context - is it appropriate in the scheme of IHT that an entity should be subject to IHT in the same manner as a trust? This consideration supports the view taken below that a foundation (stiftung) is an IHT-settlement but a usufruct is not.

84.4 Meaning of "company"

Section 1121(1) CTA 2010 provides the definition for the corporation tax acts:

> In the Corporation Tax Acts "company" means any body corporate or unincorporated association, but does not include a partnership, a local authority or a local authority association.[20]

Section 992(1) ITA provides the identical definition for the income tax acts.

Section 288 TCGA provides a similar definition for the TCGA:

> "company" includes any body corporate or unincorporated association but does not include a partnership, and shall be construed in accordance with section 99;

The CGT definition is wider that the IT/CT definition as it includes (1)

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20 This is subject to some minor (unnecessarily complicated) exceptions not considered here.

unit trusts[21] and (2) local authorities.[22]

The IHTA does not provide a definition of "company" but the definition of close company in the close company rules incorporates the CTA definition. Section 102(1) IHTA provides:

> In this Part of this Act—
> 'close company' means a company within the meaning of the Corporation Tax Acts which is (or would be if resident in the UK) a close company for the purposes of those Acts;

For SDLT, s.100(1) FA 2003 provides a similar definition:

> In this Part "company", except as otherwise expressly provided, means any body corporate or unincorporated association, but does not include a partnership.

84.5 Bare trusts/nomineeships

84.5.1 *Definition(s) of bare trust and associated terminology*

Section 466 ITA provides:

> (2) "Settled property" means any property held in trust other than property excluded by subsection (3).
> (3) Property is excluded for the purposes of subsection (2)
> (a) it is held by a person as nominee for another person,
> (b) it is held by a person as trustee for another person who is absolutely entitled to the property as against the trustee, or
> (c) it is held by a person as trustee for another person who would be absolutely entitled[23] to the property as against the trustee if that other person were not an infant or otherwise lacking legal capacity.

The phrase "absolutely entitled to property as against a trustee" is defined in s.466(5) ITA:

> A person is absolutely entitled to property as against a trustee if the person has the exclusive right to direct how the property is to be dealt

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21 Section 99 relates to unit trusts; see 39.4 (Gains accruing to unit trust).

22 See Kessler & Marre *Taxation of Charities & Non-profit Organisations* (9th ed., 2013), chapter 43 (Local Authorities).

23 The term "absolutely entitled" is defined in s.466(6) ITA:
"References to a person who is or would be so entitled include references to two or more persons who are or would be jointly absolutely entitled as against the trustee."

with (subject to the trustees' right to use the property for the payment of duty, taxes, costs or other outgoings).

I use the following terms:

"A bare trust" (or **"nomineeship"**, the terms are for present purposes synonymous) is a trust of property:

(1) within s.466(3) ITA and its CGT equivalent, s.60 TCGA (ie, not settled property for IT/CGT purposes) and

(2) not within s.43 IHTA (ie, not settled property for IHT purposes).[24]

These two definitions are not quite identical, but in practice they usually amount to the same.

"A substantive trust" is a trust that is not a bare trust.

This is now standard usage among private client practitioners. But in the past the expression "bare trust" was used in a variety of different senses.[25] This is now of historic interest only, but it needs to be kept in mind, especially when reading older cases, that references to a bare trust may not be a reference to a bare trust in the above sense.

There is some debate as to whether what I call a bare trust should always be described a "trust" but that makes no difference for tax purposes.

84.5.2 *Tax treatment of bare trust*

In short:

(1) A bare trust is transparent for CGT,[26] for IT and for IHT.

(2) A bare trust is not an IT/CGT settlement.

(3) A bare trust is not an IHT-settlement as the property is not held on trust for persons in succession (or governed by provisions equivalent in effect).

(4) A bare trust may be a settlement-arrangement. However it is not within s.87 TCGA as gains do not accrue to the trustees, so there are no s.2(2) amounts (trust gains).

The question of whether a trust is classified as a bare trust or a substantive trust is therefore of some importance.

84.5.3 *The trust law background*

In classifying an entity as a bare or a substantive trust, three rules of trust

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24 See 84.3 (Definition of "IHT-settlement").

25 The old cases are assembled in *Re Blandy Jenkins* [1917] 1 Ch 46.

26 Section 60 TCGA.

law (or succession law) are particularly relevant:

(1) A substantive trust must confer rights on more than one person. If a trust has only one beneficiary, it can only be a bare trust.

(2) A testamentary disposition has no effect during the life of the testator/settlor, so if a disposition is classified as testamentary, it can only be a bare trust during the lifetime of the testator/settlor.

(3) A trust which is a sham is generally a bare trust.

Of course a foreign law entity may be classified as a bare trust, just as an English law trust may constitute a bare trust.

84.5.4 *Substantive trust must confer rights on more than one beneficiary*

Whether a trust confers rights on more than one beneficiary is a question of construction.

There may be a substantive trust even if the interest of the second beneficiary is a future interest of no economic value. There is no *de minimis* requirement.

Thus in *Corlet v Isle of Man Bank Limited* [1937] 3 DLR 163, and *Anderson v Patton* [1948] 2 DLR 202 lifetime trusts conferred what one might regard as minimal future revocable interests on beneficiaries other than the settlor, but the trusts were valid. The latter case concerned a document reciting:

> received from A $5,000 which I am to hold in trust for A and which I am to pay out as instructed to X and Y if anything should happen to A. The money will be returned if A should demand it.

The Court held by a majority that even this was a valid trust. (One can see the force of the minority view that this was actually intended to be testamentary.)

Lewin on Trusts says:

> The reservation by the settlor of large beneficial powers and interests may leave the lifetime trusts declared in favour of others so squeletic[27] as to be considered illusory. If a power of revocation is also reserved, this can turn a settlement into a will.[28]

This may be read to suggest that a trust may purport to confer some

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27 This word is not in the OED, but one of the authors of Lewin tells me it means: skeletal.

28 (18th ed, 2008), para. 1-14

interest on other beneficiaries, but if that interest is insufficiently large or important it does not count. I refer to this as a *de minimis* principle.

The term sometimes used is "illusory trusts", but I think it causes confusion to use the term "illusory" unless it is clear what is required to be "illusory"; in other words, to call a trust or an interest "illusory" represents a conclusion of invalidity, rather than a useful test of how to reach that conclusion.

While a substantive trust must confer rights on more than one person, there is no rule that the rights of the second person must exceed some *de minimis* requirement. It is well established that a settlor ("S") may create a valid trust conferring a life interest on S, with power of revocation exercisable by S, and subject to that, for R. The reversionary interest of R is not so small it should be disregarded. But R's interest has a nil economic value and a lifetime settlement of this kind has in substance the same effect as a will. How does one distinguish between revocable reversionary interests, which are valid, and (even) less significant interests (which are not)? Unless one knows what is too small an interest (and different views on that would be possible) it will be impossible to say whether trusts are substantial trusts or bare trusts.

The authorities do not provide any support for a *de minimis* requirement of this kind. The relevant cases are not consistent with any *de minimis* requirement of this kind. The question of whether there is a substantive trust is not determined by asking whether a beneficiary's interest was "squeletic". The question is whether the "beneficiary" (using that word in a non-technical way) has an interest at all.

84.5.5 *Testamentary/non testamentary dispositions*

English law (and foreign laws which adopt common law principles) distinguish between:

(1) testamentary dispositions;

(2) non-testamentary dispositions (here called "lifetime dispositions").

The distinction matters for many reasons including the following:

(1) Different (stricter) formalities apply to testamentary dispositions.[29]

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29 If a foreign law entity were a testamentary disposition under English law, it might be valid under foreign law even though it would not satisfy English law formality requirements (two witnesses, etc). The entity may then be void in English law, lacking the formalities required for a valid will; but it may be saved by the Wills Act 1963. If the entity is void in English law but valid in foreign law, the applicable

(2) A testamentary disposition only takes effect on death. A lifetime disposition takes effect before death, normally when executed.
(3) A testamentary disposition is revocable until death. A lifetime disposition is only revocable if this is expressly stated, and even if it is revocable, circumstances which normally revoke a testamentary disposition (eg making a new will in common form, or marriage) may not revoke a lifetime disposition.

In particular, if a disposition which creates a trust is a testamentary disposition, the trust must be a bare trust during the life of the settlor/testator.

Statute law recognises the testamentary/non-testamentary distinction[30] but gives no guidance on it. There is a certain amount of (mainly antique) case law. A disposition is testamentary if it is the intention of the writer of the document "that death was the event that was to give effect to it".[31]

A disposition which confers a life interest on the settlor and also a power of revocation is in principle a valid lifetime disposition, not testamentary. In *Thompson v Browne*[32] the Court said:

> If there be anything in that decision [*Attorney-General v Jones*] to support the notion, that where a person by deed settles property to his own use during his life, and after his decease for the benefit of other persons, a power of revocation reserved in such a deed alters the character of the instrument, and renders it testamentary, … I can only say that, if this were law, a great number of transactions of which the validity has never been doubted would be liable to be impeached.[33]

The beneficiaries of a lifetime trust have an equitable interest from the date of the gift, known as a present future interest. They could in theory take proceedings in the event of a breach of trust. However in practice this may be a theoretical possibility only. The difference between a

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conflict of law principles must be applied to see which legal system has priority.

30 Section 1 Wills Act 1837 merely says that the term "will" includes a testamentary disposition.

31 *Milnes v Foden* (1890) 15 PD 105 at p.107; or (which comes to the same thing) "that it is dependent on the death for its vigour and effect"; *Cock v Cooke* (1866) 1 P&D 241 at p.243. If the document calls itself a will, the intention is usually obvious, but it is not necessary to use the word "will". For instance, a conveyance "not to take effect until after my decease" is obviously testamentary: *In the Goods of Morgan* (1866) 1 P&D 214.

32 (1835) 3 My & K 32.

33 The point is also stated in *Baird v Baird* [1990] 2 AC 548 at p.556.

testamentary disposition and a trust of this kind is then essentially one of form and not one of substance. There is no economic difference. In cases of this kind it could be harder to construe the document and determine whether the intention of the writer is:

(1) to confer a present future interest or

(2) that death is the event which gives effect to the document.

Since it makes no real (economic) difference, the writer of the document may not have formed a clear intention on the point, or even if they have, they may not have expressed that intention clearly in the document. In these cases the form of the document is an important guide to construction. If the document takes the form of a will, (ie describing itself as a will and executed with the formalities of a will) the intention of the writer must be that it is testamentary. If it takes the form of a lifetime settlement (ie describing itself as such and executed as a deed), the intention of the writer must be that it is a lifetime disposition. Of course the form of the document is not decisive. The context may show otherwise. However, the form certainly gives some guidance and in the absence of contrary indications it must be determinative.

The rule that a testamentary disposition does not create a substantive trust during the lifetime of the settlor/testator should be regarded as distinct from the rule that a substantive trust must confer an interest on more than one beneficiary. In the case of a testamentary disposition, there would be someone who is intended to benefit after the death of settlor/testator, but the question is whether they are intended to benefit immediately or on death. However, in practice, factors which suggest that the intention of the writer of the document is testamentary will also tend to show that there was no intention to confer any interest on a beneficiary during the lifetime of the settlor, so the two rules can overlap.

84.5.6 *Sham*

The doctrine of sham applies to trusts and not to other entities such as companies.

Whether or not a foreign entity is void as a sham depends on the applicable foreign law of sham, or some similar doctrine, if the foreign law has one. Most common law jurisdictions broadly follow English law principles and an English court will assume English law applies in the absence of evidence to the contrary.

The sham rule (in short, that a trust is invalid if the settlor lacked the intention to create a trust) is distinct from the rules a trust may be invalid

as merely (1) a testamentary disposition or (2) a bare trust. But in practice where it is the intention to create a testamentary disposition or bare trust, the testator/beneficial owner will not have, or manifest, the intention to create a substantive lifetime trust, so these rules may overlap. For a modern example, see *BQ v DQ*.[34]

84.6 American revocable trust (grantor trust)

Revocable trusts are commonly used in the USA for estate planning.[35] With an American settlor these are almost always grantor trusts (a USA income tax concept) and transparent for USA tax purposes as to income and capital gains, though with non-USA settlors they are only transparent in limited circumstances.

The classification of a USA revocable trust turns on the nature of the rights conferred by the trust, which depends on the drafting and proper law of the trust.[36] Only general comments are possible here.

Under a common form revocable trust, the settlor (the synonymous terms grantor, trustor, creator or donor are often used in American trust documentation) is sole trustee, the trust is revocable and the income and capital is paid to the settlor on demand. Section 603 of the America Uniform Trust Code[37] provides:

> While a trust is revocable [and the settlor has capacity to revoke the trust],[38] rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor.

A USA revocable trust of this kind is not an IT/CGT settlement as the property is not held "in trust". This seems paradoxical, but the fact that

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34 Also reported under the name *Re the AQ Revocable Trust* Supreme Court of Bermuda [2011] WTLR 373; [2011] TLI 23; 13 ITELR 260; 6 Tolley's Offshore Service Cases 15; accessible *http://www.gov.bm*

35 I am grateful to Ian Watson for his comments on this section. For other USA trusts, see Sanborn, "US tax classification of trusts", (2005) TQR Vol 3 issue 2 p.16 accessible to STEP members on *http://www.step.org*.

36 Each USA state is a separate common law jurisdiction, with its own trust law, ultimately derived from English law but with statutory and case law variations.

37 Accessible *http://www.nccusl.org*. The uniform code project is an attempt to standardise USA law. Adoption of uniform codes is far from universal, however, and each state adopting them may do so with variations. Some state statutes (eg, California Probate Code section 15800) impose rules almost identical in effect to UPC section 603, though independently of the uniform code project.

38 Square brackets in original, as the wording is intended to be optional.

American lawyers describe something as a trust does not mean that it is a trust within the meaning of the word as used in UK statutes.[39] In English law, "there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts."[40] The USA revocable trust may appear at first sight to grant rights to beneficiaries, but during the lifetime of the settlor (or at least while the settlor is mentally competent) the rights are unenforceable and do not amount to "rights" at all.

If the settlor is not the sole trustee, there is a trust; but if (in the words of the Uniform Trust Code) "the duties of the trustee are owed exclusively to the settlor" it is considered that the USA revocable trust is a bare trust for UK tax purposes. For CGT, the settlor is absolutely entitled as against the trustee. A USA revocable trust of this kind is similarly not an IHT-settlement, since:

(1) if the settlor is sole trustee there is no trust;

(2) if the settlor is not sole trustee there is only a bare trust.

The property is not held in trust for persons in succession. The better view is that a USA revocable trust of this kind is also not equivalent in effect to a trust for persons in succession. The element of succession is that of a will. In other words, a USA revocable trust of this kind is in English law a bare trust and a testamentary disposition.[41] This view was adopted in *BQ v DQ*.[42]

Depending on the wording, a USA revocable trust of this kind may cease to be a bare trust, and become a settlement (for IHT and IT/CGT) if the settlor loses mental capacity. This could of course have significant UK tax consequences.

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39 See 84.1.1 (Significance of foreign law classifications and terminology).

40 *Armitage v Nurse* [1998] Ch 241 at p.253. Likewise Hague Convention art.2 ("A trust has the following characteristics ... (c) the trustee has the power and the duty, *in respect of which he is accountable,* to manage, employ or dispose of the assets in accordance with the terms of the trust ...". The rule goes back to *Morice v The Bishop of Durham* (1804) 9 Ves Jun 399 at p.405: "There must be someone in whose favour the Court can decree performance."

41 See 84.5 (Bare trusts/nomineeships). Underhill & Hayton agree: *Law of Trusts & Trustees* (18th ed., 2010), para 4.8 fn1.

42 Also reported under the name *Re the AQ Revocable Trust* Supreme Court of Bermuda [2011] WTLR 373; [2011] TLI 23; 13 ITELR 260; 6 Tolley's Offshore Service Cases 15; accessible *http://www.gov.bm*

One could if desired draft a trust which meets the USA requirements to be a grantor trust and which is a settlement for IT/CGT and IHT purposes. It would need to be one where (during the lifetime of the settlor) the trustees owed duties to beneficiaries other than just the settlor.

84.7 *Garland* trusts

The distinctive feature of *Garland* trusts (unlike English law trusts) is that beneficiaries have no interest in the trust property. The right is *in personam* not *in rem*. In other respects *Garland* trusts are like English trusts. A *Garland* trust is in principle a settlement within the IT/CGT and IHT definitions.

The approach of the tax code is to make some statutory provision in relation to Scotland, and otherwise to ignore the problems.

For the income taxation of *Garland* trusts, and the trust law background, see 26.3 (Taxation of life tenant); 26.7.3 (Garland trusts); 26.8 (Baker or Garland trust jurisdiction?). This section considers IHT and CGT.

84.7.1 *Do Garland trusts confer an interest in possession in settled property?*

The question arises whether a beneficiary of a *Garland* trust should be regarded as having an interest in possession in settled property. (This question does not often matter for IHT for trusts made after 2006.)

"Interest in possession" is a concept of English trust law which has no equivalent in Scots trust law, and maybe in other trust laws. But that does not prevent a beneficiary under a foreign law trust from having an interest which is an interest in possession within the meaning of a UK tax statute. A beneficiary under a Garland trust has an "interest" and if that interest gives an entitlement to income, it is an interest "in possession".

However under a *Garland* trust, a beneficiary does not have an interest *in settled property*. The beneficiary does not have an interest in trust property at all.

In relation to Scots law trusts, the IHT problem is resolved by statute. Section 46 IHTA provides:

> In the application of this Act to Scotland,
> [1] [a] any reference to an interest in possession in settled property is a reference to an interest of any kind under a settlement by virtue of which

[i] the person in right of that interest is entitled to the enjoyment of the property or

[ii] would be so entitled if the property were capable of enjoyment,

[b] including an interest of an assignee under an assignation of an interest of any kind (other than a reversionary interest) in property subject to a proper liferent;

[2] and the person in right of such an interest at any time shall be deemed to be entitled to a corresponding interest in the whole or any part of the property comprised in the settlement.

There is no equivalent provision for CGT (except for proper liferents, which are not trusts). HMRC practice is to treat life tenants in *Garland* trusts as if they had an interest in possession in the settled property. The CG Manual provides:

> **31301 Scottish proper liferents** [October 2007]
> ... There are two ways in which a liferent [ie, life interest] can be set up. In the first case, where the interest is known as an improper liferent, the property is vested in trustees who administer the property and pay the income to the liferenter. In general the trustees have the power to sell the property in question and replace it by other property, whether land and buildings or other assets. On the death of the liferenter the provisions of s.72, s.73 and s.74 TCGA apply as appropriate.

A court applying a purposive approach may well reject as too subtle a distinction between an interest in settled property and an interest under a settlement which is not an interest in settled property. Since this will usually suit taxpayers, it will not often be challenged.

84.7.2 *Reversionary interest in Garland trusts*

Section 47 IHTA provides:

> In this Act "reversionary interest" means a future interest under a settlement, whether it is vested or contingent (including an interest expectant on the termination of an interest in possession which, by virtue of section 50 below, is treated as subsisting in part of any property)...

A beneficiary of a *Garland* trust may have a reversionary interest, within this definition, as although it is not strictly an interest in settled property, it is an interest under a settlement.

84.8 Foundation/*Stiftung*

84.8.1 *Terminology*

This section is concerned with non-charitable foundations, which are long established in Liechtenstein and civil law jurisdictions, and are now established by statute in many if not most tax haven jurisdictions. I focus on Liechtenstein foundations (*Stiftungen*) though I refer at points to other foundations.[43]

Foundation jurisdictions differ widely. One should not assume that foundations in all jurisdictions are so similar that they must be classified in the same way for UK tax purposes, just because they share the same name. One should not even assume that all foundations in the same jurisdiction must be classified the same way, as the drafting of the particular foundation's documentation may make all the difference.[44]

The word "foundation" is sometimes used in the UK as a name for a charity (eg "the British Heart Foundation") but the word has no specific technical meaning in English law. In the USA "private foundation" is a technical term used to describe a specific category of charities and NPOs, in short, those which receive their funds from one person and which are regarded as donor-controlled.[45] I am not concerned with charitable foundations here.[46]

84.8.2 *Is a foundation an IT/CGT settlement, or a company?*

A Liechtenstein foundation normally has legal personality. Biedermann explains:

> Since, in most cases, the Liechtenstein foundation has legal personality, it is subject to the general provisions concerning legal persons and it has a corporate structure with a board of foundation. The *in rem* aspect of

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43 On this topic see Venables, *The Taxation of Foundations* (2010); Easun, "Trusts & Foundations", ITPA Journal Vol 5, No. 3; Baker, "Beneficiaries of Trusts and Foundations" accessible *http://www.taxbar.com/gitc.html*.

44 For instance, an entity which the USA is called a lifetime trust may (depending on drafting) be regarded in the UK as a testamentary disposition and not a trust: see 84.6 (American revocable trust (grantor trust)).

45 See US Internal Revenue Code § 509 (Private foundation defined).

46 For the question of whether foreign charities qualify for UK charity tax reliefs, see Kessler & Marre, *Taxation of Charities and Nonprofit Organisations* (9th ed., 2013) chapter 2 (Definitions of Charity) (online version *http://www.taxationofcharities.co.uk*).

> the beneficial rights under trusts, i.e. non-reachability of trust property by creditors of the trustee, is not necessary for foundations, since the foundation has its own personality. The beneficial rights under a foundation may be less strong, because there is no specific tracing possibility *vis-à-vis mala fide* purchasers and volunteers. However, this deficiency is overcome by the public faith principle, since anyone dealing with a foundation has to look at the objects and competence clause of a foundation in order to know whether a board of foundation is entitled to *e.g.* sell some specific foundation property.[47]

On the evidence of this passage it is considered that property in a foundation is not held "in trust". An essential (or almost essential)[48] characteristic of a trust is that "the assets constitute a separate fund and are not a part of the trustee's own estate".[49] A foundation does not have this characteristic: A foundation holds property, but there is only one fund, not a fund separate from the foundation's own assets (as would be the case for a trustee). So it is not an IT/CGT settlement.

There are of course other significant differences between a Liechtenstein foundation and a trust, in particular the beneficiaries of a foundation have different and somewhat weaker rights. But the failure to meet what the Hague Convention on the law applicable to Trusts identifies as a defining characteristic is crucial.

A foundation is a body corporate.[50] It is therefore a company for UK tax

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47 Biedermann, "Foundations vs Trusts" [1993] PCB 283.

48 It is hard to make any comment about trusts without qualification. A charitable trustee incorporated under s.251 Charities Act 2011 might not constitute a separate fund. But that is an anomalous and unusual case and perhaps itself not a "trust" in the ordinary sense.

49 See Article 2 Hague Convention on the Law applicable to Trusts and on their Recognition. *Lewin on Trusts* (18th ed., 2008) regards the Hague Convention definition as "generally applicable": para 1-01. See too Hayton "Principles of European Trust Law" p.23 in *Modern International Developments in Trust Law* 1999, ed. Hayton: "While many mainland European jurisdictions have the functional equivalent of a charitable purpose trust in the guise of a foundation which has legal personality, we deliberately rejected extending our [conception of] trust to cover such functions. It is because a trust is not a company, not a corporate person, but a segregated fund owned by trustees, that different rules from those for companies developed for trusts."

50 See the quote from Biedermann set out above. The OECD commentary on the Model Treaty article 3(3) agrees: "... the term 'person' includes any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (*fondation, Stiftung*) may fall within the meaning of the term 'person'."

purposes. A foundation is therefore subject to UK corporation tax on its income and gains if it is UK resident and subject to income tax on UK source income at the basic rate if non-resident. The test of residence is the company test of central management and control.

A foundation is usually a close company as:

(1) The members of the board are directors.
(2) The members of the board are participators.
(3) The foundation is under the control of directors who are participators.[51]

However this depends on the constitution of the foundation.

A foundation is a settlement-arrangement[52] so it is a "settlement" for the purposes of s.87 TCGA.

As to whether a foundation is within s.13 TCGA, see 53.8 (Foundations).

84.8.3 *Foreign law views on foundations*

An Austrian Privatstiftung (non-charitable foundation) is classified as a company, not a trust, for the purposes of Canadian tax law:

> [39] ... the law of Austria does not recognize trusts as understood in Canadian law. However, it is evident that as a practical matter (and putting aside for the moment any income tax considerations), Herbert Sommerer may well have achieved many of the objectives that could have been achieved in a common law jurisdiction by settling a trust for Peter Sommerer, his spouse and their children. He did so by creating and endowing the Sommerer Private Foundation under the Austrian Private Foundations Act and naming Peter Sommerer, his spouse, and their children as beneficiaries and ultimate beneficiaries. But that does not mean as a matter of law that the creation and endowment of the Sommerer Private Foundation was the settlement of a trust, or that a trust existed or came into existence when the Sommerer Private Foundation bought the Vienna shares or the Cambrian shares from Peter Sommerer.
>
> [40] As mentioned above, an Austrian private foundation is a juridical person with the legal capacity to own property in its own right and to deal with its property on its own account. The legal right of an Austrian private foundation to deal with its own property is the same as the legal right of a Canadian corporation to deal with its own property. That is so

51 See 85.20 (Control test).

52 Assuming (as will generally be the case) that the bounty test is satisfied; see too 51.2 ("Settlement" and "trustee").

> despite the fact that the board of an Austrian private foundation must manage its affairs in furtherance of the purposes stipulated in its constating documents. The board of directors of a corporation is similarly constrained, in the sense that it must manage the affairs of the corporation in its best interests, subject to any terms and conditions in its constating documents.
>
> [41] A corporation does not hold its property in trust for its shareholders or members, except to the extent that a trust deed or an analogous legal instrument imposes the legal and equitable obligations of a trustee on the corporation with respect to specific corporate property. Assuming it is theoretically possible for an Austrian private foundation to hold its property in trust (that is, subject to conditions that are analogous to the legal and equitable obligations of a trustee in a common law jurisdiction), that possibility cannot be realized unless those conditions are formally established. Nothing in the constating documents of the Sommerer Private Foundation or the law of Austria, ... supports the conclusion that the right of the Sommerer Private Foundation to deal with its property is constrained by any legal or equitable obligations analogous to those of a common law trustee.
>
> [42] Looking at the situation from another point of view, a shareholder or member of a corporation, as such, is not the beneficial owner of any property or the corporation, and has no legal or equitable claim to the corporate property ... a shareholder or member has only an inchoate right to receive distributions of corporate property from time to time at the discretion of the board of directors, and to share in the distribution of the corporate property upon its dissolution. The same can be said of the interest of a beneficiary or an ultimate beneficiary in the property of an Austrian private foundation. Nothing in the Austrian Private Foundations Act or the constating documents of the Sommerer Private Foundation gives Peter Sommerer a legal or equitable claim to the corporate property that is different from that of a shareholder or member of a corporation.
>
> [43] For these reasons, I doubt that the Sommerer Private Foundation holds any of its property in trust for Peter Sommerer.[53]

Similar reasoning applies in the UK.

In the USA, a Luxemburg stiftung is classified for tax purposes as a

53 *Canada v Sommerer* 2012 FCA 207 accessible *http://www.canlii.org*. This adopted the criticism of the first instance decision made in the 2012/13 edition of this work para 79.6.3 (Foreign law views on foundations).

trust.[54] However the USA has statutory rules on entity classification which are different from UK tax law, so the USA material has no relevance in the UK.

84.8.4 *Is a foundation an IHT-settlement?*

Foundation property is normally held "for persons in succession" or "held with power to make payments out of the income". The question is whether a foundation is "governed by provisions equivalent in effect" to a trust. This raises a question of Liechtenstein law as to the effect of a foundation. Lorenz says:

> It now appears that the Liechtenstein Supreme Court has used Liechtenstein trust law as a basis for the development of a coherent pattern of principles applicable to all types of Liechtenstein asset planning devices, in particular foundations and establishments, and not just the trust …
> … the internal design of foundations will increasingly come to resemble that of trusts, and that disputes relating to foundations will increasingly be resolved by applying principles of trust law.[55]

Biedermann says:

> Operationally speaking, there is no difference between a family foundation and a family trust.[56]

HMRC say:

> In case of family foundations, business activity is not permitted. Accordingly, while a foundation has its own legal personality, its essence and purpose is to preserve and maintain assets for the beneficiaries, as is that of a trust.[57]

On the basis of this evidence, it is considered that a foundation is

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54 IRS Memorandum AM2009-012 (Entity Classification of Liechtenstein Anstalts and Stiftungs), October 2009, *http://www.irs.gov/pub/irs-utl/am2009012.pdf*.

55 *Disputes involving Trusts*, ed. Vogt, 1999, p.213.

56 Biedermann, "Foundations vs Trusts" [1993] PCB 283. Noseda makes a similar point: "The Foundations (Jersey) Law 2009: A Civilian Perspective" [2010] The Jersey & Guernsey Law Review 48 at [13].

57 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters, 11 August 2009 *http://www.hmrc.gov.uk/international/joint-declaration-lich.pdf*.

"equivalent in effect" to a trust and is therefore an IHT-settlement. (The contrary argument would focus on the word "equivalent", and state that since there are undoubtedly some differences, the two are not equivalent. The expression "equivalent in effect" is looking at the broad substance rather than absolute equivalence but where to draw the line is hard to tell.)

It is sometimes argued that a foundation cannot be an IHT-settlement if beneficiaries of the foundation have no enforceable rights and no interest in foundation property. But beneficiaries of a *Garland* trust have no interest in trust property. A charitable trust confers no rights at all, and a charitable trust is clearly an IHT-settlement. All that matters is that there is some legal mechanism which recognises their rights and prevents the board of a foundation treating the foundation property as their own.

84.8.5 *Is a foundation an interest in possession settlement for IHT purposes?*

Since a foundation is an IHT-settlement, the question may arise whether a beneficiary's interest under the settlement is an interest in possession. (This question does not often matter for IHT for foundations made after 2006.)

This raises two issues:

(1) What is the test for an "interest in possession". This is a question of UK tax law; "interest in possession" is a technical term of English trust law, and (subject to any particular provisions in the tax statute concerned) it will have its English trust law meaning.

(2) Whether any particular interest meets those requirements; this is a matter of applying Liechtenstein law to the document in question.

An interest in possession is a current right to current income. If a foundation confers such a right, the beneficiary has an interest in possession. Whether that should be regarded as an interest in possession *in settled property* is at first sight more doubtful. As a matter of property law, a beneficiary has no such right, just as a shareholder has no such right. However as "settlement" is given an extended meaning, it is tentatively suggested that the meaning of related expressions such as "interest in possession in settled property" should be given a comparable extended meaning. Thus a beneficiary has an IIP if they have the right to the income of the foundation as it arises.[58]

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58 See 84.7.1 (Do Garland Trusts confer an interest in possession in settled property?).

Whether a beneficiary has the right to income as it arises depends on the drafting (construed in accordance with Liechtenstein law). At the borderline the distinction between IIP and non-IIP trusts is one of form rather than substance, and not appropriate to a foundation which is not even a trust, but merely equivalent in effect. In such cases one can only answer the question on the basis of "doing the best one can" and with the benefit of appropriate foreign law advice.

84.8.6 *Is a foundation transparent for IT purposes; nature of foundation distributions for IT*

The taxation of a UK resident beneficiary on a distribution from a foundation raises interesting and unexplored questions. It is suggested that a receipt from a foundation is classified as an annual payment and not a dividend or other distribution (even though a foundation is a company and not an IT/CGT trust).

If that is right, the position depends on the drafting of the power which the foundation uses to make or authorise the distribution.[59] If the receipt is classified as income, it is classified as an annual payment, like a trust distribution.

Where the terms of the foundation require distributions to a beneficiary, the distributions are income and the question is whether the foundation are classified as transparent under *Baker/Garland* principles.

If the receipt is classified as capital the position is more straightforward as the usual s.731 and s.87 rules will apply.

84.8.7 *HMRC view*

HMRC say:

> ... foundations ("Stiftungen") [are] to be characterised, recognised and treated as *trusts* for UK tax purposes.[60]

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59 See 25.8 (Payment from discretionary trust: income or capital receipt?).

60 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters, 11 August 2009 *http://www.hmrc.gov.uk/international/joint-declaration-lich.pdf*. This is subject to a disclaimer and qualification:

"The Government of the Principality of Liechtenstein has considered and agreed with HMRC the following written guidance and consistent approach on characterisation, recognition and treatment of legal entities and fiduciary relationships for purposes related to the MOU, provided that provisions under

TDSI Guidance Notes (October 2012)[61] para 2.3 provide:

> **Anstalts & Stiftungs**
> [1] Anstalts and Stiftungs are Liechtenstein business entities which are fiscally opaque. ...
> [2] The current HMRC view is that Stiftungs are Trusts for UK tax purposes. For TDSI purposes, the deposit should be considered to belong to the settlor[62] and the TDSI treatment depends on the nature of the settlor – so if the settlor is an individual, BRT [basic rate of tax] must be deducted.
> [3] If the settlor can show that they have not retained an interest, the Financial Institution can treat the Stiftung as an interest in possession trust ... and the TDSI position will depend on the nature of the beneficiary. If the beneficiary is an individual, BRT must be deducted.

Point [3] assumes that a foundation can be transparent for IT which contradicts point [1].

HMRC do not refer to any statutory provisions but are clearly saying that in their view foundations are trusts for all tax purposes. It is true that HMRC recognise that there may be special circumstances, but in the absence of special circumstances, if it suits the foundation to take the view that the foundation is a trust for all tax purposes, including the IT/CGT definition, it could properly do so. That might be relevant, for instance, to obtain the benefit of ESC B18, or if a taxpayer wished to argue that a foundation was an interest in possession trust and transparent for income tax purposes.

Liechtenstein and UK law remain the same as currently as related to such characterisation, recognition, and treatment.
For avoidance of doubt, nothing contained herein is to affect the ability of affected persons to rely on UK law or practice permitting alternative characterisation, recognition and treatment. The parties further recognise that the ultimate UK taxation consequences for UK taxpayers will depend on the particular facts as is the case where UK or other common law entities or fiduciary relationships, such as trusts, are involved."

The same point is made in ToA draft guidance: **INTM600380 - General Conditions All cases: Income becomes payable to person abroad: person abroad - examples** "... Generally we treat ... a Stiftung like a discretionary trust."

61 *http://www.hmrc.gov.uk/taxon/guidance-notes.pdf.* For TDSI (tax deduction scheme for interest) see 18.18 (Withholding tax on interest from deposit-takers).

62 [Author's footnote] It is assumed that the foundation is a settlor-interested trust.

84.9 Dutch Foundation (Stichting)

A note on terminology. The German word *Stiftung* and the Dutch word *Stichting* are both translated by the English word "foundation". However the entities should not be regarded as having the same nature for UK tax purposes. Unless the context makes it clear, therefore, one should ideally not use the word "foundation" without specifying what type(s) of foundation is being referred to. When referring to Dutch entity, I use the word *Stichting* and prefer to avoid *Foundation*.

84.9.1 *Stichting Administratiekantoor (STAK)*

Article 2.285 of the Netherlands Civil Code provides:

> 1. A stichting is a legal person formed by means of a juridical act, that has no members, and that intends to carry out its objects, specified in its articles of incorporation, by using capital (property) which has been brought in for this purpose....
> 3. The objects of a stichting may not include the making of distributions to its founders (incorporators) or to those who are participating in its bodies or to others, except, as regards the latter, when these distributions are made for charitable (philanthropic) or social purposes.[63]

de Vries explains:

> In the corporate environment, as a vehicle for orphan structures, foundations are used to hold the shares in financing bodies. In an estate planning environment or employee benefit scheme the foundation can be a vehicle to hold shares and exercise the voting rights or shares, whereas the economic rights related to the shares are transferred through depository receipts to the beneficiaries. This structure is a popular means to address the fact that the separation of voting rights from economic rights on shares in Dutch limited liability companies is not possible. In such cases the board of directors of the foundation are formed by independent persons (in estate planning structures usually persons trusted by the family) or, for example, the management board of other entities in the structure that holds a larger share of the entity which shares are partly transferred to the foundation. The foundation in these structures is usually referred to as a STAK (*stichting administratiekantoor*). In the field of estate planning, foundations are used to own and manage estates whereby the foundation can have a

63 Netherlands Civil Code, available in English on *http://www.dutchcivillaw.com*.

purpose incorporated in the articles of association comparable to a 'letter of wishes', which mandates the board of the foundation to make funds of the foundation available for certain designated purposes, such as funding the education for certain beneficiaries.

...

On a closer inspection of the legal framework of the foundation, it is seen that a foundation is a separate legal entity under Dutch law, which is formed through the execution of a deed of incorporation by the civil law notary, and managed by its board of directors. The board of directors may consist of private individuals, but can also be legal entities, like other foundations or companies. Like other Dutch legal entities, a foundation can hold assets in its own name, can enter into agreements etc. A foundation must have a specific objective (for example, the financing of the education of family members, the protection of the family wealth, and management of certain assets), to be specified in its articles of association.

...

A further legal characteristic of a foundation is that it does not have members or shareholders, which is sometimes considered slightly odd by practitioners in common law jurisdictions, from the author's experience. The foundation can have beneficiaries, but the distribution prohibition (referred to above) establishes that the beneficiaries cannot be the same as the contributors or members of the board of the foundation (an important difference with the private foundation as indicated above regarding the distribution prohibition). A way to work around the distribution prohibition for a foundation may be to issue depositary receipts (*certificaten*) that give beneficial rights to assets that are legally owned by the foundation. It is common practice that through issuing depositary receipts the voting rights and economic rights of the assets (usually shares) are split: the voting rights of the shares remain with the foundation whereas the economic ownership of the assets rests with the holder of the depositary receipts. As referred to above, such a foundation is referred to as a STAK and is often used for asset protection or estate planning. Further a STAK may be used for employment benefit schemes. A STAK is in principle considered transparent for Dutch income tax purposes, and consequently the owners of the depository receipts will be taxed on income derived from the shares/assets held by the STAK. In the case of estate planning the board of the STAK will often be the parents whereas the depository receipts may be issued to the children. In such a way, the parents have control over the estate and can

decide upon distributions to the children.[64]

A STAK is not an IHT-settlement as there is no element of succession. It is not an IT/CGT settlement as it is not a trust (and if it were a trust, it would be a bare trust). There is usually no element of bounty, in which case it is not a settlement-arrangement.

A STAK is a company for tax purposes. However the more important question is what is the nature of the depositary receipt. It is tentatively suggested that the depositary receipt confers a proprietary interest on the holder and so is transparent.[65] The holder is treated for IT and CGT purposes as entitled to the dividends from the underlying assets held by the STAK. HMRC agree: they classify a Dutch stichting as transparent.[66] HMRC are probably considering a STAK here, though that is not expressly stated.

84.9.2 *Pension fund stichting holding Irish common contractual fund*

The Australian Revenue discuss a Dutch pension fund *stichting*:

Issue

Does Australia have the right to tax Australian sourced business profits that a Dutch Stichting (Stichting) receives as a unitholder in an Irish Common Contractual Fund (CCF), under Article 7 of Schedule 10 of the International Tax Agreements Act 1953 (the Netherlands Agreement)?

Decision

No. Australia does not have the right to tax the Australian source business profits the Stichting receives as a unitholder in a CCF under Article 7 of the Netherlands Agreement.

Facts

The Stichting is a legal entity incorporated in the Netherlands.

The Stichting is a pension fund whose sole purpose is to provide superannuation benefits for non-resident persons upon retirement or death.

The Stichting is exempt from income tax in the Netherlands under the tax laws of the Netherlands.

The Stichting has received a declaration from the Netherlands Inspector of Tax Administration to the effect that it is a resident of Netherlands for tax treaty purposes.

The Stichting is not a resident of Australia for the purposes of Australian tax.

The Stichting does not carry on business through a permanent establishment in Australia.

The Stichting is the only unitholder in an Irish CCF.

Irish CCFs are regulated by the European Communities (Undertakings for Collective

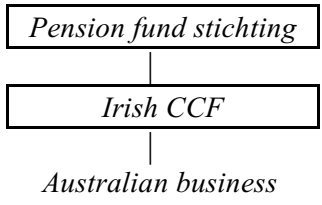
64 De Vries,"The Dutch Foundation" [2011] Journal of International Tax, Trust and Corporate Planning, p.299.

65 See 40.2.4 (Denmark, Germany and the Netherlands).

66 See 84.28 (HMRC official list of transparent and opaque entities).

Investment in Transferable Securities) Regulations 2003 (the Regulations). According to the Regulations a CCF is a contractual arrangement under which participants participate in the co-ownership of assets.
The CCF is not a resident of Ireland or Australia for the purposes of the tax treaty between Australia and Ireland.
The CCF receives Australian source business profits from investing the funds of the CCF.
The CCF does not carry on business through a permanent establishment in Australia.
The relationship between the manager and custodian of the CCF and the Stichting is considered a trust relationship for Australian tax purposes. The manager and custodian are the trustees, and the Stichting is the beneficiary.

I think the last sentence means that a CCF is transparent, which is also the HMRC view. Thus to summarise the structure:



Dutch resident; no Australian PE

Transparent; no Australian PE

Reasons for Decision
[The statement sets out art. 7 (business profits), art. 3 (definition of 'enterprise of one of the States'; these are not set out here as they follow OECD model form.]
Accordingly, for Article 7(1) of the Netherlands Agreement to apply to the Australian sourced business profits derived by the Stichting, the Stichting must be:
· a person
· a resident of the Netherlands, and
· an enterprise.
for the purposes of the Netherlands Agreement.

84.9.3 *Is a stichting a "person" for treaty purposes?*

The Australian Revenue say:

Is the Stichting a 'person' for the purposes of the Netherlands Agreement?
Article 3(1)(d) of the Netherlands Agreement defines the term 'person' to mean 'an individual, a company and any other body of persons'. The term 'company' is defined in Article 3(1)(e) of the Netherlands Agreement to mean 'any body corporate or any entity which is assimilated to a body corporate for tax purposes'. The term 'body corporate' is not defined for the purposes of the Netherlands Agreement, and in accordance with Article 3(3) of the Netherlands Agreement, the term takes its meaning from the tax laws of Australia unless the context otherwise requires.
As there is no definition of the term 'body corporate' under Australia's domestic tax law provisions, the ordinary meaning of the term applies as per tax treaty interpretation principles contained in Taxation Ruling TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements.
The Butterworths Concise Australian Legal Dictionary Second edition defines a body

corporate as 'an artificial legal entity having separate legal personality'.
[The statement sets out Article 285 of the Netherlands Civil Law Code and continues:]
As the Stichting is created under Netherlands law and has a legal personality under Netherlands law, it should be recognised as a legal entity in Australia in accordance with the principle in *Chaff and Hay Acquisition Committee v Hemphill* (1947) 74 CLR 375 (Chaff's Case).
In Chaff's Case, it was found by the High Court that a committee constituted in South Australia under the Chaff and Hay (Acquisition) Act 1944 (SA) was a legal entity despite not being incorporated under South Australian law. Chief Justice Latham found that as the committee was a legal entity in South Australia as distinct from the legal personalities of the natural persons who constitute it, then it is by comity recognised as a legal entity elsewhere. His Honour went on to state (at 384-5) that the same principle applied to the recognition of bodies created by foreign law which have the rights and liabilities distinct from those of the natural persons who constitute them. Justice Starke J further stated (at 388) that 'recognition is given in the case of companies or artificial persons which have come into existence in countries whose law of incorporation is based on principles different from those of England and Australia'.
This principle is also recognised in the Foreign Corporations (Application of Laws) Act 1989. This Act applies in determining a question arising under Australian law where it is necessary to determine the question by reference to a system of law other than Australian law. Section 7(2) provides that any question relating to whether a body or person has been validly incorporated in a place outside Australia is to be determined by reference to the law applied by the people in that place.[67]
As the Stichting is a legal entity created by legal authority in the Netherlands to achieve certain purposes, the Stichting has the features of a body corporate under the ordinary meaning of the term. As such, the Stichting is a 'person' for the purposes of the Netherlands Agreement.

84.9.4 *Is a stichting treaty-resident?*

The Australian Revenue say:

> **Is the Stichting a resident of the Netherlands for the purposes of the Netherlands Agreement?**
> [Article 4 of the Netherlands Agreement provides:
> "For the purposes of this Agreement, a person is a resident of one of the States ... (b) in the case of the Netherlands, if the person is a resident of the Netherlands for the purposes of Netherlands tax but not if he is liable to tax in the Netherlands in respect only of income from sources therein."]

The Australian Revenue treat this issue briefly:

> The Stichting here has received a declaration from the Netherlands Inspector of Tax Administration to the effect that it is a resident of Netherlands for tax treaty

67 The same applies in the UK: see Dicey, Morris & Collins, *The Conflict of Laws* (15th ed., 2012), para 30R-009 (Status).

purposes. The Stichting therefore satisfies this requirement.

Article 4 of the Netherlands Agreement was not the OECD model form definition of residence, so the position may be different under UK tax law.

84.9.5 *Is a stichting an enterprise?*

The Australian Revenue say:

Is the Stichting an enterprise for the purposes of the Netherlands Agreement?
The High Court in *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338; (1990) 21 ATR 531; 90 ATC 4717 considered the meaning of the expression 'the profits of an enterprise of one of the contracting states' in the Business Profits Article of the tax treaty between Australia and Switzerland.
Chief Justice Mason and Justices Brennan and Gaudron stated:

> this statement recognises that an activity, as well as a framework within which activities are engaged in, may constitute an "enterprise" for the purposes of the Agreement. Moreover, we agree with Sheppard J. in thinking that an enterprise "may consist of an activity or activities and be comprised of one or more transactions provided they were entered into for business or commercial purposes": (1988) 21 FCR 122 at p.146.

In carrying out the activities of a pension fund, the Stichting is considered to constitute an enterprise as the activities it conducts are entered into for business or commercial purposes.
Conclusion
Accordingly all the necessary elements of Article 7(1) of the Netherlands Agreement are satisfied by the Stichting in order for the taxing rights of the Netherlands and Australia to be determined under Article 7(1) of the Netherlands Agreement.
The Stichting does not have a permanent establishment in Australia and Article 7(1) of the Netherlands Agreement provides a residence-only taxing right to the Netherlands over the business profits of the Stichting. Accordingly, Australia, as the country of source of the business profits, does not have a right to tax the business profits under the Netherlands Agreement.[68]

84.10 Liechtenstein *Anstalt* (Establishment)

Liechtenstein Companies House explains the nature of an anstalt.[69] TDSI Guidance Notes (October 2012)[70] para 2.3 provide:

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68 ATO ID 2008/62 (April 2008) accessible *http://law.ato.gov.au*

69 *http://www.llv.li/pdf-llv-aju-hr-merkblatt_zur_neueintragung_einer_anstalt.pdf* See too "Half Trust, Half Company, All Anstalt" Bulletin for International Taxation, 1999 (Volume 53), No 8.

70 Accessible *http://www.hmrc.gov.uk/taxon/guidance-notes.pdf*. For TDSI (tax deduction scheme for interest) see 18.18 (Withholding tax on interest from deposit-takers).
The same point is made in ToA draft guidance: **INTM600380 - General Conditions All cases: Income becomes payable to person abroad: person abroad - examples**

> **Anstalts & Stiftungs**
> Anstalts ... are Liechtenstein business entities which are fiscally opaque. The current HMRC view is that Anstalts should all be dealt with as if they are companies. For TDSI, this means that Anstalts should receive gross interest.

Despite this statement, and classification in the official list as "opaque", HMRC practice has not always been consistent.[71] The Liechtenstein disclosure facility takes a different approach:

> 1) An establishment ("Anstalt") in Liechtenstein to be characterised, recognised, and treated for UK tax purposes as follows:
> a) An establishment that according to its articles is permitted to undertake a business activity ("*nach kaufmännischer Art geführtes Gewerbe*"), and therefore is obliged to have an audit, to be characterised, recognised, and treated for UK tax purposes as a *company.*
> b) An establishment that according to its articles is *not* permitted to undertake a business activity ("*nach kaufmännischer Art geführtes Gewerbe*"), and therefore is *not* obliged to have an audit, to be characterised, recognised, and treated for UK tax purposes as follows:
> i) *An establishment with founder's rights or shares* to be characterised, recognised and treated as a *company*.
> ii) *An establishment with no founder's rights or shares* to be characterised, recognised and treated as a *trust.*
>
> For avoidance of doubt, in case of an establishment with founder's rights as used above, the founder (settlor) with founder's rights has full powers to decide upon who the beneficiaries are and to change the beneficiaries, and such powers are transferrable.[72]

In the USA, a Luxemburg anstalt is classified as a company for tax purposes.[73] However the USA has statutory rules on entity classification

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"... Generally we treat an Anstalt like a company..."

71 Private correspondence.

72 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters Signed on 11 August 2009 *http://www.hmrc.gov.uk/international/joint-declaration-lich.pdf.* This statement is subject to a disclaimer and qualifications set out at 84.8.7 (HMRC view).

73 IRS Memorandum AM2009-012 16 October 2009 (Entity Classification of Liechtenstein Anstalts and Stiftungs) *http://www.irs.gov/pub/irs-utl/am2009012.pdf.*

which are different from UK tax law, so the USA material has no relevance in the UK.

84.11 Liechtenstein Treuunternehmen

This entity is modelled on the US Massachusetts business trust.

The Liechtenstein disclosure facility records the HMRC view:

> 2) A trust enterprise ("Treuunternehmen") in Liechtenstein to be characterised, recognised, and treated for UK tax purposes in an analogous way as an establishment.[74]

This is controversial.

84.12 Liechtenstein Treuhandschaft

HMRC say:

> Trusts ("Treuhandschaften") ... [are] to be characterised, recognised and treated as *trusts* for UK tax purposes.[75]

84.13 Other Liechtenstein entities

The Liechtenstein disclosure facility provides:

> 1) The European Union harmonised company forms, such as "Aktiengesellschaft" or "AG"; "Gesellschaft mit beschränkter Haftung" or "GmbH"; "Societas Europaea" or "SE", to be characterised, recognised and treated as a *company* for UK tax purposes.
> 2) Entities formed as "Kommanditgesellschaft" or "KG" or "Kollektivgesellschaft" to be characterised, recognised and treated as a *partnership* for UK tax purposes.

84.14 Legal life interest (Northern Ireland)

A Northern Ireland legal life interest is rare in practice, except in home made wills. The CG Manual provides:

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74 See above footnote.

75 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters, 11 August 2009 *http://www.hmrc.gov.uk/international/joint-declaration-lich.pdf*. This statement is subject to a disclaimer and qualifications set out at 84.8.7 (HMRC view).

> **31303 Northern Ireland** [October 2007]
> The land law of Northern Ireland, except where there is specific legislation to the contrary, is basically the same as the pre-1925 law of England & Wales. Accordingly it is possible to have a legal interest 'limited for life'. Under Section 43(5) IHTA 1984 in such a situation the property is deemed to be settled property.

This is correct. Section 43(5) IHTA provides:

> In the application of this Act to Northern Ireland this section shall have effect as if references to property held in trust for persons included references to property standing limited to persons...

The Manual continues:

> There was no comparable provision for CGT until Section 63A TCGA 1992 was enacted in FA 2006 with effect from 6 April 2006. Under this provision where a person with a legal interest limited for life dies, a person who acquires in fee simple or fee tail in possession as a consequence of the former person's death is deemed to acquire all the assets forming part of the property at market value at death. This does not apply to land in Ireland outside Northern Ireland.

Section 63A TCGA provides:

> (1) The provisions of this Act, so far as relating to the consequences of the death of a person to whom property in Northern Ireland stands limited for life ("the deceased"), shall have effect subject to the provisions of this section.
> (2) A person who acquires property in fee simple absolute or fee tail in possession as a consequence of the deceased's death shall be deemed to have acquired all the assets forming part of the property at the date of the deceased's death for a consideration equal to their market value at that date.

This confers a tax free uplift on death[76] but does not make the legal life interest into a settlement for IT/CGT purposes. Thus if the life tenant and the remainderman sell their interests:

(1) the relief in s.76 TCGA does not apply.

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76 This applies even if the life interest is not an estate IIP: the drafter of the 2006 reforms overlooked Northern Ireland life interests.

(2) the life tenant may qualify for CGT private residence relief but the remainderman will not qualify (unless they occupy the property as their main private residence, which would not be usual). The relief in s.225 TCGA will not apply.

In practice, if private residence relief may apply, it is better to create a classic settlement and not a legal life interest because then the property can be sold during the lifetime of the life tenant free of CGT.

84.15 Proper liferent (Scotland)

84.15.1 *Scots law background*

The CG Manual explains the Scots law background:

> **31301 Scottish proper liferents** [October 2007]
> In Scotland the expression 'liferent' is used to describe the situation where the income from particular property is to be paid to a person, the liferenter, for a specified period, generally his or her lifetime. At the end of the period the property will generally pass to a person known as the fiar.
> There are two ways in which a liferent can be set up ... In the second case, the title to heritable property (land and/or buildings) is held by the liferenter. In this situation he or she is a proper liferenter. A proper liferenter cannot dispose of a greater title than his own. He cannot dispose of the property in his will. On his death the property passes to the fiar.
> Where property in Scotland passes to a person for life under a will, and there is no suggestion that it is to be held by trustees, he has a proper liferent.

A proper liferent is rare in practice. I discuss it here because (aside from the intrinsic interest of the questions which arise) that sheds light on the treatment of civil law usufructs.[77] A proper liferent may be regarded as a Scottish version of the usufruct. Erskine states:

> The only one of these servitudes which has been received into our law,

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77 See *Stronach's Exrs v Robertson* [2002] SC 540 at p.553: "Liferent and fee is a form of land tenure fairly infrequently used in the 21st century. We agree with the sheriff that its lack of popularity might well be attributable, at least in part, to the fiar's inability to control the actings of the liferenter during the currency of the liferent." Note that a trust is significantly different on this point.

is usufruct; which is defined by the Romans, a right which one has to use and enjoy a subject during life, without destroying or wasting its substance; which definition is well enough adapted to the nature of our liferents.[78]

84.15.2 *CGT treatment of proper liferent*

The CG Manual provides:

> **31301 Scottish proper liferents** [October 2007]
> ... A proper liferent does not make the relevant property settled property [for CGT].

That is correct: a proper liferent is not a trust.[79] The Manual continues:

> Section 43(4)(c) IHTA 1984 provides that it is settled property for IHT purposes. TCGA does not go so far, but Section 63 provides that the person entitled to possession on the death of a proper liferenter shall be deemed to have acquired all the assets forming part of the property at their market value at death.

Section 63 TCGA provides:

> (1) The provisions of this Act, so far as relating to the consequences of the death of a proper liferenter of any property, shall have effect subject to the provisions of this section.
> (2) On the death of any such liferenter the person (if any) who, on the death of the liferenter, becomes entitled to possession of the property as fiar[80] shall be deemed to have acquired all the assets forming part of the property at the date of the deceased's death for a consideration equal to their market value at that date.

The Manual concludes:

> The disposal or termination of a proper liferent may qualify for private

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78 Institute II, Title IX, 39, However the Stair Memorial Encyclopaedia, Vol. 13, para. 1601 cites this passage from Erskine and says: "The historical development of liferents awaits examination. It is not clear whether the concept of liferent derived directly from the Civilian usufruct or was an indigenous - if analogous - concept which was subsequently identified by later writers as being the Civilian usufruct. The prevalence of the non-Civilian terminology of 'fee' and 'liferent' is perhaps evidence in favour of the latter possibility."

79 For the same reason a proper liferent was not regarded as settled property for Estate Duty purposes: *Dymond's Death Duties* (15th ed., 1973) p.303.

80 Some databases erroneously read "heir".

residence relief under section 222 TCGA as it is an interest in land.

As in Northern Ireland, this confers a tax free uplift on death[81] but it does not make the proper liferent a settlement for CGT purposes.

Thus if the liferenter and the remainderman sell their interests:

(1) The relief in s.76 TCGA does not apply.

(2) The liferenter may qualify for CGT private residence relief but the remainderman will not qualify (unless they occupy the property as their main private residence, which would not be usual). The relief in s.225 TCGA will not apply.

In practice, if CGT private residence relief may apply, it is better to create a classic settlement and not a proper liferent, because then the property can be sold during the lifetime of the liferenter free of CGT.

84.15.3 *IHT on proper liferent*

The IHT Manual provides:

> **16071 Introduction** [February 2006]
> The original view was that a proper liferenter was beneficially entitled to the property which was the subject of the liferent and that a proper liferent was a "settlement" within the meaning of [s.43 IHTA 1984] with the result that the liferenter fell to be treated as beneficially entitled to the settled property.[82]
> However the Board were advised that a proper liferenter was beneficially entitled only to his right to the liferent and not to the property itself so that on the death of a proper liferenter the liferenter was beneficially entitled to the liferent and not to the capital in which it subsisted. It follows that on the death of the liferenter the value to be placed on the proper liferent was nil.
> **16072. IHT position** [November 2013]
> Section 93 FA 1980 [now s.43(4)(c) IHTA] brought proper liferents into line with the settled property regime of the [IHTA] ...

Section 43(4) IHTA provides:

> In relation to Scotland "settlement" also includes...

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81 This applies even if the liferent is not an estate IIP: the drafter of the 2006 reforms overlooked Scottish liferents.

82 This is considering a pre-2006 liferent, which would have conferred an estate interest in possession.

(c) any deed[83] creating or reserving a proper liferent of any property whether heritable or moveable (the property from time to time subject to the proper liferent being treated as the property comprised in the settlement);

Section 47 IHTA provides:

> In this Act "reversionary interest" ... in relation to Scotland includes an interest in the fee of property subject to a proper liferent.

Lastly, for completeness, s.142(7) IHTA provides that for the purposes of s.142 IHTA (deeds of variation):

> In the application of subsection (4) above to Scotland, property which is subject to a proper liferent shall be deemed to be held in trust for the liferenter.

84.16 Usufructs

84.16.1 *The property law background*

A discussion of the law(s) of usufructs[84] is not possible here. In outline, Article 578 of the French Code Civil provides:

> An usufruct is the right to enjoy property belonging to another, as if its owner, at the expense of preserving that property.[85]

The owner of the right is called "**the usufructuary**" and the owner of the property subject to the right is here called "**the encumbered owner**". (I think this is a clearer term than "bare owner" which would be a more literal translation of the French term *nu-propriétaire*.)

84.16.2 *Is a usufruct an IT/CGT settlement?*

The CG Manual provides:

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83 Section 43(4) provides an artificially wide definition: "for the purposes of this subsection "deed" includes any disposition, arrangement, contract, resolution, instrument or writing."

84 I do not distinguish here between usufructs under different civil law jurisdictions, but it is possible that there are material differences; I would be grateful for the comments of any reader with expertise in these areas.

85 *L'usufruit est le droit de jouir des choses dont un autre a la propriété, comme le propriétaire lui-même, mais à la charge d'en conserver la substance.* The Code Civil is accessible in French on *http://www.legifrance.gouv.fr*.

> **31305 Other interests** [October 2007]
> ... A usufruct governed by French law would be regarded as a non-trust arrangement as it is broadly similar to a Scottish proper liferent.

This is clearly right. Thus if the usufructuary and the encumbered owner sell their interests:

(1) The relief in s.76 TCGA does not apply.
(2) The usufructuary may qualify for CGT private residence relief but the encumbered owner will not qualify (unless they occupy the property, which would be unusual). The relief in s.225 TCGA will not apply.

There is no CGT uplift on the death of the usufructuary.[86]

The result is a CGT discrimination against usufructs.[87] If the usufruct is in an EU jurisdiction, this discrimination is very difficult to justify, and it is suggested that an uplift on death should be available under EU law principles, and, arguably, private residence relief on a sale during the lifetime of the usufructuary.

If an individual creates a usufruct under which they retain an interest, this is a part disposal for CGT purposes as s.70 TCGA (transfers into settlement) does not apply. Some foreign tax laws (eg France) have rules to value the interests of the usufructuary and the encumbered owner for foreign tax purposes, but those rules do not apply for UK tax purposes, so the usual market value rules must be applied.

84.16.3 *Is a usufruct an IHT-settlement?*

HMRC say:

> HMRC has always been of the view that the definition of a settlement in section 43(2) IHTA 1984 means that a usufruct will more than likely fall to be treated as a settlement for Inheritance Tax purposes; although HMRC recognises that the arrangements differ between jurisdictions and the circumstances of each need to be considered. The effect is to

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86 A Scottish proper liferent qualifies for the CGT uplift on death, and there is similar provision for Northern Ireland: s.63, 63A TCGA. However s.63 provision will not apply to a foreign law usufruct unless the phrase "proper liferenter" is construed to include a usufructuary in non-Scottish laws, which is a strained construction and inconsistent with the heading to the section ("Death: application of law in Scotland").

87 It is not possible to avoid this problem by creating a classic settlement instead of a usufruct, because civil law systems do not usually recognise trusts; even if a trust is theoretically possible, it is probably not practical for tax reasons or because it raises too many uncertainties.

> treat a usufruct as giving rise to an interest in possession in the property concerned.[88]

The question is whether, under the law of the usufruct, "the administration of the property is for the time being governed by provisions equivalent in effect to those which would apply if the property were held on trust for persons in succession." There is an element of succession, but there are important differences. There is no settled property and no trustees.[89] A usufruct is more like a lease for life or a legal life interest than a classic settlement. Overall it is sufficiently unlike a trust that it is suggested that the two should not be regarded as equivalent in effect, so it is not an IHT-settlement.[90]

It might be said that there would be an anomaly if:

(1) a usufruct is not an IHT-settlement; but
(2) a proper liferent in Scotland (which is a usufruct or usufruct-like entity) is an IHT-settlements.

But the boot is on the other foot: if a usufruct were an IHT-settlement, there would have been an anomaly under the legislation between the introduction of CTT in 1975 and the enactment of (what is now) s.43(4)(c) IHTA, during which time a proper liferent was not an IHT-settlement. The enactment of a provision dealing with Scots law liferents should not affect the position of foreign law usufructs.

HMRC newsletters are a useful means of addressing mundane administrative matters. The reader may think that a HMRC statement on the inheritance taxation of usufructs should have been fully explained, with reference to the relevant UK and foreign law sources.[91] It would also have benefited from consultation before the announcement. But there it is.

84.16.4 *IHT position if a usufruct is an IHT-settlement*

HMRC say:

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88 HMRC, Trusts and Estates Newsletter (April 2013) *http://www.hmrc.gov.uk/cto/newsletter-apr13.pdf*

89 See too 51.2 ("Settlement" and "trustee").

90 This issue does not arise for proper liferents (Scotland) or legal life interests (Northern Ireland) since the last paragraph of the definition dealing with provisions "equivalent in effect" only applies to non-UK legal systems.

91 The Australian revenue practice is exemplary: see for instance 84.9.2 (Pension fund stichting holding Irish common contractual fund).

> [1] Prior to March 2006, the consequence of [the HMRC view that a usufruct was an IHT-settlement] was that a usufruct retained by the transferor did not give rise to a loss to their estate as the transferor remained beneficially entitled to the property under section 49(1) IHTA 1984. The property would continue to form part of the transferor's estate on death. If the usufruct was created in favour of another, the transaction would give rise to a potentially exempt transfer equal to the value of the property concerned and if in favour of the spouse/civil partner, exemption under section 18 IHTA 1984 would be available. HMRC is not aware that this approach was ever challenged.
> [2] Post March 2006, the consequences are rather different and
> [a] the creation of a usufruct will now give rise to an immediately chargeable transfer equivalent to the value of the property concerned and to relevant property.
> [b] It may give rise to a reservation of benefit in the property.
> [c] If the usufruct is in favour of the spouse/civil partner, [IHT spouse] exemption will no longer be available.
> [3] These changes are the natural consequence of the changes made to the Inheritance Tax treatment of settled property in 2006. Whilst the Inheritance Tax consequences of creating a usufruct over property are now much less favourable, HMRC remains of the view that, generally, a usufruct should be treated as giving rise to a settlement for Inheritance Tax purposes.[92]

Para [2] (although it does not say so) is considering the IHT consequences of a lifetime creation of a usufruct by a UK domiciled individual. The author has not thought very deeply about the IHT issues.

If a usufruct is an IHT-settlement, there would in principle be charges to IHT on the following occasions:

(1) On the creation of the usufruct.
(2) On ten-year anniversaries.[93]
(3) On the death of the usufructuary.

The property may qualify as excluded property, depending of course on the domicile of the settlor (and, if a spouse has an initial estate IIP, the domicile of the spouse).

DT relief will sometimes be available.

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92 HMRC, Trusts and Estates Newsletter (April 2013) *http://www.hmrc.gov.uk/cto/newsletter-apr13.pdf*

93 Not for a usufruct created on death, which will qualify as an IPDI.

A common case is where an owner of property ("S") creates a usufruct under which S is the usufructary and a child is the encumbered owner. If the usufruct is an IHT-settlement, and S is UK domiciled, then:

(1) S makes a transfer of value equal to the value of the property.[94]
(2) The gift is a PET so far as attributable to the child's reversionary interest.[95]

That is so absurd as to make one question whether the analysis that a usufruct is an IHT-settlement can be correct.

(3) The gift is not a gift with reservation as the donor enjoys no benefit from the property given away (the reversion). The pre-owned asset rules need consideration.
(5) The interest of the encumbered owner is a reversionary interest and so in principle excluded property, which is advantageous if the encumbered owner is UK domiciled.
(6) The IHT spouse exemption would in principle be available on the creation of a usufruct on death, which is advantageous.

So depending on the circumstances it will sometimes be in the taxpayers' interest to accept the HMRC view, and sometimes to challenge it.

84.16.5 *Commentary*

There are two problems: (1) the question whether a usufruct is an IHT-settlement is not clear; and (2) if it is an IHT-settlement, the IHT treatment is absurd. The second problem cannot be solved unless one addresses the mess which is the Inheritance Taxation of trusts.[96] In the absence of such a reform, the second best course would be to solve the first problem (and avoid the second) by a provision (in my view confirming the existing law) that a civil law usufruct is not an IHT-settlement. Then at least taxpayers would know where they stand. The problem of transitional rules for existing usufructs would be tricky.[97]

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94 See s.3(1) IHTA; the value of the usufructuary's interest is disregarded as an interest in possession in settled property: s.5(1)(a)(ii) IHTA.

95 See s.3A(1)(c) and 3A(2)(a) IHTA. The interest of the encumbered owner (the child) is excluded property but nevertheless it forms part of their estate (except on death).

96 As to which, see Kessler, "The Quest for Fair Inheritance Taxation of Trusts" (October 2012) accessible *http://www.kessler.co.uk/wp-content/uploads/2012/10/JK4393-Lecture-Trust-tax-reform-5.pdf*

97 Section 93(4) FA 1980 (turning Scottish proper liferents into IHT-settlements) offers a precedent.

I suspect that only EU pressure could give sufficient impetus to yield reform on this point.

The conclusion to draw for practical purposes is that UK domiciled individuals should not create a usufruct, except:

(1) by will; or
(2) if the value of the property falls within the nil rate band(s) of the owner(s); or
(3) if DT relief is applicable.

84.17 Société civile and société en nom collectif

The former International Tax Handbook provided:

> **304. Company and partnership distinguished**
> A company, therefore, acts for itself and not as agent or representative of its members. When profits arise they arise to the company and not to the shareholders. The shareholders have no right to them as profit. The rights of the shareholders include the right to a dividend when formally declared. In a partnership, on the other hand, each partner is the agent of the other partners. The profits arise to each partner according to the provisions of the partnership agreement. It is the existence of that agency relationship which distinguishes a partnership from a company. It is broadly true to say that a partnership does not have, as a company does, distinct legal persona but the presence of legal persona is not in itself conclusive. In Scotland a partnership is a distinct legal entity but there is, at the same time, an agency relationship between the firm and its members and between its members. That agency relationship is the hallmark of partnership and characterises the Scots partnership as a partnership rather than as a company. Considerations of this sort are important when dealing with some unfamiliar European company cum partnership creations. The French Société Civile is one such body and the Société en nom Collectif is another. Broadly speaking we regard the first as a company the second as a partnership. Both have legal personality but in the former case the profits arise to the body itself and in the latter case we take the view that the profits arise to the partners.
> ...
> **1673. Establish facts**
> The first stage is one of factual enquiry and in relation to any appeal procedure is a matter for the Appeal Commissioners. It can be a difficult stage – even for trained Revenue lawyers. Experts have been known to differ and in a case about these bodies *Dreyfus v IRC* 14 TC 560 we

think the Commissioners came to a wrong decision and we do not follow the Courts ruling. The case involved a French SNC and the Courts said it was a company, being guided by the Commissioners' finding of fact about foreign law. We – after listening to expert advice – think it analogous to a partnership. This question of foreign law is difficult. Where the foreign law is a common law it will often share basic concepts with English law and that eases things a little. But if the foreign law is a civil law – a written code of law – the chances of a communications gap developing between a foreign expert adviser and an English lawyer seeking his advice are much greater.

There are no hard and fast rules governing this question of foreign law; every association has to be considered separately and in the light of its Articles of Association or equivalent code. We look for indicators as to whether the Association carries on the business itself or whether the participators do so jointly; and whether the profits accrue directly to the participators or whether they accrue to the Association which then distributes them to the participators. These conclusions should then help us decide whether the members of the Association are carrying on a trade, profession or vocation solely or in partnerships and, if so, whether the income is immediately derived by the member from the carrying on of that trade.

84.17.1 *Société civile immobilière*

The Employment Income Manual provides:

> **11371 Homes outside the UK owned through a company: General background** [January 2009]
> ...Meaning of company
> Company is defined in section 992 ITA 2007 as any body corporate or unincorporated association other than a partnership, a local authority or a local authority association. This wide definition is not restricted to companies registered in the UK and includes a number of entities formed under foreign law through which individuals may acquire homes outside the UK. Such entities will generally be classified as opaque for UK tax purposes. Examples include the ownership of a home in France through a "Societe Civile Immobiliere" (SCI) or in the United States through a Limited Liability Company (LLC).

The view that a SCI is a company for UK tax purposes is controversial.[98]

98 See Frimston and Urquhart, "La Vie en France" Taxation, 13 Jun 2002 (Vol 149, Issue 3861), p.296.

A société civile is classified as a partnership in the UK/France IHT DTA.[99] The introduction of benefit in kind foreign homes relief and the France/UK DTA have made the issue somewhat less important but it still matters.

The issue arose in *Joseph Carter v Baird* 72 TC 303 where a company sold land and purchased a SCI. The company claimed roll-over relief which only applied on a purchase of land. The company failed since it acquired an interest in the SCI and not land. Unfortunately the question of whether an SCI was transparent for CGT was not argued and the necessary expert evidence was not put to the general commissioners. (The litigant appeared in person and was not represented by counsel). The case therefore has no authority at all, and on another occasion there is nothing to stop a taxpayer putting forward the argument for transparency, properly supported by evidence.

84.18 Jersey general and limited partnerships

A Jersey general partnership is transparent.[100]

HMRC classify a Jersey limited partnership as transparent in the official list.

84.19 Foreign limited liability partnership

References to a LLP in UK legislation are references to UK incorporated LLP (unless the context otherwise requires).[101] It is considered that the statutory rules which (generally) make a UK LLP transparent for tax purposes[102] do not apply to a foreign LLP.

HMRC agree. Business Income Manual provides:

> **82145 Limited Liability Partnership: International aspects** [December 2013]
> *UK branches of overseas LLPs*
> The tax treatment of a UK branch of an overseas LLP, and the members

99 See 69.6.2 (Treaty situs: France and Italy). See too John Avery Jones "Characterisation of Other States' Partnerships for Income Tax", [2002] BTR at p.425.

100 *Padmore v IRC* 62 TC 352; see Jersey Law Commission "The Jersey Law of Partnership" (consultation paper, 2008) para 21.12 ("Viewed as a whole, in fact the law of partnership of [England and Jersey is] essentially the same...").

101 See 41.8.1 (Definition of LLP).

102 See 41.8 (Limited liability partnership); 82.34.3 (Situs of LLP).

> of such a LLP, depends on how the foreign entity is regarded for the purposes of the UK taxation provisions. Where the foreign LLP is regarded as a 'body corporate' for the purposes of the UK Taxes Acts the profits of the UK branch will be chargeable to CT. On the other hand if it is regarded as a partnership then members are separately liable to Income Tax on their share of the branch's profits under the legislation for partnerships. The Limited Liability Partnership Act 2000 only applies to UK registered LLPs.

This discrimination would however be in breach of EU law so foreign LLPs, in Member States at least, may be treated as transparent.

HMRC classify a Jersey LLP as opaque in the official list. This is controversial.[103] However the issue seems unimportant because (partly as a result of the HMRC view and partly due to burdensome Jersey law requirements) only 14 Jersey LLP have been registered at present.[104]

84.20 Hindu undivided property

The CG Manual provides:

> **31305 Other interests** [October 2007]
> ... a case involving Hindu Undivided Property would be regarded as a discretionary trust rather than an unincorporated association.

84.21 Japanese tokkin

HMRC regard a tokkin as transparent. The INTM provides:

> **355160 Claims by Japanese "Tokkin" funds** [February 2006]
> 'Tokkin' is an abbreviation of 'tokutei kinsen', and means 'designated monetary trust'.
> Cash or other assets for this type of fund are deposited by the investor(s) with a trustee who manages them on behalf of the investor(s), and in accordance with his/her/their instructions. The tokkin is set up and managed under the terms of a written agreement between the parties, drawn up under Law No 62 of 21/4/1922 of Japan.
> Because the Dividends and Interest Articles of the convention provide for relief **only to the beneficial owner** (INTM332000) of the income, claims in respect of income paid to tokkin funds **must** be made by the

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103 Walker, "Limited Liability Partnerships: True Partnerships" [1998] JLR 1 argues that a Jersey LLP is a partnership in the ordinary sense of the word. In *R v IRC ex p. Bishopp* 72 TC 322 the Court was asked but refused to decide the point.

104 *https://www.jerseyfsc.org/registry/documentsearch* accessed 18 June 2014.

beneficial owner of the tokkin (the 'investor(s)'above), and **cannot** validly be made by the tokkin's manager.

So if you see a claim or supporting voucher which makes any reference to tokkin, you should ensure that you consider only claims made by the beneficial owner, that is, the **original investor**, in respect of his/her/their share in the tokkin.

There is no reason why a single investor should not own **all** the funds in a tokkin, but you should make certain that your claim has been made by the beneficial owner and not by the trustee, or an investment manager.

The original investors/beneficial owners may be either individuals or companies.

But it should be clear in either case that **no** relief can be due to the tokkin **itself**.

84.22 Korean Hapja Hoesa

The Australian Revenue have guidance on this subject:

Classification of a Korean Hapja Hoesa for Australian income tax purposes

Issue

Is the Korean Hapja Hoesa a company pursuant to the definition within section 995-1 of the Income Tax Assessment Act 1997 (ITAA 1997)?

Decision

Yes. The Korean Hapja Hoesa is a company within the meaning of section 995-1 of the ITAA 1997.

Facts

The Hapja Hoesa is a legal form of corporation, which may be established under the Korean Commercial Act (Commercial Act). The Hapja Hoesa is also a private equity fund which is regulated by the Korean Indirect Investment Asset Management Business Act (IIAMBA).

In essence, the Hapja Hoesa is an unlimited investment specialty vehicle that is established for the purpose of investing the assets of the entity into the shares or equity of other entities - with the purpose of increasing the value of such entities through participation in the management of the entities or improving the business structure or control structure of the entities. The Hapja Hoesa may be used only for private equity investment purposes.

Currently under Korean legislation, a Hapja Hoesa has the following features:

- a Hapja Hoesa is incorporated, and is formed by registering its incorporation (Article 144-5(2) of the IIAMBA; Article 172 of the Commercial Act);
- a Hapja Hoesa has a legal personality that is separate from the members (Article 171(1) of the Commercial Act);
- a Hapja Hoesa does not have partners, it has members (Article 268 of the Commercial Act);
- a Hapja Hoesa has members with limited liability and members with unlimited liability (Article 144-3 of the IIAMBA; Article 268 of the Commercial Act);

· a Hapja Hoesa has articles of incorporation (Article 144-5 of the IIAMBA; Article 178 of the Commercial Act);
· a Hapja Hoesa exists for a specific term, which must be specified in the articles of incorporation, but after the term expires, the Hapja Hoesa may continue with consent of all or some members (Article 144-5(1) of the IIAMBA; Article 229 of the Commercial Act);
· a member's interest in a Hapja Hoesa is referred to as a share (Article 197 of the Commercial Act);
· in order to transfer their share in the Hapja Hoesa, a member needs the consent of other members (Article 197 of the Commercial Act);
· members can transact with the Hapja Hoesa (Articles 199 and 275 of the Commercial Act);
· subject to limitations for Limited Liability Members, members are jointly and severally liable if assets of the company are insufficient to satisfy its obligations (Articles 212 and 279(1) of the Commercial Act);
· distributions by the Hapja Hoesa are referred to as 'dividends' (Article 279(1) of the Commercial Act).

The articles of incorporation of this particular Hapja Hoesa include the following terms:

· a Limited Liability Member may not transfer any part of their interest in the Hapja Hoesa without the consent of all Unlimited Liability Members;
· an Unlimited Liability Member may not transfer any part of their interest without the consent of all members;
· a Limited Liability member may not withdraw from the Hapja Hoesa without transferring their interest, and the transfer of an interest requires the consent of all Unlimited Liability Members;
· a member does not have a right to a distribution of distributable cash. Instead, a resolution of members is required before any profits can be distributed;
· meetings of the Hapja Hoesa will be convened by the Manager or on request of members;
· a member has one vote per unit of their interest in the Hapja Hoesa;
· members may pass resolutions on dissolution of the Hapja Hoesa; extension or reduction in the term of the Hapja Hoesa; approval of distributions;
· business cannot be transacted at a meeting of the Hapja Hoesa unless a quorum is present;
· the Hapja Hoesa will be dissolved on expiration of its term; with a resolution of the Members; on bankruptcy or insolvency; on an order of the court; or if the Korean Financial Supervisory Commission denies or cancels registration.

Reasons for Decision

'Company' is defined in section 995-1 of the ITAA 1997 as:

(a) a body corporate; or

(b) any other unincorporated association or body of persons;

but does not include a partnership or a non-entity joint venture.[105]

As the term 'body corporate' is not defined in Australia's income tax legislation, the

105 The same applies in the UK; see 84.4 (Meaning of "company").

ordinary meaning of the term applies. The Butterworths Concise Australian Legal Dictionary Second edition defines a body corporate as 'an artificial legal entity having separate legal personality'.

Being an entity that was created by registration, and that has separate legal personality, the Hapja Hoesa is a 'body corporate'. Consequently, it will be a company under paragraph (a) of the definition of 'company' in section 995-1 of the ITAA 1997, providing that it is not also a partnership.

Section 995-1 of the ITAA 1997 defines 'partnership' as:

(a) a body of persons (other than a company or limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly; or
(b) a limited partnership.

The Hapja Hoesa has some features commonly associated with a partnership, and some features associated with a company.

The following features favour characterisation of this particular Hapja Hoesa as a company.

· a resolution of members is required before profits can be distributed. This indicates that profits belong to the Hapja Hoesa, and that the members are not in receipt of income jointly;
· distributions are referred to in the Commercial Act as 'dividends' rather than as a share of profits;
· the Hapja Hoesa was formed by registration of its incorporation, whereas a partnership is generally formed by a partnership agreement between the partners;
· the Hapja Hoesa has members rather than partners;
· the Hapja Hoesa has articles of incorporation, and not a partnership agreement;
· the Hapja Hoesa has a form of perpetual succession. It will not terminate on the withdrawal of a member, as is the case with a partnership. Instead, it will continue until the occurrence of one of the events specified in its articles of incorporation.

The features which favour characterisation of this Hapja Hoesa as a partnership include:

· to withdraw from the Hapja Hoesa a Limited Liability Member in effect needs the consent of all Unlimited Liability Members;
· members' interests are not freely transferable; in order to transfer their share in the Hapja Hoesa, a member needs the consent of other members.

The predominance of characteristics favours classification as a company rather than a partnership. Further, as the Hapja Hoesa does not have partners who carry on its business or who receive income jointly, it is not a partnership for the purpose of the definition of 'partnership' or 'company' in section 995-1 of the ITAA 1997.

As the Hapja Hoesa is a body corporate and not a partnership, it follows that it is a company within the meaning of section 995-1 of the ITAA 1997.[106]

It is considered that the same reasoning should apply in the UK.

84.23 Dutch bewind

Kortmann and Verhagen say:

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106 ATO ID 2010/27 (28 January 2010) accessible *http://law.ato.gov.au*

> The *bewind* cannot be characterised as a trust in the sense of Article 1 of the Principles. A trust in the sense of the Principles only exists in situations where the trustee legally owns the assets to be managed, which is not so in the case of *bewind*. In the case of *bewind* the beneficiary is legal owner of the assets to be managed. There are, however, restrictions on the beneficiary's right to dispose of the assets placed under *bewind*. Either the legal owner cannot dispose of these assets at all, or he can only do so subject to the *bewind*. The *bewindvoerder*, as the administrator is usually called, acts in the case of *bewind* only as agent for the owner of the assets (the beneficiary). Because the assets to be managed are not legally owned by the *bewindvoerder*, the assets remain unaffected by the bankruptcy of the *bewindvoerder*.[107]

On this basis it is considered that a bewind is a bare trust.[108]

84.24 Netherlands Fonds voor gemene rekening (closed funds for mutual account)

In 2010 the UK and the Netherlands reached the following agreement regarding the application of the UK/Netherlands DTA to investors in closed funds for mutual account *fonds voor gemene rekening* ("closed FGR"):

> This Agreement applies to closed FGRs formed in conformity with the Decree of 11 January 2007, CPP2006/1870M, Dutch. Gov. Gaz. No 15, 2007. A closed FGR can act as a pooled investment vehicle for the assets of pension funds and other investors. The closed FGR invests these assets on behalf of those investors.
> The competent authorities of the Netherlands and the UK agree that a closed FGR[109] is fiscally transparent.
> A closed FGR can also consist of several closed FGRs as described in par. 4 of the Decree of 11 January 2007, CPP2006/1870M, Dutch. Gov. Gaz. No 15, 2007. Such an umbrella fund is also fiscally transparent.

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107 Hayton, Kortmann and Verhagen, *Principles of European Trust Law, Law of Business and Finance* Vol 1,(1999) p.199. Similarly Gretton "Trusts Without Equity" (2000) 49 Int'l & Comp. L.Q. 599: "Though it functions as a trust, the *bewind* is not a trust, for a simple reason: the location of legal title is the reverse of the trust."

108 See 84.5 (Bare trusts/nomineeships).

109 [Footnote original] Various translations of 'Fonds voor Gemene Rekening' are possible, such as 'fund for mutual account' or 'fund for joint account'.

> Since a closed FGR is fiscally transparent, all income and gains derived by the fund from the fund assets are allocated to the investors in the closed FGR in proportion to their participation in the fund.
> *Request for application of the benefits of a Convention on behalf of the participants*
> A closed FGR which is established in the Netherlands and which receives income arising in the UK may itself, represented by its fund manager or its depository, in lieu of and instead of the investors in the closed FGR, claim the benefits of an agreement for the avoidance of double taxation to which the UK is a party and which is applicable to those investors on behalf of those investors in the closed FGR.
> Such claims may be subject to enquiry and, where requested, a fund manager or depository shall provide relevant information which may include a schedule of investors and allocated income relevant to a claim.
> A closed FGR may not make a claim for benefits on behalf of any investor in the closed FGR if the investor has itself made a claim for benefits in respect of the same income. If a closed FGR intends to make a claim for benefits on behalf of an investor, the fund manager or its depositary should clearly communicate this to the investor to avoid duplicate claims in respect of the same income.
> This Agreement shall be subject to regular review.

84.25 US S-Corps and LLCs

In UK law the terms "company" and "corporation" are used more or less as synonyms (the latter word having perhaps slightly grander overtones). But in US law, a corporation and a limited liability company are different types of entity.

84.25.1 *LLCs: US company law background*

I take the US company law background from Field, "Checking in on Check-the-Box" 42 Loy. L.A. L. Rev. 451 (2009):[110]

> In 1977, in an effort to develop a vehicle that provided owners corporate-like protection from liability for the entity's debts while attempting to achieve pass-through tax treatment under the Kintner regulations, the Wyoming legislature enacted the country's first legislation authorizing LLCs. LLCs combined very desirable characteristics- "limited liability for all members, partnership features

110 *http://digitalcommons.lmu.edu/llr/vol42/iss2/4*. I omit some footnotes for reason of space.

such as dissolution at will and lack of free transferability, and members' ability to participate in control without risking loss of their limited liability." ...

In 1988, the IRS finally resolved the issue of the tax classification of an LLC formed under Wyoming's LLC statute.[111] In a published revenue ruling, the Service concluded that any LLC formed under Wyoming's LLC statute to carry on a business and divide the gains therefrom would necessarily (by virtue of the terms of the LLC statute itself) lack the corporate characteristics of continuity of life and free transferability of interests, and therefore would be classified as a partnership for federal tax purposes. The Service reached this conclusion despite the fact that "neither the managers nor the members of [the LLC] are personally liable for [the LLC's] debts and obligations.

After this IRS pronouncement clarifying the federal tax classification of LLCs, demand for LLCs grew rapidly, and states quickly began enacting their own LLC statutes. Some of these state statutes, like Wyoming's LLC statute, were "bullet-proof," causing any LLC formed thereunder to necessarily lack at least two corporate characteristics, thereby automatically resulting in partnership classification.[112] Other state statutes were sufficiently flexible so as to allow the LLC to qualify as either a partnership or a corporation for federal tax purposes, depending on the terms of the specific LLC agreement.[113]

This flexibility afforded under some state LLC statutes "highlight[ed] the failure of the resemblance test.[114] One commentator explained that, "[p]ractically speaking, there is no difference between a closely-held entity that is organized as an LLC and one that is organized as a corporation .... Left unchanged, two very different tax regimes will govern entities with almost identical management and perhaps even

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111 [Footnote original] Rev. Rul. 88-76, 1988-2 C.B. 360.

112 [Footnote original] See, e.g., COLO. REV. STAT. ANN. §§ 7-80-101 to -1101 (West Supp. 1994); MICH. CoMP. LAWS ANN. §§ 450.4101-.5200 (West 1994); NEV. REV. STAT. ANN. §§ 86.011-.571 (West 1994); S.D. CODIFIED LAWS §§ 47-34-1 to -59 (1994); VA. CODE ANN. §§ 13.1-1000 to -1073 (West 1993); W. VA. CODE §§ 31-1A-1 to -69 (Cum. Supp. 1994).

113 [Footnote original] See, e.g., DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1992); MO. STAT. ANN. §§ 359.70-908 (West 1994) (both allowing flexibility regarding transferability of interests and centralized management). See generally Robert R. Keatinge et al., The Limited Liability Company: A Study of the Emerging Entity, 47 BUS. LAW. 378, 425-30 (1992) (discussing the application of the Kintner factors to LLC statutes from various states); Miller et al., supra note 14, at 586-600 (discussing "bullet proof' versus flexible LLC statutes).

114 [Footnote original] Hobbs, supra note 21, at 517.

> similar financial structures."[115] The failure of the corporate resemblance test was also illustrated by professional corporations and limited partnerships, which are also business organizations that could be classified for tax purposes as partnerships under the corporate resemblance test while retaining significant corporate features like limited liability.[116] Moreover, given the bright line rules set forth in the Kintner regulations and the flexibility afforded under the applicable state business statutes, practitioners were often able to create LLCs and other business entities with a carefully tailored set of rights and responsibilities so as to achieve tax classification as either a corporation or a partnership, as desired by the client, while retaining significant features of the other classification.[117]

To a UK reader, it seems paradoxical to say that a LLC may be a partnership for tax purposes; but only if one forgets that company in foreign law may not have the same meaning as company in UK tax law. One must (try to) look at the position unbiased by the terminology.

84.25.2 *Transparency*

The DTR Manual provides:

> **DT19853A United States of America: United States limited liability companies** [September 2011]
> Generally speaking, United States federal income tax is charged on the profits of LLCs on the basis that they are fiscally transparent, ie tax is imposed on the members of the LLC and not on the LLC itself.
> However, for the purposes of UK tax we have taken the view in relation to those LLCs that we have so far considered that they should be regarded as taxable entities and not as fiscally transparent. Accordingly we tax a UK member of a LLC by reference to distributions of profits made by the LLC and not by reference to the income of the LLC as it arises.

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115 [Footnote original] Id. at 517-18.

116 [Footnote original] Seeid. at 481-510.

117 [Footnote original but abbreviated] *Littriello v. U.S.*, 484 F.3d 372, 376 (6th Cir. 2007), cert. denied, 128 S. Ct. 1290 (2008) ("These unincorporated business entities had the characteristics of both corporations and partnerships, combining ease of management with limited liability, and were increasingly structured with the Kintner regulations in mind, in order to take advantage of whatever classification was thought to be the most advantageous.").

This view was upheld in *Anson v HMRC* where a Delaware LLC, taxed in the US as a partnership, was held to be opaque for IT purposes.[118]

Tax Bulletin 29 also contained a concession but the problem is now dealt with in the 2001 treaty, see 59.15 (US/UK DTA). Also see 84.30.4 (Ordinary share capital: Delaware LLC).

84.25.3 *Treaty-residence of LLC and S-Corp*

The Canadian Revenue Agency say:

> **US S-Corps and LLCs**
> The Department views U.S. S-Corps to be resident in the United States for the purposes of the Convention. This view is based on the fact that they are "liable to tax" under the Internal Revenue Code (IRC) unless they make an election to be treated as a partnership. Furthermore, notwithstanding the election, an S-Corp. would be taxed in the United States on its world-wide income if certain conditions are not met.
> The Department recognizes that the above position is arguably inconsistent with its view that U.S. LLCs are not resident in the U.S. for the purposes of the Convention. [The Department continues to be of the view that a U.S. LLC that is treated under U.S. tax law as a partnership and which is therefore not liable to tax in the United States, is not a resident of the United States for the purposes of Article IV of the Convention.] Possibly if the Department had had the knowledge and experience it now has in the area of residency determination when it formed its opinion regarding the residence of U.S. S-Corps, it may have reached a different conclusion regarding the residence of U.S. S-Corps.
> In the context of the foreign affiliate legislation, a U.S. LLC which is treated as a partnership under the IRC and which is a foreign affiliate of a resident of Canada would qualify as resident in the United States (i.e., a designated treaty country) under paragraph 5907(11.2)(b) of the Income Tax Regulations provided that such LLC was resident only in the United States under the common law test of residency.[119]

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118 [2013] STC 557. This will need to be reviewed when the case is final. The decision concerned only this particular Delaware LLC, and since there is wide freedom to vary the terms of a Delaware LLC, it may not be of general application. However I understand that the LLC did not in fact have any particularly unusual features.

119 *http://www.cra-arc.gc.ca/E/pub/tp/itnews-16/itnews-16-e.html* (The Agency go on to comment on Barbados exempt insurance companies, but that is too specialist to be considered here.) For practice under the USA DTA, see 59.16.3 (US partnerships and LLCs).

84.26 Capital contribution

84.26.1 *Company law background*

Capital contributions are a common method for Delaware companies to raise additional capital. The CG Manual explains the company law background:

> **43500 General** [October 2010]
> The company law provisions of some foreign jurisdictions, notably the USA, provide for the making of capital contributions to companies. A capital contribution is a contribution to the equity capital of a company, but is not made in exchange for shares issued to the contributor and it does not constitute a separate asset in its own right. See INTM503050 where any equity function arguments are raised.
> An overseas company receiving a capital contribution may treat it in a number of ways, depending on the law of the foreign jurisdiction concerned and the conditions attaching to the payment. These may give the company a choice whether to designate the contribution as 'surplus' or as 'capital'. Amounts designated as 'surplus' may be available for distribution to shareholders, subject to solvency requirements. Amounts designated as 'capital' may only be repayable by way of a capital reduction. A company's balance sheet will generally show capital contributions made to it as an item of shareholders' funds separate from paid up share capital. Capital contributions may be described, for example, as 'additional paid in capital'.
> Capital contributions are not recognised under UK company law and if a payment is not made as part of the terms of issue of shares, it is possible it is either a loan or a gift. If a UK taxpayer contends that a sum paid to an overseas company is a capital contribution rather than a loan or gift, evidence to support that contention should be sought.
> For example if a UK company suggests a payment to an overseas affiliate is a capital contribution rather than a loan or gift there should be evidence of the appropriate treatment in the company accounts. If however there is a possibility that the money can be repaid, it is likely to be a debt within the loan relationships regime, see CTM51200. It is therefore necessary to examine all the circumstances surrounding the money transfer before coming to any conclusion as to what the nature of the payment is. If however agreement cannot be reached as to the nature of the payment and therefore the tax consequences (see CG43501 and CG43502 below), the decision lies with the Tribunals and the Courts.
> Occasionally a capital contribution may be made to a UK company. As capital contributions are not a concept formally recognised within UK

company law, a contribution received by a UK company should be reported within distributable reserves either as a gift or possibly a donation. If however it can be repaid in any circumstances it should be considered as a loan falling within the loan relationships regime.

The International Manual also makes some comments:

502050 Issues affecting equity function cases [April 2012]
... Capital contributions
As mentioned in INTM502010, company law provisions of some foreign jurisdictions, notably the USA, allow for the making of capital contributions to companies. A capital contribution is a contribution to the equity capital of a company. It is not a loan and creates no obligation to transfer economic benefit to the maker of the contribution.
In the UK there is no company law provision regarding capital contributions. If a UK company receives a capital contribution it will appear as such on the balance sheet within shareholders' funds. If the company makes a capital contribution, it will normally be included in the accounts as an added cost of investment in a subsidiary.
If a UK company contends that a sum paid to an overseas affiliate is a capital contribution rather than a loan, HM Revenue & Customs can only accept the contention if there is evidence supporting it. For example, there should be a written agreement that a capital contribution has been made rather than a loan, and evidence of the appropriate treatment in the company accounts. If there is a possibility that the money can be repaid, it is a 'money debt' under the loan relationships legislation. It is necessary to examine all the circumstances surrounding the money transfer before making a decision. From HMRC's point of view, the amount contributed should not be distributable.

In *Fenston v HMRC* [2007] STC (SCD) 316 the position was explained as follows:

... assuming that at all relevant times the assets of the Company exceeded its liabilities, ... as a result of the Contributions, the state of the Company's stock changed in the sense that the amount of funds distributable with respect to the Shares as a dividend or upon liquidation was increased by the amount of the Contributions.
Under Delaware law, the funds available for payment of dividends, if and when declared by a corporation's board of directors, are payable out of "surplus". 8 Del. C.§ 170. "Surplus" is defined in relation to "capital". "Capital" with respect to no par stock, such as the Shares, is defined as that portion of the consideration received by a corporation for the issued shares of its capital stock that the directors determine to be capital, or if

no such determination is made, the amount of consideration received. 8 Del. C. § 154. The excess, if any, at any given time, of the net assets of the corporation over the amount so determined to be capital shall be "surplus". 8 Del. C. § 154. "Net assets" means the amount by which total assets exceed total liabilities. 8 Del. C. § 154. Therefore, the "surplus" of a corporation is an amount equal to the total assets of the corporation, minus the total liabilities of the corporation, minus the capital of corporation, minus the total liabilities of the corporation, minus the capital of the corporation (as just described). Here, the Contributions increased the Company's net assets, and thus its surplus, thus increasing the amount of funds the Company could lawfully have distributed to the trustees (as stockholders) as a dividend.

With respect to entitlement to distributions on dissolution, when a corporation dissolves, its assets are held in trust for the benefit of creditors, and if creditors are paid in full, the stockholders. Accordingly, when a corporation dissolves it must first pay or provide for its creditors, both fixed and contingent, in full before any distribution can be made to stockholders. However, once creditors are paid or provided for, any residual assets are to be distributed to the corporation's stockholders. 8 Del. C. § 281. As described above, the Contributions increased the Company's total assets. If the Company had been dissolved immediately after such Contributions had been made (which the trustees, as the sole stockholders, could have done pursuant to Section 275(c) of the General Corporation Law, 8 Del. C. § 275(c), then the amounts the trustees (as stockholders) would have been entitled to receive as stockholders upon dissolution with respect to the Shares would [have] been increased by the amount of the Contributions assuming, in each case, that amounts would remain for distribution to the stockholders following the payment in full of the Company's creditors.

Therefore, the Contributions would have increased the amounts that could have been distributed with respect to the Shares either as a dividend or as a liquidating distribution.'

84.26.2 *Capital contribution: Tax analysis*

The CG Manual then turns to the tax analysis:

43501 Made under terms of share issue [February 2006]

A shareholder may make a capital contribution to a company at the same time as the shareholder acquires shares in the company. If the capital contribution is made as part of the terms of issue of the shares, then the capital contribution should be accepted as consideration given wholly and exclusively for the acquisition of the shares within TCGA 1992, Section 38(1)(a). If a capital contribution is made as part of the terms of

a share issue which is treated as a reorganisation for capital gains purposes, then the capital contribution should be accepted as consideration given for the new holding for the purposes of TCGA 1992, Section 128(1). The amount of the capital gains deduction will remain subject to the other general rules, such as TCGA 1992, Section 17 and TCGA 1992, Section 128(2), see CG14530+ and CG51840+-

So far the law is fair. However the Manual continues:

43502. Other contributions not allowable [January 2008]
Where shares are disposed of in a company to which a capital contribution has been paid a claim may be made for a deduction in respect of that contribution in the capital gain computation. The claim will normally be for the contribution to be allowable as enhancement expenditure under Section 38(1)(b) TCGA 1992.
Although a capital contribution will typically affect the value of the shares in the company to which the contribution is made, it does not represent either
[1] expenditure on the shares,[120] or
[2] expenditure reflected in the state or nature of the shares at the time of their disposal.
The Special Commissioners decision in the case of *The Trustees of the F. D. Fenston Will Trusts v HMRC* (SpC589/07) confirmed that a capital contribution which is not made as part of the terms for the issue of shares is not, in the absence of anything to indicate that the rights and privileges attaching to the shares have been enhanced, an allowable deduction within Section 38 TCGA 1992 when shares in the company are disposed of. In particular, the capital contribution does not represent enhancement expenditure within Section 38(1)(b) TCGA 1992.
In applying this decision it may be argued there are circumstances were the tax result will be distorted if the amount of tax payable takes account of value realised, directly or indirectly, by a shareholder from a capital contribution, but the capital contribution itself is not reflected in allowable expenditure for capital gains purposes. Below are some examples where such distortion may be alleged.[121]
[1] A capital contribution is returned by a company to its shareholders as a dividend or distribution and they are taxed on the distribution but

120 Author's footnote: Point [1] is wrong and directly contradicted by the decision in *Fenston* but it would be sufficient if HMRC are right on point [2].

121 Author's footnote: "Distortion" is a euphemism for unfairness, and "alleged" is tendentious since the unfairness of [2] and [3] is obvious and undeniable.

> the shareholder will have had no deduction for the contribution. Our view is that a dividend or distribution is paid out of the surplus of the company so therefore is not a direct return of the capital contribution paid by the shareholder (in which case it is probably a loan). The nature of the receipt is changed when a dividend or distribution is made in comparison with the time when the capital contribution was paid.
>
> [2] A capital contribution is retained by the company at a time when there is a sale of shares in the company. The contribution may be reflected in an increased consideration for the disposal of the shares but a capital gains deduction will not be given.
>
> [3] There is similar scope for distortions where a capital contribution is followed by a share exchange, reconstruction or amalgamation treated as a share reorganisation for capital gains purposes, see CG52500+. This is then followed by a disposal of the new holding for an amount which reflects the capital contribution made to the company in which the original shares were held, and the capital contribution is not allowable expenditure on the original shares.
>
> In these last two cases, unless the capital contribution resulted in a change in the rights and privileges attaching to the shares, and that change is reflected in the nature of the shares at the time of their disposal, it is not an allowable deduction within Section 38(1)(b) TCGA 1992 when those shares in the company, or replacement shares in that or a different company acquired by virtue of a share reorganisation are disposed of.

Section 38(1)(b) TCGA allows a deduction for:

> the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal ...

In *Fenston*, the Special Commissioners correctly held that the capital contribution was expenditure "on the asset for the purpose of enhancing the value of the asset." Unfortunately they held that the expenditure was not reflected in the state or nature of the asset at the time of the disposal:

> 23 ... [1] Further, 'state and nature' for these purposes must be something other than merely the value of the asset—otherwise this phrase would add nothing to the immediately preceding words.
>
> [2] In this case the capital contributions did not result in any increase in the number of shares in issue, or result in any change in the rights or restrictions attaching to the shares. The only effect of the capital

> contributions was to increase the surplus of the company—which would increase the amount available for distribution to shareholders, and therefore presumably the value of the shares. We do not consider this sufficient for the expenditure on the capital contributions to be reflected in the state and nature of the shares, either at the time the expenditure was incurred or at any time subsequently.

Point [1] is wrong[122] and point [2] is not in the least convincing. It is considered that the decision ought not to be followed, though a taxpayer who challenges it risks litigating to the Court of Appeal.

The CG Manual discusses the possibility of relief under the last part of s.38(1)(b) TCGA which allows a deduction for "expenditure wholly and exclusively incurred by them in establishing, preserving or defending his title to, or to a right over, the asset."

> There may also be cases where companies call on their shareholders to provide further capital to meet a specified purpose, in circumstances where a shareholder who fails to provide the additional funds may lose the entitlement to the shares held. In this situation, depending on the particular facts, the shareholder may be able to establish that the additional payment represents expenditure on preserving or defending the title to the shares within the terms of Section 38(1)(b) TCGA 1992.

84.26.3 *Planning implications*

The tax planning advice is that companies should if possible be funded by subscriptions for shares or loans, and not by capital contributions, because the expense of the capital contributions will in most cases be disallowed for CGT purposes (or else the taxpayer will have to litigate to a high level to obtain them).

The HMRC view that "If there is a possibility that the money can be repaid, it is likely to be a debt" mitigates some of the unfairness of the treatment of capital contributions by reducing the number of occasions where a transaction is categorised as a capital contribution.

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122 The words "reflected in the state or nature of the asset" are needed to cover this situation: suppose T spends £x on a kitchen in T's home. 15 years later the kitchen is replaced by a new kitchen. The £x was "incurred on the asset for the purpose of enhancing the value of the asset" but was not "reflected in the state or nature of the asset" at the time of disposal. In this case it is sensible to disallow the capital expenditure in a CGT computation.

84.26.4 *Commentary: Fairness and the tax system*

Fenston raises an interesting question of policy, leaving aside the narrower legal question of whether it was rightly decided by the Tribunal. Assuming this was an issue where two views of a legal provision were possible, it was a case where one view lead to a fair and sensible result - tax on an economic gain. The other view lead to a patently unfair result. There can be no doubt about that.

(1) Adopting the traditional view summarised in the slogan that "there is no equity in a taxing statute" a tax administration would be expected to take any point. The only criterion is the prospect of success in a court:

> The Inland Revenue is not slow - *and quite rightly* - to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue.[123]

(2) The more modern view pays much more regard to fairness and "the right amount of tax." On this view the appeal should not have been taken, and the decision to take the appeal is greatly to be regretted. One might perhaps adopt the view that fairness applies in favour of HMRC but not the taxpayer; but no-one has had the temerity to advocate that.

Of course the consequence of unfair taxation may be to some extent to increase the tax yield, but unfair tax law has an intangible cost in that it brings the UK tax system into disrepute. There seems no prospect of legislative reform, indeed such reform would difficult to draft. This is another reason for hoping that an appeal will eventually overturn *Fenston:* that would restore credibility to the UK tax system. But there it is.

84.27 USA limited partnership

The Australian Revenue have guidance on this subject:

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123 *Ayrshire Pullman Motor Services v IRC* 14 TC 794. (The passage is well known for the rhetoric that immediately preceded this: "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores.")

US Limited Partnership: whether it is a company for the purposes of Article 10 of the US Convention

Issue

Is a United States (US) limited partnership (US LP), which is treated as a partnership for US federal tax purposes, a company for the purposes of Article 10 of the Convention between Australia and the US contained in Schedules 2 and 2A to the International Tax Agreements Act 1953 (the US Convention)?

Decision

No. A US LP which is treated as a partnership for US federal tax purposes is not a company for the purposes of Article 10 of the US Convention.

For the purpose of the US Convention, US LP is neither a 'body corporate' nor 'an entity which is treated as a company or body corporate for tax purposes'. Consequently it is not a company for the purposes of Article 10 of the US Convention, and does not qualify for either of the reduced rates for certain cross-border inter-corporate dividends flowing between Australia and the US.

Facts

US LP is a limited partnership established under US (Delaware) state law (the Delaware Revised Uniform Limited Partnership Act (DRULPA)).

A limited partnership under the DRULPA is formed upon the execution and filing of a certificate of limited partnership under section 17-201 of the DRULPA.

As a limited partnership formed under the DRULPA, US LP is an unincorporated hybrid business entity having features commonly associated with both a business carried on by partners as partners and with a company.

The DRULPA does not incorporate a limited partnership, nor does it provide that a limited partnership is a body corporate.

US LP is a separate legal entity, and exists as such until cancellation of the certificate of limited partnership under paragraph 17-201(b) of the DRULPA. Section 15-201 of the DRULPA also provides that US LP has separate legal personality distinct from its partners.

US LP is 'for all purposes a partnership', per section 15-202 of the DRULPA.

US LP is treated as a partnership (and so is fiscally transparent) for US federal tax purposes and not as a taxable unit.

All income derived by US LP is subject to US tax in the hands of its US resident partners. All partners are US resident corporations.

US LP is a 'person' under Article 3(1)(a) of the US Convention.

US LP is a 'resident' of the US for tax treaty purposes within the meaning of Article 4(1)(b)(iii) of the US Convention, because Article 4(1)(b)(iii) treats a US partnership as a US resident for tax treaty purposes to the extent that the income it receives is subject to US income tax either in its hands or in the hands of a partner.

US LP is not treated as a company by the US for tax treaty purposes because it is treated as a partnership for US federal tax purposes.

US LP owns all the shares in an Australian resident company. During the income year the Australian resident company paid an unfranked dividend (not assessable income and not exempt income) to US LP, which was legally and beneficially entitled to that dividend.

US LP would be taxed as a company under Australian domestic law (Division 5A of the Income Tax Assessment Act 1936, ITAA 1936) if it derived Australian source assessable income. US LP is not a resident of Australia under section 94T of Division 5A of the

ITAA 1936.

US LP is not a 'foreign hybrid limited partnership' under section 830-10 of the Income Tax Assessment Act 1997 (ITAA 1997) as it is not a CFC (per paragraph 830-10(1)(e)) of the ITAA 1997.

Reasons for Decision

To qualify for benefits under the US Convention the claimant must first be a 'person' and a 'resident' for the purposes of the US Convention. In this case US LP, being a US domestic partnership, is both a 'person' and a US 'resident' according to the terms of the US Convention. Note that the US Convention is unusual in that it applies treaty benefits for income derived through fiscally transparent entities such as a partnership, at the level of the entity (in this instance US LP).

Article 10 of the US Convention provides that certain cross-border inter-corporate dividends flowing between Australia and the US are either:

- subject to a maximum of 5% rate of source country tax if the person beneficially entitled to those dividends is a company which holds directly at least 10 per cent of the voting power in the company paying the dividends (Article 10(2)(a) of the US Convention); or
- exempt from source country tax where the person beneficially entitled to the dividends is a company that has owned shares representing 80 per cent or more of the voting power of the company paying the dividends for a 12 month period ending on the date the dividend is declared, and satisfies certain other conditions (Article 10(3) of the US Convention).

The words of the US Convention are quite specific. For the reduced dividend withholding tax rates under Article 10(2)(a) or Article 10(3) of the US Convention to apply to an unfranked dividend paid by an Australian resident company, the person beneficially entitled to the dividend must be a 'company'. Here, the 'person' beneficially entitled to the dividends paid by the Australian resident company is US LP.

Article 3(1)(b) of the US Convention defines 'company' for the purposes of the Convention 'unless the context otherwise requires', to mean 'any body corporate or any entity which is treated as a company or body corporate for tax purposes'.

Accordingly, for the purposes of our analysis, US LP will be a 'company' for the purposes of the US Convention if:

(a) it is a body corporate; or

(b) it is an entity that is treated as a company or body corporate for tax purposes -

unless the context of the US Convention otherwise requires.

(a) Is US LP a ' company' for the purpose of the US Convention by virtue of being a ' body corporate' ?

US LP is not a 'company' for the purpose of the US Convention by virtue of being a 'body corporate' for Australian purposes.

The term 'body corporate' is not defined in the US Convention. Thus, in accordance with Article 3(2) of the US Convention, the term will generally take its meaning from the taxation laws of the country applying the tax treaty (being in this case Australia), 'unless the context otherwise requires'. As 'body corporate' is not defined in Australia's domestic income tax law legislation, the ordinary meaning of the term in Australia may then apply (see the tax treaty interpretation principles set out in paragraphs 63 to 71 of Taxation Ruling TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements).

The *Butterworths Australian Legal Dictionary*, 1997 defines a 'body corporate' as 'an artificial legal entity having separate legal personality'. The Macquarie Dictionary, Fourth

edition, 2005 defines 'body corporate' in its legal context, as 'a person, association or group of persons legally incorporated in a corporation'. Generally a 'body corporate' is established under an Act of Parliament or under a statutory procedure of registration, such as the Corporations Act 2001 (refer to paragraphs 22-23 of Taxation Ruling IT 2634 and paragraphs 30-34 of Miscellaneous Taxation Ruling MT 2006/1).

As US LP is created under Delaware state law and has a legal personality under that law, it should be recognised as a legal entity in Australia in accordance with the principle in *Chaff and Hay Acquisition Committee v Hemphill* (1947) 74 CLR 375.

While US LP is a legal entity having legal personality, it is essentially quite different in character from the bodies which are incorporated under corporations law in Australia. For example, while a corporation continues in existence until it is dissolved notwithstanding changes in its membership or business, a limited partnership formed under the DRULPA is usually formed for a limited period of time and terminates in the same way as a partnership. A corporation in Australia has perpetual succession, a personality that is continuous and free transferability of interests. US LP does not. Further, the partners of US LP derive the profits made by US LP, and a partner's individual share of the profits in US LP is ascertained in accordance with its interest in US LP, rather than on the basis of distributions made.

Notwithstanding, as US LP is an artificial legal entity having a form of separate legal personality, it is prima facie a 'body corporate' under the ordinary meaning of the term in Australia. Although, generally a 'body corporate' has the 'ability to continue in existence indefinitely and to keep its identity regardless of changes to its membership' (see paragraph 30 of MT 2006/1) and US LP does not enjoy such a continued existence. But, as highlighted above, the requirement in Article 3(2) of the US Convention to in this case interpret an undefined term such as 'body corporate' in accordance with Australian taxation law, applies only if the 'context' does not require an alternative interpretation .... [The statement makes some general observations on treaty interpretation[124] and continues:]

Paragraph 12 of the OECD Commentary on Article 3 emphasises that the interpretation set out in the 'undefined terms' provision applies 'only if the context does not require an alternative interpretation'. It adds that the 'context' is determined in particular by the intention of the Contracting States, as well as 'the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based)'. However, US federal tax law does not specifically define the term 'body corporate'.

In this case, the OECD Commentary on the definition of 'company' is particularly relevant to the context of the term 'body corporate'. Paragraph 3 of the OECD Commentary on Article 3 provides the following:

> 3. The term "company" means in the first place any body corporate. In addition, the term covers **any other taxable unit** that is treated **as a body corporate according to the tax laws** of the Contracting State in which it is **organised**. The definition is **drafted with special regard to the Article on dividends**. The term "company" has a bearing only on that Article, paragraph 7 of Article 5, and Article 16. [Emphasis added]

It follows from the OECD Commentary's statement that the second limb of the term

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124 Referring to TR 2001/13; see 57.6 (Interpretation of DTAs: ordinary meaning & purposive construction) and following paragraphs.

covers any other taxable unit, that the first limb of the definition of 'company' is designed to deal only with entities which are bodies corporate under general law and also taxable units under tax law (which is a central consideration in applying the terms of Australia's tax treaties).

While the requirement for the entity to also be a 'body corporate' for tax law purposes under the first limb is not explicit, treaties should be interpreted more 'liberally' than domestic legislation to smooth over the gaps, imprecision and ambiguities in the treaty text in a way that addresses the context and meets the object and purpose of the treaty... Where the context of a term allows a specific tax law meaning and a non-tax law meaning, the former should prevail (see paragraph 68 of TR 2001/13).

In addition, it is clear from the OECD Commentary on Article 3 that the question of whether a dividend recipient is an entity 'treated as a body corporate' for tax purposes must be made by reference to 'the tax laws of the Contracting State in which it is organised' - and not the state of source. Thus, paragraph 3 of the OECD Commentary on Article 3 provides with regard to the terms 'company' and 'body corporate' that the relevant taxation laws to consider are those of the country in which the entity was created (i.e. being the domestic laws that apply to the entity). The 'context' requires an examination of US taxation law and not Australian taxation law to determine whether a US entity is a 'company' for the purpose of qualifying for the reduced rate of withholding tax on inter-corporate dividends.

Hence, in determining whether an entity is treated as a 'body corporate' for tax treaty purposes, reference is not made to the tax law of the country applying the treaty (in this case Australia), unless the entity was organised there. Specifically, as indicated above, the 'context' surrounding the terms 'company' and 'body corporate' in the US Convention, for the purpose of US LP qualifying for the either of the reduced rates of withholding tax on the unfranked dividends paid by the Australian resident company, requires an examination of US taxation law.

Accordingly, to determine whether US LP is a 'body corporate' under the US Convention, the relevant consideration is where US LP was organised. US LP was not organised in Australia, but in the US. Hence, the potential Australian tax treatment of US LP (that is, that the entity can be treated as a company for Australian tax purposes by virtue of Division 5A of the ITAA 1936) is irrelevant. Rather, only the US tax treatment of US LP is relevant.

US LP is not a taxable unit and so is not treated and taxed as a 'body corporate' for US federal tax purposes - but is treated and taxed as a partnership.

Finally and importantly, paragraph 3 of the OECD Commentary on Article 3 emphasises that the definition of 'company' is '**drafted with special regard to the Article** on dividends' and 'the term "company" has a bearing only on that Article, paragraph 7 of Article 5, and Article 16.'

Paragraphs 10-11 of the OECD Commentary on Article 10 explains the rationale behind reduced taxation rates for inter-corporate dividends as follows:

> 10. On the other hand, a lower rate (5 per cent) is expressly provided in respect of dividends paid by a subsidiary company to its parent company. If a **company** of one of the States owns directly a holding of at least 25 per cent in a company of the other State, it is reasonable that **payments of profits by the subsidiary to the foreign parent company** should be taxed less heavily to avoid recurrent taxation and to facilitate international investment. The realisation of this intention depends on the **fiscal**

> **treatment of the dividends** in the State of which the **parent company is a resident**....
> 11. If a partnership is **treated as a body corporate under the domestic laws** applying to it, the two Contracting States may agree to modify sub-paragraph (a) of paragraph 2 in a way to give the benefits of the reduced rate provided for parent companies also to such partnership. (Emphasis added)

Paragraph 2 of Article 10 of the OECD Model Tax Convention is not materially different from paragraph 2 of Article 10 in the US Convention, with the exception of the differences in the percentage holding thresholds in the respective treaties.

Klaus Vogel on Double Tax Conventions, Vogel, K et al 1997, 3rd edition, Kluwer Law, The Hague, makes the following statements (at pages 583-584 and 599) about paragraph 2 of Article 10 of the OECD Model Tax Convention:

> Art. 10 is still completely geared to the 'classical' system of company taxation... and is, consequently, based on the conception that it is appropriate to subject income derived by a company (within the meaning of Art. 3(1)(b)MC) to a tax of its own distinct and separate from the tax imposed on the distributions received by a company's shareholders ... the maximum rates on inter-company dividends should differ from those on 'all other' dividends.... Such preferential treatment, however, applies only where direct investments are held by companies and does not apply where a substantial interest is held by an individual or a partnership....
>
> If, under the law of its State of residence, a partnership is considered a body corporate, but is ... not itself subjected to tax ... there would be no justification for allowing it to benefit from the limited rate of 5 per cent, because its interposition actually does not result in any double taxation.

It is apparent, from all of the above, that the intention of Article 10(2) of the OECD Model Tax Convention is to provide reduced rates of withholding tax for dividends derived by companies from direct investments on a reciprocal basis. It would be contrary to the intention of Article 10(2) if the reduced inter-corporate dividend withholding tax rate was to apply where the tax law of the resident country treated the beneficial owner of the dividends as a partnership.

Specifically, in the case of US LP, it would be inappropriate for a partnership formed under US state law and treated as a partnership for US tax purposes, to be able to access the inter-corporate rate of withholding tax for dividends under either Article 10(2) or Article 10(3) of the US Convention. The purpose behind Article 10(2) and 10(3) is to prevent multiple layers of taxation of corporate economic groups. Where the recipient does not have tax imposed (that is, because it is treated as a partnership in its state of residence), the rationale for granting the reduction in (or exemption from) withholding tax disappears.

The context of Article 10 and the OECD Commentary requires the implicit inclusion in the first limb of the definition of 'company', that a 'body corporate' is a taxable unit under the relevant taxation laws. Further, the relevant taxation laws are clearly the domestic laws affecting the entity - that is, those laws under which the entity is organised or created.

US LP is not a taxable unit and not a 'body corporate' for US tax purposes. Therefore, US LP does not satisfy the first limb of the meaning of the term 'company' in Article 3(1)(b) of the US Convention. It follows that US LP will not be a 'company' for the purposes of Article 10 of the US Convention by virtue of being a 'body corporate' for Australian purposes.

(b) Is US LP a ' company' for the purpose of the US Convention under the second limb

of the meaning of the term ' company' - that Is to say, is US LP an entity that is treated as a ' company' or ' body corporate' for tax purposes ?

The OECD Commentary on the definition of 'company' (outlined above) makes it clear that, under the second limb of the definition, the determination is to be made by reference to the laws of the State in which the entity is **organised** (in this case US federal tax law). US LP is not taxed as a 'company' or 'body corporate' for US federal tax purposes. Rather it is treated and taxed as a partnership. This is essentially because, although US LP has a form of separate legal personality under Delaware state law, the US federal tax position is that while state law attributes of an entity control various aspects of business relations, they are not controlling under US tax law (unless the tax law so provides) - see *Morrissey v Commissioner of Internal Revenue*, 296 U.S. 344 (1935); *United States v R Kintner*; 216 F.2d 418 (9th Cir. 1954); *McNamee v Dept of the Treasury*, 2007 U.S. App. LEXIS 12016, 488 F.3d 100, (2nd Cir. 2007).

In general, under the US 'check-the-box' (CTB) Treasury Regulations, any separate business entity other than an incorporated entity may choose its classification for tax purposes. Specifically, US CTB Treasury Regulations §301.7701-2(b)(1) and §301.7701-3(a) do not allow an entity organized under a Federal or State statute, that refers to the organization as 'incorporated', 'corporation', 'body corporate', or 'body politic', to elect its classification. Instead, such an entity is taxed as a corporation; see Checking in on " Check-the-Box", Loyola of Los Angeles Law Review [Vol. 42:451], by Heather M. Field.[125]

The DRULPA does not refer to a limited partnership created under its provisions as 'incorporated', a 'corporation', 'body corporate' or 'body politic' and US LP is not mandatorily taxed as a corporation. Rather, US LP is taxed as a partnership unless it elects to be taxed as a corporation. As no such election was made by US LP, it is not a taxable unit and is not taxed as a corporation under the tax laws of the US.

Hence, US LP is not an 'entity that is treated as a company or body corporate for tax purposes' and so does not satisfy the second limb of the meaning of the term 'company' for the purposes of the US Convention.

Conclusion

For the purpose of the US Convention, US LP is neither a 'body corporate' nor an 'entity that is treated as a company or body corporate for tax purposes'. Consequently it is not a 'company' for the purpose of Article 10 of the US Convention, and does not qualify for either of the reduced rates for certain cross-border inter-corporate dividends flowing between Australia and the US.

This is consistent with the US position for tax treaty purposes which is that a US partnership which does not elect to be taxed as a corporation will not be a 'company' for US treaty purposes. The Issues in International Taxation No. 6 ' The Application of the OECD Model Tax Convention to Partnerships' report includes the US response to the OECD Partnership Report at page 127. This response states that US partnerships (including limited partnerships such as Delaware limited partnerships, but also US LLCs and LLPs) not electing to be treated as corporations are not considered to be companies for the purposes of US tax treaties.

Note. Article 10(2)(b) of the US Convention provides a reduced rate of 15% in some

125 *http://digitalcommons.lmu.edu/llr/vol42/iss2/4*

circumstances, and does not require the recipient of the dividend to be a company. US LP will be entitled to the reduced rate of 15% if it satisfies all of the requirements for that reduction.[126]

84.28 HMRC official list of transparent and opaque entities

The International Manual provides:

> **180020 Considerations when using the List of Classifications of Foreign Entities for UK tax purposes** [April 2012]
> A list of foreign entities where we have been asked our view on the question of transparency/opacity is set out in INTM180030.

I refer to this as "**the HMRC official list**".[127]

> It should be noted that the list only gives our general view as to the treatment of the specified foreign entity. In a particular case regard may also need to be had to:
> (a) The specific terms of the UK taxation provision under which the matter requires to be considered:
> (b) The provisions of any legislation, articles of association, by-laws, agreement or other document governing the entity's creation, continued existence and management, and;
> (c) The terms of any relevant Double Taxation Agreement.
> It should also be borne in mind that in relation to the classifications set out on the list:
> In some instances HMRCs view was given many years ago, and there may have been significant changes in the relevant foreign law which may mean that a different conclusion as to the status of that entity might now be reached. Changes in foreign law after the publication of these instruments may be significant for the same reason. ...
> Where clarification is sought in relation to a foreign entity we will attempt to give a view in particular cases in line with Code of Practice HMRC document CAP 1 (approvals and clearances).

I here set out a combination of two lists: the TB 83 list, together with the additional references in the version of that list in INT Manual 180030 [November 2010].[128]

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126 ATO ID 2010/81, 9 April 2010, accessible *http://law.ato.gov.au*

127 HMRC originally published their views in Tax Bulletin 83 (also called RI 279) but the HMRC website states that this is "superseded by INTM180000".

128 I have restored diacritical marks which HMRC somewhat illiterately omitted in the official list and omit the more obvious abbreviations.

I add an English translation, mainly from the IATE database,[129] which also contains some details about the entities. There are no exact equivalents. A legal concept is not just a word: it is a vast theoretical construction, the world in a grain of sand. Some terms can be brought over into English easily; others require a long explanation. There is not often a single standard or correct translation: the IATE database usually offers several choices. In cases where the foreign entity does not have a close English law equivalent, it would generally be better to use the foreign language term rather than a potentially misleading English translation.

Country/name of entity	**UK tax treatment & date last considered**	**Translation**
ANGUILLA		
Partnership	Transparent Oct 91	
Limited Liability Company	Opaque Jan 08	
ARGENTINA		
Sociedad de responsabilidad limitada	Opaque Jun 58	Limited Liability Company
ARMENIA		
Limited Liability Company	Opaque May 06	
AUSTRALIA		
Limited Partnership	Transparent Sep 07	
Unit Trust	Transparent Apr 07	
AUSTRIA		
Kommanditgesellschaft	Transparent Aug 71	Limited Partnership
Kommandit[130] Erwerbsgesellschaft (KEG)	Transparent Nov 03	Limited Partnership
GmbH & Co KG	Transparent May 02	
Gesellschaft mit beschränkter Haftung (GmbH)	Opaque Nov 05	Limited liability company
Aktiengesellschaft (AG)	Opaque Nov 05	Public limited company
BELGIUM		
Société privée à responsabilité limitée	Opaque Aug 94	Limited liability partnership
Société en nom collectif	Transparent May 92	General partnership
Société Anonyme	Opaque Nov 05	Limited company
Naamloze Vennootschap	Opaque Nov 05	Limited company
Société en commandite[131] par actions	Opaque Nov 05	Co limited by shares
Commanditaire vennootschap[132] op aandelen (CVA)	Opaque Nov 05	Company limited by shares
BERMUDA		
Limited partnership with legal personality	Transparent Dec 07	

129 *http://iate.europa.eu*

130 HMRC original erroneously reads: Kommand.

131 HMRC original erroneously reads: commanditaire.

132 HMRC original erroneously reads: venootschap.

BRAZIL		
Sociedade[133] por quotas de responsabilidade limitada (Srl)	Opaque Jan 77	
Fundo de Investimento en participacoes	Transparent Dec 07	
BVI		
Limited Partnership	Transparent Mar 09	
CANADA		
Partnership and limited partnership	Transparent Nov 05	
CAYMAN ISLANDS		
Limited partnership	Transparent Nov 93	
CHILE		
Sociedad de responsabilidad limitada	Transparent Sep 03	Limited Liability Company
CHINA		
Wholly foreign owned entity	Opaque Oct 05	
CZECH REPUBLIC		
Akciová společnost	Opaque Nov 05	Societas Europaea
Společnost s ručením omezeným	Opaque Nov 05	Limited liability company
DENMARK		
Danske Investingsforening	Opaque Jan 09	
EUROPEAN UNION		
Societas Europeas	Opaque Jul 05	
FINLAND		
Kommandiittiyhtiö (Ky)	Transparent May 91	Limited partnership
Osakeyhtiö (Oy)	Opaque Nov 05	Limited company
Aktiebolag (Ab)	Opaque Nov 05	Limited company
FRANCE		
Groupement d'intérêt économique	Transparent May 88	Economic interest grouping
Société en nom collectif	Transparent[134] Aug 00	General partnership
Société civile immobilière	Opaque[135] Nov 05	Property investment co
Société civile exploitation agricole[136]	Opaque Feb 98	
Société en commandite simple	Transparent Sep 97	Limited partnership
Société en participation	Transparent Jun 92	Special partnership
Société à responsabilité limitée	Opaque	Limited liability company
Fonds commun de placement à risques	Transparent Jan 97	Venture capital mutual fund
Société par actions simplifiée	Opaque Apr 04	simplified joint stock company
Société anonyme	Opaque Apr 04	Company limited by shares

133 HMRC original erroneously reads: Sociedad.

134 See 84.17 (Société Civile and Société en nom collectif).

135 See 84.17 (Société Civile and Société en nom collectif).

136 Tax Bulletin 83 referred to a Société civile agricole which I assume is the same entity.

Groupement foncier d'agricole[137]	Opaque May 01	
Société civile[138]	Opaque Nov 05	Civil society
Société en commandite par action	Opaque Nov 07	limited partnership with a share capital
GERMANY		
Stille Gesellschaft	Opaque Jun 98	Silent partnership
Kommanditgesellschaft[139]	Transparent Feb 97	Limited partnership with share capital
Offene Handelsgesellschaft (OHG)	Transparent Sep 96	General partnership
Gesellschaft mit beschränkter Haftung (GmbH)[140]	Opaque Feb 97	Limited liability company
GmbH & Co. KG[141]	Transparent Feb 97	
GmbH & Co. KGaA[142]	Opaque Apr 08	
Gesellschaft des bürgerlichen Rechts	Transparent Apr 94	Civil law partnership
Aktiengesellschaft (AG)	Opaque Nov 05	Limited liability company
GIBRALTAR		
Limited partnership	Transparent Jan 09	
GUERNSEY		
Limited partnership	Transparent Jan 05	
Protected cell company[143]	Opaque Nov 04	
Open ended investment company with limited liability	Opaque Nov 04	
HUNGARY		
Korlátolt felelösségü társaság	Opaque Nov 05	Limited liability company
Részvénytársaság (Rt)	Opaque Nov 05	Societas Europaea
ICELAND		
Hlutafélag	Opaque Nov 05	Public limited liability co
IRELAND		
Limited partnership	Transparent	
Irish investment limited partnership	Transparent	
Common contractual fund[144]	Transparent Jan 04	
Unit trust	Opaque Aug 08	
ISLE OF MAN		
Limited liability company	Opaque Nov 08	

137 This is a misprint but I do not know what is intended.

138 See 84.17 (Société Civile and Société en nom Collectif).

139 HMRC original erroneously reads: Kommandit Gesellschaft.

140 See 84.30.3 (Ordinary share capital: German GmbH).

141 This is a partnership (KG) with a company (GmbH) as the general partner and the GmbH's shareholders, their families or others as limited partners

142 This is a Kommanditgesellschaft auf Aktien (KGaA) whose *Komplementär* is a company (GmbH).

143 See McCarthy, "Protected Cell Companies and s.13 TCGA" [2009] PCB 316.

144 See 84.9.2 (Pension fund stichting holding Irish common contractual fund).

ITALY		
Società per azioni	Opaque Nov 05	Public limited company
Società a responsabilità limitata	Opaque Feb 08	Private limited company
JAPAN		
Goshi-Kaisha	Transparent Feb 97	
Gomei Kaisha	Transparent	
Tokumei Kumiai	Transparent Nov 05	
Kabushikikaisha[145]	Opaque Nov 05	Joint stock company
Yugen-kaisha	Opaque Nov 05	Limited liability company
JERSEY		
Limited liability partnership[146]	Opaque Feb 01	
Limited partnership	Transparent	
KAZAKHSTAN		
Limited liability company	Opaque Nov 06	
LIECHTENSTEIN		
Anstalt[147]	Opaque Mar 04	Establishment
LUXEMBOURG		
Société en commandite par actions	Opaque Jul 92	Limited partnership with share capital
Fonds commun de placement[148]	Transparent May 05	Mutual fund
Société anonyme	Opaque Nov 05	Co limited by shares
Société à responsabilité limitée	Opaque Nov05	Limited liability company
Société en nom collectif	Transparent Feb 07	General partnership
Société civile	Opaque Dec 07	Civil society
Société d'investissement à capital variable	Opaque Jul 08	Special-purpose fund
MALTA		
Société d'investissement à capital variable	Opaque Jul 08	Special-purpose fund
[Partnership] en nom collectif	Transparent Sep 07	General partnership
Société civile	Opaque Dec 07	**civil society**
NETHERLANDS		
Vennootschap onder firma	Transparent Feb 95	General partnership
Commanditaire vennootschap both "open" and "closed"	Transparent Aug 00	Limited partnership with a share capital
Naamloze vennootschap	Opaque Oct 81	Limited company [149]
Besloten vennootschap met beperkte aansprakelijkheid[150]	Opaque Oct 81	Ltd liability co[151]

145 HMRC original erroneously reads: Kabushiki Kaisha.
146 See 84.19 (Foreign limited liability partnership).
147 See 84.10 (Liechtenstein Anstalt (Establishment)).
148 See 34.3.4 (Luxembourg Fonds Commun de Placement).
149 Literally translated "open corporation"; sometimes translated: public limited liability company.
150 HMRC original erroneously reads: Aansprakelijheid.
151 Literally translated "closed corporation".

Maatschap	Transparent Oct 93	Partnership
Stichting[152]	Transparent Jul 05	Foundation
Cooperatie uitsluiting aansprakelijkheid[153]	Opaque Aug 00	
Cooperatie beperkte aansprakelijkheid[154]	Transparent Sep 08	
Cooperatie wettelijke aansprakelijkheid	Transparent Sep 08	
Besloten fonds voor gemene rekening[155]	Transparent Jan 08	
NEW CALEDONIA		
Société en nom collectif	Transparent Jul 05	General partnership
NORWAY		
Aksjeselskap[156]	Opaque	Limited liability company
Kommandittselskap[157]	Transparent Jan 81	Limited partnership
OMAN		
Limited Liability Company	Opaque Jun 08	
POLAND		
Spólka z ograniczona odpowiedzialnoscia[158] (SP. zo. o)	Opaque Mar 96	Limited company
PORTUGAL		
Sociedade por quotas	Opaque Apr 93	Limited company
Sociedade anónima	Opaque 4/1993	Limited company
RUSSIA		
Joint Venture under "Decree No. 49"	Opaque Jan 93	
Limited liability company	Opaque Nov 03	
SEYCHELLES		
Limited partnership	Transparent Mar 09	
SLOVAK REPUBLIC		
Spoločnost' s ručenim obmedzeným[159]	Opaque Nov 05	Limited liability company
SOUTH AFRICA		
Close Corporation	Opaque Nov 05	
SPAIN		
Fondo de Capital Riesgo	Transparent Dec 08	Venture capital fund
Sociedad Civil[160]	Opaque Dec 80	Civil law partnership
Sociedad Anónima	Opaque Nov 05	Co limited by shares
Comunidad de bienes	Transparent Jun 01	Co-ownership
Sociedad Collectiva	Opaque Jun 08	
Sociedad Civil Professional	Transparent Jun 08	Society

152 See 84.9 (Dutch Foundation (Stichting))..

153 HMRC original erroneously reads: Aansprakelijheid.

154 HMRC original erroneously reads: Aansprakelijheid.

155 See 84.24 (Netherlands Fonds voor gemene rekening (closed funds for mutual account)).

156 HMRC original erroneously reads: Alkjeselskap.

157 HMRC original erroneously reads: Kommandittselkap.

158 HMRC original erroneously reads: Spolkaz ograniczonaodpowiedzialnoscia.

159 HMRC original reads (I think erroneously): Spolocnost's rucenim obmedzenim

160 HMRC original erroneously reads: Civila.

Sociedad Commanditaria Simple	Transparent Oct 07	
Uniones Temporales de Empresas	Transparent Jul 08	
Sociedad de Responsabilidad Limitada	Opaque Nov 05	Limited liability company
SWEDEN		
Aktiebolag	Opaque Nov 05	Limited company
Kommanditbolag	Transparent Oct 05	Limited partnership
SWITZERLAND		
Société simple	Transparent Dec 90	Limited partnership
Gesellschaft mit beschränkter Haftung (GmbH)	Opaque Nov 05	Limited liability company
Kommanditgesellschaft (KG)	Transparent Sep 07	
TURKEY		
Attorney Partnership	Transparent Apr 04	
Anonim Şirket	Opaque Nov 05	Joint stock company
Limited Şirket (Ltd Ş)	Opaque Nov 05	Limited liability company
USA		
Partnership under Uniform Partnership Act	Transparent Sep 83	
Limited Partnership under Uniform Limited Partnership Act	Transparent Aug 00	
Limited Liability Company including New York[161]	Opaque Jun 97	
Limited Liability Partnership	Transparent Dec 99	
Massachusetts Business Trust	Transparent Feb 80	
S. Corporation (S. Corp)[162]	Opaque Jul 05	
Real Estate Investment Trust	Opaque Jun 07	
Limited liability limited partnership under Revised Uniform Limited Partnership Act	Transparent Aug 07	

84.29 Stamp Taxes Manual body corporate list

The former Stamp Taxes Manual offered another list (with some overlap) addressing the question of whether a foreign entity is a body corporate:

> **6.124 Foreign Companies**
> Some foreign companies have been accepted as falling within the term 'body corporate' for the purposes of the intra group relief. The following is a list of examples of foreign bodies accepted by us as falling within the definition of "body corporate" for Section 42 [FA 1930] and Section 151 [FA 1995] purposes:–

Although the list is expressed to be for the purposes of two specific provisions, there is no special definition of "body corporate" in those

161 See 84.25 (US S-Corps and LLCs).

162 See 84.25 (US S-Corps and LLCs).

sections; if an entity is an entity for those purposes, it is a body corporate (and normally a company) for tax purposes generally.

Australia	Private companies which do not need to comply with certain requirements, are known as 'proprietary' companies. Such companies registered in New South Wales are bodies corporate.
Bahamas	Companies described as limited.
Belgium	Société de personnes à responsabilité limitée (descussocies).[163]
Bermuda	Companies described as limited.
British Virgin Islands	A company described as limited and which is incorporated under the Companies Act 243.
Canada	Companies described as limited.
Cayman Islands	Companies described as Ltd.
Denmark	A company described as an A/S.
Finland	An 'Oy' (Osakeyhtiö) is a Finnish limited company which may be public or private.
France	Société Anonyme and Société en commandite par actions.
Germany	Aktiengesellschaft. Gesellschaft mit Beschränkte Haftung. (GmbH) Kommanditgesellschaft[164] auf Aktien. (KGaA)
Guernsey	A company constituted under the laws of Guernsey and Registered before the Royal Court.
Holland	Naamloze Vennootschap. Besloten Vennootschap.
Hong Kong	Companies described as limited.
Irish Minister of State	An Irish minister may be accepted as a parent body corporate for S42 purposes
Italy	Societa per Azioni.
Liberia	Companies described as limited but note that we may require to see the Certificate of Incorporation.
Malaysia	A company which includes the word 'Berhad' as part of and at the end of its name.
Netherlands Antilles[165]	Naamloze Vennootschap.
Norway	Aksjeselskap (et) or Aktieselskap[166] (et). (AS)
Panama	Sociedad Anonima. 'Corp.' 'Inc.' Note that 'Ltd' is not conclusive.
Portugal	A body which is a Sociedade por Quotas.
Saudi Arabia	A company organised pursuant to the laws of the Kingdom of Saudi Arabia has been accepted although it did not have perpetual succession.
Singapore	Companies described as limited.
South Africa	A Company which is 'limited by shares'.

163 "descussocies" is a misprint but I do not know what is intended.

164 HMRC original erroneously reads: Kommanditfellschaft.

165 Netherlands Antilles ceased to exist in 2010 and is now Curaçao and Sint Maarten. The law of the former Netherlands Antilles continues to apply unless and until amended.

166 HMRC original erroneously reads: Aktieselscap.

Spain	Sociedad Anonima and Sociedad de Responsabilidad Limitada.
Sweden	Aktiebolaget (AB) Also The Kingdom of Sweden.
Switzerland	Société Anonyme, Société en commandite[167] par actions and Aktiengesellschaft. A verein.[168]
Trinidad	A company limited 'by shares'.
USA	Corporations (usually described as 'Corporation' 'Company' or 'Incorporated') organised under the laws of various states. Delaware Limited Liability Companies.
Venezuela	Corporations organised under the laws of Venezuela.

84.30 Share capital

84.30.1 *Significance of ordinary share capital*

If an entity issues ordinary share capital, it may be a "75% subsidiary" for tax purposes. It follows that it is possible for the entity to qualify for CGT and IT group reliefs, and to benefit from CGT reliefs for share exchanges.

84.30.2 *When does a body have ordinary share capital?*

HMRC Brief 87/09[169] provides:

Corporation Tax: Meaning of Ordinary Share Capital
HMRC have been asked to provide a list of foreign entities that they consider to have 'Ordinary Share Capital' for the purposes of TA 1988, s 832. Unfortunately as each case will have its own particular set of facts it is not feasible for an exhaustive list to be created, nor, in the context of considering legal systems other than the UK's, that are subject to change, would it be practical to do so.
Set out below is HMRC's interpretation of TA 1988 s 832 and information that, it is hoped, will be useful to companies and advisors, as well as officers within HMRC, in deciding whether a particular non-UK entity has 'Ordinary Share Capital' for the purposes of TA 1988 s 832. Also included below are some details of our position on two of the most often queried foreign entities, the Delaware LLC and the German GmbH.
Please note, this brief only seeks to consider the meaning of 'Ordinary Share Capital' for the purposes of TA 1988 s 832. Specifically, it does not cover the classification of a foreign entity for UK tax purposes (whether it is 'transparent' or 'opaque'). ...
The reader should also note that the Companies Act 2006 received Royal Assent on 8 November 2006 and the Government has announced its intention to commence all parts of the act by 31 October 2008. The DBERR has published an implementation timetable according to which the relevant sections of Part 17, A Company's Share Capital, will come into force on 1 October 2008. This article will be reviewed in due course to ensure it takes account of any necessary amendments due to legislative changes.

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167 HMRC original erroneously reads: commandit.
168 "A verein" is a misprint but I do not know what is intended.
169 12 January 2010. An earlier version appeared in HMRC Brief 54/07.

Definition

Ordinary share capital is defined in TA 1988 s 832 as follows:

" 'ordinary share capital', in relation to a company, means all the issued share capital (by whatever name called) of the company, other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the profits of the company;"

This definition therefore includes all of the issued share capital of a company, apart from capital carrying a right to a dividend at a fixed rate only. The bracketed wording 'by whatever name called' should not be overlooked as it is important to note that companies often categorise share capital into shares bearing different names, eg A Ordinary; B Ordinary, for purposes which may be of no relevance to the application of the definition above.

Characteristics of issued share capital in a UK company—general principles

UK companies

Ordinarily, references to a company will be understood to mean a limited liability company. Limited liability companies are so called because the liability of each shareholder for the company's debts and other liabilities is limited to the amount which remains unpaid on his shares. There are two types of limited liability company in the UK, public and private. The main difference between these types of company is that a public company can apply to be listed and offer its shares to the public in order to raise capital. There are, however, other types of less commonly used company forms: unlimited companies, with or without share capital, and companies limited by guarantee.

In the latter case the members' liability is limited to amounts they undertake to contribute in the event of a winding up; the amount of this maximum liability of each of the members will be set out in the 'guarantee clause' of the company's memorandum. The total commitment of the members, taken together, is known as the 'guarantee fund'; this fund only comes into existence on a winding up. In practice, this form of vehicle is usually unsuitable for most businesses but is often used, for example, by charities.

Companies limited by guarantee incorporated on or after 22 December 1980 cannot also have a share capital (Section 1(4) Companies Act 1985). Companies limited by guarantee incorporated before that date may, however, also have share capital.

In 1999 the Special Commissioners considered the status of 'founders' deposits' with a company limited by guarantee in the case *South Shore Mutual Insurance v Blair* [1999] STC (SCD) 296. They came to the conclusion that the deposits were not issued share capital; the company did not, in fact, have any authorised share capital and, as a consequence, could not have issued share capital. Although the decision is not binding authority, the case contains a useful review of some of the authorities about share capital.

Shares in UK companies

A company limited by shares is currently required to stipulate the maximum share capital the company may issue and the number and nominal value of the shares into which it is divided, its 'authorised share capital', in a document called the company's memorandum of association (section 2(5)(a), Companies Act 1985).

Note: The reader should note that the Companies Act 2006 abolishes the requirement for a company to have an authorised share capital by the repeal of section 2(5)(a). This should take effect from 1 October 2008. The new act nonetheless requires that, on formation, a company with a share capital will be required to submit a statement of capital and initial shareholdings to the Registrar at Companies House.

The memorandum is one of two essential documents that must be filed at Companies House on incorporation, the second is the company's articles of association; these documents together set out provisions governing the manner in which the company will operate. The amount of authorised share capital set out in the company's memorandum may be later increased by an ordinary resolution of the shareholders (requiring a simple majority of the vote).

The company's assets are owned by the company itself, not by the shareholders individually, although in turn the shareholders together have ownership of the company. The shares express the shareholders' proprietary relationship with the company.

In principle, shares are transferable, but in practice there are often restrictions on transfer, found in the company's articles of association.

The principal rights that usually attach to a share are rights to dividends declared, a right to vote and a right to share in the company's assets in a winding up. The principal responsibility that attaches to a share is to pay what is due on the share. The rights and duties are all subject to the memorandum and articles of association.

For a company limited by shares, the share capital must be stated in a fixed amount. In *Ooregum Gold Mining of India v Roper* [1892] AC 125 Lord Halsbury said:

> "The capital is fixed and certain, and every creditor is entitled to look at that capital as his security."

A share certificate is prima facie evidence of ownership of a share. However, it does not, of itself, constitute ownership of the share and is not essential to demonstrate that share capital has been issued. In order to be a member of a company, under the Companies Act, a person must be entered in the company's register of members. See s 112 Companies Act 2006. The decision in *National Westminster Bank plc v IRC* ([1994] STC 580), confirms this position, ie the 'issue' of share capital is only complete when members are recorded in the company's register of members.

Characteristics of issued share capital in a body incorporated in another country—relevant factors

When looking at whether a body incorporated under the law of another country, it is self evident that UK company law is not directly applicable. In *Ryall v The Du Bois* 18 TC 431, Lord Hanworth M.R. said:

'a share in a foreign company may be something different from and, indeed, is almost necessarily different from, a share as we know it in an incorporated company.'

Slesser L.J. said

'We have to consider what would be analogous to stocks and shares in Germany in dealing with what is a company, and allowing for differences of law in that country'.

Slesser L.J.'s comments were given in the statutory context of whether foreign income was income from stocks and shares for the purposes of Case V Schedule D. However we consider them as authority for proceeding by analogy in deciding whether the capital of a foreign company can be considered as 'issued share capital'.

A number of factors are relevant in deciding whether or not a foreign 'company' has 'issued share capital'.

Firstly the body concerned must have a legal personality separate and distinct from that of its members, able to carry on business and owning its assets in its own right, in the same way as a UK company. If that characteristic is absent the members cannot have the type of proprietorial interest which is characteristic of holders of issued share capital of a company incorporated under the laws of the UK.

If the body concerned possesses a separate legal personality, as described above, the following factors will then become relevant to the question of whether a member's interest in such company is analogous to an interest in 'issued share capital' as understood in the UK:

- whether the member's interest is like shares (that is, a portion of the fixed capital of the corporate body) or like debt (that is, money owed by the body corporate to the members)
- whether any subscription for the members' interests is payable
- whether the subscription payable for the 'shares' remains the member's property or whether it becomes the property of company
- what proprietary rights, such as rights to participate in control by voting, rights to receive a dividend out of the company's profits and rights to share in a distribution out of the company's assets in the event of a winding up, attach to the member's interests and what responsibilities, such as a responsibility to pay up on the 'share' if called, attach to the member
- whether the member's interest can be legally evidenced in accordance with local laws; for example, by being registered in a company-held document, or with a public authority, or by a certificate or similar document
- whether the member's interest is denominated in a stated fixed value
- whether the member's interest forms a fixed and certain amount of capital, or a part of that, to which creditors can look as security
- whether the non-UK law concerned requires amounts subscribed to be allocated to capital of the company which is fixed capital, and the extent to which subscriptions are so allocated
- whether the member's interests is capable of transfer and if so whether such a transfer would be similar to a transfer of a portion of the capital of the company, with attendant proprietary rights, rather than similar to a transfer of money or a loan account; and
- any other factors which point to the member's interests being 'issued' and having the character of ordinary share capital.

The background information a company or its advisers are likely to want to consider includes the following documentation:

- The corporate law of the foreign country which governs the body in question.
- Whatever general commentaries are available on the legal and commercial status of the body in question.
- The documents establishing the body, and any other documents which regulate its activities, especially those which deal with subscription for capital and those which govern what happens to the profits and assets of the body.

The accounts that show the state of affairs of the body, in particular the balance sheet, may be helpful in showing whether, and to what extent, money subscribed or otherwise provided by the members of the body is allocated to a fixed amount of permanent capital or whether it is loan debt.

In deciding whether the body has issued share capital, it is not necessary for every factor to be present, but there should be a preponderance of indicators pointing to there being issued share capital. Different weight may need to be given to the various factors. For instance it would be of considerable importance if the member's interest had the character of debt. However restrictions on transfer of a member's interest would be of lesser importance. It is by no means uncommon for there to be restrictions on transfer of shares

in a UK company.

84.30.3 *Ordinary share capital: German GmbH*

HMRC Brief 87/09 provides:

> A Gesellschaft mit beschränkter Haftung (GmbH) in Germany, literally a 'company with limited liability', is an entity of a very similar kind to a UK private limited liability company. An Aktiengesellschaft (AG), sometimes called a 'joint stock company' may be considered more akin to a UK public limited liability company (plc) as its stock may be listed.
> Under German law, the capital of a GmbH is not divided up into small units. However, a GmbH has a fixed amount of capital (Stammkapital) which corresponds to the maximum amount of share capital that the company may issue, similarly to a UK limited liability company's 'authorised share capital'. The amounts originally contributed (Stammeinlagen) by the members (Gesellschafter) will also be noted, just as in the UK the initial subscriber shares will be noted in the memorandum of a limited liability company.
> Article 5 of the German GmbH law sets out a minimum amount of Stammkapital (authorised share capital) as €25,000, and the minimum amount of Stammeinlage (original contribution/subscription) of each Gesellschafter (member) at €100.
> Based upon GmbH cases HMRC have previously considered, the amounts of Stammeinlage subscribed by the members may normally be regarded as issued share capital for the purposes of the Taxes Acts.

84.30.4 *Ordinary share capital: Delaware LLC*

For the general nature of a Delaware LLC, see 84.25 (US S-Corps and LLCs). This section considers whether a LLC has ordinary share capital.

HMRC Brief 87/09 provides:

> **Delaware Limited Liability Companies**
> ... Section 18–702c of the Delaware Limited Liability Act provides that:
> > 'Unless otherwise provided in a limited liability company agreement, a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company.'
>
> If a DLLC issues 'shares' in this way and the other factors relating to the company suggest that it has share capital then we will accept that these 'shares' may be regarded as 'ordinary share capital' for the purpose of Section 832 ICTA 1988.
> It should be noted that not all DLLCs issue share certificates but they may still have 'ordinary share capital'. Regard must be had to the particular terms of the agreement by which the LLC has been created. In any case of doubt or difficulty regarding the status of the share certificates HMRC will advise in particular cases in line with Code of

> Practice 10. The contact point is ...
> Other States within the United States of America have comparable legislation to Delaware. Where it can be shown that a particular State has legislation analogous to the Delaware legislation with which we are familiar, HMRC would expect to be able to provide advice in line with that for DLLCs.

In 2010 a Tribunal found that the membership interest in a Delaware LLC was not similar to share capital but something more similar to partnership capital of an English partnership. The membership interest would not have been ordinary share capital. However HMRC took no notice of that,[170] rightly, as it has turned out so far, as the decision has been reversed: *HMRC v Anson*.[171]

84.31 Commentary: Should the UK enact US style check the box rules?

Heather M. Field, "Checking in on Check-the-Box" 42 Loy. L.A. L. Rev. 451 (2009) explains:[172]

> In 1995, the Service acknowledged that the flexibility afforded by applicable state laws undermined the theory of the corporate resemblance test and explained:
>
> > [M]any states recently have revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that have traditionally been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships....
> >
> > One consequence of the narrowing of the differences under local law between corporations and partnerships is that taxpayers can achieve partnership tax classification for a non-publicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation. The Service and Treasury recognize that there is considerable flexibility under the current rules to effectively change the classification of an organization at will ....[173]
>
> Accordingly, the preamble to the proposed CTB regulations explained

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170 HMRC, "Swift v HMRC: UK tax treatment of a US LLC" (May 2010) *http://www.hmrc.gov.uk/international/swift-v-hmrc.htm*.

171 [2013] STC 557 reversing the tribunal decision reported under the name *Swift v HMRC* [2010] UKFTT 88. The position will need to be reviewed when the case is final.

172 *http://digitalcommons.lmu.edu/llr/vol42/iss2/4*

173 [Footnote original] I.R.S. Notice 95-14, 1995-14 I.R.B. 7.

> that the "Treasury and the IRS believe[d] that it [was] appropriate to replace the increasingly formalistic rules under the [Kintner] regulations with a much simpler approach that generally is elective."[174]
> Moreover, the Service acknowledged that, under the Kintner regulations, "taxpayers and the IRS must expend considerable resources on classification issues."[175] Since the issuance of Revenue Ruling 88-76, the Service issued seventeen revenue rulings, several revenue procedures, and numerous letter rulings on entity classification issues.[176] Presumably, taxpayers also incurred significant legal fees in obtaining advice on these classification issues. Further, the Service noted that small businesses could be particularly hard hit by the considerable costs of obtaining advice regarding how to structure business entities to obtain the most favourable combination of state law and tax treatment.[177] These additional cost, resource allocation, and distributive considerations contributed to the Service's decision to move to a simplified elective entity classification regime, where taxpayers could "elect to treat certain domestic unincorporated business organizations as partnerships or as associations for federal tax purposes,"[178] while still availing themselves of the local laws' flexibility for structuring unincorporated businesses.[179]

It is suggested that similar regulations would be beneficial in the UK; though it would require careful thought, and the development of the idea

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174 [Footnote original] Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,990 (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301).

175 [Footnote original] *Id.*

176 [Footnote original] *Id.*

177 [Footnote original] *Id.*; see also Rod Garcia, Treasury Officials Address Check-the-Box Entities, 67 TAX NOTES 1009 (1995) (A Treasury official explained: "It's a resource allocation question .... Too many resources have been wasted both by the IRS and the private sector in resolving classification issues, even though in the end the taxpayer gets the desired status .... Classification becomes a very intricate game that if you have counsel[,] you get out of the maze and you're home free.") (internal quotations omitted).

178 [Footnote original] I.R.S. Notice 95-14, 1995-14 I.R.B. 7

179 [Footnote original] Simplification of Entity Classification Rules, 61 Fed. Reg. at 21,990. This goal of increased flexibility in organizational choice actually dates back to the adoption of subchapter S, enacted to enable "certain corporations to opt out of the double tax system so as to maximize organizational choice for small business owners." Steven A. Bank, The Story of Double Taxation: A Clash over the Control of Corporate Earnings, in BUS. TAX STORIES 153, 178 (Stephen A. Bank & Kirk J. Stark, eds., 2005) (citing S. REP. NO. 85-1983, at 87 (1958)).

to a consultation stage would require some investment in time and resources. Ideally the issue would be dealt with at an EU or even OECD level, though that may not be practical.

CHAPTER EIGHTY FIVE

CONTROL, CONNECTED, CLOSE AND RELATED EXPRESSIONS

85.1 Introduction

This chapter considers meaning of the terms "control", "connected person", "close company" and associated terms such as "participator".

The definitions interlink but need to be considered separately.

85.2 Control

85.2.1 *Why does control matter?*

Control of a company is a concept used so often in tax legislation that it is impossible to write a full list.

The concept is important in particular for the definition of connected person: a person is connected to a company they control. The concepts of control and connected overlap.

85.2.2 *Meaning(s) of "control"*

There are two main definitions of control in the Taxes Acts (as well as numerous specialist definitions not considered here). The legislation does not have terminology to describe them, so I coin the following:

(1) "**Control in the ultra-wide sense**"- the definition in s.450 CTA 2010.

(2) "**Control in the strict sense**" - the definition in s.995 ITA.

Sometimes the word control is used without definition; I refer to that as **"control in a natural (undefined) sense"**; though that sense must be taken from the context as the word does not have a single fixed sense.

The word control is used in accountancy, where it has another set of definitions again.[1] Those definitions do not apply for tax, so a person who

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1 FRS 102 (The Financial Reporting Standard applicable in the UK and Republic of Ireland, March 2013) para 9.4; IFRS 10 (Consolidated Financial Statements) para 7.

has control in one of the tax senses may not be the same as the person named in company accounts as the ultimate controlling party of the company.

Section 989 ITA provides:

> The following definitions apply for the purposes of the Income Tax Acts—
> "control", in relation to the control of a body corporate or a partnership, is to be read in accordance with section 995.[2]

Thus for IT the strict sense is the default meaning, though in practice the ultra-wide sense is more common.

By contrast, s.288(1) TCGA provides:

> In this Act, unless the context otherwise requires—
> "control" shall be construed in accordance with sections 450 and 451 of CTA 2010;

Thus for CGT the ultra-wide sense is the default meaning.

For IHT, s.269 IHTA provides yet another definition of control. Such is the patchwork nature of UK taxation. The IHT definition is not discussed here as it does not arise in the IHT issues closest to the themes of this book.

85.3 Control in ultra-wide sense

85.3.1 *Introduction*

Section 450 CTA 2010 provides:

> (1) This section applies for the purpose of this Part [Part 10 CTA 2010].

The definition is also applied by reference in many other contexts.

> (2) A person ("P") is treated as having control of a company ("C") if P—
> (a) exercises,
> (b) is able to exercise, or
> (c) is entitled to acquire,
> direct or indirect control over C's affairs.
> (3) In particular, P is treated as having control of C if P possesses or is entitled to acquire—

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2 The point is repeated (unnecessarily) in s.719 ITEPA and s.1021(2) ITA: "Section 995 (meaning of "control") applies for the purposes of this Act unless otherwise indicated."

(a) the greater part of the share capital or issued share capital of C,
(b) the greater part of the voting power in C,
(c) so much of the issued share capital of C as would, on the assumption that the whole of the income of C were distributed among the participators, entitle P to receive the greater part of the amount so distributed, or
(d) such rights as would entitle P, in the event of the winding up of C or in any other circumstances, to receive the greater part of the assets of C which would then be available for distribution among the participators.

The CT Manual identifies the five heads of control:

> **60210 Control: Definition** [September 2011]
> Control is defined under several headings:
> [1] Control over the affairs of the company (see CTM60220).
> [2] Control through voting power (see (a) of CTM60220).
> [3] Control through share capital or through issued share capital (see (b) of CTM60220).
> [4] Control over income of the company (see (c) of CTM60220).
> [5] Control over assets of the company (see (d) of CTM60220).

In *R v IRC ex p. Newfields Developments*, Lord Hoffmann said:

> [10] It will be seen that although this definition starts in subs (2) with a concept of control which reflects its meaning in ordinary speech ('a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs'), that fairly simple notion is enormously widened by subsequent subsections. ...
> [11]… The effect of those cumulative definitions is that for the purpose of deciding whether a person 'shall be taken to have control of a company' under [what is now s.450], it may be necessary to attribute to him the rights and powers of persons over whom he may in real life have little or no power of control. Plainly the intention of the legislature was to spread the net very wide.[3]

The test requires one to ascertain what are the rights exercisable by a shareholder. In *HMRC v UBS*, a provision in the company's articles provided (in short) that when the shareholder was UBS the shares carried no right to dividends and only a right to receive par on a winding-up. The

3 73 TC 532, at p.556.

purpose was to ensure that when UBS held the shares it did not have control of the company. An argument that this should be ignored as a sham was roundly rejected:

> 107. This argument is also hopeless. There was no finding that the participants did not intend article 2(15) to take effect according to its terms and so the argument that it was a sham was rightly rejected. Once this point is reached, I am at a loss to know on what basis article 2(15) can be airbrushed out of the scheme.[4]

Sham is however fact sensitive, and in other circumstances an article of that kind might perhaps be ignored as a sham.

85.3.2 *Control over a company's affairs*

P is treated as having control of C if P—
(a) exercises,
(b) is able to exercise, or
(c) is entitled to acquire,
direct or indirect control over C's affairs.

In the last line of this head, "control" is used in a natural (undefined) sense.

Para (a) concerns someone who *actually* exercises control. It is not clear whether that would apply if P exercises *de facto* control but has no right of control.

Para (b) concerns someone *able* to exercise control. It does not matter if they choose not to exercise any control. It is not clear whether that would apply if P is only able to exercise *de facto* control but has no right of control and chooses not to exercise any control.

It is suggested that para (a) applies where P exercises mere *de facto* control, but para (b) only applies if P has a right of control, ie *able* means legally entitled to. The attraction of this reading is that para (a) and (b) both have some role to play. For if para (a) required a right of control, then (b) would be otiose; if para (b) did not require a right of control, then para (a) would be otiose.[5]

However it would be rare for someone to actually exercise control without having a right to do so, and so fall within para (a). Mere influence

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4 [2014] EWCA Civ 452 at [107].

5 This view is also consistent with the meaning of "able to control" in ToA enjoyment condition E: see 29.6.7 (Enjoyment condition E: control).

does not constitute control: *de facto* control would only apply if the person with actual control surrendered all independence and acted as a "rubber stamp".

85.3.3 *Control at shareholder level or control at board level*

In *Steele v EVC International* 69 TC 88 the Court of Appeal said:

> ... control of the affairs of the company in s [450] means control at the level of general meetings of the company ... control at that level carries with it the power to make the ultimate decisions as to the business of the company and in that sense to control its affairs.

The CT Manual provides:

> **60220 Control: Over the company's affairs** [September 2011]
> ... As regards the level at which control is exercised, the judgment in *Steele v EVC International NV* 69 TC 88 confirms that what is required is control at the participator or general meeting level, not at administrative or board level.

SP 1/01 provides:

> 54. Where the establishment of a connected person's relationship depends on the question of whether a person falls to be regarded as having control of a company's affairs within the terms of [s.450 CTA 2010], it is not considered that a person's ability (whether de facto or de jure) to appoint the majority of the Board of directors will itself constitute control of the company's affairs—unless, that is, the Board exercises powers which would normally be exercised by the shareholders at a general meeting.

85.3.4 *"Control"*

In *HMRC v UBS*, Rimer LJ said:

> ... the scheme was pre-ordained and involved a co-ordinated course of action between the participants, with Investec and DB, two wholly independent companies, playing pre-ordained and co-ordinated roles, with each having its own commercial interests in bringing the scheme to fruition. It does not, however, begin to follow from this that DB was in relevant control of Investec. If A Ltd proposes to B Ltd, an unconnected and independent company, a co-ordinated course of action with a view to achieving a commercial end to the benefit of both, and B Ltd agrees to the proposal and co-operates in its implementation, it is beyond my comprehension why such a state of affairs should be thought

> to justify the inference that, in playing its own part in the operation, B Ltd is to be regarded as being 'controlled' in what it does by A Ltd. The proposition is wrong. B Ltd will, by inference, want to take part, and will do so. But there will ordinarily be no basis for an inference that the decisions it makes en route to the ultimate goal will be decisions it makes other than independently, and in its own interests, in achieving the proposed end.[6]

85.3.5 *Shares*

> *P is treated as having control of C if P possesses or is entitled to acquire ... (a) the greater part of the share capital or issued share capital of C.*

This is straightforward.

85.3.6 *Votes*

> *P is treated as having control of C if P possesses or is entitled to acquire ... (b) the greater part of the voting power in C.*

This is otiose, since a person with the greater part of the votes has control under s.450(2) CTA 2010: they are able to exercise control over the company's affairs.

85.3.7 *Right to income*

> *P is treated as having control of C if P possesses or is entitled to acquire ... (c) so much of the issued share capital of C as would, on the assumption that the whole of the income of C were distributed among the participators, entitle P to receive the greater part of the amount so distributed.*

Section 450(4) CTA 2010 provides:

> Any rights that P or any other person has as a loan creditor are to be disregarded for the purposes of the assumption in subsection (3)(c).

This will not normally make any difference, as a company would not normally distribute income to loan creditors.

The CT Manual provides:

> **60240. Control: Summary** [February 2006]
> ... The test in (c) of CTM60220 depends on the dividend rights of the

6 [2014] EWCA Civ 452 at [139].

issued capital and will be mainly of interest where shares with no voting rights carry the right to a high dividend.

But this is not the only case. The life tenant of an IIP trust holding a majority of the shares in a company in principle has control of the company under this head.

85.3.8 *Right to capital*

P is treated as having control of C if P possesses or is entitled to acquire ... such rights as would entitle P, in the event of the winding up of C or in any other circumstances, to receive the greater part of the assets of C which would then be available for distribution among the participators.

The CT Manual provides:

60230. Control: Right to receive most assets [September 2011]
Control under (d) of CTM60220 exists where a person or persons have a right to receive the greater part of the assets then available for distribution among participators, in any circumstances, (for example, on redemption of redeemable share capital or on repayment of loans to the company) but also, specifically, on a winding up of the company.
'Participators' for this purpose includes loan creditors (unlike (c) of CTM60220). As regards the definition of loan creditors, see CTM60130. If a loan creditor is an open company, see CTM60300.
The test under CTA2010/S450 (3) ... only applies to the assets that would come to a participator in that capacity. In the case of a bank, for example, no regard would be had to any assets that would come to it in respect of loans made in the ordinary course of its banking business, because it is not deemed to be a loan creditor (and, hence it is not a participator) in respect of such loans by virtue of CTA2010/S453 (4) ...
60240. Control: Summary [February 2006]
...3. The test in CTM60230 will normally be of interest only where loan creditors are participators (see CTM60130) or there exist special rights to participate in the assets available for distribution in a winding-up or in any other circumstances for example, on redemption of redeemable share capital.

But this is not the only case. If trustees hold a company on trust for A for life, remainder to B absolutely, then B has control under this head: for B will in the future be entitled to the assets of the company. If trustees hold a company on trust for B contingently (eg on attaining the age of 25, if B is under 25) then B does not have control under this head.

85.3.9 *"Entitled to acquire"*

Section 451 CTA 2010 provides:

> (1) This section applies for the purposes of section 450.
> (2) A person is treated as entitled to acquire anything which the person—
> (a) is entitled to acquire at a future date, or
> (b) will at a future date be entitled to acquire.

The INT Manual comments on identical wording in the CFC legislation:

> **210050 'Entitled to acquire' and 'entitled to secure'** [February 2006]
> The terms 'entitled to acquire' and 'entitled to secure' in (a), (b) and (c) of INTM210040 apply both where a person is presently entitled to acquire or secure an asset at a future date and where a person will at a future date be entitled to acquire or secure that asset. They do not extend to situations where, in an entirely arm's length transaction, one party temporarily has future rights over the other's property, for instance, in the period between exchange of contracts and completion of a sale of land.
> A person whose entitlement to acquire or secure is contingent on a default of any person, including the controlled foreign company in question, will not be treated as having an interest in the controlled foreign company, unless that default has occurred.
> So, for example, a person will have an interest in a controlled foreign company if, by means of a contractual right or some other arrangement, he can
> • require a shareholder to transfer shares to him, or
> • secure the issue to him of unissued share capital of the company, or
> • secure that if a distribution is made by the company he has a share in the distribution or premium.
> A person will not have an interest in a controlled foreign company solely by virtue of rights over the income or assets of the company which are exercisable on the default of any person. Thus the contingent rights of banks, trade creditors, etc. to acquire some or all of the company's assets in the event of a default would not amount to an interest in the company in advance of the default.

See too 85.17.6 ("Entitled to do").

85.4 "Nominees"

Section 451(3) CTA 2010 provides:

If a person—

(a) possesses any rights or powers on behalf of another person (A), or

(b) may be required to exercise any rights or powers on A's direction or behalf,

those rights or powers are to be attributed to A.

It is self-evident that the powers of a nominee should be attributed to its principal. The section is in fact wider than that, since the cases where "A may be required to exercise rights at the direction of B" extend beyond the case where A is a nominee for B in the strict sense of nominee. However the subsection is otiose, for if A may be required to exercise rights on the direction of B, or on behalf of B, then these are rights which B possesses or is entitled to acquire, so the rights would be taken into account in any event in the test of control.

See Howard, "Remote Control" (Sep 2011) Tax Adviser, p.45.[7]

85.5 Associates

The concept of associates is used in various contexts, but the most important is the rule that (for the definition of control) a person is treated as holding the rights of their associates.[8] This section considers the definition; the next section considers the attribution rule; and the following section gives some examples and concludes with a comment on the difficulties caused by the width of the definition.

The definition of associate has four parts:

(1) Relatives and partners
(2) Trustees
(3) Companies
(4) Personal representatives

85.5.1 *Relatives and partners*

Section 448(1) CTA 2010 provides

In this Part "associate", in relation to a person ("P"), means—

(a) any relative or partner of P

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7 Accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2011/09/Control_company_RC.pdf*

8 See 85.6 (Attribution of rights of associates and controlled companies).

Section 448(2) CTA 2010 defines relative:

> In this section, "relative" means—
> (a) a spouse or civil partner,
> (b) a parent or remoter forebear,
> (c) a child or remoter issue, or
> (d) a brother or sister.

The Company Taxation manual provides:

> **CTM60150 Tests: Associates** [November 2011]
> ... Separated spouses should be regarded as associated with each other but divorced persons should not. Other relatives in (a)(ii) to (iv) should be regarded as associated only if there is a blood relationship, for example, half-brothers are associated but stepbrothers are not...

The definition of connected person is wider. A spouse of a brother, sister, etc is a connected person but is not an associate; see 85.11 (Connection with family members).

85.5.2 *Trustees & settlor/settlor-relatives*

Section 448(1) CTA 2010 provides:

> In this Part "associate", in relation to a person ("P"), means ...
> (b) the trustees of any settlement in relation to which P is a settlor,
> (c) the trustees of any settlement in relation to which any relative of P (living or dead) is or was a settlor

The definition of connected person is narrower. The relative of a deceased settlor is an associate of the trustees but not a connected person.[9] "Settlement" has the standard IT/CGT meaning; contrast the definition of connected person where the word has the settlement-arrangement meaning.

85.5.3 *Trustees and beneficiaries*

Section 448(1) CTA 2010 provides:

> In this Part "associate", in relation to a person ("P"), means ...
> (d) if P has an interest in any shares or obligations of a company which are subject to any trust, the trustees of any settlement concerned

9 See 85.12 (Connection with trustees).

If the trustees hold shares or securities on trust for A for life, remainder to B, then A and B are associates of the trustees. If the trustees hold on discretionary trusts then the beneficiaries are not associates, as they do not have an interest (in the strict sense); though the person (if any) entitled on the termination of the discretionary trust would be an associate.

There is no equivalent rule for connected persons, which is narrower on this point.

85.5.4 *Companies*

Section 448(1) CTA 2010 provides:

> In this Part "associate", in relation to a person ("P"), means ...
> (e) if P—
> (i) is a company, and
> (ii) has an interest in any shares or obligations of a company which are subject to any trust,
> any other company which has an interest in those shares or obligations ...
> (g) if P—
> (i) is a company, and
> (ii) has an interest in any shares or obligations of a company which are part of the estate of a deceased person,
> any other company which has an interest in those shares or obligations.

This must be a rare case.

85.5.5 *Personal representatives*

Section 448(1) CTA 2010 provides:

> In this Part "associate", in relation to a person ("P"), means ...
> (f) if P has an interest in any shares or obligations of a company which are part of the estate of a deceased person, the personal representatives of the deceased

There is no equivalent rule for connected persons, which is narrower on this point.

85.6 Attribution of rights of associates and controlled companies

Section 451(4) CTA 2010 provides that for the purposes of the definition of control in the ultra-wide sense:

There may also be attributed to a person all the rights and powers—

(a) of any company of which the person has, or the person and associates of the person have, control,[10]

(b) of any two or more companies within paragraph (a),

(c) of any associate of the person, or

(d) of any two or more associates of the person.[11]

In short, a person is treated as holding the rights of associates and controlled companies. Section 451(5) CTA 2010 provides:

The rights and powers which may be attributed under subsection (4)—

(a) include those attributed to a company or associate under subsection (3) [nominees], but

(b) do not include those attributed to an associate under subsection (4).

One is not treated as holding the rights of an associate of an associate.

Section 451 uses the word "may" but here that means "shall". Section 451(6) CTA 2010 provides:

Such attributions are to be made under subsection (4) as will result in a company being treated as under the control of 5 or fewer participators if it can be so treated.

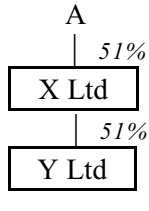
I refer to this as "**the attribution rule**".

This rule does not apply for the purposes of the definition of participator (that is, the fact that A is an associate of a participator does not mean that A is a participator).

85.7 Examples

85.7.1 *Chain of wholly owned companies*

A chain of companies is straightforward. Suppose:



10 Control here has the ultra-wide meaning: see s.450(1) CTA 2010 set out in 85.3.1 (Introduction).

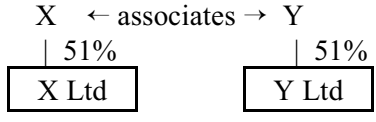
11 Para (b) and (d) must be otiose, but it does not matter.

A controls X Ltd.
A controls Y Ltd for two independent reasons:
(1) A controls it in the undefined sense.
(2) The rights of X Ltd are attributed to A.

It also follows that A is connected to X Ltd and Y Ltd. That is what one might expect.

85.7.2 *Associates each own a company*

Suppose two persons are associates and each own a company:



X controls X Ltd
X also "controls" Y Ltd because the rights of Y are attributed to X.[12]

It also follows that:
(1) X is connected to X Ltd and to Y Ltd.
(2) X Ltd is connected to Y Ltd (as the same person has "control" of both companies).

85.7.3 *Commentary: An excessively wide definition*

The attribution rule - together with the wide definition of associates - is what makes the s.450 definition of control ultra-wide. It is so wide that the word "control" is not apt to describe the concept ("some loose association" would be nearer the mark). It is confusing to depart from statutory terminology, but where the ultra-wide sense of control is used, the actualities demand quotation marks. For instance:
(1) A has "control" of a company owned by a relative (say, a sister) even though A has no beneficial interest in the company, and, of course, no right to know that the relative owns the company or anything about the company.
(2) A has "control" of a company owned by a trust of which a relative is a settlor, even though A is not a beneficiary and has no right to know that the trust had been made, let alone to know anything about the

12 See 85.6 (Attribution of rights of associates and controlled companies).

trust or its property. Indeed the relative need not be the settlor but only *a* settlor, so the rule would apply if (say) a sister provides a nominal amount of property to a trust.

(3) A partner has "control" of a company owned by a partnership even if it is an investment partnership with a large number of unconnected partners. The modern use of partnerships as collective investment vehicles raises this problem, because investment partnerships have large numbers of partners,[13] and partners do not know who their fellow partners are.

This has three noteworthy consequences.

The first is practical: it is not possible for a person to know whether they control a company, or to draw up a list of all companies which they control. In practice there is substantial innocent non-compliance and selective or arbitrary enforcement, where HMRC sufficiently dislike a taxpayer to make enquiries not normally made.

The second point is presentational but nevertheless important: anti-avoidance provisions which refer to control may appear to the non-tax specialist to be reasonable because control seems a sensible limiting factor; but they generally operate unreasonably widely (because the meaning of *control* is so wide).

Thirdly, this leads to complexity. On occasions, where the difficulty caused by the extravagance of the definition has come to be recognised, the definition of control[14] is then restricted.[15] However this is done on a

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13 In 2014 there were 500 partnerships which file an SA800 return and have more than 50 partners; some have more than 1,000 partners (unfortunately HMRC software does not cope with more than 999) and, anecdotally, one has more than 20,000 partners; data from Office of Tax Simplification "Review of partnerships: interim report" (2014) para 5.25 and appendix A.
https://www.gov.uk/government/publications/partnerships-review

14 or some concept in which the word control is used, such as associate or connected person.

15 For instance, ss.27, 29, 30 CTA 2010. Section 27 CTA 2010 provides:
"(2) In the application of section 451 (meaning of 'control': rights to be attributed) for the purposes of the determination, the references in section 451(4) and (5) to an associate of a person ("P") include a partner of the person only if the condition in subsection (3) below is met.
(3) The condition is that tax planning arrangements which—
(a) involve P and the partner, and
(b) secure a relevant tax advantage,
have at any time had effect in relation to the taxpayer company."

piecemeal basis, where taxpayer lobbying has for some reason given rise to government action. So the result is a complexity which would not arise if a more restrained definition of control had been adopted in the first place.

The same difficulties apply to provisions using the term "connected person" (since that term uses the concept of "control" in the ultra-wide sense). It will in practice be impossible for a person to identify all persons who are "connected" with them. One individual might easily have 500 persons connected with them. If one could write a full list, it would vary continuously. Even an attempt to enquire would be grossly intrusive.

The point was made in responses to the consultation on the substantial donor rules:

> charities described the connected persons rule as an "impossible requirement", a "substantial administrative burden" and a "compliance nightmare".[16]

There was nothing particularly unusual in the substantial donor rules, except, perhaps, that the charities who responded to the consultation felt a greater obligation than most taxpayers to seek to comply with the tax rules: this difficulty applies generally to the use of the concepts of control and connected persons. But HMRC's priority in anti-avoidance legislation is not to produce legislation with which everyone can comply: it is to produce legislation which catches everything that they may wish to catch. Thus the definition of connected person in the tainted donation rules (which replaced the substantial donor rules in 2011) is even wider than the standard ultra-wide definition![17] But there it is.

85.8 Control by two or more persons together

Section 450(5) CTA 2010 provides:

> If two or more persons together satisfy any of the conditions in subsections (2) and (3), they are treated as having control of C.

For instance, if A and B each hold 50% of a company, then A and B

For other examples, see 50.3.2 ("Control" and "participator"); 44.7.4 (HMRC practice on 20% rule).

16 HMRC, Substantial Donors to Charity Consultation Responses Document, (January 2009) para 3.12, [2009] STI 65.

17 See s.809ZQ ITA.

together have control. Why does it matter? This does not mean that A (alone) has control or that B (alone) has control. It matters for the following purposes:

(1) Two companies are connected if (in short) they are under the control of the same (or connected) persons.[18]

(2) Two companies are associated (for the purposes of small profits relief) if (in short) both are under the control of the same persons.

So it is often necessary to identify the persons who together control a company.

The CT Manual provides:

> **60250 Control: In multiple** [September 2011]
> More than one person or one group of persons may 'control' a company. For example, one person may have the greater part of the voting power, while two people hold the greater part of the issued share capital and a group of three people are entitled to the greater part of the assets in a winding up. All three combinations of people can be taken to have control of the company at the same time.
> If say three persons, A, B and C, each hold one third of the shares in a company, and they are not connected in any way which would allow the rights and powers of one to be attributed to another, then control is held by A and B, or B and C, or A and C but not A, B and C together.
> This is because in determining whether companies are 'associated companies', you should only consider 'minimum' controlling combinations. You should disregard combinations containing superfluous members. For example, a company controlled by the unconnected persons A, B and C, but not by any one or two of them alone should not be regarded as associated with any company controlled by one of them alone (as in the first subparagraph above) or by any two of them (as in the second subparagraph above). (See also CTM03730 for an example of this.)
> However deciding on the 'minimum' controlling combination for any of the tests set out at ICTA 1988/416(2)(a) to (c) does not mean you have to establish the smallest controlling combination of each company when determining whether companies are associated companies.
> In his High Court judgment in *R v IRC ex p. Newfields Developments* (73 TC 532 at page 541B) Moses J said that Section 416 [ICTA] had to be exercised for the statutory purposes for which it was conferred:
> "In the context of Section 13 [ICTA], that purpose is to ascertain

18 See 85.15 (Connection with company).

> whether, in the instant case, two companies are under the control of the same person pursuant to Section 13(4). That is the statutory question. If it is possible to answer that in the affirmative, by exercising the power of attribution, in my judgment, that power must be exercised. Conversely, if that question, namely, are the two companies under the control of the same person, can only be answered in the affirmative by refraining from the exercise of the power, then the power should not be exercised".
>
> So in the first sub-paragraph above, you may be able to determine that two companies are associated because the three people who together have an entitlement to the greater part of the assets in a winding up also together hold the greater part of the voting power in another company. In that case you would take this group as controlling the company and not the single or two person combinations. As this example shows, the identical controlling combination does not need to be established by the same test in each company.

This passage is written in the context of (what is now) s.25(4) CTA 2010 which provides:

> For the purposes of this Part, a company is an associated company of another at any time when—
>
> (a) one of the two has control of the other, or
>
> (b) both are under the control of the same person or persons.

The same approach would apply to the definition of connected person: see 85.15 (Connection with company).

85.9 Control in strict sense

This section considers the meaning of what I call "control in the strict sense".[19] Section 995(1) ITA provides:

> This section has effect for the purposes of the provisions of the Income Tax Acts which apply this section.

This is misleading as the s.995 definition is the default definition of control in the income tax acts.

Section 995(2) ITA provides the definition:

> In relation to a body corporate ("company A"), "control" means the power of a person ("P") to secure—

19 See 85.2.2 (Meaning(s) of "control").

(a) by means of the holding of shares or the possession of voting power in relation to that or any other body corporate, or
(b) as a result of any powers conferred by the articles of association or other document regulating that or any other body corporate,

that the affairs of company A are conducted in accordance with P's wishes.

The CT equivalent is s.1124 CTA 2010.

The CT Manual provides:

80165. Arrangements - transfer of company to another group [May 2011]

... The test is whether a person is able to secure that the affairs of the company, including the business of the company as managed by its Board, are conducted in accordance with his wishes. Usually shareholders cannot dictate to or overrule the Board on management matters entrusted to the Board. So a necessary element of control is the ability to determine the composition of the Board, or failing that, to appoint directors who have the power to impose their decisions on directors appointed by any other shareholder.

The voting rights shareholders can exercise in general meetings will normally include the right to vote on the appointment and removal of directors. However, it is not safe to assume that possession of the majority of voting rights will bring automatic control of the Board. In *Irving v Tesco Stores (Holdings)* 58 TC 1, the claimant did not have Boardroom control of the surrendering company because:

- more than half of the directors were to be appointed by the minority shareholder and could not be removed without his consent, and
- the directors appointed by the claimant could not impose their decision on the directors appointed by the minority shareholder.

80170. Control [May 2011]

Section [995 ITA] does not define "control" merely in terms of direct shareholdings and voting rights in the company concerned. A person or persons have Section [995] control if they have power to secure that the affairs of the company are conducted in accordance their wishes. So you may have to consider:

- shareholdings and voting rights in any company, and also
- powers conferred by the documents regulating any company if these affect the "control" situation.

So, to determine whether relevant arrangements exist, you will need to consider:

- the Memorandum and Articles of Association of the company (and

any other document regulating the company), and
- the various documents relating to loans made to the company.

Where a company other than the parent company holds shares, etc, you may also need to consider the shareholdings, etc, of that company.

The same point is made in Employee Share Schemes Unit Manual:

43210. Control of the scheme company [September 2013]
... 'Control' for this purpose is defined as having the meaning given in Section 719 ITEPA 2003. This means having the power to secure that the affairs of the scheme company are conducted in accordance with its wishes.
Control will not necessarily be obtained simply because of the size of a share holding in the scheme company. Shareholders cannot ordinarily dictate to or overrule the Board of Directors in respect of matters of management entrusted to them. So a necessary element of control is (by voting powers or other powers) to have economic control of the company and the power of a person to secure that the affairs of the company are conducted in accordance with their long term wishes. The ability to determine the composition of the Board, or failing that, to appoint directors who have the power to impose their decisions on directors appointed by any other shareholder are indicators of control.
...

The Corporate Finance Manual provides:

35120. What is control? [January 2012]
Meaning of Control
Section 472 CTA 2009 gives the meaning of control. The test is whether a person can 'secure that the company's affairs are conducted in accordance with his wishes'. A person (an individual or company) can do this by
- holding most of the shares, or
- holding most of the voting rights in the company (or another company, such as the ultimate parent), or
- through any other powers, given through any document (such as the company's Memorandum and Articles of Association).

Control through shares
A majority shareholding will usually ensure control, unless different classes of shares carry different voting rights. Share held on trading account and their voting rights are ignored for this purpose.
Control through voting rights: example
MK Ltd's issued share capital is made up of

- 1,000 ordinary shares, carrying one vote each
- 2,000 'A' ordinary shares with no voting rights.

KB Ltd owns 800 ordinary shares.

JR Ltd owns 200 ordinary shares and 2,000 'A' ordinary shares.

Although JR Ltd has the majority of the issued shares, KB Ltd has control because it has the majority of the shares with voting rights, and can therefore use those voting rights to ensure that MK Ltd acts according to its wishes.

Control through other powers: example

AV Ltd owns 40% of the shares of BK Ltd, but it has the power, through BK Ltd's Articles, to appoint more than half of BK Ltd's board of directors. These directors will manage the business according to AV Ltd's wishes, so AV Ltd has control...

See Howard, "Remote Control" Taxation Practitioner, Sep 2011 p.45.

85.9.1 *Control of partnership*

Section 995(3) ITA provides the definition:

> In relation to a partnership, "control" means the right to a share of more than half the assets, or of more than half the income, of the partnership.

85.10 Connected person

There are separate definitions for the separate taxes. There are more definitions elsewhere, sometimes the same and sometimes different.

It is a pity that the tax law rewrite did not tidy up this mess; the opportunity is now lost. However the definition(s) considered in this chapter might be considered to represent a single, (more or less) standard definition.

85.10.1 *IT, CGT & CT definitions of connected person*

For CGT, s.286 TCGA provides:

> [a] Any question whether a person is connected with another shall for the purposes of this Act be determined in accordance with the following subsections of this section ...

For IT, s.989 ITA provides:

> The following definitions apply for the purposes of the Income Tax Acts—
>
> "connected", in relation to two persons being connected with one

> another, is to be read in accordance with sections 993 and 994.[20]

The CGT and IT definitions are substantially the same but the ITA drafting in some respects improves on the TCGA. Where they are the same, I give the text of the TCGA and the IT provision in footnotes.

For CT, s.1122(1) CTA 2010 provides:

> This section has effect for the purposes of the provisions of the Corporation Tax Acts which apply this section (or to which this section is applied).

At first sight that seems more limited. But s.1176(1) CTA 2010 provides:

> Section 1122 (how to tell whether persons are connected) applies for the purposes of this Act unless otherwise indicated (whether expressly or by implication).

Section 1316 CTA 2009 is identical. Thus the CT s.1122 definition applies for the CTAs 2009 and 2010 unless disapplied. It could have been drafted more neatly. I do not consider the CT definition in much detail, but what is said about IT is generally applicable to CT

85.10.2 *IHT definition*

For IHT, s.270 IHTA provides:

> For the purposes of this Act any question whether a person is connected with another shall be determined as, for the purposes of the 1992 Act it falls to be determined under section 286 of that Act, but as if in that section 'relative' included uncle, aunt, nephew and niece and 'settlement', 'settlor' and 'trustee' had the same meanings as in this Act.

Thus IHT adopts the CGT definition of "connected person" with a little tinkering.

85.10.3 *Definition in outline*

The definition of connected person has five parts:

(1) Family members
(2) Trustees
(3) Companies held by trusts
(4) Partnerships

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20 The point is repeated (unnecessarily) in s.1021(1) ITA: "Section 993 (meaning of "connected" persons) applies for the purposes of this Act unless otherwise indicated."

(5) Companies generally

85.10.4 *Reciprocity of connection*

Section 286(1) TCGA continues:

> [b] (any provision that one person is connected with another being taken to mean that they are connected with one another).

The meaning is that "connected" is a reflexive relationship: if A is connected with B then B is connected with A. For IT, s.994(4) ITA is makes the same point more clearly:

> If any provision of section 993 provides that a person ("A") is connected with another person ("B"), it also follows that B is connected with A.

85.11 Connection with family members

Section 286(2) TCGA provides:

> A person is connected with an individual if that person is
> [a] the individual's spouse or civil partner,
> [b] or is a relative,
> [c] or the spouse or civil partner of a relative,
> [i] of the individual or
> [ii] of the individual's spouse or civil partner.

The CG Manual unpacks this definition:

> **14580 Connected persons** [October 2011]
> A person is connected with an individual if that person is
> [1] the individual's spouse or civil partner
> [2] a relative of the individual
> [3] the spouse or civil partner of a relative of the individual
> [4] a relative of the individual's spouse or civil partner
> [5] the spouse or civil partner of a relative of the individual's spouse or civil partner.

The IT equivalent is better worded, but comes to the same thing. Section 993(2) ITA provides:

> An individual ("A") is connected with another individual ("B") if—
> (a) A is B's spouse or civil partner,
> (b) A is a relative of B,
> (c) A is the spouse or civil partner of a relative of B,
> (d) A is a relative of B's spouse or civil partner, or

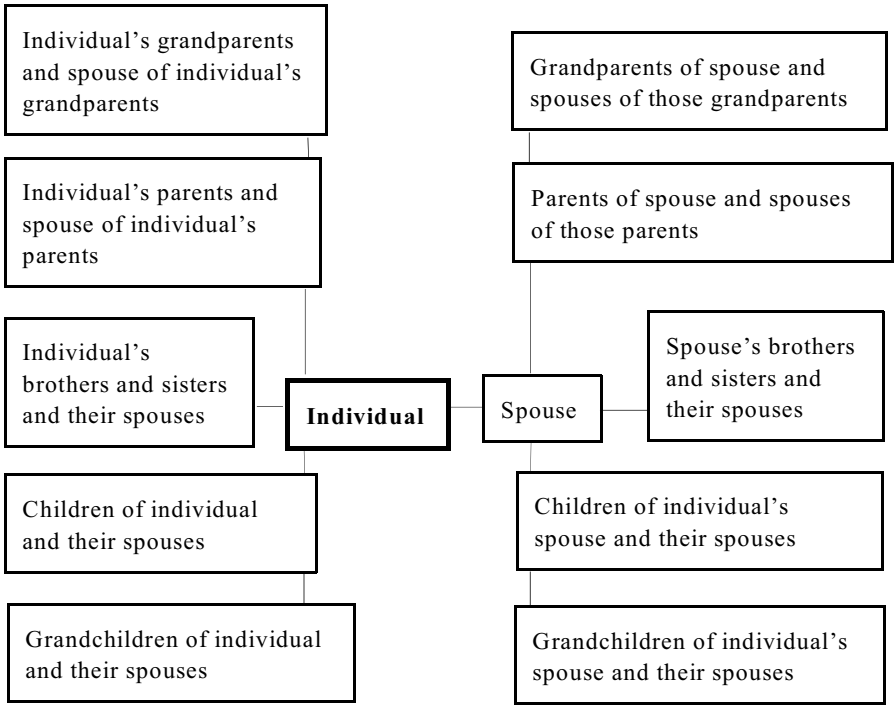
(e) A is the spouse or civil partner of a relative of B's spouse or civil partner.

Section 286(8) TCGA provides:

> In this section "relative" means brother, sister, ancestor or lineal descendant.[21]

The CG Manual provides:

> **14580. Connected persons** [October 2011]
> ... The term 'relative' does not cover all family relationships. In particular, it does not include nephews, nieces, uncles and aunts.
> **14580. Connected persons** [October 2011]
> The following diagram illustrates the provisions of Section 286(2) TCGA 1992. All of the people in the diagram are connected with the individual. They are not all connected with each other[22]



21 For IT the identical definition is in s.994(1) ITA.

22 In this diagram "spouse" includes civil partner.

> All the persons in the diagram are connected with the individual. Excluded are the widows or widowers, or surviving civil partners, of deceased persons, or relatives of a deceased spouse or of a deceased civil partner unless connection can be established by a route not involving the deceased. A dissolution of a civil partnership or a divorce can similarly lead to persons in addition to the former civil partner or spouse ceasing to be connected with the individual.

Readers are invited to speculate whether this diagram is or is not a useful aid to comprehension.

In the definition of connected person for IHT purposes, "relative" also includes an aunt, uncle, nephew and niece.[23] A two dimensional diagram could not do justice to that.

85.12 Connection with trustees

85.12.1 *Settlors and settlor-connected persons*

Section 286(3) TCGA provides:

> A person, in his capacity as trustee of a settlement, is connected with-
> (a) any individual who in relation to the settlement is a settlor,
> (b) any person who is connected with such an individual ... [24]

Similarly for IT, s.993(3) ITA provides:

> A person, in the capacity as trustee of a settlement, is connected with—
> (a) any individual who is a settlor in relation to the settlement,
> (b) any person connected with such an individual,

The CG Manual provides:

> **14590. Connected persons: Trustees** [January 2010]
> ... The trustees are no longer connected to the persons connected to the settlor after the settlor has died.

More accurately, trustees are not connected with family members or other persons who would have been connected with the settlor when the settlor

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23 See 85.10.2 (IHT definition).

24 For IT, s.993(3) ITA provides similarly:
> A person, in the capacity as trustee of a settlement, is connected with—
> (a) any individual who is a settlor in relation to the settlement,
> (b) any person connected with such an individual ...

was alive.[25]

The CG Manual provides:

> **14590. Connected persons: Trustees** [January 2010]
> [1] A settlor is considered to be connected with the trustee at the moment when property is put into the settlement.
> [2] For the purposes of determining whether a trustee is connected with an individual, the identity of the trustee is irrelevant. So, for example, if the trustee is the wife or civil partner of the individual, he or she is only connected in his or her capacity as trustee if the case is within one of the three cases in CG14590.

Point [2] is correct since trustees are regarded as distinct from the persons who are actually the trustees.

The CG Manual provides:

> **14590. Connected persons: Trustees** [January 2010]
> Although under the tests outlined an individual is not connected with particular trustees, this may not prevent him or her from being connected with a company controlled by the trustees.

This is correct: see 85.15 (Connection with company). The Manual continues:

> Under ICTA 1988, S 417, a beneficiary of a trust can be attributed with the rights and powers of trustees. In such circumstances he or she may control the company through the tests in ICTA 1988, S 416 and ICTA 1988, S 417 and hence be connected under TCGA 1992, S 286.

There is no general rule that the rights of trustees are attributed to beneficiaries. However the attribution will often be made on the grounds that beneficiaries are relatives of the settlor[26] or (sometimes) that beneficiaries possess rights to income or capital.[27]

Suppose:

(1) A creates a trust (trust A) and

---

25 The Tribunal took this view in *Harris v HMRC* [2010] SFTD 1159 at [33]: "Section 839(3)(b) [ICTA] is expressed in the present tense, and s 839(3)(a) requires the settler at the relevant time to be an individual who *is* the settlor. None of this is apt to include a deceased settlor." In s.993 ITA, the tax law rewrite has deleted the second *is* but that makes no difference.
Contrast the definition of associates. See 85.5 (Associates).

26 See 85.6 (Attribution of rights of associates and controlled companies).

27 See 85.3.7 (Right to income); 85.3.8 (Right to capital).

(2) B (who is connected with A, eg a spouse) creates a trust (trust B). A is connected with the trustees of trust A (A is the settlor). A is connected with the trustees of trust B (a connected person is the settlor). However the trustees of trust A are not connected with the trustees of trust B. For the position if the trusts own companies, see 85.15.10 (Example: Trusts with connected settlors own separate companies).

For completeness: s.286(3)(d)(e) TCGA deal with sub-fund settlements.[28] Since sub-fund settlements are (virtually) never found in practice, this is dead-letter law which need not be considered even in a work which seeks to be comprehensive.

Trustees are not connected with a corporate settlor.

85.12.2 *Meaning of settlement and trustee*

Section 286(3ZA) TCGA defines "settlement":

> For the purpose of subsection (3) above-
>
> (a) "settlement" has the same meaning as in section 620 of ITTOIA 2005

Why is the settlement-arrangement definition applied? (Contrast the definition of associate.) Perhaps non-corporate employers complained that a transfer by them to a pension fund was (before 2006) a connected person transaction whereas a transfer by a company to a pension fund was not. Now a transfer to a pension fund is not a connected person as the transferor is not in principle connected with a pension trust.[29] But that is speculation as no reason was ever provided. A consequence is that will trusts are not settlements for the purposes of the connected persons rules, which is odd.[30]

Before 2006, the settlement-arrangement definition applied for IT but not for CGT. The reason for the CGT change might have been that the same rule should apply for both taxes. Of course an alternative would have been to bring IT in line with CGT. Had a reason for the change been

---

28 "(d) if the settlement is the principal settlement in relation to one or more sub-fund settlements, the trustees of the sub-fund settlements, and
(e) if the settlement is a sub-fund settlement in relation to a principal settlement, the trustees of any other sub-fund settlements in relation to the principal settlement."

29 See 80.34.1 (Is a pension trust or employee trust a settlement?).

30 See 78.6.1 (Is an estate a "settlement" within s.87 TCGA?). For completeness: This was overlooked in an obiter passage in *Harris v HMRC* [2010] UKFTT 385 at [32] where the relevant authorities were not cited.

given, the issues could have been publically discussed. But there it is.

Section 286(3ZA)(b) TCGA defines "trustee":

> "trustee", in relation to a settlement in relation to which there would be no trustees apart from this paragraph, means any person in whom the settled property or its management is for the time being vested.

For the definition of control for IHT purposes, "settlement" "settlor" and "trustee" have their IHT meanings: s.270 IHTA.

85.13 Company connected with trustees

Section 286(3) TCGA provides:

> A person, in his capacity as trustee of a settlement, is connected with ...
> (c) any body corporate[31] which is connected with that settlement,

This takes us to s.286(3A) TCGA which provides:

> For the purpose of subsection (3) above a body corporate is connected with a settlement if-
> (a) it is a close company (or only not a close company because it is not resident in the UK) and the participators include the trustees of the settlement; or
> (b) it is controlled (within the meaning of section 1124 of the Corporation Tax Act 2010) by a company falling within paragraph (a) above.

It is confusing that the drafter used the expression "connected with a settlement" since in that expression the term "connected" is not used in the normal CGT sense of connected persons. But it does not matter.

The IT equivalent is more clearly drafted. Section 993(3) ITA provides:

> A person, in the capacity as trustee of a settlement, is connected with ...
> (c) any close company whose participators include the trustees of the settlement,
> (d) any non-UK resident company which, if it were UK resident, would be a close company whose participators include the trustees of the settlement,
> (e) any body corporate controlled (within the meaning of section 995) by a company within paragraph (c) or (d)

---

31 I do not know why the subsection refers to body corporate rather than company, but I don't think it makes any difference.

Thus trustees are connected with any close company in which they have any interest, no matter how small, but non-trustees are connected only if there is some element of "control".

85.14 Connection with partners

Section 286(4) TCGA provides:

> Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with
> [a] any person with whom he is in partnership,
> [b] and with
> [i] the spouse or civil partner
> [ii] or a relative
> of any individual with whom he is in partnership.[32]

A partner is connected with a company controlled by a partnership because the partner has "control" of the company[33] and a person is connected to a company of which they have "control".[34]

85.15 Connection with company

Apart from the rule connecting trustees with companies, s.286 TCGA provides two ways by which a company may be connected with another person:
(1) company and person with control;
(2) company and persons acting together to exercise control.
In addition there are two ways by which a company may be connected with another company (an "inter-company connection"):
(1) 2 companies with common control;
(2) 2 companies with groups of connected controllers.

---

32 For IT, s.993 (4) ITA provides similarly:
"A person who is a partner in a partnership is connected with—
(a) any partner in the partnership,
(b) the spouse or civil partner of any individual who is a partner in the partnership, and
(c) a relative of any individual who is a partner in the partnership.
But this subsection does not apply in relation to acquisitions or disposals of assets of the partnership pursuant to genuine commercial arrangements."

33 See 85.5.1 (Relatives and partners).

34 See 85.15.4 (Person controls a company).

For completeness: the standard definition of company is disapplied for the purposes of s.993 and 994 ITA (though not for CGT purposes).[35] So s.994 needs to provide its own definition of company,[36] but since the definition is (almost) the same as the standard definition, this makes (almost) no difference.[37]

For IT, s.994(1) ITA provides:

> In section 993 and this section ...
> "control" is to be read in accordance with sections 450 and 451 of CTA 2010 (except where otherwise indicated)

The only place where the context indicates that "control" is not used in the ultra-wide sense is in the phrase "acting together to secure or exercise control" and for all other references the ultra-wide sense applies. For this reason the concept of being connected with a company is also ultra-wide and no-one can draw a complete list of all the companies with which they are connected.

The CGT equivalent is s.288(1) TCGA. The wording is slightly different: but the position is exactly the same.

85.15.1 *Inter-company connection: One person controls two companies*

Section 286(5)(a) TCGA provides:

> A company is connected with another company-
> (a) if the same person has control of both...

A simple case is if one person owns two companies:

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35 See 84.4 (Meaning of "company").

36 Section 994 ITA provides:

"(1) In section 993 and this section—

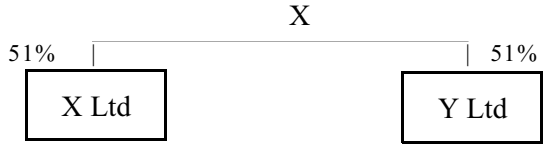
'company' includes any body corporate or unincorporated association, but does not include a partnership (and see also subsection (2)),...

(2) For the purposes of section 993—

(a) a unit trust scheme is treated as if it were a company, and

(b) the rights of the unit holders are treated as if they were shares in the company."

37 The only difference concerns the somewhat specialist topic of local authorities; see Kessler & Marre *Taxation of Charities & Non-profit Organisations* (9th ed., 2013), para 43.5.1 (Group relief).



X Ltd is connected with Y Ltd.

85.15.2 *Inter-company connection: Connected persons control two companies*

Section 286(5)(a) TCGA provides:

> A company is connected with another company-
> (a) if ..
> [i] a person has control of one and
> [ii] [A] persons connected with him, or
> [B] he and persons connected with him,
> have control of the other,

If two persons ("X" and "Y") are associates, this is not needed because the rights of X are attributed to Y.[38] It is relevant in a case where two persons are connected but not associates.

85.15.3 *One group controls two companies*

Section 286(5)(b) TCGA provides:

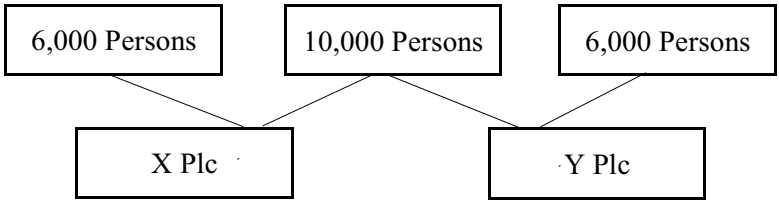
> A company is connected with another company...
> (b) if
> [i] a group of 2 or more persons has control of each company, and
> [ii] the groups either
> [A] consist of the same persons or
> [B] could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he is connected.

The group may be vast and does not need any common purpose or identity. In *Kellogg Brown v HMRC*[39], two quoted companies each with over 16,000 shareholders were connected by a somewhat unimaginative

38 See 85.6 (Attribution of rights of associates and controlled companies).

39 *Kellogg Brown & Root Holdings (UK) v HMRC* [2010] STC 925

construction of this head, since there was sufficient overlap between the two groups.



X Plc and Y Plc are connected.

85.15.4 *Person controls a company*

Section 286(6) TCGA provides:

> A company is connected with another person, if
> [a] that person has control of it ...

Since control is ultra-wide, this head of control is also ultra-wide. See 85.7.2 (Associates each own a company).

85.15.5 *Connected persons control a company*

Section 286(6) TCGA provides:

> A company is connected with another person, if ...
> [b] if that person and persons connected with him together have control of it.[40]

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40 For IT, s.993 ITA provides similarly:
(5) A company is connected with another company if—
(a) the same person has control of both companies,
(b) a person ("A") has control of one company and persons connected with A have control of the other company,
(c) A has control of one company and A together with persons connected with A have control of the other company, or
(d) a group of two or more persons has control of both companies and the groups either consist of the same persons or could be so regarded if (in one or more cases) a member of either group were replaced by a person with whom the member is connected.
(6) A company is connected with another person ("A") if—
(a) A has control of the company, or

If two persons ("X" and "Y") are associates, this is not needed because the rights of X are attributed to Y.[41] For instance, suppose:
(1) X and Y are relatives or partners.
(2) X owns 30% of A Ltd and Y owns 30% of A Ltd.
X "controls" A Ltd so this provision is not needed. It is only relevant in a case where two persons are connected but not "associates".

Suppose
(1) A and B are connected persons but not associates.
(2) B controls X Ltd and A has no interest in X Ltd.
It is considered that A is connected to X Ltd. It might be argued that A and B do not *together* have control, but various anomalies would arise, and that is reading too much into the word *together*.

85.15.6 *Persons acting together to exercise control*

Section 286(7) TCGA provides:

> Any 2 or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another and with any person acting on the directions of any of them to secure or exercise control of the company.[42]

For the purposes of discussion I abbreviate "secure or exercise control" to "exercise control".

The CG Manual comments on the phrase "acting together to exercise control":

> **14622 Companies: 2 or more persons acting together to control** [February 2006]
> ... For this subsection to operate it is not sufficient for the persons to have control of the company, the persons do have to act in some way to control the company. However, for example, exercising control could mean refraining from voting in a particular way and so enabling another

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(b) A together with persons connected with A have control of the company.

41 See 85.6 (Attribution of rights of associates and controlled companies).

42 For IT, s.993(7) ITA provides similarly:
"In relation to a company, any two or more persons acting together to secure or exercise control of the company are connected with—
(a) one another, and
(b) any person acting on the directions of any of them to secure or exercise control of the company."

> person to win a vote, as well as by actually voting.

In *Steele v EVC International* 69 TC 88 one issue was whether two joint shareholders were "acting together". The Court of Appeal said:

> the mere coincidence of voting the same way at general meetings is insufficient. Likewise, combining together to carry a particular resolution would not normally be sufficient to constitute acting together to exercise control either at all or on any continuing basis cf *IRC v Lithgows* 39 TC 270.

So far so good. The Court continued:

> the shareholders' agreement set out in great detail how EVC was to be constituted and administered. At all material times the agreement was in force and performed and observed by each of the shareholders. ... such performance and observation constituted the necessary "acting together".

The existence of a shareholders agreement does not show that the shareholders are acting together to exercise control. It is a question of fact. In *EVC*, most of the terms of the shareholders agreement seem to me to be indicative of each side protecting its interest acting separately! The agreement ensured that the company was deadlocked at board level as it was at general meeting level. However the following term suggested the shareholders were acting together:

> that EniChem and ICI should procure that not less than two-thirds of the profits of the joint venture available for dividend should be distributed to the shareholders and should procure that the shareholders vote accordingly to achieve this.

Foulser v MacDougall[43] is another example of acting together, but the facts were unusual. An individual (in short) owned a company through a life policy wrapper. He arranged the sale of the company on behalf of the insurance company shareholder. The insurance company shareholder and the individual were held to be acting together to exercise control. The Court said:

> there is no reason why the concept of two or more persons "acting together to … exercise control of a company" should, necessarily, be

43 [2005] STC (SCD) 374. The finding was not challenged on appeal.

> confined to cases where each of the persons acting together has less than a controlling shareholding, so that (absent some combination between them) none would be able to exercise control individually. It seems to me that the concept is sufficiently wide to include cases where one person (who has shareholder or voting control) agrees to exercise that control in accordance with the wishes of another.[44]

A more restrictive view was taken in *HMRC v UBS*:

> The UT's view ... appears to have been that if DB controlled Investec in relation to the latter's voting at general meetings of Dark Blue, then 'the test of control in section 416(3) [ICTA = s.993(7) ITA] was satisfied'. Mr Goy submitted, and I agree, that section 416(3) is irrelevant to our facts. Investec, by virtue of its holding in Dark Blue, was formally in control of Dark Blue within the meaning of section 416(1). The relevant question for our purposes, however, is whether Investec was, vis-à-vis its role as a Dark Blue shareholder, itself in the control of DB. If it was, the opening words of section 416(2) are satisfied and DB and Dark Blue are associated companies. If it was not, those words are not satisfied. I do not understand what section 416(3) is thought to have to do with it. It is contemplating a case in which, for example, DB and X Ltd together had relevant control of Dark Blue via their combined control of Investec. On no footing is that this case.[45]

85.15.7 *Directors*

The CG Manual considers the position of directors:

> **14623. Directors of a company** [August 2009]
> Directors of a company are not necessarily connected persons in relation to transactions between themselves. Whether or not one of them controls the company or two or more together control the company, they are not connected persons unless they are 'relatives' or partners. Section 286(7) TCGA 1992 makes two or more directors connected persons only in relation to transactions with the company.

The last sentence means that if directors are acting together to exercise control at shareholder level, they are connected persons only in relation to transactions with the company.

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44 [2007] STC 973 [42]. *UBS v HMRC* [2012] UKUT 320 (TCC) is an example where companies were held not to be acting together.

45 [2014] EWCA Civ 452 at [133].

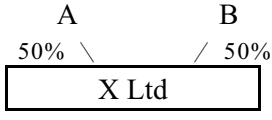
85.15.8 *Personal representatives*

The definition of connected person does not expressly mention PRs (unlike the definition of "associates"). PRs cannot be connected with individuals or trustees.[46]

PRs may be connected with a company. They are "persons" so they are connected if (inter alia) they have control of the company or if they act with others to exercise control.

85.15.9 *Example: Unconnected persons jointly own a company*

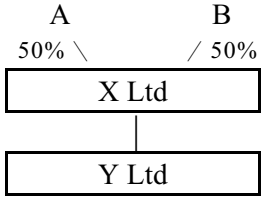
Suppose individuals A and B (who are not connected or associated) each own 50% of X Ltd.



If A and B are not acting together to exercise control then they are not connected with each other or to X Ltd.

Suppose A and B are acting together to exercise control (as may well be the case). In that case they are "treated in relation to that company as connected with one another." A and B are also connected with the company. However, A does not control the company.

Suppose X Ltd has a subsidiary thus:



It is considered that A is connected to Y Ltd since A and persons connected to A (ie X Ltd) together control Y Ltd.[47]

Of course, A and B together control X Ltd. Suppose A and B own two companies thus:

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46 The same conclusion was reached, though in a more roundabout way, in *Harris v HMRC* [2010] UKFTT 385 at [31] - [33].

47 See 85.15.5 (Connected persons control a company).

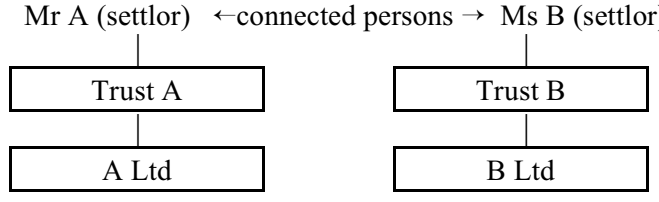
X Ltd and Y Ltd are connected with each other.

85.15.10 *Example: Trusts with connected settlors own separate companies*

Suppose:

(1) A creates a trust (trust A) which owns a company (A Ltd) and

(2) B (who is a relative or spouse of A) creates a trust (trust B) which owns a company (B Ltd), thus:



The analysis is as follows:

(1) A is connected with Trust A (because A is the settlor).

(2) A has "control" of A Ltd (the trustees of trust A are associates of A, because A is the settlor; so their rights are attributed to him).

(3) A is connected with A Ltd (because of that control).

(4) A is connected with the trustees of trust B (because a connected person is the settlor).

(5) A has "control" of B Ltd (the trustees of trust B are associates of A because a relative is the settlor; so their rights are attributed to him).

(6) A is connected with B Ltd (because of that control).

(7) A Ltd is connected with B Ltd (because A has "control" of both).

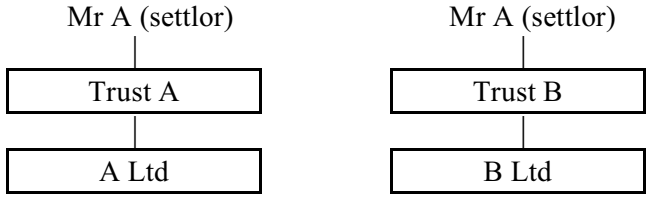
The trustees of trust A are not connected with the trustees of trust B but that does not stop their companies from being connected. Note that it is not necessarily possible for A Ltd or the trustees of trust A to know that A Ltd is connected with B Ltd.

What if A and B have died? If there is any person alive who is a relative of A and B, as defined, the relative has "control" of both companies and so A Ltd and B Ltd are still connected. But if A and B have no relatives (as defined) then the two companies are not in principle connected.

85.15.11 *Example: Trusts with same settlor own separate companies*

Suppose A is the settlor of two trusts (trust A and B) which each own a

company (A Ltd, B Ltd), thus:



The analysis is as follows:

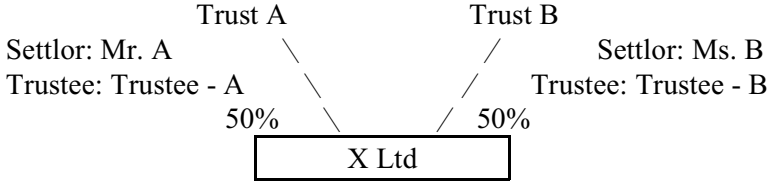
(1) A is connected with Trust A and with Trust B (because A is the settlor).
(2) A has "control" of A Ltd and B Ltd
(3) A is connected with B Ltd (because of that control).
(4) A Ltd is connected with A Ltd and B Ltd (because A has "control" of both).

The trustees of trust A are not connected with the trustees of trust B but that does not stop their companies from being connected.

What if A has died? If there is any person alive who is a relative of A, as defined, the relative has "control" of both companies and so A Ltd and B Ltd are still connected. But if A has no relatives (as defined) then the two companies are not in principle connected.

85.15.12 *Example: Unconnected trusts jointly own a company*

Suppose individuals Mr A and Ms B (who are not otherwise connected) are settlors of trusts which each own 50% of X Ltd. The trustees are Trustee-A and Trustee-B.



If none of Mr A, Ms B, Trustee-A and Trustee-B are acting together to exercise control then none of Mr A, Mr B, Trustee-A, Trustee-B or X Ltd are connected.

Suppose Mr A, Ms B, Trustee-A and Trustee-B are all acting together to exercise control (as may well be the case). In that case they are "treated in relation to that company as connected with one another." Mr A is also connected with the company. They would similarly be connected with a subsidiary of the company. Mr A does not control the company.

85.16 Why does it matter who is a participator?

The term "participator" is used throughout the Taxes Acts, and it is not practical to give a full list. For the purposes of this book, the term is particularly important in the following contexts:

(1) The definition of "relevant person" for the ITA remittance basis
(2) Section 13 TCGA (non-resident company gains attributed to participators)
(3) The test of whether trustees control a company[48]
(4) The definition of "close company"

85.17 Definition of participator

Section 454(1) CTA 2010 provides a general statement:

> For the purposes of this Part, "participator", in relation to a company, means a person having a share or interest in the capital or income of the company.

Section 454(2) CTA 2010 goes on to list five specific categories of participator:

> In particular, "participator" includes—
>
> (a) a person who possesses, or is entitled to acquire, share capital or voting rights in the company,
> (b) a loan creditor[49] of the company,
> (c) a person who possesses a right to receive or participate in
> [i] distributions[50] of the company or
> [ii] any amounts payable by the company (in cash or in kind) to loan creditors by way of premium on redemption,
> (d) a person who is entitled to acquire such a right as is mentioned in paragraph (c), and
> (e) a person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for the person's benefit.

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48 See 85.13 (Company connected with trustees).

49 See 85.18 (Loan Creditor).

50 Section 454(4) CTA 2010 defines "distribution": "In subsection (2) 'distribution' is to be construed without regard to section 1000(2) (extended definition of distribution for close companies)."

This is so wide that it is difficult to think of a case falling within (1) which is not within (2).

The definition is expressed to apply for the purposes of Part 10 CTA 2010, but it should be a taxes-act-wide definition. When the word participator is used in connection with close companies, the definition is almost always incorporated and where there is no definition it must be implied. Occasionally the definition is adopted with extensions: s.454(6) CTA 2010 anticipates this:

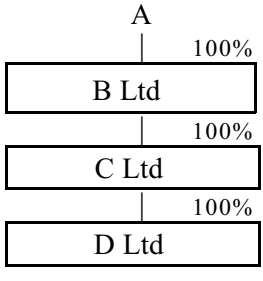
> This section does not affect any provision of this Part requiring a participator in one company to be treated as being also a participator in another company.

85.17.1 *Charge over shares*

Suppose a person has a charge over shares to secure a debt. The charge is an interest in the shares of the company, but not an interest in the capital or income of the company, and it is not in principle within any of the categories of s.454(2). Accordingly a chargee is not in principle a participator.

85.17.2 *Chain of wholly owned companies*

Suppose a chain of wholly owned companies:



C Ltd is obviously a participator in D Ltd. But A and B Ltd are also participators in D Ltd, under s.454(2)(e) CTA 2010.[51] This is so wherever the companies are resident.

85.17.3 *Chain of partly owned companies*

Suppose a chain of partly owned companies which do not confer control, such as:

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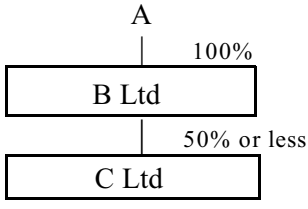
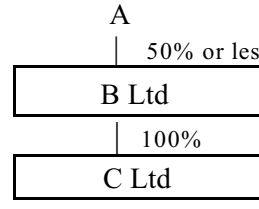
51 This view is not universally held.

Example 1



Example 2



A is a participator in B Ltd. A does not control C Ltd[52] and it is considered that A is not a participator in C Ltd. It might be argued that the rights of a minority shareholder are such that A is a participator within s.454(2)(e) - ie that A has the right to secure that the income of C Ltd is applied for A's benefit. I refer to this as the wide view. But this is very doubtful and in practice it appears that HMRC do not take the wide view. Section 455(5) CTA 2010 provides a wider than standard definition of "participator":

> If a company (c) controls[53] another company (D), a participator in C is to be treated for the purposes of this section as being also a participator in D.[54]

This applies in a few specific circumstances, in particular:
(1) For the definition of relevant person in the ITA remittance basis.[55]
(1) For s.1064 CTA 2010 (extended meaning of "distribution" for close companies.)
(2) For s.455 CTA 2010 (loans to participators).

The CT Manual provides:

> **60110 Participator: Extended meaning of** [November 2011]
> ... If, for example, Company B holds all the issued share capital of Company T and Company T makes a loan to W, a shareholder in Company B, that loan is within [s.455 CTA 2010] since W as well as being a participator in Company B is deemed also to be a participator in Company T.

This example is essentially example 2 above. It assumes that the wide view is not correct; that is why the extended definition of "participator"

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52 In the absence of special facts, eg provisions in the company articles or shareholder agreements.

53 The ultra-wide definition of "control" applies: see 85.3 (Control in ultra-wide sense).

54 This provision is also found in s.459(4) CTA 2010.

55 See 11.5.1 ("Participator").

is needed.

85.17.4 *Trustees and beneficiaries*

Suppose trustees hold a share or interest in a company. The trustees are participators under s.454(1) CTA 2010. A person holding a share or interest as trustee is not a participator in their personal capacity since trustees are (at least for IT and CGT purposes) deemed to be a separate person. Beneficiaries of a *Baker* trust, other than merely discretionary beneficiaries, are also participators under s.454(1) since they too have an interest in the trust property. Beneficiaries of a *Garland* trust do not have an interest in trust property. However they are participators under s.454(2)(a)(c)(d) by virtue of their right to compel administration of the trust.

HMRC agree. The CT Manual provides:

> **60160. 'Interested in'** [February 2006]
> The words 'interested in' have a wide meaning and, for example, where shares are held by trustees, the trustees, the beneficiaries and the remainderman (if any) of the trust are interested in the shares. Where shares are held by trustees under a will for persons in succession, the life tenant and the remainderman, as well as the trustees, are interested in the shares. (See, in this connection, *IRC v Park Investments* 43 TC 200, particularly the judgment of Danckwerts LJ at page 225, *IRC v Tring Investments* 22 TC 679, and *Alexander Drew and Sons v IRC* 17 TC 140.)

As to whether a person holding as nominee is a participator in their private capacity, see *Bramwell on Corporation Tax* (looseleaf) para A.11.1.16.

What about beneficiaries of a discretionary trust? The question is whether they have an "interest" in the company. The general rule is that the word "interest" is ambiguous and may or may not be taken to include the rights of a discretionary beneficiary: the context must decide the question; see *Leedale v Lewis* 56 TC 501. The difficulty is that the concept of participator is used in many contexts, and the definition section itself does not offer much context. *Bramwell on Corporation Tax* takes the view that beneficiaries of a discretionary trust are participators, and for practical purposes it would be safest to proceed on the basis that this may well be correct.

85.17.5 *Personal representatives and beneficiaries of estates*

Suppose PRs hold shares in a company. The PRs are participators under

s.454(1) CTA 2010.

A person holding shares as PR is not a participator in their private capacity for CGT purposes as for CGT the PRs are deemed to be a separate person. The Tribunal reached the same conclusion for IT purposes even in the absence of a provision expressly deeming PRs to be a separate person.[56]

Beneficiaries of the estate are not participators under s.454(1) since they do not have a legal or equitable "interest" (in the strict sense) in the assets of the estate. However they are participators under s.454(2)(a)(c)(d) by virtue of their right to compel administration of the estate.

The CT Manual provides:

> **60160. 'Interested in'** [February 2006]
> ...The executors or administrators are interested in the assets of a deceased person's estate during the period of administration (*Willingale v Islington Green Investment* 48 TC 547). The beneficiaries should be regarded as interested in any assets of the estate from which they may benefit.

85.17.6 *"Entitled to do"*

Section 454(3) CTA 2010 provides:

> For the purposes of subsection (2), a person is treated as entitled to do anything which the person—
> (a) is entitled to do at a future date, or
> (b) will at a future date be entitled to do.

The CT Manual provides:

> **60120. Entitled to acquire or secure** [November 2011]
> The words 'entitled to acquire' and 'entitled to secure' introduce the concept of a potential participator. So, for example, a person is a participator if, by means of a contractual right or by rights arising under a trust deed, they can:
> • require a shareholder to transfer shares to that person, or

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56 *Harris v HMRC* [2010] SFTD 1159 at [31]: "There must be a distinction between a benefit being received by an individual beneficiary and a benefit being received, albeit by the same person, in a representative capacity.... Otherwise a different result would obtain depending on whether the residuary beneficiaries were the same persons as, or different persons from, the personal representatives."
However *Bibby v IRC* 29 TC 167 was not cited.

- secure the issue to that person of unissued capital of the company, or
- secure that if the company makes a distribution or if a loan is redeemed by the company at a premium, that person has a share in the distribution or the premium.

Similarly, a person is a participator if by means of a contractual right or some other arrangement they can secure that income or assets of the company will be applied directly or indirectly for their benefit. See too 85.3.9 ("Entitled to acquire").

85.18 Loan Creditor

85.18.1 *Why does it matter who is a loan creditor?*

The expression is used too often to set out a full list, but in particular:
(1) A loan creditor is a participator.
(2) The expression is used in the definition of close company.

85.18.2 *Definition of loan creditor*

Section 453 CTA 2010 provides:

> (1) For the purposes of this Part, "loan creditor", in relation to a company, means a creditor—
>
> (a) in respect of any debt within subsection (2), or
>
> (b) in respect of any redeemable loan capital issued by the company.
>
> But this is subject to subsection (4).
>
> (2) Debt is within this subsection if it is incurred by the company—
>
> (a) for any money borrowed or capital assets acquired by the company,
>
> (b) for any right to receive income created in favour of the company, or
>
> (c) for consideration the value of which to the company was (at the time when the debt was incurred) substantially less than the amount of the debt (including any premium on the debt).

The CT Manual paraphrases this provision and continues:

> **60130. Loan creditor** [November 2011]
>
> A person is not a participator merely because he or she is a normal trade creditor of the company.
>
> As the normal debenture issued by a company is redeemable, debenture holders are participators.
>
> Payments to be made under a hire purchase agreement would not

> normally be regarded as part of the company's loan capital. This is because under the usual hire purchase agreement there will be no debt for capital assets acquired by the company. The terms of the typical agreement make it clear that the assets remain in the ownership of the hire company until the final instalment is paid. The payments not made in order to acquire a capital asset, but rather they are rent for the use of the asset.
>
> An example of a sum owing in the circumstances described in [s.453(2)(b)] is where a person contracts to make annual payments to the company, in return for a capital sum due at some later date. The capital sum is treated as loan capital of the company and the person will be a participator.
>
> ... It should be borne in mind that [s.1000 CTA 2010] provides that the interest etc on certain loans is a distribution. As regards such loans, the creditor is in any case a participator as he or she 'possesses a right to receive or participate in distributions of the company' (see [s.454(2)(c)]).

85.18.3 *Interest in debt*

Section 453(3) CTA 2010 provides:

> A person who—
>
> (a) is not the creditor in respect of any debt or loan capital to which subsection (1) applies, but
>
> (b) has a beneficial interest in that debt or loan capital,
>
> is, to the extent of that interest, treated for the purposes of this Part as a loan creditor in respect of that debt or loan capital (but this is subject to subsection (4)).

The words "to the extent of that interest" are not well expressed, since a person either is or is not a loan creditor. One cannot be a loan creditor "to an extent". But it does not matter.

85.18.4 *Bank creditor*

Section 453(4) CTA 2010 provides:

> A person carrying on a business of banking is not treated as a loan creditor in respect of any debt or loan capital incurred or issued by the company for money lent by the person to the company in the ordinary course of that business.

The CT Manual provides:

60130. Loan creditor [November 2011]
Banking business
[The manual summarises the provision and continues:] Where a company has borrowed money from a person, that person is a participator unless the person carries on the business of banking and made the loan in the ordinary course of that business (Section 453(4) CTA 2010... There is no statutory definition of what constitutes carrying on a banking business (the definition of bank in Section 1120 CTA 2010 ... does not apply to Section 453 CTA 2010 ...) so we rely instead on the common characteristics of banking established in the (non-tax) case of *United Dominions Trust v Kirkwood* 1966 2 QB 431 and endorsed in *Hafton Properties v McHugh* 59 TC 420.
If you have any queries on whether a person is carrying on a business of banking, or whether a loan is made in the ordinary course of that business, please consult CTIAA (Technical).

85.19 Close company: Introduction

"Close" company is a concept used so often in tax legislation that it is impossible to write a full list. For the purposes of this book, the concept is important in particular in the definitions of relevant person (for remittances); connected person, and for the application of s.13 TCGA.

"Close company" is one of the most elaborately defined expressions in the taxes acts, and that is really saying something. There are two main tests of close, the control test and the winding up test.

The definition in the CTA is for the purposes of the corporation tax acts. This is extended to income tax by s.989 ITA:

> The following definitions apply for the purposes of the Income Tax Acts—
> "close company" is to be read in accordance with Chapter 2 of Part 10 of CTA 2010 (see in particular section 439 of that Act)

The definition is extended to CGT by s.288(1) TCGA:

> In this Act, unless the context otherwise requires—
> "close company" shall be construed in accordance with Chapter 2 of Part 10 of CTA 2010 (see in particular section 439)

85.20 Control test

Section 439(1) CTA 2010 provides:

> For the purposes of the Corporation Tax Acts, a "close company" is a company in relation to which condition A or B is met.

I refer to **"close company conditions A and B"**.

85.20.1 *Close company condition A: Control of five or fewer participators*

Section 439(1) CTA 2010 provides:

> Condition A is that the company is under the control—
> (a) of 5 or fewer participators, or
> (b) of participators who are directors

Control has the ultra-wide sense.

85.20.2 *Control of participators who are directors*

This takes us to the idiosyncratic definition of director in s.452 CTA 2010:

> (1) In this Part, "director", in relation to a company, includes—
> (a) a person occupying the position of director of the company, by whatever name called,
> (b) a person in accordance with whose directions or instructions the directors of the company are accustomed to act, and
> (c) a person within subsection (2).

(1)(a)(b) are standard form; but (c) leads to a distinctly non-standard extension:

> (2) A person (P) is within this subsection if P—
> (a) is a manager of the company or otherwise concerned in the management of the company's trade or business, and
> (b) is—
> (i) the beneficial owner of, or
> (ii) directly or indirectly able to control,
> at least 20% of the ordinary share capital of the company.
> (3) For the purposes of subsection (2)(b), P is treated as owning or controlling (as the case may be) what any associate of P owns or controls.

A company controlled by director-participators is a close company, even if the number of director-participators exceeds five. Directors have "control" of a company if (*inter alia*) they exercise direct or indirect control over the company's affairs. This is puzzling as (under standard articles)[57] company law directors manage the business of the company,

57 The Companies (Model Articles) Regulations 2008 Model Article para 3; (formerly Table A paragraph 70).

and may exercise all the powers of the company. In one sense, directors always control their company. It cannot be that every company whose directors happen to be participators is made a close company under this part of the definition. The answer is that "control" here means control at shareholder level, the ability to pass an ordinary resolution in general meeting. Directors do not "control" a company, in the relevant sense, unless they control the company at that level.[58]

It follows that a charitable company is normally close if its directors constitute all or a majority of the members of the company.[59]

As to whether a foundation is a close company, see 84.8.2 (Is a foundation an IT/CGT settlement, or a company?).

85.20.3 *HMRC examples*

The CT Manual gives some examples:[60]

> **CTM60420 - Close companies: tests: examples** [Nov 2011]
> ... The examples refer to companies having shares that are not dealt in or quoted on a stock exchange.
> **Example 1**
> Company X has 1,000 issued shares of £1 held as below.
> Trustees of A's settlement 449
> Mrs A (settlor) 60
> Ten other shareholders 491
> Total issued ordinary shares 1,000
> The ten shareholders are not associated with each other or with A or Mrs A and no one of them holds more than 50 shares.
> The trustees of A's settlement are associates of Mrs A by virtue of CTA2010/S448 (1) (b) and (c) ... and their rights and powers may be

---

58 *Steele v EVC International* 69 TC 88 at p.127. See Venables, *The Taxation of Foundations* (2010) para E2.1.4.3 (Direct or Indirect Control over the Company's Affairs).

59 For example, an Oxford college (a body corporate) may be a close company, since:
(1) Its fellows may be "participators", if they possess voting rights in the body corporate.
(2) Its fellows manage the business of the body corporate, so they are (in principle) "directors".
(3) Its fellows control the body corporate, at shareholder level (or more accurately, at corporate member level).
It appears that HMRC do not take this point in practice.

60 In these examples I omit internal Manual cross references and alter the formatting for increased clarity.

attributed to Mrs A who therefore controls the company.
Company X is therefore a close company.

This is correct, but it is not necessary to rely on the associates rule to reach the conclusion that the company is close. The company would be close even if Mrs A were not the settlor since it is under the control of two (less than five) persons.

The Manual continues:

CTM60420 - Close companies: tests: examples [Nov 2011]
... **Example 2**
The £1 issued shares in a trading company are owned as follows.

Ordinary shares		
Directors		
A	4	
B (cousin of A)	4	
Others: 12 individuals equally, none of whom is a nominee associate, etc, of any other shareholder		4,992
Total issued ordinary shares		5,000
5% preference shares		
A (see above)		5,000
Total nominal and issued capital		10,000

There are no loan creditors ranking as participators or members.
Control by reference to possession of the greater part of the issued share capital (CTA2010/S450 (3).
The company is a close company because A possesses more than half the issued capital.

This is straightforward.

The Manual continues:

CTM60420 - Close companies: tests: examples [Nov 2011]
... **Example 3**
The issued ordinary shares in a trading company carry one vote each but the 'A' ordinary shares do not confer voting rights. The shareholders are as below.

	Ordinary	'A' ordinary
A	280	
Wife of A	100	
B (brother of A)	10	
Trustees of A's settlement	40	
Company X (controlled by A)	80	
	510	

Mrs C (daughter of B)	20	
10 other equal holdings	470	500
Total issued shares	1,000	500

The shares carry equal rights to dividend. A's wife has made a loan of £20,000 to the company at 5% interest. There is no share premium account or other comparable account.
Control by voting rights (CTA2010/S450 (3) ...
The associates of A are:
- his wife and his brother, (ICTA88/S417 (3)(a) and (4), ... and
- the trustees of A's settlement, CTA2010/S448 (1) (b) and (c)...
The rights and powers attributable to A are:
- the rights and powers of his associates (CTA2010/S451 (4) to (6) ... and
- the rights and powers of Company X (CTA2010/S451 (4) to (6)).
As a total of 510 votes are thus possessed by A or attributable to him, the company is a close company controlled by one person.

This is correct, but it is not necessary to rely on the associates rule. The company would be close even if none of the shareholders were associates, since it is under the control of five participators. A's wife's loan is wholly irrelevant and it is difficult to see why the example mentions it.

Alternatively control by holding the greater part of the issued share capital, (CTA2010/S450 (3)), - any eight of the other equal holdings will control the company by holding the greater part of the issued share capital.

I do not understand this comment. Perhaps the text of the example is corrupt.

CTM60420 - Close companies: tests: examples [Nov 2011]
... Example 4
The authorised and issued share capital of Company X is £1,000 in the form of 1,000 ordinary shares of £1 each, held as below.

A	200
B	100
C	50
D	50
E	40
Company Y	99
Other shareholders	461
Total issued ordinary shares	1000

A, B and C are directors.

The issued capital of Company Y, is £100 in the form of 100 ordinary shares of £1 each, held by:

F (son of E)	60
G	40
Total issued shares	100

The shareholders in Company X, other than Company Y, are all individuals and none are related or otherwise associated. No 'other shareholder' holds more than 50 shares.

Control - the rights in the shares held by Company Y in Company X may be attributed to F who controls that company (CTA2010/S451 (4) to (6) ...

F is an associate of E but the rights attributed to F cannot be further attributed to E (CTA2010/S451 (4) to (6)).

No group of five participators or fewer can control Company X, nor do the director/participators control, and nor would the winding up test be of assistance here.

Company X is not a close company.

CTM60420 - Close companies: tests: examples [Nov 2011]

... Example 5

The facts are the same as in Example 4 except that F is the holder of one share in Company X.

Control rights can be attributed to F as below.

Shares held in own right	1
Shares held by E (an associate)	40
Shares held by Company Y (controlled by F)	99
	140

Thus A, B, C, D and F hold (or have attributed to them) the rights in 540 shares and control the company.

Company X is a close company.

This example neatly illustrates the arbitrary nature of the rules. At the margin, there is obviously some scope for tax planning.

CTM60420 - Close companies: tests: examples [Nov 2011]

... Example 6

Company X has authorised capital of £5,000 in £1 ordinary shares of which £3,000 is issued as below.

A	150
B	150
C	150
D	250
E	250
F	250

20 other shareholders (no one holder having over 100 shares)	1800
Total issued ordinary shares	3000

The 20 other shareholders are individuals and none of the shareholders is an associate of any other. A, B and C are the directors. They each enter into a service agreement providing that they are to remain directors for five years from 1 January 1992, and that on 31 December 1996, they shall each have the right to purchase 500 £1 shares in the company at par.
Control - A, B and C each exercises or is entitled to acquire rights in 650 shares (CTA2010/S450 (3) ... and CTA2010/S451 (2) ...- CTM60220).
Thus A, B, C, D and E (or A, B, C, D and F, or A, B, C, E and F) together constitute a group which is 'able to exercise or is entitled to acquire, control' of the company (with 2,450 shares out of 4,500, i.e. the 3,000 issued plus the 1,500 to be issued to the directors).
The company is a close company from 1 January 1992.

CTM60420 - Close companies: tests: examples [Nov 2011]
... Example 7
The authorised and issued capital of an investment company is £33,000and is owned equally by eleven individuals who are not associated. The loan creditors are:

A (director and shareholder)	£35,000
B (not a shareholder)	£13,500

Neither A nor B is a bank. B is not an associate of a director.
In a winding up, the value of the net assets distributable among members, including loan creditors, would be £120,000 as below.

Deposits with local authorities	£30,000
Market value of quoted investments(representing the remainder of the assets)	£110,000
	£140,000
Deduct sundry creditors	
Management expenses	£300
Bank overdraft	£19,700
	£20,000
Value of net assets	£120,000

Control - the company cannot be shown to be controlled by five or fewer participators under CTA2010/S450 (3) (a) to (c)... In a liquidation, the assets would, however, be distributed as below.

A as loan creditor	£35,000
B loan creditor	£13,500
Shareholders (£6,500 each)	£71,500
Value of net assets	£120,000

More than half of this sum would be received by three persons, that is:

A (£35,000 plus £6,500)	£41,500
B	£13,500
Any shareholder other than A	£6,500
Distribution to three persons	£61,500

The company is therefore a close company by reference to CTA2010/S450 (3) (d) ... because the inclusion of loan creditors as participators shows that it is controlled by three participators.

85.21 Close company condition B: Winding-up test

Condition B provides for a case where the participators have rights which do not confer control. Section 439(3) CTA 2010 provides:

(3) Condition B is that 5 or fewer participators, or participators who are directors, together possess or are entitled to acquire—

(a) such rights as would, in the event of the winding up of the company ("the relevant company") on the basis set out in section 440, entitle them to receive the greater part of the assets of the relevant company which would then be available for distribution among the participators, or

(b) such rights as would, in that event, so entitle them if there were disregarded any rights which any of them or any other person has as a loan creditor (in relation to the relevant company or any other company).

The CT Manual provides:

60320 Rights in a winding-up [November 2011]
The tests so far considered in determining whether a company is a close company have depended on the question of control. With effect from 1 April 1989 there is a further test, in which control is irrelevant, based on rights in a winding-up. It is in Section 444 to 449 CTA 2010 and provides that a company ('the relevant company') is close if five or fewer participators, or participators who are directors, together possess or are entitled to acquire such rights as would, in the event of the winding-up of the company, entitle them to receive the greater part of the company's assets then available for distribution among the participators. By reason of Section 451 (4) to (6) CTA 2010 ... there is attributed to any participator all the rights of his associates.
This test is applied first on the basis that loan creditors are included as participators and then on the basis that they are disregarded. The company is close if it satisfies the test on either basis.

Section 440 CTA 2010 sets out the basis of the notional winding-up:

(1) This section applies for the purposes of section 439(3).
(2) In the notional winding up of the relevant company, the part of the assets available for distribution among the participators which any person is entitled to receive is the aggregate of—
- (a) any part of those assets which the person would be entitled to receive in the event of the winding up of the relevant company, and
- (b) any part of those assets which the person would be entitled to receive if—
  - (i) any other company which is a participator in the relevant company and is entitled to receive any assets in the notional winding up were also wound up on the basis set out in this section, and
  - (ii) the part of the assets of the relevant company to which the other company is entitled were distributed among the participators in the other company in proportion to their respective entitlement to the assets of the other company available for distribution among the participators.

(3) In the application of subsection (2)—
- (a) to the notional winding up of the other company mentioned in paragraph (b) of that subsection, and
- (b) to any further notional winding up required by that paragraph (or by any further application of that paragraph),

references to "the relevant company" are to be read as references to the company concerned.

Section 441 CTA 2010 provides:

(1) The following provisions apply for the purpose of determining whether under subsection (3) of section 439 five or fewer participators, or participators who are directors, together possess or are entitled to acquire rights such as are mentioned in paragraph (a) or (b) of that subsection.
(2) A person is to be treated as a participator in or director of the relevant company if the person is a participator in or director of any other company which would be entitled to receive assets in the notional winding up of the relevant company on the basis set out in section 440.
(3) No account is to be taken of a participator which is a company unless the company possesses or is entitled to acquire the rights in a fiduciary or representative capacity.
(4) But subsection (3) does not apply for the purposes of section 440.

CT Manual provides:

> **60320 Rights in a winding-up** [November 2011]
> If in the course of the deemed winding-up of the relevant company assets would be received by a participator which is a company, we proceed on the basis that the corporate participator is itself wound-up and that the assets it received from the winding-up of the relevant company are distributed to its own participators in proportion to their respective entitlement to the assets of that corporate participator. If in the course of that deemed winding-up assets would be received by a further company the process is repeated. The process continues to be repeated until all of the assets of the relevant company are distributed to individuals (with the exception referred to below). The effect is that we 'look through' all participators which are companies.
> The exception to this looking through is any company whose rights are possessed purely in a fiduciary or representative capacity. These stand with the individual participators in determining whether five or fewer participators would be entitled to receive the greater part of the assets available for distribution.
> For the purposes of this test, then, the assets of the relevant company which would be distributed to any participator are the sum of what he would receive directly from the winding-up of that company plus what he would receive indirectly through the winding-up of participators which are companies.
> For the purposes of this provision a person is treated as a participator in the relevant company if he is a participator in any company itself entitled to receive assets, directly or indirectly, in the winding-up of the relevant company.

85.22 Exceptions to close company test

85.22.1 *Non-resident close company*

Section 442 CTA 2010 sets out three exceptions to the general rule:

> A company is not to be treated as a close company if—
> (a) it is non-UK resident

A note on terminology. The rule that only a UK resident company counts as a close company is often disapplied. There are three different drafting techniques used to achieve this:

(1) Statute most often makes provisions which apply to a company "which would be a close company if it were resident in the UK".

(2) Statute sometimes uses the term "qualifying company" defined to mean a close or a non-resident close company.[61]
(3) Statute sometimes redefines the term "close company" to include a non-resident close company.[62]

There is no consistency of terminology across tax legislation; perhaps that is too much to expect. In this book I refer to such a company as **"a non-resident close company"** which I think is the clearest term.

85.22.2 *Industrial & provident society or building society*

For completeness: s.442 CTA 2010 provides:

> A company is not to be treated as a close company if ...
> (b) it is a registered industrial and provident society, or
> (c) it is a building society.

85.22.3 *Company controlled by the Crown*

Section 443 CTA 2010 provides:

> (1) A company is not to be treated as a close company as a result of section 439(2) if it is controlled by or on behalf of the Crown.
> (2) A company is "controlled by or on behalf of the Crown", for the purposes of this section, if it is under the control of the Crown or of persons acting on behalf of the Crown, independently of any other person.
> (3) But a company is not controlled by or on behalf of the Crown, for the purposes of this section, if it is a close company as a result of being under the control of persons acting independently of the Crown.

EN CTA 2010 provides:

> 1340. The [words *as a result of section 439(2)*] leave it open for a company controlled by or on behalf of the Crown to be a close company if condition B in section 439(3) is met.[63] ...
> 1341. The italicised words also leave it open for a company controlled by or on behalf of the Crown to be a close company if condition A in section 439(2) is satisfied by reference to persons acting independently

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61 For examples see 51.8.2 ("Qualifying company"); 80.35.1 (Trust made by company: s.86 definition of settlor).

62 See 62.16 (Transfer of value by close company).

63 See 85.21 (Close company condition B: Winding-up test).

> of the Crown. See subsection (3).
> 1342. In short, section 414(1)(c) of ICTA is a qualified exception to [close company condition A, control of five or fewer participators] but not an exception to [close company condition B, winding up test].

So strictly the exemption for crown controlled companies is limited. If the crown own all the shares, the company is close under close company condition B. The exemption would only apply if the crown held voting shares only. That must be rare. Perhaps it will not often matter, but the CT Manual does suggest that HMRC do not take that point:

> **60270 Control: By the Crown** [September 2011]
> A company is to be treated as controlled by or on behalf of the Crown (and therefore not a close company) if, and only if, it is by any of the control tests under the control of the Crown or of persons acting on behalf of the Crown, independently of any other person. If, however, it can be shown that under some other control test:
> • five or fewer participators, or
> • participators who are directors,
> control the company and those participators (or director/participators) act independently of the Crown, the company is a close company.
> The Crown for this purpose includes any Minister, Government Department or other person acting on behalf of the Crown.

The next paragraph extends the exemption, though on what authority I do not know:

> **60280. Control: Overseas governments and local authorities** [September 2011]
> A company should not be treated as a close company if the only persons who can be taken to have control of that company are any of the following:
> • Overseas governments.
> • The Crown Agents for Overseas Governments and Administrations.
> • Local authorities or local authority associations exempt from tax under Section 984 CTA 2010 ...
> Nor should a company be treated as a close company if the only persons who can be taken to have control of that company are any of the above together with:
> • a company or companies resident in the UK which are not close, or
> • an overseas company or companies which, if resident in the UK, would not be close.

85.22.4 *Control by open company*

The next, important, exception concern companies controlled by open (ie non-close) companies. Section 444 CTA 2010 provides:

> (1) A company is not to be treated as a close company if condition A or B is met.
> (2) Condition A is that the company—
> (a) is controlled by one or more companies none of which is a close company, and
> (b) cannot be treated as a close company except by taking, as one of the 5 or fewer participators requisite for its being so treated, a company which is not a close company.
> (3) Condition B is that the company—
> (a) would not be a close company were it not for paragraph (a) of section 439(3) or paragraph (d) of section 450(3), and
> (b) would not be a close company if the references in those paragraphs to participators did not include loan creditors which are companies other than close companies.
> (4) References in subsections (2) and (3) to a close company include a company which, if UK resident, would be a close company.

The CT Manual provides:

> **60290 Control: By another company** [September 2011]
> A company is not to be treated as a close company where:
> - the company is controlled ... by an open company, or by two or more open companies, and
> - it cannot be treated as a close company ... except by including an open company in the group of five or fewer participators.
>
> A company is also not to be treated as a close company where:
> - the company can only be shown to be close under the control test in Section 450(3)(d) CTA 2010 ... (entitlement to receive the greater part of the assets in a winding-up, etc, see CTM60230), and
> - the company would not be close under the control test if the reference to 'participators' in Section 450 (3) excluded loan creditors who are open companies.
>
> Where, in considering the above, you have to take into account a company not resident in the UK, the non-resident company is to be treated as a close company if, were it resident in the UK, it would be such a company.
>
> **60300 Open company loan creditor**
> A company is not to be treated as a close company if:
> i) it is only close by virtue of the control test in Section 450 (3)(d)

CTA 2010 ... (see CTM60220) or the 'winding- up' test in Section 439 (3)(a) CTA 2010 ...) (see CTM60320), and

ii) it would not be close if, for the purposes of those tests, open companies were not regarded as participators in respect of their interests in the company as loan creditors.

In arriving at the amount available for distribution among the participators, any amount due to an open company as a loan creditor (including any amount due to it as a holder of loan capital) may be disregarded if the result is that the company ceases to be close (Section 414(5)(b) ICTA 1988).

If the open company loan creditor also holds shares in the company, it will remain a participator in respect of that holding and any amount which would be distributed to it in respect of those shares should be taken into account for the purposes of Section 416(2)(c) and Section 414(2)(a).

85.23 Pension schemes

Section 445 CTA 2010 provides:

(1) If shares in a company ("C") are held on trust for a registered pension scheme, the persons holding the shares are to be treated, for the purposes of section 444(2) and (3)—

(a) as the beneficial owners of the shares, and

(b) in that capacity, as a company which is not a close company.

(2) But subsection (1) does not apply if the scheme is established wholly or mainly for the benefit of—

(a) directors, employees, past directors or past employees of a company within subsection (3), or

(b) dependants of an individual within paragraph (a).

(3) The companies within this subsection are—

(a) C,

(b) an associated company of C,

(c) a company which is under the control of—

(i) a director of C,

(ii) an associate of a director of C, or

(iii) two or more persons each of whom is such a director or associate, and

(d) a close company.

The CT Manual summarises this and provides:

60290 Control: By another company [September 2011]

The broad effect of the above conditions is that the fund or scheme must

be one established for the benefit of employees, etc, of an unrelated company which is not close. A joint fund for the benefit of employees of two or more companies is not disqualified if the majority of the beneficiaries are or were employees of qualifying companies or are dependants of such employees.

85.24 Quoted company exemption

Section 446 CTA 2010 provides:

(1) A company is not to be treated as a close company at a particular time if—

(a) shares in the company carrying at least 35% of the voting power in the company have been allotted unconditionally to, or acquired unconditionally by, and are at that time beneficially held by, the public, and

(b) any such shares have within the preceding 12 months been the subject of dealings on a recognised stock exchange, and the shares have within those 12 months been listed on such an exchange.

(2) But subsection (1) does not apply to a company at any time when the total percentage of the voting power in the company possessed by all of the company's principal members exceeds 85%.

(3) For the purposes of this section, a person is a principal member of a company if the person possesses a percentage of the voting power in the company of more than 5% (but see subsection (4)).

(4) If there are more than 5 persons within subsection (3), a person is a principal member of the company only if—

(a) the person is one of the 5 persons who possess the greatest percentages, or

(b) in a case where there are no such 5 persons because two or more persons possess equal percentages of the voting power in the company, the person is one of the 6 or more persons (including those two or more who possess equal percentages) who possess the greatest percentages.

(5) In determining for the purposes of this section the voting power which a person possesses, there is to be attributed to the person any voting power which would be attributed to the person if section 451(3) to (6) applied for the purposes of this section.

(6) In this section "shares"—

(a) include stock, but

(b) do not include shares entitled to a fixed rate of dividend, whether with or without a further right to participate in profits.

The CT Manual provides:

> **60310 35% or more voting power held by public** [November 2011] ... The total voting power for the purpose of (i) and (ii) above is that of all the issued shares (or stock) including that of shares, etc, entitled to a fixed dividend, etc, which are excluded under (i) above in determining the voting power in the hands of the public. ...
> 1. Where the company holding the shares loses its beneficial interest on commencement of winding-up (see CTM36125) you should not normally contend that a company which was not close before the commencement of that winding-up, thereby becomes a close company.
> 2. Shares beneficially held by an authorised unit trust (see CTM48200 onwards) are to be regarded as beneficially held by a company which is not a close company unless five or fewer persons hold more than half of the units issued by the trust. In determining the number of units held by a person, there should be attributed to him or her any units held by his or her associates (see CTM60150) or by his or her nominees or by any company (or companies) of which he/she has, or he/she and his associates have, control.

85.24.1 *"Held by the public"*

Section 447 defines "shares beneficially held by the public":

> (1) For the purposes of section 446, shares in a company (c) are beneficially held by the public if they are—
> (a) beneficially held by a UK resident company which is not a close company, or by a non-UK resident company which would not be a close company if it were UK resident,
> (b) held on trust for a registered pension scheme, or
> (c) not comprised in a principal member's holding.
> (2) But shares are not beneficially held by the public if they are held—
> (a) by a director of C,
> (b) by an associate of such a director,
> (c) by a company which is under the control of one or more persons each of whom is such a director or associate,
> (d) by an associated company of C, or
> (e) as part of a fund the capital or income of which is applicable or applied wholly or mainly for the benefit of any of individuals within subsection (3).
> (3) Those individuals are—
> (a) employees, directors, past employees or past directors of C or of any company within subsection (2)(c) or (d), and

(b) dependants of any individuals within paragraph (a).

(4) The reference in section 446(1) to shares which have been allotted unconditionally to, or acquired unconditionally by, the public is to be read in accordance with subsections (1) to (3).

(5) For the purposes of subsection (1), a principal member's holding consists of the shares which carry the voting power possessed by him.

(6) The reference in subsection (2) to shares held by any person includes shares the rights or powers attached to which would be attributed to the person if section 451(3) applied for the purposes of that subsection.

(7) Subsections (3) to (5) of section 446 (meaning of "principal member" and determination of voting power possessed) apply for the purposes of this section as they apply for the purposes of that section.

(8) In this section, "shares" includes stock.

The CT Manual provides:

CTM60310 35% or more voting power held by public [November 2011]

Where a company in [s.315(5)(b)(c)] above loses its beneficial interest in the shares, etc, on commencement of winding-up (see CTM36125) you should not normally accept that a company which was close before the commencement of that winding-up, thereby ceases to be close. ...

For the purpose of (b)(iii) above, shares held in accordance with (b)(i) or (ii) above are deemed to be beneficially held by the public (provided that they are not excluded by (c) above) even if they are comprised in a principal member's holding.

The CT Manual provides two simple examples of the quoted company exemption:

CTM60420 - Close companies: tests: examples [Nov 2011]

... Example 8

The issued ordinary capital of a trading company (other issued capital having no voting rights) is held as below.

Company A (not a close company)	280
Company B (a close company)	270
Company C (not a close company)	230
D (director)	40
E (director)	30
F (an individual)	30
20 others	120
Total issued ordinary shares	1,000

Control -the requirements of CTA2010/S444 (2)(a) ... are regarded as

satisfied because, upon one combination of shareholdings, control is in the hands of Company A and Company C, even though by other combinations a controlling group which includes only one of those companies may be established. The company is not a close company if the requirements of CTA2010/S444 (2) (b) ... are also satisfied, that is, if none of the control tests enables control by five or fewer participators to be established without including a non-close company among those participators, and the company is not controlled by its directors and cannot be shown to be close on the or winding up test (CTM60320) without including a non-close company among the five or fewer participators (see, however, Example 9 below).

Example 9

The ordinary shares are held as in Example 8. G, an individual, holds redeemable loan stock and would receive in a winding-up more than half of the assets available for distribution among the participators.

Control - as G is in control of the company by reference to CTA2010/S450 (3) (d) ... the requirements of CTA2010/S444 (3) ... are not met and, irrespective of the control by open companies, the company is a close company.

CHAPTER EIGHTY SIX

PERMANENT ESTABLISHMENT AND BRANCH/AGENCY

86.1 Why does permanent establishment matter?

It is not practical to set out a complete list of the significance of PE for tax, but the following are the most important.

In the absence of a PE, a non-resident *company* trading in the UK is subject to income tax on its income. A non-resident company trading through a PE is subject to corporation tax on income linked to the PE.[1]

In the absence of a PE, a non-resident company is not subject to CGT. A company trading in the UK through a PE is subject to corporation tax on gains linked to the PE.[2]

Corporation Tax may be collected from the branch/agency.[3]

PE of a corporate trustee is relevant to trust residence.

In the absence of a PE, a person treaty-resident in a foreign state with a DTA in OECD model form qualifies for relief for UK source trading income, dividends, interest, royalties, capital gains and other income. All these reliefs are restricted for income/gains linked to a PE in the UK.

If a non-resident *individual or trustee* is carrying on a trade in the UK, the UK domestic law tax position is not affected whether or not they are carrying on their trade through a PE; but similar rules apply if they are carrying on business through a branch/agency, which is a similar concept.[4]

PE and branch/agency (or very similar concepts) are also relevant for many non-tax purposes, such as civil jurisdiction.

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1 See 15.7 (Trading income of non-resident companies).

2 See 49.8 (Non-resident trade with UK branch).

3 See 43.1 (Collection of tax from UK representatives).

4 See 86.13 (Why does branch/agency matter?).

86.2 Meaning(s) of "permanent establishment"

The definition(s) of PE need a long book to itself and several such books have been written.[5] This chapter is a relatively brief introduction.

The term "permanent establishment" is used in different places with different definitions. It is strictly necessary to distinguish between:

(1) "**UK-law PE**" (which the INT Manual calls domestic law PE), defined in s.1141 CTA 2010.

(2) "**OECD Model PE**" defined in the OECD Model. The INT Manual calls this "treaty PE" but I prefer the term "OECD Model PE" because some treaties have different definitions.[6]

There are two types of PE which I call:

(1) **"Fixed place of business PE"** and

(2) **"Agency PE"**

"A hybrid PE" is an entity which is classified as a PE in one state and not in another. This is currently one of the objects of the OECD project on mismatches, but is not considered here.

86.2.1 *Scope of UK law definition*

Section 1141 CTA 2010 provides:

> For the purposes of the Corporation Tax Acts a company has a permanent establishment in a territory if ...

This definition applies only for the purposes of the corporation tax acts so it needs to be incorporated in other contexts

For CGT, s.288 TCGA provides:

> In this Act, unless the context otherwise requires—
> "permanent establishment", in relation to a company, is to be read in accordance with Chapter 2 of Part 24 of CTA 2010;

Similarly, for IT, s.989 ITA provides:

> The following definitions apply for the purposes of the Income Tax Acts—
> "permanent establishment", in relation to a company, is to be read in

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5 There is a bibliography in Reimer, Urban and Schmid (ed), *Permanent Establishments* (2011), para 1.3. See too IFA, *Is there a Permanent Establishment?* Cahiers du Droit International, (Vol 94a, 2009); [2006] BTR at p.722. For Australian Revenue views, see Taxation Ruling TR 2002/5.

6 For instance, see 86.11 (PE in Colonial Model treaties).

> accordance with Chapter 2 of Part 24 of CTA 2010...

Thus we have a taxes-act-wide definition but it only applies in relation to companies. The statutory definition does not apply in relation to a non-company.

If a UK tax statute used the expression PE in relation to a *non-company*, the statutory definition would not apply and the expression would (subject to context) bear its normal meaning. If the view expressed here is right, that UK-law PE has the same meaning as OECD law PE, that would be the normal meaning which would apply. There is no other meaning. But as far as I know, in UK domestic tax law, the term PE is only used in relation to companies; the drafter presumably realised this, which is why they restricted the definition to companies. So the question of the meaning of PE in statutory provisions relating to non-companies does not arise.

86.2.2 *Carrying on trade through a PE*

UK tax provisions refer to a company carrying on a trade through a PE, so one might think that there are two distinct questions:

(1) whether a PE exists

(2) whether the company is carrying on a trade through the PE.

However PE is defined as "a fixed place of business through which the business of the company is carried on"; so if a company owns (say) an office building which it does not use (or which it does not use for its business) then strictly the office building is not a PE at all.

86.3 Fixed place of business PE

Section 1141 CTA 2010 provides:

> For the purposes of the Corporation Tax Acts a company has a permanent establishment in a territory if (and only if)—
>
> (a) it has a fixed place of business there through which the business of the company is wholly or partly carried on ...

OECD Model PE is substantially the same as UK-law PE. Article 5(1) provides:

> For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

INTM para 264060 [February 2006] discusses UK-law PE but that merely repeats and refers to the INTM discussion of OECD Model PE:

266050 Fixed place of business permanent establishment [September 2011]

[The Manual refers to model treaty Article 5(1) and continues:]

This definition therefore contains the following essential features, all of which must be present:

a. there must be a geographic place of business, possibly premises or a site, although it can, in certain circumstances, be machinery or equipment.
b. the place of business must be fixed, that is, have a certain degree of permanence, and
c. the non-resident's business must be carried on through this fixed place of business, normally by the personnel of the enterprise.

It is possible for an enterprise to have more than one fixed place of business permanent establishment if it carries on business activities from more than one place for the necessary duration of time.

The INTM then goes on to consider these three conditions in more detail.

86.3.1 *Geographic condition*

INTM para 266060 provides:

Fixed place of business permanent establishment – Geographic condition [February 2006]

The words used in article 5(1) make it clear that there is a geographical condition within the fixed place of business treaty permanent establishment definition. There must be a distinct place of business being used for carrying on the business of the enterprise. The place could be premises, facilities, plant or machinery or even a site or installation. But equally the place of business could consist only of a space where premises are not necessarily required for the activities concerned. For example, a street vendor or market barrow enterprise could meet the geographic place condition where the business was carried out from appreciably one place whereas a French travelling salesman arriving in the UK and trading his French produce from door to door before returning to France would not meet the geographic condition and there would be no fixed place of business in the UK. For guidance on the scope for automated machinery to constitute a permanent establishment see INTM266090.

A place of business of one enterprise could be situated in the business premises of a second enterprise, including possibly an affiliated company, if some space were put at the disposal of the first enterprise. In considering whether a place of business is 'at the disposal of' an enterprise it makes no difference whether that enterprise's use is exclusive or shared, whether the enterprise owns, rents or even occupies a place illegally. As an example of when premises would be considered to be 'at the disposal of an enterprise', a travelling salesman would not be considered to have the premises of each of his prospective customers at his

disposal, but a parent company using an office in the headquarters of a subsidiary company to oversee that subsidiary for a period would have had that office space at its disposal. Other examples can be found in the commentary to Article 5.

86.3.2 *Degree of permanency*

INTM para 266070 provides:

Fixed place of business permanent establishment – Time condition – Degree of permanence of activities [February 2006]

The words used in article 5(1) make it clear that there is a time or degree of permanence condition inherent within the term 'fixed place of business' but it is not necessary that equipment or plant be physically fixed to the ground before it could constitute 'a fixed place of business'. There is no certain rule on the period that must pass before a place of business becomes 'fixed' and this can often depend on the nature of the activities. But it is immaterial how long an enterprise operates in another Country if it does not do so at a distinct place.

Since the place of business must be fixed, it also follows that a PE can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a PE even though it exists, in practice, only for a very short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices of the different Member States of the OECD are not necessarily consistent in so far as time requirements are concerned, experience has shown that PEs have normally not been considered to exist in situations where a business has been carried on in a country through a place of business that was maintained for less than six months. Conversely practice shows that there were many cases where a PE has been considered to exist where the place of business was maintained for a period longer than six months. One exception to the six month yardstick has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a period of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried out in that country, its connection with that country is stronger. Temporary interruptions of business activities do not cause a PE to cease to exist. Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a PE but it is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and [as brought out at para 6.3 of the commentary to model treaty article 5(1)] can thus retrospectively be a PE. A place of business can also constitute a PE from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances, e.g. death of the taxpayer, investment failure etc, it was prematurely terminated.

A PE begins to exist as soon as the enterprise commences to carry on business through a fixed place of business. A period of preparation, as distinct from the

real business activities, should not be treated as the business being carried out. The PE ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it.

A single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to the business. For example, the market stall mentioned already if it moved position within a market area. Similarly, a painter who undertook under a single contract to paint a multi-occupied estate would have a single place of business and the duration of his activities at that place would be gauged accordingly. But if the painter entered into individual contracts with unrelated occupants of premises on an estate his activities should be considered separately rather than as a coherent whole.

86.3.3 *Personnel condition*

INTM para 266080 provides:

Fixed place of business permanent establishment – Personnel condition [February 2006]

For a fixed place of business to constitute a PE the business of the enterprise must have been carried on through that place, i.e. persons working in the business must have worked from that place. Those persons could be employees, the entrepreneur or proprietor themselves or any other persons receiving instructions from the enterprise e.g. self-employed consultants.

It would follow that property let out to third parties is not a PE of the landlord.

266090. Fixed place of business permanent establishment – Automated equipment [February 2006]

Where the business of an enterprise is carried out through automated machinery a PE may nevertheless exist if personnel are required to set up, operate, control or maintain such equipment. Whether or not gaming or vending machines and the like set up by a foreign enterprise in another State constitute a PE thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A PE does not exist if an enterprise merely sets up a machine and then leases it to another enterprise but it could if the first enterprise also operated and maintained the machine for its own account. This also applies if the machine is operated and maintained by an agent dependent (INTM266150) on the enterprise.

266100. Fixed place of business permanent establishment – E-commerce/ E-tailers/servers/internet trading [September 2011]

The development of e-commerce places a strain on the traditional definition of a PE in cases where the computer equipment is positioned in one territory whilst the enterprise has no personnel active in the business in that territory. The UK does not concur with other OECD Member States on whether a server of itself can constitute a fixed place of business permanent establishment. Accordingly the

> UK has made an observation to that effect in the commentary to the Model Treaty Article 5(1).
> In the UK, we take the view that a server either alone or together with web sites could not as such constitute a PE of a business that is conducting e-commerce through a web site on the server. We take that view regardless of whether the server is owned, rented or otherwise at the disposal of the business.
> Other OECD Member States take the view that a server, as distinct from mere web sites (which cannot fulfil the geographic situs condition) could constitute a PE where the equipment is in fact fixed, i.e. that in fact it is not moved and is located at a specific location for a sufficient duration to indeed become fixed (INTM266050). See also INTM263000 for place of contract in e-commerce.

86.3.4 *Items specifically included as PE*

Section 1141(2) CTA 2010 provides a list of items which constitute a fixed place of business PE. The first seven are:

> For this purpose a "fixed place of business" includes (without prejudice to the generality of that expression)—
> (a) a place of management,
> (b) a branch,[7]
> (c) an office,
> (d) a factory,
> (e) a workshop,
> (f) an installation or structure for the exploration of natural resources,[8]
> (g) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; ...

This is based on OECD Model Art 5(2). The INTM para 266110 [February 2006] sets out a précis of the article and continues:

> The wording of article 5(2)[9] make it clear that this is not an exhaustive list of the places that could be a permanent establishment.

Obviously. The INTM continues:

> Furthermore, it is clear that, to be a treaty permanent establishment, any of these types of places would also need to have the general attributes of a fixed place of business, i.e. the geographic, period of duration and personnel conditions.

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7 See 86.14.2 (Meaning of "branch").
8 This is not in the OECD Model definition.
9 The text erroneously reads: 5(1).

The point was less clear and it is helpful to see it in writing.

86.3.5 *Building site, construction or installation project*

This is the eighth item in the list in s.1141(2) CTA 2010:

> For this purpose a "fixed place of business" includes (without prejudice to the generality of that expression)— ...
> (h) a building site or construction or installation project.

The OECD Model moves this item into a paragraph of its own, and the wording is not quite the same. Article 5(3) provides:

> A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

This item, like the first seven in the list, is only a PE if it also meets the geographic, time and personnel conditions.

The INTM para 266130 provides:

> **Fixed place of business permanent establishment – Building sites or construction or installation projects** [September 2011]
> The OECD model treaty article 5 includes specific provisions in para 3 that a building site or construction or installation project constitutes a treaty permanent establishment only where it lasts more than 12 months. The commentary makes it clear that this includes also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipes-lines and excavating and dredging. Additionally, the term 'installation project' is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors.
> The OECD member states have made this type of activity the subject of a specific rule because of the frequency with which it caused difficulties of interpretation. And, for clarity in the model treaty, 12 months duration has been taken to be a sufficient indication that the activity is a fixed place of business permanent establishment. Of course particular treaties may vary from the model in this respect and indeed different durations are included in many of the UK's treaties all of which can be referred to in full at DT2140 onwards. The UK domestic charging provisions in s.1141(2)(h) CTA 2010] define permanent establishment (see INTM264050) in a way that specifically includes all building sites or construction or installation projects without duration qualification. Although initially this may [!] appear inconsistent you should remember that the treaty provisions will override the domestic legislation. In that way, any duration specified in any applicable treaty within which the site will become a permanent establishment will be the duration that applies.
> If the non-resident is involved (directly or indirectly through subcontractors) in more than one site or project, each should be considered as a potential permanent

establishment separately from the others. The 12 months or other duration test applies to each site or project. A site or project should be regarded as a single potential permanent establishment even if it is based on several contracts provided that it forms a coherent whole commercially and geographically. If it appears that a single site or project has been fragmented to avoid the appearance of being a PE the facts of the original tendering should be investigated.
A site or project exists from when the contractor begins work, including any preparatory work, in the country where the construction etc. is to be established. It continues to exist until the work is completed or permanently abandoned. Temporary discontinuation, seasonal or other temporary interruptions should be ignored.

86.4 Agency PE

Section 1141 CTA 2010 provides:

> For the purposes of the Corporation Tax Acts a company has a permanent establishment in a territory if (and only if) ...
> (b) an agent acting on behalf of the company has and habitually exercises there authority *to do business on behalf of the company*.

OECD Model PE is different. Article 5(5) provides:

> [a] Notwithstanding the provisions of paras 1 and 2, where a person – other than an agent of an independent status to whom para 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority *to conclude contracts in the name of the enterprise*, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise,
> [b] unless the activities of such person are limited to those mentioned in para 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.[10]

I refer to this as "**agency PE**" though the term "dependent agency PE" is sometimes used (as an independent agent is not a PE).

86.4.1 *The policy background*

The OECD Commentary provides:

> 31. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain

10 See 86.9 (PE: preparatory and auxiliary activities).

conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. [Article 5(5)] intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it.

86.4.2 *Distinctions between OECD and UK-law agency PE*

Dawn Primarolo (then Paymaster General) explained why the wording of UK-law PE differs from OECD law PE:

> **Dawn Primarolo**: ... the wording used in clause 147(1)(b) [FB 2003, now s.1141 CTA 2010] to define "dependent agent" varies from the exact wording in article 5(5) of the OECD model tax convention. Instead, it is based on guidance given in the commentary on article 5, which can be found in paragraphs 31 to 45, because article 5 refers to an agent who has the authority to conclude contracts in the name of the enterprise.
> However, the OECD commentary on article 5 makes it clear that that phrase is not necessarily to be taken at face value. For instance, it covers contracts in the name of an enterprise, contracts binding on the enterprise but not in its name, and contracts recognised by the agent but signed by some other person, while excluding contracts that do not relate to the business proper of the enterprise, although concluded by the agent. The area is very complicated and there is an interaction between the commentary and the article itself.
> UK legislation cannot be directly interpreted by reference to the commentary,[11] so the phrase used in clause 147 is intended to encapsulate the current OECD interpretation in respect of dependent agents. That would not have been achieved if the wording in article 5(5) were copied directly into UK domestic law.
> **Mr. Burnett:** The Paymaster General will recall ... that the Inland Revenue confirmed that the reference to an agent in clause 147 is restricted to those persons who contractually can and do bind their principals and not to persons acting in some other representative capacity falling short of having such authority. The Paymaster General is obviously well aware of *Pepper v Hart* and the reliance people may put on what she says in Committee. I would welcome her comments on that point raised by the Law Society.
> **Dawn Primarolo:** I was coming to that important point, which was

11 This is not correct, but fortunately no-one reminded Ms Primarolo of (what is now) s.164 TIOPA (Application of OECD principles).

> outlined in a letter to the Law Society and the Chartered Institute of Taxation on 8 May.
> I was trying to explain that the article wording must be read in parallel with the commentary. The commentary needed to be part of the description that went into UK legislation in order to make that clear. In drafting the legislation, the importance of maintaining certainty on international understanding and practice on the OECD guidelines and model conventions while understanding how the commentary affects their operation was one of the major points, which was continually made to the Revenue and me. That is how we chose the clause's wording.
> Amendment No. 101 seeks to add to the definition of dependent agent used in clause 147(1)(b). It would mean that an agent would be a dependent agent of a foreign company as long as they had the authority to enter into arrangements on its behalf and had entered into contractually binding arrangements with it. That may not have been the amendment's intended effect, but I ask the Committee to reject it nevertheless. The suggested addition is unnecessary and the language used in clause 147(1)(b) already reflects the current OECD position on dependent agents. As such, no further clarification or definition is required.... The Bill does not extend the charge to tax on non-resident companies and there is no less certainty for an agent of a non-resident company on whether they are within the charge to corporation tax. The rules are set out in the OECD treaty and commentary and in UK law, which has had and will have specific rules to facilitate foreign investment in the City.[12]

Similarly, the INTM para 264050 provides:

> **Permanent establishment – Domestic law definition** [April 2007]
> The definition of domestic law permanent establishment is at [FA 03 s.148]. This is similar to and has the same broad effect as the OECD model treaty article 5 definition of permanent establishment which is an important factor bearing in mind that treaty law takes precedence over domestic law. So it is unlikely that the application of a treaty that followed the model article 5 would cause any variance to the UK domestic charge to tax on a non-resident trading in the UK through a permanent establishment as defined under domestic law. Because of the similarities of wording and effect between PE under domestic law and under the OECD model treaty

12 House of Commons Standing Committee B, accessible *http://www.publications.parliament.uk/pa/cm200203/cmstand/b/st030520/pm/part1/30520s06.htm*

> the guidance on interpretation of treaty PE at INTM266000 is understandably substantially applicable to domestic law PE as well. A lot of our interpretation of treaty PE is based on the Commentary to Article 5 of the OECD Model Treaty (INTM266030). Although the Commentary is not imported into UK domestic law the UK has contributed to and agreed the content except in specific instances where the UK has put on record either an observation or a reservation to a specific section of the Commentary. So, where the wording of the UK domestic law PE provisions are the same as those used in the OECD Model Treaty Article 5 then the commentary interpretation on those words will apply to those provisions and this guidance will contain cross-references into the guidance on treaty PE at INTM266000. If the Commentary interpretation of PE were to materially vary through periodic update or amendment the changes would have to be accepted by the UK Parliament before they could be taken to apply also to interpretation of UK domestic law PE.

The simpler way to achieve the intention would have been to incorporate the OECD definition by reference, but it is considered that the UK law definition has reached that destination, even though by a less satisfactory route.[13] EN CTA 2010 agrees:

> 3253. This Chapter determines what constitutes a permanent establishment in a territory of a company which is not resident in that territory. ...
> 3254. The determination is in line with various internationally recognised characteristics commonly used in the UK's double tax agreements.

Likewise an HMRC press release when the current law was enacted:

> The rules also alter our current terminology so that in future we tax "permanent establishments", (a term recognised internationally and used in our double taxation agreements), rather than "branches". The new rules are to be interpreted in accordance with OECD guidelines, to ensure that the UK is in accord with international consensus that reflects UK agreement. If internationally agreed changes are made in the future, then any new guidance can be included to assist in the interpretation of the

13 If that is right, it answers the concerns expressed in Nias, "Taxation of non-resident companies and the meaning of agent" [2003] BTR 468.

UK rules, if the UK government decides it wishes to adopt them.[14]

86.5 OECD model agency PE

86.5.1 *Enactment history*

As usual, the wording has varied over the years, but without any change of meaning. The OECD Commentary provides:

> 31... The paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

This matters as the old wording survives, for instance in the Luxembourg/UK DTA.

86.5.2 *Authority*

The phrase *authority to conclude contracts in the name of the enterprise* is at the heart of OECD model agency PE. The OECD Commentary provides:

> 32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent agents falling under para 6. Such persons may be either individuals or companies. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, para 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activities in the State concerned.

The OECD Commentary provides:

> Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he

14 REV BN 25 para 8 (17 April 2002).

solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.

86.5.3 *In the name of the enterprise*

The OECD Commentary provides:

> 32.1 Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.

The INTM provides:

> **266160. UK common law – Variance with civil law** [September 2011]
> The majority of European countries have civil law codes whereas the UK has a common law code. Any matters of interpretation of undefined terms used in the OECD Model Treaty, article 5 or any other article of a treaty should be interpreted in the UK under UK law or at least common meaning. The civil law concept of agency is different from that under common law in that civil law will not usually regard the actions of an agent as though they were the actions of the principal. Civil law separates the relationship between the principal and the agent on the one hand and that between the agent and the third party (including a customer) on the other. Thus civil law countries do not, as the UK does, necessarily see the presence of the non-resident principal in the actions of the resident agent. In the UK, under common law, we interpret any actions carried out by an agent as having been performed for the principal and binding the principal in the same way as though they had carried out those actions themselves. For example, a contract arranged by an agent in the UK to deliver goods owned by a foreign principal to a customer would be treated for UK tax purposes as though the foreign principal themselves had contracted in the UK for the delivery. This is the case, regardless of whether the contract is written in the name of the principal or in the name of the agent (commentary to model treaty article 5(5), para 32.1 of July 2010 version).

The former International Tax Handbook provided:

> **851.** Treaties following the example of the OECD Model are influenced by the civil law concept of agency. Para 5 of Article 5 of the Model deems an agent to be a permanent establishment if the agent has and habitually exercises an authority to conclude contracts in the name of the enterprise of the treaty partner state, unless the agent is an agent of independent status within para 6. There are two pointers here to civil law influence. One is 'contracts in the name of the enterprise', the other is 'agent of independent status'.

852. In the name of principal

The making of contracts in the name of the principal would be regarded by civil law countries as a characteristic of a dependent agent whereas contracts made in the agent's own name would be characteristic of independent status (though the wording of the Article does not preclude the possibility of independent status even if the contracts are in the name of the 'enterprise'). In our law, if the contracts are made on behalf of and with the authority of the principal the relationship of the agent to the principal is not affected by whether the contract is made in the name of the principal or in the agent's own name. So agents, who in all other respects would be dependent agents according to the OECD Model, could in our law make contracts in their own name. We would not wish such agents to be regarded as agents of independent status under a treaty and therefore resist the literal meaning of 'in the name of' and argue that the words should be interpreted as 'on behalf of', which is an acceptable translation of the words 'au nom de' which appear in the French version of the Model Convention. The commentary on Article 5 of the 1992 Model included a note of our view at para 45 and in 1994 a sentence was added to the commentary itself at para 32 confirming that this is now the accepted interpretation.

The INTM discussion of OECD Model PE at 266140 [September 2011] is a lightly adapted version of the OECD commentary, so is not set out here. Article 6(5) USA/UK DTA provides a definition of agency PE very similar to the OECD model.[15]

The US Department of the Treasury Technical Explanation of the Convention[16] provides:

> The OECD Model uses the term "in the name of that enterprise" rather than "binding on the enterprise". There is no substantive difference. As indicated in paragraph 32 to the OECD Commentary on Article 5, paragraph 5 of the Article is intended to encompass a person who "concludes contracts which are binding on the enterprise, even if those contracts are not actually in the name of the enterprise".
>
> The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise rather than ancillary activities.

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15 "Notwithstanding the provisions of paragraphs 1 and 2 of this Article, where a person—other than an agent of an independent status to whom paragraph 6 of this Article applies—is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority *to conclude contracts that are binding on the enterprise,* that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities that the person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 of this Article that, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph."

16 Accessible *http://www.irs.gov/pub/irs-trty/temod006.pdf*

86.5.4 *Authority to conclude contracts*

It seems to me that "agent" can be used in three broad senses:

(1) A person who can *legally* enter into contracts which bind their principal. I refer to that as a "**contract-law agent**".

(2) A person who can *effectively decide whether* to enter into a contractual relationship which binds their principal though the further step to create a contract is required as a legal formality or "rubber stamping".

(3) In a looser, colloquial sense, an intermediary, spokesperson, or representative (who lacks power to make an effective decision).[17]

The meaning here is meaning (2). If in practice a person can a commercial or substantial commitment, they will be regarded as having authority to conclude contracts, even if they lack formal authority of a contract-law agent, so that any contract needs to be "rubber stamped" by the principal.[18]

A company with an agent of this kind in a state may in fact be resident in that state: an agent who concludes contracts on behalf of the company in a state cause the effective management/management and control of the company to take place in that state.

86.5.5 *Exercise of authority in a contracting state*

What if the negotiating work is done by the agent in a state, but the contract is signed elsewhere? This does not alter the position:

> Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority

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17 "The use of the word 'agent' in any mercantile transaction is, of itself, wholly uninformative of the legal relationship between the parties and the use of the words 'independent agent' takes the matter no further. Either is consistent with a self-employed person acting either as a true agent who puts his principal into a contractual relationship with a third party or with such a person acting as a principal." See *Potter v CE* [1985] STC 45 at p.51 cited with approval in *Umbro International v HMRC* [2009] STC 1345 at [29].

18 See Dunahoo, "Contract Conclusion and Agency Permanent Establishments: Here, There and Everywhere" in Baker & Bobbett (eds) *Tax polymath: a life in international taxation: essays in honour of John F. Avery Jones* (2010).
The point has been decided the same way in relation to branch/agency: see 86.14.5 (Difference between branch/agency and PE).

> "in the State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise.

86.5.6 *Auxiliary and preparatory work*

The article 5(4) exemption (auxiliary & preparatory work, etc)[19] applies to agents:

> Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.
>
> 33. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person has authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only.

The US Department of the Treasury Technical Explanation of the Convention[20] provides a similar example:

> The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise rather than ancillary activities. For example, if the agent has no authority to conclude contracts in the name of the enterprise with its customers for the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise's business equipment used in the agent's office, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly.

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19 See 86.9 (PE: preparatory and auxiliary activities).

20 Accessible *http://www.irs.gov/pub/irs-trty/temod006.pdf*

86.5.7 *Habitually*

"Habitually" echoes the requirement of "degree of permanency" for a fixed place of business PE. The OECD Commentary provides:

> The OECD Commentary provides:
>
> 32. ... The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.
>
> 33.1 The requirement that an agent must "habitually" exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in para 6 would be relevant in making that determination.[21]

86.5.8 *Extent of agency PE*

The OECD comments on the extent of an agency PE:

> 34. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts in the name of the enterprise.

86.5.9 *Relationship between fixed place of business and agency PEs*

The OECD Commentary provides:

> 35. Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), [fixed place of business] it is not necessary to show that the person in charge is one who would fall

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21 See 86.3.2 (Degree of permanency).

under paragraph 5.

86.6 Independent agent exemption

The rule in short is that an independent agent is not a PE. I refer to this as **"the independent agent exemption"**.

Investment managers and brokers may be an agency PE, but have a special exemption which clarifies the independent agent exemption; see 44.1 (Investment manager exemptions - Introduction).

86.6.1 *Independent agent exemption: UK-law PE*

Section 1142(1) CTA 2010 provides:

> A company is not regarded as having a permanent establishment in a territory by reason of the fact that it carries on business there through an agent of independent status acting in the ordinary course of the agent's business.

86.6.2 *Independent agent exemption: OECD model PE*

The OECD Model is slightly differently worded, but the differences do not seem material. Article 5(6) provides:

> An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

The OECD Commentary summarises:

> 36. Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business (cf. paragraph 32 above). Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.

I refer to this as **"the independent agent exemption"**.

The view that the independent agent exemption is only inserted for the avoidance of doubt is important in contexts (such as Colonial Model treaties) where the exemption is not stated expressly

37. A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if

a) he is independent of the enterprise both legally and economically, and
b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

The requirements of independent status and "ordinary course of business" overlap somewhat, but it is best to consider them separately.

86.7 Independent status

This is a multifactorial concept.

86.7.1 *Control by principal*

The OECD commentary provides:

38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-a-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents.

38.1 In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.

38.2 The following considerations should be borne in mind when determining whether an agent may be considered to be independent.

38.3 An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

38.4 Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

38.5 It may be a feature of the operation of an agreement that an agent will

provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

86.7.2 *Multiple principals*

The OECD commentary provides:

38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

The INTM provides:

264080 Independent agents do not create a permanent establishment [April 2007]

[The INTM summarises s.1142(1) and continues:] Whether an agent is of independent status is tested by reference to the legal, financial and commercial characteristics of the particular business relationship between the non-resident and the agent. If the relationship between them is the same as a relationship between independent businesses dealing with each other at arms length then the agent will be 'an independent agent'. For example, an agent who acted for other independent unconnected businesses on the same terms as those under which he acted for the non-resident could be an 'independent agent' and it would be clear that the agent had been acting in the ordinary course of his business if his activities were repeated for various unconnected customers. Dependent or independent status does not turn on the shareholding relationship between principal and agent. The fact that an agent is a subsidiary company does not necessarily make it a dependent agent.[22] However, a subsidiary company will constitute a domestic law agency PE of its parent company in the same way as any other agent of the parent company if independence by reference to the factors detailed in the guidance that follows cannot be demonstrated.

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22 See 86.8 (Controlled companies and group companies).

Whether an agent acts in the ordinary course of their own business is something that should be considered by reference to the behavioural facts as opposed to intentions not followed through in business performance. Matters relevant would include (but not necessarily be limited to) the number of unrelated principals that the agent acted for and the extent of the business activities customarily carried out by independent agents in the specific business sector concerned.

Assuming they did act in the ordinary course of their own business, in general, an agent would be independent and would not constitute an agency PE of the foreign enterprise for which it acts where it is independent of the principal enterprise both legally and economically. The perspective of application of this test is with relevance to the business conducted by the agent for the principal rather than, for example, any shareholding relationship between the principal and agent. Other relevant factors of independence may include:

- the extent of the obligations which the agent has vis-à-vis the non-resident;
- whether the agent is subject to detailed instructions or comprehensive control;
- whether the agent bears the entrepreneurial risk for the business that the agent carries out for the non-resident;
- the degree of reliance on the agent's special skill and knowledge by the principal in the business done, and
- Whether there is reference by the agent to the principal for approval of the manner in which the business is to be conducted.

There will undoubtedly be circumstances where, whether deliberately or not, the relationship between a non resident and a UK agent is obscure or even where the declared terms of that relationship are very different from the actual terms. In such cases there is no substitute for detailed enquiry into the relationship to see whether it falls within the category of dependent or independent agent.

INTM discusses the OECD Model wording. It partly duplicates the text of the discussion on domestic law agency PE. The other parts provide:

266150. Agent of independent status – Article 5(6) [September 2011]
... The work done by an agent, where that work was all done for one non-resident client, is unlikely to be viewed as the conduct of his 'own business' but more likely that of the non-resident's business. An exception to that view might be where the concentration on one client was an unusual occurrence within a settled continuous trade involving several clients. ...

86.7.3 *"Ordinary course of business"*

The OECD commentary tries but cannot elucidate this:

38.7 Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to

conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.

39. [This deals with insurance companies and is not discussed here].

86.7.4 *USA DTA*

Article 4(6) USA/UK DTA is similar to the OECD model.[23]

The US Department of the Treasury Technical Explanation of the Convention[24] provides:

> Whether the agent and the enterprise are independent is a factual determination. Among the questions to be considered are the extent to which the agent operates on the basis of instructions from the enterprise. An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.
>
> In determining whether the agent is economically independent, a relevant factor is the extent to which the agent bears business risk. Business risk refers primarily to risk of loss. An independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from the activities it performs is not economically independent and therefore is not described in paragraph
>
> Another relevant factor in determining whether an agent is economically independent is whether the agent has an exclusive or nearly exclusive

23 "An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such person is acting in the ordinary course of his business as an independent agent."

24 Accessible *http://www.ustreas.gov/offices/tax-policy/library/teus-uk.pdf*

relationship with the principal. Such a relationship may indicate that the principal has economic control over the agent. A number of principals acting in concert also may have economic control over an agent. The limited scope of the agent's activities and the agent's dependence on a single source of income may indicate that the agent lacks economic independence. It should be borne in mind, however, that exclusivity is not in itself a conclusive test; an agent may be economically independent notwithstanding an exclusive relationship with the principal if it has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits. Thus, exclusivity should be viewed merely as a pointer to further investigation of the relationship between the principal and the agent. Each case must be addressed on the basis of its own facts and circumstances.

86.7.5 *Broker and general commission agents*

The precise meanings of broker and general commission agent in the OECD Model PE definition do not greatly matter since both terms are subsumed into "other agent of independent status".

For completeness, "broker" is discussed at 44.5.2 ("Broker"). The former International Tax Handbook explained "general commission agent" in a passage too amusing to omit:

> **935. General commission agent**
> ... Although the words general commission agent appear in the legislation, nobody really knows what a general commission agent is and textbooks on agency make no reference to such a character; the expression is indeed used in our Double Taxation Agreements but it is not a term that our treaty partners are familiar with. They say it has no particular meaning for them and think that it is there because the British were rather insistent about it.
>
> **936. London Produce case**
> The one case to which we most often turn for guidance on who may or may not be a general commission agent is the London Produce case [*Fleming v London Produce Co* 44 TC 582]. The London Produce company acted as agents in importing meat from New Zealand and selling it for commission on the London market. 95 per cent of its business was carried out for one principal. It claimed to be a general commission agent.
>
> Megarry J enjoyed himself with the expression saying that he found it puzzling and unidentified. He wondered whether he might get at a meaning by looking at the words general, commission and agent separately and then adding the constituent parts together. He felt, however, that that was not a good idea because one could not arrive at the meaning of a particular high office by adding together the separate words lord, privy and seal. He came to the conclusion that a general commission agent must have broker-like qualities as it is included in the term

'broker' in the Section and that it is someone who holds himself out as being ready to work for clients generally. In his view Section 82(1) [TMA] (then Section 373(1) ITA 1952) could not be relevant if 'in substance what is done is that (the non-resident) carries on business within the UK through the medium of an agent who is virtually a sole agent running the entire business for him and merely sending him remittances on request'. London Produce lost the case.
The only other case is the earlier one of *Boyd v Stephen* [10 TC 698] (concerned with bacon) when Rowlatt rather summarily dismissed the suggestion that the agents were general commission agents on the grounds that they did much more than such an agent would normally do. What the words are probably getting at is somebody like an import commission agent. That is someone, probably more common in 1915, who, acting for a non-resident producer, will sell goods through a broker on the market in return for a commission. It is unlikely that the authors of the Section had in mind the smaller domestic markets such as meat and bacon.

86.8 Controlled companies and group companies

Article 5(7) OECD Model provides:

> The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

The OECD commentary provides:

> 40. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business is carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.
> 41. A parent company may, however, be found, under the rules of paragraphs 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company (see paragraphs 4, 5 and 6 above) and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraph 3 and 4 of the Article (see for instance, the example in paragraph 4.3 above). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any

activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent (see paragraphs 32, 33 and 34 above), unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies.

41.1 The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal (see paragraphs 4, 5 and 6 above) and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article(see paragraphs 32, 33 and 34 above). The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.

42. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

There is no equivalent of art 5(7) in UK-law PE, but it is considered that the same rules should be implied.

86.9 PE: Preparatory and auxiliary activities

Section 1143 CTA 2010 provides:

> (1) If the condition in subsection (2) is met, a company is not regarded as having a permanent establishment in a territory by reason of the fact that—
>
> (a) a fixed place of business is maintained there for the purpose of carrying on activities for the company, or
>
> (b) an agent carries on activities there for and on behalf of the company.
>
> (2) The condition is that, in relation to the business of the company as a whole, the activities carried on are only of a preparatory or auxiliary character.
>
> (3) For this purpose "activities of a preparatory or auxiliary character" include (without prejudice to the generality of that expression)—
>
> (a) the use of facilities for the purpose of storage, display or delivery of goods or merchandise belonging to the company,
>
> (b) the maintenance of a stock of goods or merchandise belonging to the company for the purpose of storage, display or delivery,
>
> (c) the maintenance of a stock of goods or merchandise belonging to the company for the purpose of processing by another person, and
>
> (d) purchasing goods or merchandise, or collecting information, for the company.

This is a slight rewrite of OECD Model para 5(4):

> Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
>
> c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
>
> d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
>
> e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
>
> f) the maintenance of a fixed place of business solely for any

combination of activities mentioned in subparas a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

The differences in wording do not seem significant.

INTM para 264050 discusses this, but need not be set out as it only refers to (and repeats some material from) the INTM discussion of OECD Model PE:

266120 Fixed place of business permanent establishment – Activities specifically excluded from the definition of permanent establishment [April 2007]

Model treaty Article 5(4) lists certain activities that are not to be treated as permanent establishments even if they are carried on through a fixed place of business.

The Manual sets out a précis of the article and continues:

In deciding whether or not a fixed place of business of a non-resident enterprise is used for activities of a preparatory or auxiliary nature, consider the following factors:

a. Are the services it performs so remote from the actual realisation of profits by the enterprise that it would be difficult to allocate any part of the profit to the fixed place of business? If they are, then the fixed place of business will not be a permanent establishment. The benchmark to gauge the activities against are those of the trade as a whole entity. So, for example, if the UK activities are no different to the essence of the trade, e.g. the UK personnel collect market research information and the non-resident company's main trade is concerned with market research, then the activities in the UK would not be preparatory or auxiliary and there could be a permanent establishment in the UK.

An example is a research division of a trading or manufacturing company.

b. Does the activity of the fixed place of business form an essential and significant part of the enterprise as a whole?

This sentence is from the OECD commentary but with respect it cannot be a correct or helpful test since all the activities specified as auxiliary are significant and some of them are essential.

A fixed place of business whose general purpose is identical to the general purpose of the enterprise is not used for activities of a preparatory or auxiliary nature. Examples of this are fixed places of business used for the purpose of managing an enterprise, or where a fixed place of business is maintained to supply spare parts of machinery supplied by the enterprise to customers and to service such machinery.

Note that the exclusion of activities of a preparatory or auxiliary nature from the definition of a permanent establishment only applies if these activities are solely for the non-resident enterprise. If the activities are performed not only for the

> enterprise but also for other enterprises, including other companies in the same group, then the fixed place of business will not be within the scope of the exclusion.

I find the last paragraph rather surprising though it is in the OECD Commentary. The OECD Commentary explains the reason for the exemption for collecting information:

> The reference to the collection of information in subpara d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".

86.10 Alternative finance arrangements

Section 1144 CTA 2010 deals with alternative finance arrangements (shari'ah compliant arrangements for interest). This is not discussed here.

86.11 PE in Colonial Model treaties

Article 2(1) of the UK/Jersey DTA provides another definition of PE:

> The term "permanent establishment", when used with respect to an enterprise of one of the territories,
> [a] means a branch, management or other fixed place of business, but
> [b] does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or has a stock of merchandise from which he regularly fills orders on its behalf.

Guernsey and the Isle of Man are the same. This wording is based on s.17 FA 1930 and is clearly an ancestor of the current OECD Model PE.

To what extent is this different from OECD Model PE? It is suggested that the Courts ought to have regard to the general international law understanding of PE (that is, current OECD Model PE) and construe the Colonial Model definition in the same way. Notwithstanding the multiplicity of definitions, a multiplicity of concepts should be avoided or minimised so far as possible. Otherwise we will never know much about the meaning of this expression, as there will never be the litigation to answer all the puzzles which could arise.

86.12 Commentary: Let's have one definition of PE

We only need one definition of PE and it is suggested that the statutory PE

should be repealed and replaced by rule that PE has the same meaning as in the OECD model definition. That is indeed what the current statutory definition is intended to achieve.

It would also be a simplification if the treaties based on the Colonial Model could be amended to adopt standard OECD model wording. Obviously, that cannot be achieved by the UK unilaterally, and the point may not have much priority in the agendas of tax simplification or treaty negotiation, but in the fullness of time it should happen.

86.13 Why does branch/agency matter?

It is not practical to set out a complete list of the significance of branch/agency for tax, but the following are the most important.

In the absence of a PE, a non-resident individual or trust is not generally subject to CGT. An individual or trust trading in the UK through a PE is subject to CGT on gains linked to the branch agency.[25]

IT and CGT may be collected from the branch/agency.[26]

A branch/agency of an individual who is a trustee is relevant to trust residence.

Lastly, the branch/agency is likely to be a PE, which is relevant for DTAs.

Branch/agency is not relevant to companies. In theory one could envisage a situation where a non-resident company does not have a UK PE but does have a UK branch/agency, and such a company would be within the scope of CGT under s.10 TCGA. In practice, this does not happen, or if it does, no-one takes any notice.[27]

86.14 Meaning of "branch or agency"

86.14.1 *The statutory (non-)definition*

Section 10(6) TCGA provides:

> In this Act, unless the context otherwise requires,

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25 See 49.8 (Non-resident trade with UK branch).

26 See 43.1 (Collection of tax from UK representatives).

27 See for instance the HMRC trustee residence guidance which states conveniently (if not strictly accurately):
"This is in line with section 10B Taxation of Chargeable Gains Act 1992 *which has the effect that an overseas company is not taxed on the gains made by a UK branch or agency, but only on those made by a permanent establishment here*." (Emphasis added).

[a] "branch or agency" means any factorship, agency, receivership, branch or management, but

[b] does not include any person within the exemptions in section 82 of the Management Act (general agents and brokers).

For the purposes of UK representatives rules[28] the term is likewise defined to mean "any factorship, agency, receivership, branch or management". The definition here does not include the restriction for general agents and brokers but these categories are taken out of the UK representative rules by other provisions.

The definition in s.10(6)[a] TCGA is completely useless, since it incorporates both words being defined, merely adding three further obscure or archaic terms which seem to mean "agent" if they mean anything.[29] The INTM expresses the same point more tactfully:

> **264090. Branch or agency – Statutory definition and practical recognition of a branch** [April 2007]
>
> ...
>
> There is a statutory definition of 'branch or agency' at [Section 834(1) ICTA 1988] thus – "any factorship, agency, receivership, branch or management".[30] This is not particularly helpful so we must look for authority elsewhere including case law.

86.14.2 *Meaning of "branch"*

The former International Tax Handbook stated at para 842:

> There is very little guidance on the meaning of 'branch'. We have been

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28 See 43.1 (Collection of tax from UK representatives).

29 The former International Tax Handbook explained at 842:

> "Factorship and receivership are forms of agency and so, usually, would 'management' be. The former two categories are found in the 1842 machinery provisions, 'Management' was added in 1915 but has acquired more modern associations with the growth in the use of managers such as project managers and investment managers."

To be fair, s.10(6)[a] was not intended to be a definition as such, but simply as an abbreviation, to avoid the more cumbersome wording of, e.g. s.370 ITA 1952:

> "A non-resident person shall be assessable and chargeable in respect of any profits or gains arising, whether directly or indirectly, through or from any factorship, agency, receivership, branch or management, and shall be so assessable and chargeable in the name of the factor, agent, receiver, branch or manager."

30 [Author's Note.] The reference should be s.126(8) FA 1995. However, the definition there is the same, so it does not matter.

> advised that the presence of a principal (in the case of a sole trader or partnership) or of employees on a more or less regular basis is likely to be an essential ingredient of a branch (though employees may also be agents).

That repeats the personnel condition in the definition of PE. The INTM discusses the meaning of branch at para 264090 [April 2007]:

> Most people recognise a branch of a foreign business when they see one and the impression given to the public is helpful in deciding whether or not a branch exists. For example there are many branches of foreign banks that trade on the High Streets of many towns and cities in the UK. We know this, whether we bank with these branches or not, because the name of the foreign bank will be displayed across the shop front of the UK branch. The personnel running the UK branch will be carrying on the part of the foreign bank's trade that takes place in the UK. This amounts to the UK presence of the foreign bank's trade, i.e. a branch of its trade. That's an easy example in part because banks actually call themselves branches but it is worth stressing that whatever terminology is used it is the activities carried on in the UK in relation to the foreign enterprise's overall business activities that are most relevant in deciding whether the UK activities are a branch of the foreign business.

86.14.3 *Meaning of "agency"*

The INTM continues:

> **264100. Agency – Common law concept** [February 2006]
> Practical experience will have introduced all of us to the idea of agency. We do not always deal directly with the principal because we sometimes deal with an intermediary or agent. The agent represents the principal in accordance with the terms of the agreement in place between them. That agreement may be oral or in writing and in legal terms is called the agent's authority. In representing the principal the agent may bring about a legal relationship between that principal and a third party. Typically the agent may conclude a contract on the principal's behalf with a third party – the common situation is that of the UK agent who makes a contract with an UK third party to sell some goods on behalf of a foreign principal.
> The English common law concept of agency is sometimes described by legal writers as the doctrine of identity. This conveys the concept that the agent is the alter ego of the principal. In the act of the agent we see directly the act of the principal; we regard what the agent does for the principal in just the same way as we would have regarded the same act

> if the principal had been here and had done it. If a contract for sale were made in the UK it would follow that a non-resident making a contract here through an agent would be trading here. Thus our domestic law concept of trading within the UK by non-residents and our common law concept of agency are intimately linked although the word agent appears nowhere in the income tax charging legislation. This contrasts with the legal position under civil law, which is detailed in the guidance at INTM266160.

The "agent" need not be an agent in the contract law sense of a person empowered to enter into contracts on behalf of a principal.[31]

86.14.4 *Exception for general agents*

Section 10(6)[b] TCGA provides that branch or agency:

> does not include any person within the exemptions in section 82 of the Management Act (general agents and brokers).

The reference is to s.82 TMA 1970 which was absent-mindedly repealed in 1995! I think the repeal should be regarded as not affecting s.10(6), ie s.82 continues to have effect for this purpose. Taxguide 3/10 records:

> HMRC agreed that the position in respect of the reference to s82 TMA 70 in s10(6) TCGA 1992 is not immediately clear and they will clarify it.[32]

But the point has been forgotten or perhaps filed as too difficult.

Section 82 provides (or provided):

> [a] Nothing in this Part of this Act shall render a non-resident person chargeable in the name of a broker or in the name of an agent not being an authorised person carrying on the regular agency of the non-resident person, in respect of profits or gains arising from sales or transactions carried out through such a broker or agent:
> [b] Provided that where sales or transactions are carried out on behalf of a non-resident person through a broker in the ordinary course of his business as such and the broker
> (a) is a person carrying on bona fide the business of a broker in the UK, and
> (b) receives in respect of the business of the non-resident person which is

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31 See *Brackett v Chater* 60 TC 134.

32 Taxguide 3/10 Trustee Residence: Guidance note agreed by HMRC issued August 2010 by ICAEW, CIOT and STEP accessible *http://www.icaew.com/~/media/archive/files/technical/tax/tax-news/taxguides/TAXGUIDE-3-10-Trustee-Residence.pdf.*

> transacted through him remuneration at a rate not less than that customary in the class of business in question,
>
> then, notwithstanding that the broker is a person who acts regularly for the non-resident person as such broker, the non-resident person shall not be chargeable in the name of that broker in respect of profits or gains arising from those sales or transactions.
>
> In this subsection, "broker" includes a general commission agent.

There are two exceptions here. The exception at [a] applies only to cases where there is no regular agency.[33] This is similar to the rule that casual agents do not constitute an agency PE.[34] The exception at [b] is similar to the broker exemption. There is no statutory exemption for investment managers or other independent agents. This is, I think, an oversight. It is considered that the exemption (or something like it) should be implied.[35] As far as investment managers are concerned, in practice it does not matter much, as individuals or trusts are not likely to be trading in securities (and if they were, I do not expect that anyone would take any notice).

86.14.5 *Difference between branch/agency and PE?*

It is considered that "branch" should have (more or less) the same meaning as fixed place of business PE, and "agency" should have (more or less) the same meaning as agency PE, so the composite expression has (more or less) the same meaning as PE.

HMRC agree. The SALF Manual provides:

> **704 UK representatives of non-residents chargeable under Case I and II Schedule D** [February 2011]
>
> *Definition of UK representative*

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33 The phrase "not being an authorised person carrying on the regular agency of the non-resident person" governs "broker" as well as "agent", ie the section means:
"Nothing in this Part of this Act shall render a non-resident person chargeable
[i] in the name of a broker *not being an authorised person carrying on the regular agency of the non-resident person*, or
[ii] in the name of an agent not being an authorised person carrying on the regular agency of the non-resident person,
in respect of profits or gains arising from sales or transactions carried out through such a broker or agent..."

34 See 43.5 (Casual agent exemption).

35 See 86.6 (Independent agent exemption) citing the OECD Model commentary:
"... it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis."

> Branch or agency has the statutory definition at Section 126(8) FA 1995 of 'Any factorship, agency, receivership, branch or management' but it is interpreted on broadly equal lines to 'permanent establishment'...[36]

In *Brackett v Chater*,[37] the Special Commissioners took a different approach. They treated the term "branch or agency" as composite phrase containing a single concept. They did not think it correct to consider separately whether there was a branch, and whether there was an agent. The difficulty with this approach is that it is far from clear what the single concept is, if it is distinct from the concepts of branch and agency and PE. (The statutory definition, as noted, does not help.) The Special Commissioners' solution is to ignore the wording altogether.[38] It is not necessary to go that far, even when dealing with these 19th century fossils, and at a time when more emphasis is placed on a purposive approach.

The Special Commissioners continued:

> Mr. Brackett represents Drishane in this country and is in sole charge of the day to day conduct of the trading operations other than the formation of contracts. It is not straining language, in our opinion, to say that by entrusting those operations to his care Drishane has established at least a branch in this country. Alternatively Mr. Brackett can properly be described as the manager of those operations, because he personifies them. Nor can we accede to Mr. Brackett's argument that it is inappropriate to assess him as "agent for Drishane" because he does not have the status of an agent under the general law. The definition of "branch or agency" in s 118 Taxes Management Act adds that "branch or agent" shall be construed accordingly. We take that to mean that the term "agent" is used as the cognate noun to describe a person who represents a branch or agency. Mr. Brackett is undoubtedly the personification of the branch or management of Drishane's business in this country and is, in our opinion, properly assessed as "agent for Drishane" on the authority of s 79.

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36 Similarly the HMRC trustee residence guidance: "The examples all relate to non-UK resident companies that are trustees. The same principles would apply for other non-UK resident persons who are trustees (and for whom the relevant UK-based entity would be a branch or agency rather than a permanent establishment)."

37 60 TC 134 & 639, at p.646.

38 "It would, in our view, be perverse to hold that Drishane, which was effectively trading only in this country, through Mr. Brackett, is not within the charge to tax because of some semantic difficulty in fitting its arrangements with him to the wording of the definition of a branch or agency."

This conclusion does follow from the finding of fact in the first sentence, though the only support it received in the High Court was that the decision was one which the Special Commissioners were entitled to reach.

86.15 Can you trade in the UK without a branch/agency or PE?

In *Brackett v Chater* the judge said:

> ... I find it difficult to imagine how a non-resident company which carries on a trade with any degree of continuity in the UK can do so otherwise than through a "branch or agency" as defined in the Taxes Management Act 1970.[39]

This is *obiter*, but given the breadth of the expression it seems right as a general rule but not as an absolute rule. This applies to a PE as well as to a branch/agency.

The former International Tax Handbook at 846 took the view that trading in the UK without a branch or agency was rare:

> Although such cases are rare it is possible for a non-resident individual to trade here other than through a branch or agency. A non-resident individual might come to this country for a short time so as not to become resident and carry on an itinerant trade. There would in such a situation be no branch and no agency. It is rather more difficult to imagine situations of that sort where the person concerned is a company. But notwithstanding the judge's comments in the *Brackett* case there may be cases where the UK activities of a non-resident company are divided between various persons in such a way that, although the activities amount to trading here, no one person or group of persons can be identified as a branch or agency through which the trade is carried on.

86.16 Commentary: Let's abolish branch/agency

The FA 2003 replaced "branch or agency" with "PE" for the purposes of corporation tax. The reason was to achieve consistency with international tax law. A press release explained the reason:

> The rules also alter our current terminology so that in future we tax "permanent establishments", (a term recognised internationally and used in our double taxation agreements), rather than "branches". The new rules are to be interpreted in accordance with OECD guidelines, to ensure that the UK is in accord with

39 60 TC 134 at p.149.

international consensus that reflects UK agreement.[40]

This was a good reason to change corporation tax, and it is an equally good reason to bring IT and CGT into line. We do not need both concepts. The term PE should replace "branch or agency" altogether. This would be a worthwhile and trouble-free simplification in the law. It would make no difference in practice, because in practice the two terms come to much the same thing, and no-one takes much notice of such differences as there may be, but the reform would remove some puzzles and much complexity and duplication.

86.17 PE: The future

The OECD say:

> **The definition of PE must be updated to prevent abuses.** In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor? In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by "commissionnaire arrangements" with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country? Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities?
>
> **ACTION 7 Prevent the artificial avoidance of PE status** Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions.[41]

Action is promised for September 2015.[42]

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40 REV BN 25 para 8 (17 April 2002).

41 OECD, "Action Plan on Base Erosion and Profit shifting" (2013) p.19 *http://www.oecd.org/ctp/BEPSActionPlan.pdf*

42 OECD Action Plan, p.32.

CHAPTER EIGHTY SEVEN

DISCLOSURE AND COMPLIANCE

87.1 Disclosure and compliance: Introduction

A full discussion of disclosure and compliance issues requires a book to itself. This chapter focuses on matters closest to the themes of this book.

The topic of DOTAS requires a book to itself (and such books have been written); it is not discussed here.

For the Proceeds of Crime Act 2002, see 92.5 (Money laundering: introduction).

87.1.1 *Cross references*

This chapter discusses general principles. The question how specific types of income/gains are disclosed on a tax return is considered in the chapters on that type of income; see:

27.14 (Tax return – disclosure of s.624 income)
29.17 (Tax return – disclosure of s.720 income)
30.40 (Tax return – disclosure of s.731 income)
32.45 (Tax return – disclosure of motive defence)
51.37 (Tax return – disclosure of s.87 gains).

87.2 Standards of disclosure and mistake

87.2.1 *Standards of care: culpability of mistakes*

It is helpful first to define some terminology and draw some distinctions. Errors may be classified by certain standards:

"**An honest error**": where the maker meets the standard of honesty.

"**A careless error**": where the maker meets the standard of reasonable care.

"**A reasonable-excuse error**": where the maker has a reasonable excuse. This is similar to a non-careless error, but perhaps it reflects a higher standard: it is perhaps possible to envisage an error which is not careless

but for which one still cannot find a reasonable excuse. But the difference (if any) is only a matter of nuance and for most purposes they are the same.

The tax penalty regime distinguishes

(1) careless errors

(2) "**deliberate"** errors, (subdivided into those which are or are not concealed).

Deliberate error is similar to dishonesty, though it is just possible to envisage errors which are dishonest but not deliberate; and errors which are deliberate but not dishonest.

The minimum level of care required is that of reasonable care, ie if there is a mistake in a return (or any other document given to HMRC) the error is honest, non-deliberate, and non-careless.

87.2.2 *Standards of disclosure*

Taxpayers disclosure may be classified by various standards:

"**Minimum disclosure**" – the minimum required by statute.

"**Voluntary disclosure**" meeting some higher standard above that minimum. This is a (deliberately) loose expression since (in the absence of context) a variety of standards might be applied. One particular standard (discussed below) I call "***Veltema*-disclosure**" but there can be other standards.

"**Full disclosure**" (in the absence of context) is not an apt expression, and I prefer to avoid it, because one cannot disclose *everything*: that is not practical. Indeed even to try would swamp HMRC with information so they could not identify what is relevant. HMRC are themselves aware of this. SP 1/06 provides:

> 9. A taxpayer can further restrict the opportunity for discovery [assessments] by providing enough information for an HMRC officer to realise within the enquiry period that the self-assessment is insufficient. However taxpayers are encouraged to submit the minimum necessary to make disclosure of an insufficiency. The *Veltema* judgement does not require the provision of enough information to quantify the effect on the assessment. Information will not be treated as being made available where the total amount supplied is so extensive that an officer 'could not have been reasonably expected to be aware' of the significance of particular information and the officer's attention has not been drawn to it by the taxpayer or taxpayer's representative.

87.3 Self-assessment tax return: minimum disclosure

A tax return is a series of questions, and the duty of taxpayers (and their advisers) is simply to answer them. The answers should be honest and non-careless. That is, one cannot always avoid error, but any error in the return should be honest and non-careless.

The standard of honesty is the ordinary standard of reasonable and honest people.[1] In practice debate normally focuses on carelessness.

87.4 Carelessness

87.4.1 *Significance of carelessness*

Carelessness is relevant to time limits of assessment and to penalties.

As far as time limits are concerned, it is convenient to read s.34(1) and 36(1) TMA together:

> **34(1)** Subject to the following provisions of this Act, and to any other provisions of the Taxes Acts allowing a longer period in any particular class of case, an assessment to income tax or capital gains tax may be made at any time not more than 4 years after the end of the year of assessment to which it relates. ...
>
> **36(1)** An assessment on a person in a case involving a loss of income tax or capital gains tax brought about carelessly by the person[2] may be made at any time not more than 6 years after the end of the year of assessment to which it relates ....

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1 But what is that standard? It ultimately depends on the view of the judge or jury as finders of fact. Did Pepys reflect those standards when he wrote in his diary for 10 December 1660:

> "This afternoon there was a Couple of men with me, with a book in each of their hands, demanding money for polemony; and I overlooked the book and saw myself set down *Samuel Pepys, gent.,* 10*s* for himself and for his servants 2*s.* Which I did presently pay without any dispute; but I fear I shall not escape so, and therefore I have long ago laid by 10*l.* for them; but I think I am not bound to discover myself."

The point of the entry is that Pepys was liable to pay £10 under the Act (12 Car. II c.9) as an esquire. His good fortune continued under the next poll tax: The entry of 20 March 1667 reads:

> "I ... assessed by the late Pole-bill, where I am rated at an Esquire; and for my office, all will come to about 50*l* – but not more then I expected, nor so much by a great deal as I ought to be for all my offices – so I shall be glad to escape so."

2 Section 36(1B) TMA provides: "In subsections (1) and (1A), references to a loss brought about by the person who is the subject of the assessment include a loss brought about by another person acting on behalf of that person."

In short, there is normally an (approximately) 4-year limit on assessments. In the case of carelessness, assessments may be made up to 6 years (and in other specified cases up to 20 years.)

The taxpayer may be subject to penalties if they are guilty of carelessness. In penalty matters the carelessness must (in short) be personal carelessness of the taxpayer, not of their agents[3] (though it is of course possible for both taxpayer and agent to be guilty of carelessness).

87.4.2 *Meaning of "carelessness"*

A note on terminology. Enquiry Manual correctly provides:

> **5125 Culpability: Neglect, Negligence and Negligent Conduct** [May 2013]
> The terms neglect, negligence and negligent conduct are interchangeable.

Modern drafting uses the word "careless" defined to mean "failure to take reasonable care".[4] This is just a Plain English synonym of "negligence" or "neglect". HMRC agree. Compliance Handbook provides:

> **53400. What is careless behaviour?** [May 2013]
> The 6-year time limit applies where income tax, capital gains tax or corporation tax, stamp duty land tax, stamp duty reserve tax and petroleum tax has been under-assessed or over-repaid due to the careless behaviour of
> • the person, see CH51600, or
> • a person acting on their behalf, see CH53200.
> "Careless" means a failure to take reasonable care in relation to your tax affairs.
> Carelessness can be likened to the longstanding concept in general law of "negligence".
> In the 1856 case of *Blyth v Birmingham Waterworks Co*,[5] Baron Alderson said
>
> > Negligence is the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do. The defendants might be

3 Para 18(3) Sch 24 FA 2007.

4 See s.29(4) and s.118 TMA as amended; similarly the penalty provisions in Sch 24 FA 2007.

5 (1856) 11 Ex 781, p784.

> liable for negligence, if, unintentionally, they omitted to do that which a prudent and reasonable person would have done, or did that which a person taking reasonable care would not have done.
>
> There is no question of whether or not the person intended to make the inaccuracy or fail to comply with the obligation. If they did that would be deliberate, see CH53700. It is simply a question of examining what the person did or failed to do and asking whether a prudent and reasonable person taking reasonable care would have done that or failed to do that in those circumstances.
>
> Repeated inaccuracies may form part of a pattern of behaviour which suggests a lack of care by a person in developing adequate systems for the recording of transactions or preparing tax returns. Similarly, repeated failures in relation to the relevant obligations in CH53900 to CH54100 inclusive may suggest a lack of care. It is, however, important to keep a sense of proportion. For example, repetition of the same inaccuracy would not always, of itself, indicate a failure to take reasonable care.
>
> People do make mistakes. We do not expect perfection. We are simply seeking to establish whether the person has given the care and attention that could be expected from a reasonable person taking reasonable care in similar circumstances....

The question must be decided in the light of the position as it was at the relevant time without the benefit of hindsight. The fact that a view turns out to be mistaken does not show that it was careless to form that view. Otherwise any judge whose decision is reversed on appeal would be guilty of carelessness and how often does that happen!

The onus of proof rests on HMRC to prove carelessness. An allegation of carelessness is a serious one and it should not be lightly made. I stress these points because HMRC ignore them and allege neglect as a matter of course, whenever carelessness is necessary to justify out of time assessments.[6]

Depending on which statutory provision is in point, it may be necessary to ascertain:

(1) whether the taxpayer is guilty of carelessness; or
(2) whether the taxpayer's agent is guilty of carelessness.

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6 See eg International Manual which contains this revealing statement:
"**268520 Assessing time limits** [September 2011]
…If we come to the reasonable conclusion that there is a PE, or that the company is resident in the UK, there must have been careless or deliberate conduct in the failure to notify."

87.4.3 *The standard of care: taxpayers*

A taxpayer who is not an expert in taxation must leave technical tax issues to their professional advisers. When tax law is complicated a properly represented taxpayer cannot be expected to identify their advisers' mistakes. So where there are technical errors of law, the issue is normally whether the taxpayer's professional advisers have been guilty of carelessness. HMRC agree (if grudgingly):

> A taxpayer who
> [1] goes to an ostensibly competent professional adviser,
> [2] provides a full and accurate account of the facts,
> [3] checks that advice to the limit of his or her ability and competence,
> [4] and then follows the agent's advice (or signs the return prepared on that basis)
> has not been negligent. He or she has taken reasonable care. If it turns out that the agent has made a careless error in giving the advice or in preparing the tax return the taxpayer who has taken reasonable care will not be penalised.[7]

This wording is somewhat overfavourable to HMRC; paragraphs [2] and [3](depending on what nuance one puts on the expressions used) do seem to exceed a requirement of reasonable care. But the basic point is correct.

An interesting question is what the taxpayer should do if their advisers disagree. A safe course(if the amounts involved make this reasonable) is to seek the advice of counsel, or more senior counsel, or a tax QC, but what is to be done if two QCs disagree or if the amounts do not justify that expense? It is suggested that the correct course is as follows:

(1) The individual must ask himself whether one view or the other is obviously or glaringly wrong. However it is not to be expected that this will often provide a solution.
(2) Subject to that, the individual can in principle follow whichever view suits them, provided that the person whose advice is adopted is suitably experienced, has seen the contrary advice and maintains their view. Then (even if the practitioner whose view is adopted turns out

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7 "Modernising Powers, Deterrents and Safeguards: Working with Tax Agents" 22 April 2009, accessible: *http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_RatesCodesTools&propertyType=document&id=HMCE_PROD1_029453*

to be wrong) any error is non-careless and a reasonable-excuse error.

87.4.4 *The standard of care: tax practitioners*

The question then is what reasonable tax practitioners should do in advising or completing a client's tax return. The standard of care is that to be expected of a reasonable practitioner.[8]

A solicitor or accountant is entitled to rely on advice given by an appropriate expert counsel (provided it is not obviously or glaringly wrong). A person who acts in this way is not careless.[9] This rule applies in the completion of a tax return. So where counsel has advised, HMRC would normally need to allege that counsel is guilty of carelessness in order to make an out of time assessment.

What should a practitioner do if the law is so unclear that they are unable to form a view? In many cases the only honest answer to the question of how a court would decide is "I don't know" or "toss a coin". This includes some basic issues, such as the source of interest. In such cases the proper course is to complete the tax return on whichever view best suits the client.

A trickier question is where professional views differ between view A and view B, the practitioner prefers view A, but view B suits the client. It is suggested the practitioner can advise the client to fill in their return on view B. Take, for example, the old chestnut problem of GWR and trusts. Some practitioners (including myself) thought there is no IHT charge on the death of an individual who has a GWR in an excluded property trusts even if they are IHT deemed domiciled (or indeed actually UK domiciled). Some practitioners (I think, a minority) took the view that there is a charge and for a decade or so HMRC also officially took that view.[10] Should they really advise their clients to complete the return on that basis? I would have thought not. If that were wrong, then the best advice one could give would be to change advisers, which can hardly be

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8 Of course, the adviser's duty is not merely (merely?) to understand the law. He/she must explain it, record it in writing, and identify the risk factors to the client. Is this so obvious that it is unnecessary to say? It is not: *Chandrasekaran v Deloitte & Touche Wealth Management* [2004] EWHC 1378 at [72].

9 *Locke v Camberwell Health Authority* [1991] 2 Med LR 249 accessible *http://www.kessler.co.uk/tfd-archive*.

10 This passage was written before HMRC issued guidance accepting the view put forward in this book, which for practical purposes resolves the problem, but I retain the text as the example neatly illustrates the problem.

right.

87.5 Significance of reasonable excuse

It is not possible to give a full list. The most important is s.59C TMA which imposes a 5% surcharge on tax paid more than 28 days late and another 5% on tax paid more than 6 months late. It is not a requirement that the taxpayer or their agent be guilty of carelessness. (This is no doubt why the term used is "surcharge" and not "penalty".) Instead there is a defence for a taxpayer with a "reasonable excuse".

87.6 Advantages of voluntary disclosure

This section considers whether a tax return should contain more than the minimum disclosure of answering the questions asked. The "white box" section of a tax return "Any other information" is designed for this purpose, or material may be put in a covering letter.

Any such disclosure is voluntary. Everyone who is responsible for completing tax returns has to ask questions and decide on the answers. If an answer is reached, there is in general no obligation to disclose to HMRC the reasons, doubts, and facts which are not considered to affect the position. Failure to disclose these things does not render answers in the return (even if they turn out to be wrong) to be dishonest or careless errors.

The CIOT used to say that clearly:

> *In the preparation of a tax return, there is no duty to provide more information to the tax authorities than the return requires simply because some pieces of information known to the member might support a different tax treatment from that which the member, after due consideration of all the information available to him, honestly considers to be the tax treatment.*[11]

That continues to be the law, and the CIOT have not changed their view, but in the current (2014) version of the code they no longer have the confidence to express it in such clear and uncompromising terms:

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11 CIOT, *Professional Conduct in Relation to Taxation* (2004), para 3.10.
The Keith Committee recommended that taxpayers' doubts should be disclosed to HMRC but the recommendation was rightly rejected as impractical: see Committee on Enforcement Powers of Revenue Departments (1983) Cmnd 8822 para 7.3.6 and HMRC consultation papers "The Inland Revenue and the Taxpayer" and "Keith: Further Proposals" (1988).

> A tax return must contain at least the minimum information required by law.[12]

That sentence is a truism, and not in any meaningful sense guidance, for the question is to identify the information which is "required by law". However one can infer from what follows that the CIOT view has not changed, as the passage goes on to identify reasons for *voluntary* disclosure:

> In general it is likely to be in a client's own interests to ensure that factors relevant to his tax liability are adequately disclosed to HMRC ... In addition, it may be desirable to make fuller disclosure than is strictly necessary.[13]

The fact that there is a possibility that the courts might disagree with an adviser's view does not in itself require any disclosure. The law could not sensibly take any other view, as that possibility almost always exists, even if the law seems clear. Readers will easily bring to mind long lists of strange decisions, some corrected on appeal[14] and others not,[15] to illustrate the uncertainties – or (which comes to the same thing) the lottery element in litigation.

The same of course applies both ways. When HMRC assess tax to the best of their judgement, they disclose what tax they consider due, but not their doubts or reasons.

Voluntary disclosure (in the words of the CIOT, "fuller disclosure than is strictly necessary") may be desirable for any one or more of the following reasons:

(1) It may curtail HMRC's enquiry period.
(2) It may facilitate good relations with HMRC.
(3) It may help avoid allegations of misconduct, which might later arise if the view taken turns out to be in error, and tax is due:

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12 *Professional Conduct in Relation to Taxation* (2014), para 3.13 *http://www.tax.org.uk/Resources/CIOT/Documents/2014/02/Professional%20Conduct%20in%20Relation%20to%20Taxation%20190214%20final.pdf*
I refer to this for short as the CIOT's code, but it is in fact issued jointly by all the major professional bodies.

13 CIOT, *Professional Conduct in Relation to Taxation* (2014), para 3.14, 3.15.

14 For example, *Rysaffe v IRC* [2003] STC 536; *Grimm v Newman* [2002] STC 1388.

15 For example, *Phizackerley v HMRC* [2007] STC SCD 328.

(a) Allegations of dishonesty (based on a suspicion that the taxpayer might be relying on HMRC not finding out the facts).
(b) Allegations of carelessness.
(c) Allegations of no reasonable excuse.

87.7 Voluntary disclosure to curtail enquiry period

HMRC usually have 12 months in which to begin an enquiry into a tax return. However, s.29 TMA provides an extension of time in certain cases:

> (1) If an officer of the Board or the Board discover, as regards any person (the taxpayer) and a year of assessment—
>
> (a) that any income which ought to have been assessed to income tax, or chargeable gains which ought to have been assessed to capital gains tax, have not been assessed, ….
>
> the officer or, as the case may be, the Board may, subject to subsections (2) and (3) below, make an assessment in the amount, or the further amount, which ought in his or their opinion to be charged in order to make good to the Crown the loss of tax. ….
>
> (3) Where the taxpayer has made and delivered a return under section 8 or 8A of this Act in respect of the relevant year of assessment, he shall not be assessed under subsection (1) above—
>
> (a) in respect of the year of assessment mentioned in that subsection; and
>
> (b) in the same capacity as that in which he made and delivered the return,
>
> unless one of the two conditions mentioned below is fulfilled.

I refer to these conditions as **"the culpable mistake condition"** and **"the innocent mistake condition"**. The terminology is from *Veltema*.

87.7.1 *The culpable mistake condition*

Section 29(4) TMA provides:

> The first condition is that the situation mentioned in subsection (1) above was brought about carelessly or deliberately by the taxpayer or a person acting on his behalf.

This condition will not be satisfied in the absence of fraud or carelessness. That takes us to the second condition.

87.7.2 *The innocent mistake condition*

Section 29(5) TMA provides:

> The second condition is that at the time when an officer of the Board—
>
> (a) ceased to be entitled to give notice of his intention to enquire into the taxpayer's return under section 8 or 8A of this Act in respect of the relevant year of assessment; or
>
> (b) informed the taxpayer that he had completed his enquiries into that return,
>
> the officer could not have been reasonably expected, on the basis of the information made available[16] to him before that time, to be aware of the situation mentioned in subsection (1) above.

The advantage of voluntary disclosure is that HMRC cannot (after the one-year period has passed) make any further enquiries into the return. If a taxpayer wants security that the matter is closed after one year, therefore, it would be necessary to disclose relevant facts. I refer to disclosure which meets the requirements of the innocent mistake condition as "***Veltema*-standard disclosure**".

Taxpayers are entitled to weigh up the advantages of *Veltema*-standard disclosure (curtailing the enquiry period) against the disadvantages (possible costs).

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16 Section 29(6) TMA provides:

> "For the purposes of subsection (5) above, information is made available to an officer of the Board if—
>
> (a) it is contained in the taxpayer's return under section 8 or 8A of this Act in respect of the relevant year of assessment (the return), or in any accounts, statements or documents accompanying the return;
>
> (b) it is contained in any claim made as regards the relevant year of assessment by the taxpayer acting in the same capacity as that in which he made the return, or in any accounts, statements or documents accompanying any such claim;
>
> (c) it is contained in any documents, accounts or particulars which, for the purposes of any enquiries into the return or any such claim by an officer of the Board, are produced or furnished by the taxpayer to the officer; or
>
> (d) it is information the existence of which, and the relevance of which as regards the situation mentioned in subsection (1) above—
>
> (i) could reasonably be expected to be inferred by an officer of the Board from information falling within paras (a) to (c) above; or
>
> (ii) are notified in writing by the taxpayer to an officer of the Board."

87.8 *Veltema*-standard[17]

87.8.1 *HMRC views*

The Enquiry Manual provides:

> **3260 Discovery in SA years - Made Available** [January 2010]
> ...
> In *Langham v Veltema* 76 TC 259, Auld LJ considered two issues relating to s 29(6).
> The first issue was 'whether [the inspector's] awareness or inference of actual insufficiency is required to negative the [innocent mistake] condition, or would awareness that it was questionable do'.
> The second issue was 'what is the relevant information before the Inspector on the basis of which he could be said to have been reasonably expected to be aware of an insufficiency'.
> ***First issue***
> In addressing this Auld LJ concluded:
>
> > '.. it is plain from the wording of the statutory test in s 29(5) that it is concerned ... with what he could have been reasonably expected to be aware of. It speaks of an Inspector's objective awareness, from the information made available to him by the taxpayer, of 'the situation' mentioned in s 29(1), namely an actual insufficiency in the assessment. ...
> > It is a mark of the way in which the subsection provides an objective test of awareness of insufficiency, expressed as a negative condition in the form that an officer 'could not have been reasonably expected ... to be aware of the insufficiency. It also allows as s 29(6) expressly does, for constructive awareness of insufficiency, that is, for something less than an awareness of an insufficiency, in the form of an inference of insufficiency.'
>
> ***Second issue***
> Auld LJ considered:
>
> > 'It seems to me that the key to the scheme is that the Inspector is to be shut out from making a discovery assessment under the section only when the taxpayer or his representatives, in making an honest and accurate return or in responding to a Section 9A enquiry, have clearly alerted him to the insufficiency of the assessment in question.'

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17 See Gordon, "Discovery Assessments – The Consequences of the Decision in *Corbally v Stourton*" 12 PTPR 45, accessible *http://www.khpplc.co.uk/reviews*

There is more HMRC guidance in SP 1/06. This comments on valuation and accountancy issues (not discussed here) and then provides:

> ***Taking a Different View***
> 18. It is open to a taxpayer properly informed or advised to adopt a different view of the law from that published as HMRC's view. To protect against a discovery assessment after the enquiry period, the return or accompanying documents would have to indicate that a different view had been adopted. This might be done by comments to the effect that the taxpayer has not followed HMRC guidance on the issue or that no adjustment has been made to take account of it. This would offer an opportunity to HMRC to take up the return for enquiry. It is not necessary to provide all the documentation that HMRC might need to quantify that insufficiency if an enquiry into the Return is made.
> 19. Provided the point at issue is clearly identified and the stance adopted is not wholly unreasonable, the existence of an under-assessment or insufficiency is demonstrated by the statement that a different view of the law has been followed. In these circumstances the taxpayer achieves finality if no enquiry is opened within the statutory time limit.

87.8.2 *Case law*

There is a growing body of case law and a full discussion would need a long chapter to itself.[18]

In *R v HMRC ex p. Pattullo*[19] the taxpayer entered into a CGT tax avoidance scheme. In his return he put the following:

> 1. On [date] I settled an interest in possession trust with £6,000.
> 2. The trust is called 'The Pattullo 2004 Life Interest Settlement'.
> 3. I had borrowed on commercial terms a sum of £2,665,000 from Investec Bank UK Limited and settled this amount into the trust.
> 4. The trustees 'Nexus Trustee Company Limited' used the funds to acquire a number of capital redemption contracts [and transferred them][20] to me on 4 March 2004.
> 5. I surrendered the Capital redemption contracts on 8 March 2004 and received redemption proceeds of £2,600,000.

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18 See Gordon, "Discovery Assessments – The Consequences of the Decision in *Corbally v Stourton*" 12 PTPR 45, accessible *http://www.khpplc.co.uk/reviews*

19 [2010] STC 107. Note incidentally that the Latin tag *ex p.* which has been rejected in English law usage seems to have survived in Scotland.

20 The context shows that some words like this were omitted from the law report.

> 6. This has given rise to a capital loss as a consequence of Section 37(1) TCGA 1992 amounting to £2,665,000.

I would have thought this made it obvious to any competent inspector exactly what had happened. However the Court of Session held that this did not reach *Veltema*-standard. The Court said:

> [114] ...the white space does not contain the following:
> 1. A statement that Mr Pattullo was a participant in the CRC Mark II tax avoidance scheme.
> 2. A statement that the petitioner and his advisers had adopted a different view of the law from that published as HMRC's namely: they had taken a view in respect of the tax treatment of Capital Redemption Contracts which is the opposite of that taken by HMRC Capital Gains Tax Manual [*sic*] at CG69004 ... is not contained within the white space.[21] ...

The judge erroneously continues:

> The necessity to make such a declaration in order to comply with the duty to clearly alert has been held to exist in *HMRC v Household Estate Agents* where it was held as follows:
>
> > "Taxpayers who adopt a different view of the law from that published as HMRC's can protect against a discovery assessment after the enquiry period. The return and accounts would have to indicate that a different view had been adopted by entering comments to the effect that they did not follow HMRC guidance on the issue or that no adjustment had been made to take account of it."

This is a reference to a submission made by HMRC, which did not form part of the Commissioners decision in favour of the taxpayer.[22]

> 3. There is no explanation as to how Mr Pattullo contends that Section 37 operates in order to produce the capital loss.
> 4. The details other than the basics of the transactions which have been entered into are not contained within the white space.

The judge wisely does not seek to identify what details were missing.

> 5. There is no indication of any doubt in the disclosure that the petitioner is entitled to the loss. I accept ... that the taxpayer does not require in

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21 This may be factually incorrect, the judge does not set out the relevant text of the Manual, but that does not affect the point of principle.

22 78 TC 705 at [10]. For completeness, the Commissioners decision in *Household Estate Agents* was reversed on other grounds on appeal.

> order to clearly alert to say there is an insufficiency as of course that is not his position. However, in circumstances such as this a reference to doubt or as I have said to the fact that it is, a position contrary to HMRC's would be necessary to comply with the duty incumbent upon him.
> In the absence of information of the type as above described an inspector of the skill and knowledge as I have earlier defined it could not in my judgment have been aware of actual insufficiency. ...

The judge does not say whether it is generally necessary to indicate a doubt. It is suggested that this should not be necessary except in special cases. There must always be a doubt when there is a white box disclosure, for if there is no doubt, what is the point of disclosure?

In the 10th edition of this work I concluded:

> One can, I think, expect some back-tracking, refinement or qualification from the Courts for taxpayers they regard as more meritorious than Mr. Pattullo.

Subsequently, a less onerous view of the *Veltema*-standard was taken in *Charlton v HMRC*[23] though the taxpayer was no more meritorious. The disclosure was essentially as follows:

> I acquired a life policy on [date] for £205k.
> I made a partial surrender of the policy on [date] for £192k.
> I sold my residual interest in the policy on [date] for £10k.
> The loss on sale is calculated as the difference between the sale proceeds and the cost of acquisition.
> Proceeds from the partial surrender are excluded from the capital gains calculation as they have already been taken into account as a receipt in computing income for the purposes of income tax.

The DOTAS scheme number was also disclosed on the return.[24] It was not mentioned that the scheme had been held to be unsuccessful by the Special Commissioners in *Drummond v HMRC,* the taxpayers advisors having formed the view[25] that *Drummond* (at least as far as concerned their own scheme) was wrongly decided and likely to be reversed on appeal. It was

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23 [2011] UKFTT 467; the position will need to be reviewed when the decision is final.

24 This did not happen in *Pattullo* where the transactions were carried out before the DOTAS rules took effect.

25 Which the tribunal found to be a reasonable view, though subsequently the Special Commissioner's decision was upheld: *Drummond v HMRC* 79 TC 793.

held this met the *Veltema*-standard

87.8.3 *IHT: voluntary disclosure to curtail enquiry*

The IHT rules are differently worded (and drafted in an earlier era, more concise) but the standard of disclosure is similar. A certificate of discharge discharges "all persons from any further claim for the tax on the value transferred by the chargeable transfer concerned". See s.239(3) IHTA. However, s.239(4) provides:

> A certificate under this section shall not discharge any person from tax in case of fraud or failure to disclose material facts. ...

87.9 Voluntary disclosure for sake of good relations with HMRC

CIOT Professional Conduct in Relation to Taxation used to provide:

> *It may be in the client's best interest to furnish more information than he is strictly required to do because this is likely to lead to a more reasonable approach by the tax authorities, thereby saving money and time in the long run ...*

The CIOT are tentative (note the *may*) and the validity of the point is not easy to assess: it may vary from client to client, from time to time, and from department to department. HMRC solicitors department, for instance, in the author's experience, adopt an uncompromisingly adversarial approach in the conduct of tax litigation.

In the 2010/11 edition of this work I commented:

> It seems to me that the only tangible incentive for above-minimum disclosure is to curtail the enquiry period, and obtaining "a more reasonable approach by the tax authorities" is uncertain, unquantifiable, unenforceable and ultimately chimerical. But readers who deal directly with HMRC on a daily basis will be in a better position than I am to form a view on this issue, and this is (understandably) an attitude that HMRC wish to encourage.[26]

The CIOT may agree, since in 2011 they watered down this passage; it now reads:

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26 See comments on the "enhanced relationship" in the OECD Study into the Role of Tax Intermediaries, 2008, *http://www.oecd.org/dataoecd/28/34/39882938.pdf* and the OECD's "Engaging with High Net Worth Individuals on Tax Compliance" (May 2009);*http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/engaging-with-high-net-worth-individuals-on-tax-compliance_9789264068872-en*

> In general it is likely to be in a client's own interests to ensure that factors relevant to his tax liability are adequately disclosed to HMRC because:
> - His relationship with HMRC is more likely to be on a satisfactory footing if he can demonstrate good faith in his dealings with them ...[27]

If it is anticipated that questions will be asked, it is sensible to anticipate them by providing details in a tax return.

This debate should be seen in the context of a broader fundamental controversy concerning the relationship between the Revenue and the taxpayer. The traditional view has been that:

(1) The relationship is adversarial: the interests of HMRC and taxpayer are distinct.
(2) The relationship should be characterised by adherence to legal rules (substantive tax rules determining the amount of tax due, and the requirement of honesty) supplemented by procedural professional conduct rules (such as courtesy and efficiency).

A rival (and more recent[28]) view is the opposite:

(1) The relationship should be a mutual one, taxpayer and Revenue working together in harmony towards a common goal, to ascertain the right amount of tax.[29]
(2) The right amount of tax is defined only partly in legal rules but also discernable from a more insubstantial spirit of the rules.[30] (Perhaps

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27 CIOT, *Professional Conduct in Relation to Taxation* (2014), para 3.14 *http://www.tax.org.uk/Resources/CIOT/Documents/2014/02/Professional%20Conduct%20in%20Relation%20to%20Taxation%20190214%20final.pdf*

28 It is difficult to identify a specific date when this school of thought emerged, but I think it reflects a change of administration around the beginning of the second term of the Labour Government (2001). Contrast the discussion of the term "compliant" in 44.6.4 (Investment manager condition E: customary remuneration).

29 Also called "the proper amount of tax".

30 An example is the Code of Practice on Taxation for Banks, (December 2009) which prescribes that banks should "not undertake tax planning that aims to achieve a tax result that is contrary to the intentions of Parliament; ... not engage in tax planning other than that which supports genuine commercial activity... Remuneration packages for bank employees ... should be structured so that the bank reasonably believes that the proper amounts of tax and national insurance contributions are paid... Relationships with HMRC should be transparent and constructive, based on mutual trust [adding with jarring realism: "wherever possible"]. The features of this relationship should include disclosing fully the significant uncertainties in relation to

> HMRC consider themselves the arbiter of this spirit, or perhaps no arbiter is needed: so far as the point is not governed by law, the question can be fudged.)[31]

I refer to the traditional view as **"the adversarial relationship"**, and the rival view as **"the partnership relationship"**. A range of positions are possible within the two extremes.

The controversy raises empirical questions of whether HMRC and taxpayers actually regard the partnership relationship as the model of their relationship, or pretend to do so; and political and moral questions of whether they should do so, or the extent to which they should do so. The controversy raises the legal questions of whether the Courts would enforce a co-operative approach or only the adversarial approach. The short answer seems to be that the Courts will not enforce a co-operative approach. It rests outside the law.[32] Thus in one case, HMRC noticed that a company had failed to put in a loss election, but did not inform the company until the deadline for the election had passed. The court held that there was nothing wrong in that.[33]

Those who believe that tax should be governed by law will regard the partnership approach with suspicion. For a restatement of the traditional view, see the speech of Anthony Thomas when president of the CIOT:

> We need to return to the "healthy tension" between HMRC and the tax profession that existed ten to 20 years ago: no special relationships, no cosy conferences; no favours, deals and understandings; no inside tracks and private access. ... Senior tax officials did not subject directors, businesses and the professions to the kind of lectures one would expect from a politician. The job of civil servants is, and always has been, to apply the rule of law in an even handed manner.[34]

A full discussion lies beyond the scope of this book, but the issues are

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tax matters... engaging in a co-operative, supportive and professional manner in all interactions ... working collaboratively...."

31 HMRC say: "Any disagreements arising under the Code will be dealt with using existing processes." See "A Code of Practice on Taxation for Banks - Consultation Response Document" (December 2009).

32 HMRC rightly say (under the heading "The Rule of Law"): The Code is not law. See "A Code of Practice on Taxation for Banks - Consultation Response Document" (December 2009).

33 *R (oao Bampton Property Group) v King* [2014] STC 56.

34 "We Need Trust", Taxation (2 June 2011) p.7.

deep, and will not go away.

87.10 Voluntary (?) disclosure to avoid allegation of misconduct

Disclosure may be sensible to avoid allegations of misconduct, which might later arise if the view taken turns out to be in error, and tax is due: that is, allegations of dishonesty, carelessness or absence of "reasonable excuse". Cases where disclosure is needed for this reason are rare, but examples are:

(1) Where the taxpayer is taking a view which is contrary to a HMRC view which has been formally published in a SP.
(2) The same applies if the HMRC view is clearly known from more informal sources, such as the HMRC Manuals, RI or Business Briefs, or correspondence published by the professional bodies, or private correspondence; unless the HMRC view expressed is fairly clearly wrong.
(3) Where the adviser is following a view in the profession which they themselves do not share.
(4) Where the adviser is following a view in the profession which is very much a minority view, even if the adviser does share that view.[35]

In earlier editions I said that disclosure in circumstances such as these was best practice but not a matter of obligation. On further reflection I am not quite sure about that. The principle that one need not disclose matters of doubt may be pushed beyond breaking point. If tax was in fact due, the sanction for non-disclosure would then be penalties on the basis of deliberate error. Alternatively a hostile court may be inclined to find the taxpayer guilty of neglect.

87.11 IHT reporting requirement on creation of settlement

Section 218(1) IHTA provides:

> Where any person, in the course of a trade or profession carried on by

35 I formerly added another category: Where the taxpayer has carried out a complex, artificial, and aggressive tax avoidance scheme. In such a case (even though it is reasonably considered the scheme should succeed) full disclosure of the transactions should be made so HMRC have a proper opportunity to review the matter. In practice such cases should be caught by DOTAS so the issue of disclosure on a tax return does not arise.

> him, other than the profession of a barrister,[36] has been concerned with the making of a settlement and knows or has reason to believe—
>
> (a) that the settlor was domiciled in the UK, and
>
> (b) that the trustees of the settlement are not or will not be resident in the UK,
>
> he shall, within three months of the making of the settlement, make a return to the Board stating the names and addresses of the settlor and of the trustees of the settlement.

The duty of disclosure rests on a person ("the practitioner") acting in the course of their trade or profession. The duty rests on the firm or company acting and not directly on its employees.

Barristers are exempt. The reason is that they will usually be instructed by others who are subject to the duty.[37]

The practitioner must be concerned with the making of a settlement. This would include not only solicitors who might draft the settlement but other advisers who advise in relation to the creation of a settlement, even if the actual execution of the settlement were delegated to foreign advisers.

The practitioner might advise on the matter generally, leaving the client to take whatever action they wish in light of the advice, perhaps in conjunction with the trustees; in such circumstances they are probably not "concerned with the making of a settlement"; this presupposes the settlement had been established. What if the client had decided against a non-resident settlement after all or wanted to think about it? The practitioner may not know what the client eventually decided to do. The obligation under s.218 must be restricted to those who are able to provide the relevant information.

The practitioner must know or have reason to believe that the settlor is domiciled in the UK. A settlement may have more than one settlor.[38] Suppose one settlor is domiciled in the UK but the other is not. Does the reporting requirement arise? On a literal construction one could not say

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36 Section 272 IHTA provides: "barrister" includes a member of the Faculty of Advocates.

37 A consultation paper was published in 2009 but the proposed reforms were dropped. See HMRC Consultation Document "Modernising Powers, Deterrents and Safeguards: Tackling Offshore Tax Evasion" (December 2009); HMRC Consultation Response Document "Tackling Offshore Tax Evasion" (March 2010).

38 "Settlor" for this purpose has the usual IHT meaning: see 80.1 (Who is the settlor?). The separate settlements fiction does not apply for this purpose: see 64.3 (The separate settlements fiction).

"the settlor" is UK domiciled and the reporting requirement would not arise. A purposive construction suggests that the duty does arise. That is the better view at least if the foreign domiciled settlor only provides a nominal amount. A practitioner should err on the side of caution.

A question also arises about the time when the settlor's domicile is relevant. Section 218 merely says that it applies if the settlor *was* domiciled in the UK. Does this mean domiciled in the UK at the time the settlement was made? Or does it mean that the settlor had at any time been domiciled in the UK? Context and common sense dictate that the provision is referring to the domicile of the settlor at the time the settlement was made because that is the date that matters for IHT.

IHT Manual para 42993 formerly provided:[39]

> **42993 Section 218 notices** [April 2010]
> ***Where settlor is a company***
> A s.218 notice is still required because s.218 refers to settlors domiciled in the UK
> - 'settlor' in relation to a settlement includes any person by whom the settlement was made (s.44 IHTA)
> - In terms of the Interpretation Act 1889 Rule 19 'the expression person shall, unless the contrary appears, include any body of persons corporate or unincorporate'[40]
> - In general a company is domiciled where it is registered – *Gasque v IRC* [1940] 2 KB 80.
>
> So where a non-UK resident [Employee Benefit Trust] is established by a company registered in the UK a s.218 notice is mandatory.

The person must know or have reason to believe that the trustees of the settlement are not or will not be resident in the UK**.**

In marginal cases the practitioner may be placed in difficulty. It may be necessary in some cases to disclose the creation of the settlement to HMRC out of caution.

There is no requirement under s.218 to notify the amount or nature of the settled property. However, HMRC have power in s.219 IHTA to require information to be provided by "any person" and they would know from the notification to whom further enquiries could be directed.

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39 Since April 2011 the Manual reads 'our guidance on Employee Benefit Trusts is currently being rewritten'.

40 The text is 30 years out of date; the reference should now be to Sch. 1 Interpretation Act 1978, but the point is still valid.

Sch 5A TCGA imposes overlapping reporting requirements relating to non-resident settlements. But s.218 IHTA is wider in some respects. It applies to settlements which are not necessarily non-resident under the CGT rule.[41] Thirdly, the CGT duty is imposed on the settlor. The IHT duty is on the professional advisers.

For the position where IHT DT relief applies see 72.9 (Claims for foreign IHT credit relief).

87.11.1 *Non-resident practitioner*

It is suggested that no duty will arise on foreign practitioners who have no UK connection; the usual territorial limitation must apply: see *Clark v Oceanic* 56 TC 183. At first sight the requirement that the settlor is domiciled in the UK is sufficient to meet the territorial requirement so that no further territorial limitations should be implied. But the domicile connection may be a faint one. Suppose an individual leaves the UK in 2000 and settles in the USA, and in 2003 he makes a settlement. The individual may still be IHT deemed domiciled, but it is not realistic to expect the US practitioner to file a s.218 return (particularly having regard to the fact that the USA IHT DTA provides some IHT exemption).

87.11.2 *Penalty for failure to disclose*

Failure to make the return gives rise only to a nominal penalty.[42] More seriously, the practitioner faces criminal liability for fraud on HMRC or conspiracy to defraud if:

(1) the practitioner dishonestly fails to disclose in breach of the duty to do so; or

(2) any person dishonestly agreed with another practitioner or a client that there shall be no disclosure in breach of the duty to do so.

See too 8.7 (Disclosure of emigration or treaty-emigration of trust).

87.12 Reporting on death of foreign domiciled individual

I consider here the reporting duty of personal representatives on the death of an individual not domiciled in the UK. The legislation draws a distinction between:

(1) "**excepted estates**"; and

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41 For IHT Trust residence, see 5.18 (Trustee residence for IHT). This is quite different from the IT/CGT definition.

42 Section 245A(1) IHTA 1984.

(2) "**ordinary estates**"; I coin this term to describe an estate which is not an "excepted estate".

For the position where IHT DT relief applies see 72.9 (Claims for foreign IHT credit relief).

87.12.1 *Meaning of "PRs" for IHT*

The definition of "personal representatives" matters for various purpose for IHT, in particular for liability to pay the tax and duty to put in an account.

Section 272 IHTA provides:

> In this Act, except where the context otherwise requires ...
> "personal representatives" includes
> [a] any person by whom or on whose behalf an application
> [i] for a grant of administration or
> [ii] for the resealing of a grant made outside the UK
> is made, and
> [b] any such person as mentioned in section 199(4)(a) above;

Para [b] takes us to s.199(4)(a) which refers to:

> (a) any person who takes possession of or intermeddles with, or otherwise acts in relation to, property so as to become liable as executor or trustee (or, in Scotland, any person who intromits with property or has become liable as a vitious intromitter) ...

The technical term in succession law is *executor de son tort*. The point is strictly a matter of succession law. The only reported example in a CTT/IHT context is *IRC v Stype Investments (Jersey) Ltd* [1982] STC 625 where a Jersey nominee held land in England subject to a contract for sale. That was a UK situate asset. The beneficial owner died and the Jersey company directed the sale proceeds to be paid outside the UK. That act made it an executor de son tort and so a PR for IHT purposes.[43]

The definition of PRs is different from the definition for IT and CGT purposes.

A person who applies for a foreign grant which is not resealed in the UK

43 The taxpayer was unmeritorious (perhaps dishonest) and this is perhaps another of the Templeman cases where the Court decided the answer first and the reasoning second.

is not a PR within this definition; otherwise para [a][ii] would be unnecessary.

The definition is inclusory but I cannot think of a person who is a PR in the general sense who is not within the statutory words.

87.13 Reporting: ordinary estates

Section 216(1) IHTA provides (so far as relevant):

> Except as otherwise provided by this section or by regulations under section 256 below, the personal representatives of a deceased person ... shall deliver to the Board an account specifying to the best of his knowledge and belief all appropriate property...and the value of that property.

The relevant form is IHT400 (IHT Account, April 2012), together with supplementary pages IHT 401 and following.

87.13.1 *"Appropriate property"*

"Appropriate property" is defined in s.216(3) IHTA which provides (so far as relevant):

> Subject to subsections (3A) and (3B) below,[44] where an account is to be delivered by personal representatives ... the appropriate property is—
>
> (a) [i] all property which formed part of the deceased's estate immediately before his death
>
> [ii] (or would do apart from s.151A(3)(b) or 151C(3)(b) above),[45]
>
> [iii] other than property which would not, apart from section 102(3) of the Finance Act 1986, form part of his estate; and
>
> (b) all property to which was attributable the value transferred by any chargeable transfers made by the deceased within seven years of his death.

Excluded property is not appropriate property as it does not form part of a person's estate immediate before death. Gifts of excluded property are not chargeable transfers and so do not fall within (b).

The term "appropriate property" is perhaps not the best of labels, but it is easier to adopt the statutory terminology.

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44 Subsections (3A) and (3B) are not relevant here.

45 These provisions relate to certain pension funds.

87.13.2 *Estate without appropriate property*

There is no obligation to complete a return if there is no appropriate property, ie if:
(1) the deceased had no chargeable (non-exempt) property, and
(2) has made no chargeable transfers within 7 years of death.

87.13.3 *Estates with appropriate property*

In other cases (eg if the deceased had some property, even if of very little value) there is an obligation to return the details of the appropriate property.

In making the return there is no statutory obligation to specify excluded property. However Question 22 form IHT401 (Domicile outside the United Kingdom, 2008) asks:

> Did the deceased leave any assets outside the UK? If yes give approximate value.

There is no legal duty to supply this information.[46] But refusal to answer the question may give rise to further enquiries.

In making the return, there is no statutory duty to disclose details of gifts of excluded property which the deceased made before death. However Question 30 form IHT400 asks:

> **Gifts and other Transfers of Value:** Did the deceased make any lifetime gifts or other transfers of value on or after 18 March 1986?

It is considered that the reference in the question to "gifts" means gifts which are transfers of value so that if the deceased made gifts of excluded property it is correct to answer "no". The guidance in IHT400 Notes (August 2013) is consistent with this:

> **Gifts and other transfers of value**
> You can tick 'No' and do not need to fill in Schedule IHT403 if the only gifts made by the deceased were in the following categories:
> • to their spouse or civil partner and Spouse or Civil Partner Exemption

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46 The former HMRC form D2 (Notes, 12/05) tacitly recognised this:
"*If the deceased was domiciled outside the UK when they died, any assets they owned abroad will not be liable to inheritance tax. Even so, you can help us to deal with this estate more quickly if you can give us a rough idea of the value of all of the deceased's estate outside the UK.*"
I have not found a similar comment in the current forms which were revised in 2008.

applies
- outright gifts to any individual which do not exceed £250 in any one year(these will be covered by the Small Gifts Exemption)
- outright gifts to any individual of money or listed stocks and shares that are wholly covered by the Annual Exemption
- outright gifts made regularly from income where the total gifts did not exceed £3,000 in each year.

These exemptions are detailed on page 72 of this guide.
If the deceased had made any other gifts or 'transfers of value' since 18 March 1986, including transfers into trust, payment of insurance premiums for the benefit of another person, advances out of a trust fund or any assets that were taken out of a trust before death, you must fill in Schedule IHT403 Gifts and other transfers of value. In general, a 'transfer of value' is any transaction where the deceased did not receive full value in exchange.

Question 45 IHT400 provides:

> **Assets held in trust**: Did the deceased have any right to benefit from any assets held in trust (including the right to receive assets held in a trust at some future date)? No/Yes – Use Schedule IHT418.

The word "right" only includes fixed interests, it is not apt to describe discretionary trusts. But it appears that "right to benefit" here is used (confusingly) to mean a right to an estate interest in possession. IHT400 Notes (August 2013) provides:

> ***Schedule IHT418 Assets held in trust***
> You should fill in Schedule IHT418 *Assets held in trust* if the deceased's interest in possession was in:
> • a trust set up before 22 March 2006
> • a trust that was set up on or after 22 March 2006 and was
> — an immediate post death interest
> — a disabled person's interest
> — a transitional serial interest.

This would include an excluded property trust where the deceased had an estate interest in possession. In such a case the answer to Question 45 is, "yes". However only limited information needs to be disclosed in form IHT418. IHT400 Notes (August 2013) provides:

> **Foreign trusts** If the deceased had a right to benefit from settled property where the assets are overseas and the person who set up the trust was domiciled outside the UK when the trust was created, please

answer questions 2 to 5 only.

87.14 Excepted estates

The law is in the IHT (Delivery of Accounts) (Excepted Estates) Regulations 2004, which I abbreviate to **"Excepted Estates Regulations 2004"**.

87.14.1 "Excepted estate"

Regulation 4(1) Excepted Estates Regulations 2004 provides:

> An excepted estate means the estate of a person immediately before his death in the circumstances prescribed by paras (2), (3) or (5).

Thus there are three categories of excepted estate.

87.14.2 Low value estates

Regulation 4(2) Excepted Estates Regulations 2004 provides:

> (2) The circumstances prescribed by this paragraph are that—
> (a) the person died on or after 6th April 2004, domiciled in the United Kingdom;
> (b) the value of that person's estate is attributable wholly to property passing—
> (i) under his will or intestacy,
> (ii) under a nomination of an asset taking effect on death,
> (iii) under a single settlement in which he was entitled to an interest in possession in settled property, or
> (iv) by survivorship in a beneficial joint tenancy or, in Scotland, by survivorship in a special destination;
> (c) of that property —
> (i) not more than £150,000 represented value attributable to property which, immediately before that person's death, was settled property; and
> (ii) not more than £100,000 represented value attributable to property which, immediately before that person's death, was situated outside the United Kingdom;
> (ca) that person was not a person by reason of whose death one of the alternatively secured pension fund provisions applies;
> (d) subject to paragraph (7A), that person died without having made any chargeable transfers during the period of seven years ending with his death other than specified transfers where, subject to paragraph (7), the aggregate value transferred did not

exceed [£150,000; and

(e) the aggregate of—

(i) the gross value of that person's estate,

(ii) subject to paragraph (7), the value transferred by any specified transfers made by that person, and

(iii) the value transferred by any specified exempt transfers made by that person,

did not exceed the IHT threshold.

87.14.3 *Estates qualifying for the IHT spouse or charity exemption*

Regulation 4(3) Excepted Estates Regulations 2004 provides:

(3) The circumstances prescribed by this paragraph are that—

(a) the person died on or after 6th April 2004, domiciled in the United Kingdom;

(b) the value of that person's estate is attributable wholly to property passing—

(i) under his will or intestacy,

(ii) under a nomination of an asset taking effect on death,

(iii) under a single settlement in which he was entitled to an interest in possession in settled property, or

(iv) by survivorship in a beneficial joint tenancy or, in Scotland, by survivorship in a special destination;

(c) of that property—

(i) subject to paragraph (8), not more than £150,000 represented value attributable to property which, immediately before that person's death, was settled property; and

(ii) not more than £100,000 represented value attributable to property which, immediately before that person's death, was situated outside the United Kingdom;

(ca) that person was not a person by reason of whose death one of the alternatively secured pension fund provisions applies;

(d) subject to paragraph (7A), that person died without having made any chargeable transfers during the period of seven years ending with his death other than specified transfers where, subject to paragraph (7), the aggregate value transferred did not exceed £150,000;

(e) the aggregate of—

(i) the gross value of that person's estate,

(ii) subject to paragraph (7), the value transferred by any specified transfers made by that person, and

(iii) the value transferred by any specified exempt transfers made by that person, did not exceed £1,000,000;

(ea) the total value transferred on that person's death by a spouse, civil partner or charity transfer is greater than nil; and

(f) the aggregate of—

does not exceed the IHT threshold, where—

A is the aggregate of the values in sub-paragraph (e),

B, subject to paragraph (4), is the total value transferred on that person's death by a spouse[, civil partner]1 or charity transfer, and

C is the total liabilities of the estate.

87.14.4 *IHT deemed domiciled deceased*

HMRC say that an individual who is IHT deemed domiciled cannot qualify under the first two categories:

IHTM06023 - Rules about excepted estates: what is not an excepted estate

There are instances when an estate cannot qualify as an excepted estate, regardless of the value. These are:

- where the deceased held an interest in possession (IHTM16060) in more than one item of settled property (IHTM16041)
- for deaths on or after 1 September 2006 where a charge arises under IHTA1984 S. 151A-C (IHT charge on an alternatively secured pension fund),
- where , on or after 18 March 1986, the deceased made a gift with reservation of benefit and either:
- the reservation still subsists at the death (IHTM04072), or the property ceased to be subject to the reservation within the seven years before the death - (unless this constituted a specified transfer (IHTM06018),
- the reservation still subsists at the death (IHTM04072), or
- the property ceased to be subject to the reservation within the seven years before the death - (unless this constituted a specified transfer (IHTM06018),
- where the deceased has elected that property should be treated as part of their estate for IHT rather than pay a pre-owned asset charge,
- where the deceased is regarded as deemed domiciled (IHTM13024) in the UK under the provisions of IHTA1984 S.267.

I am not sure about that, but it hardly matters.

87.14.5 *Foreign domiciled deceased*

Regulation 4(5) Excepted Estates Regulations 2004 provides:

> The circumstances prescribed by this paragraph are that—
>
> (a) the person died on or after 6 April 2004;
>
> (b) that person was never
>
> [i] domiciled in the UK or
>
> [ii] treated as domiciled in the UK by section 267 [IHTA];

It is arguable that a person treated as domiciled by a spouse exemption domicile may qualify, but I would not want to rely on that.

> (ba) that person was not a person by reason of whose death one of the alternatively secured pension fund provisions[47] applies; and
>
> (c) the value of that person's estate situated in the UK is wholly attributable to
>
> [i] cash[48] or
>
> [ii] quoted shares or
>
> [iii] securities
>
> passing under his will or intestacy or by survivorship in a beneficial joint tenancy or, in Scotland, by survivorship in a special destination, the gross value of which does not exceed £150,000.[49]

87.14.6 *Disclosure obligations of "excepted estate"*

While an "excepted estate" is not required to put in an account *under s.216 IHTA* it is required to deliver more or less the same information.

The term "excepted estate" is not apt, because the estate is not excepted from the reporting requirements. It is easier to adopt the statutory terminology but quotation marks would be justified.

Regulation 6(1) Excepted Estates Regulations provides:

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47 Reg 4(9) provides:

> "In this regulation 'the alternatively secured pension fund provisions' means the following sections of the 1984 Act—
>
> (a) section 151A (person dying with alternatively secured pension fund);
>
> (b) section 151B (relevant dependant with pension fund inherited from member over 75); and
>
> (c) section 151C (dependant dying with other pension fund)."

48 IHT Manual 6018 shows that HMRC sensibly construe "cash" widely, so as to include a bank account.

49 See reg.4(5).

(1) Subject to paragraphs (3) and (4), a person who by virtue of these Regulations is not required to deliver to the Board an account under section 216 of the 1984 Act of the property comprised in an excepted estate, must produce
[a] the information specified in paragraph (2)
[b] and, where the criteria specified in regulation 5A(3) and (4) are met, paragraph (2A),
to the Board in such form as the Board may prescribe.

The main requirement is the list in regulation 6(2):

The information specified for the purpose of para (1) is—
(a) the following details in relation to the deceased—
  (i) full name;
  (ii) date of death;
  (iii) marital or civil partnership status;
  (iv) occupation;
  (v) any surviving spouse or civil partner, parent, brother or sister;
  (vi) the number of surviving children, step-children, adopted children or grandchildren;
  (vii) national insurance number, tax district and tax reference;
  (viii) if the deceased was not domiciled in the UK at his date of death, his domicile and address;
(b) details of all property to which the deceased was beneficially entitled and the value of that property;
(c) details of any specified transfers, specified exempt transfers and the value of those transfers;
(d) the liabilities of the estate; and
(e) any spouse, civil partner or charity transfers and the value of those transfers.

The relevant form is IHT207 (Return of estate information, 2006).

It is considered that there is no obligation to give information about excluded property. This is perhaps a purposive construction, because, strictly, excluded property is "property to which the deceased was beneficially entitled" even though it does not form part of their estate for IHT purposes immediately before their death. However, it is absurd to say that there is an obligation on excepted estates to disclose excluded property, when there is no such obligation on ordinary estates. In practice the relevant form (IHT207) does not ask about non-UK property.

The significance of being an "excepted estate" is not to reduce disclosure obligations. At first sight an "excepted estate" has the significant advantage of a discharge from IHT in regulation 8 Exempt Estates Regulations 2004:

> (1) Subject to paragraph (2) and regulation 9, if the information specified in regulation 6 has been produced in accordance with these Regulations, all persons shall on the expiration of the prescribed period be discharged from any claim for tax on the value transferred by the chargeable transfer made on the deceased's death and attributable to the value of the property comprised in an excepted estate and any Inland Revenue charge for that tax shall then be extinguished.
> (2) Paragraph (1) shall not apply if within the prescribed period the Board issue a notice to—
> (a) the person or persons who would apart from these Regulations be required to deliver an account under section 216 of the 1984 Act, or
> (b) the solicitor or agent of that person or those persons who produced the specified information pursuant to regulation 6, requiring additional information or documents to be produced in relation to the specified information produced pursuant to regulation 6.

But regulation 9 Exempt Instrument Regulations undoes the effective benefit of this:

> Regulation 8 shall not discharge any person from tax in the case of fraud or failure to disclose material facts and shall not affect any tax that may be payable if further property is later shown to form part of the estate and, in consequence of that property, the estate is not an excepted estate.

87.14.7 *Territorial limitations*

The statutory provisions fail to provide much of a territorial limitation on the duty to disclose. They merely provide two regimes of disclosure, one for ordinary estates and one for excepted estates.

The Courts may devise further territorial limitation, as they have on occasion done elsewhere: *Clark v Oceanic* 56 TC 183. The question is, what should it be? It is may be that no duty applies to foreign personal representatives, at least in the absence of any IHT liability. But disclosure in one form or another will be required in all cases where the PRs need a UK grant of probate.

87.14.8 *Conclusion*

Disclosure is required for an excepted estate even though no tax is payable on the death (eg because the property falls within the nil rate band). How well observed this requirement is in practice is another matter. However, if a foreign domiciled individual wishes to ensure that their personal representatives are under no duty to put in UK returns on their death, they should not have any UK situate property at the time of their death and perhaps appoint foreign executors. Then there is no duty to disclose the assets of the estate.

CHAPTER EIGHTY EIGHT

SWISS TAX AGREEMENT: INTRODUCTION

88.1 Swiss tax agreement: Introduction

The subject of the next four chapters of this book is the tax agreement made between the UK and Switzerland. Its full title is "The Agreement Between the United Kingdom of Great Britain and Northern Ireland and the Swiss Confederation on Cooperation in the Area of Taxation". The title is not particularly apt. I refer to it as **"the STA"**.

The STA contains two distinct regimes:

(1) The first regime, contained in Part 2,[1] deals with the period before commencement. In short, it offers UK residents with Swiss bank accounts the opportunity to make a one-off payment to clear their existing tax liabilities; with an alternative of one-off disclosure to HMRC. I refer to this as **"the STA clearance facility"**.

(2) The second regime, contained in Part 3, deals with the period afer commencement. It provides a withholding tax for future income/gains and IHT, with an alternative of annual disclosure. I refer to this as **"STA withholding tax"**.

The STA followed the model of the Germany/Switzerland agreement, signed two weeks earlier[2] but rejected by the German Parliament in December 2012.

A similar agreement with Austria was signed on 13 April 2012 and took effect on 1 January 2013. Negotiations on similar agreements are under way with Greece and Italy.[3]

The STA clearance facility is a new development in UK taxation: it is

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1 Part 1 ("General provisions") is introductory and contains definitions.

2 21 September 2011. A version tracking the differences between the two agreements (in German) is accessible *http://www.kessler.co.uk/tfd-archive*.

3 Swiss Federal Department of Finance Press Release Dec 2012 *http://www.sif.admin.ch/00488/index.html?lang=en&msg-id=47354*

very different from the Liechtenstein/UK agreement made August 2009 and the earlier Offshore Disclosure Facility announced April 2007.

STA withholding tax is in some respects similar to the EU Savings Directive withholding tax, which (in the case of Switzerland) is contained in the agreement made in 2004 between Switzerland and the EU. I refer to that as **"Swiss/EU Savings Tax Agreement 2004"**. STA withholding tax is wider as it applies to all income and gains (not just interest) and it allows clearance and anonymity.

The STA is written in English and French,[4] and (as usual) each text is stated to be "equally authoritative." Some idiosyncrasies in the English language version are probably due to the fact that the text was not composed, or entirely composed, by lawyers whose first language is English.

The STA and its associated documents are available on *http://www.hmrc.gov.uk/taxtreaties/ukswiss.htm*.

The STA is aimed at UK residents who have not complied with UK tax obligations; I describe such persons as **"non-compliant"**. However all UK residents with Swiss accounts must consider its effect.

The STA was came into force on 1 January 2013.

The STA has effect in the UK by virtue of the FA 2012. There is similar enacting legislation in Switzerland.

For commencement of STA withholding tax, see 90.1.1 (Commencement of STA withholding tax).

88.1.1 *Guidance*

HMRC have published brief guidance in a FAQ which I call **"the STA FAQ"**.[5]

The important guidance will be that (if any) issued in Switzerland, since it is in Switzerland that the most important steps for the operation of the STA will take place. If HMRC agree its guidance with the Swiss authorities, it will no doubt be followed there.

The Swiss Bankers Association has issued a Q&A which provides a little background.[6]

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4 See *http://www.news.admin.ch/NSBSubscriber/message/attachments/24481.pdf* for the French text.

5 *http://www.hmrc.gov.uk/taxtreaties/ukswiss-faqs.htm#12*

6 *http://www.swissbanking.org/en/20111102-5000-masterdoku-einigung_uk_final-cfr.pdf*

88.1.2 *How much tax will the STA raise?*

The amount of tax raised by the STA will depend on:

(1) how much income/gains within the scope of the STA was held by non-compliant individuals when it took effect; and

(2) the willingness of those individuals to regularise their affairs.

The STA may bring in tax in four ways:

(1) The one-off payments under the STA clearance facility. This has turned out to be a £342m receipt in 2012/13 and £804m in 2014/15.[7]

(2) STA withholding tax. I do not think anyone could expect that to amount to much; a few years time will tell.

(3) Tax paid as a result of enquiries following STA voluntary disclosure. This should be little, as taxpayers must opt for STA voluntary disclosure and they will not do so unless they are satisfied that their tax affairs are in order.[8]

(4) Tax paid by individuals who chose the Liechtenstein disclosure facility or other self-disclosure routes, in order to avoid the consequences of STA one-off payment/disclosure. It will not be practical to identify how much tax collected under these other routes is due to the STA.

It is also possible that the STA will discourage future non-compliance

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7 *http://www.hmrc.gov.uk/statistics/receipts/receipts-stats.pdf* under the heading "Swiss Capital Tax". This is the total of the one-off payments, not including the annual withholding tax (private correspondence). Since a quid pro quo of the STA was that Swiss banks can now operate in the UK under easier conditions, it may be that this payment should not be regarded purely as a tax receipt. Also some of the tax collected under the STA would no doubt have been collected by other means in the absence of the STA. However it is impossible to put a figure on this.

8 Hansard 14 October 2013 records: "To date HMRC has received details of 18,000 accounts under the UK-Swiss Agreement, which it is matching to UK individuals. HMRC will make contact with each and every individual who opted for disclosure and has already written to over 9,000. Switzerland has until the end of December to provide details in respect of those who wish their account details to be disclosed to HMRC." See *http://www.publications.parliament.uk/pa/cm201314/cmhansrd/cm131014/text/131014w0008.htm?j=469995&e=kessler@kessler.co.uk&l=346_HTML&u=12468388&mid=1062735&jb=0#13101535000033*

No conclusions can be drawn from the figure. It is likely that the vast majority of these accounts are of compliant taxpayers, as they have consciously allowed disclosure. There may be some accounts of non-compliant taxpayers who have lost track of their accounts or lost mental capacity.

That discouragement is important but not susceptible to measurement.

In 2011 Dave Hartnett, then Permanent Secretary for Tax, predicted between £4 billion and £7 billion![9] The Office of Budgetary Responsibility rejected the higher figure, but still suggested £4 billion.[10] As predicted in the 2013/14 edition of this work, the evidence has shown that the "market" for qualified amnesties of this kind is only a small fraction of what HMRC had claimed.[11]

No estimate has been published of the cost to taxpayers and banks of administering the STA (including the time of the readers of this book in understanding it). I would have thought it would make a large dent in the £1 billion which the STA may be taken to yield, if, indeed, there was any change at all. But HMRC took a different view on that too:

> Tax compliant individuals may suffer negligible administration costs, involving familiarisation with the terms of the agreement and the cost of proving that they are already compliant.[12]

The yield of the STA will inevitably include tax from compliant taxpayers where the taxpayer failed to opt for disclosure owing to a failure of communication between the bank and the taxpayer, which may not be due to the fault of the taxpayer. It remains to be seen whether HMRC would reimburse tax in these cases, or keep the windfall.

88.1.3 *Assessment of the STA*

HMRC have said that the STA "signals the beginning of the end for offshore evasion" but that is braggadocio intended for the political stage and the media. The STA is more accurately described as a skirmish in the battle between tax evaders and the state, which seems likely to continue for as long as government and human nature remain imperfect.

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9 [2011] STI 2651.

10 "Ministers and HMRC have publicly stated that the agreement should yield £4 to 7 billion. We have not yet certified this costing formally, but our initial discussions with HMRC suggest there are significant uncertainties, especially regarding the amount of UK funds in Switzerland and the assumed level of compliance. We currently judge that the yield from the agreement is likely to be towards the lower end of the range." *http://cdn.budgetresponsibility.independent.gov.uk/EFO-speaking-note-Nov-2011.pdf*

11 The Liechtenstein disclosure facility was published in 2009, and 876 registrations were received by 30 September 2010: Hansard 2 November 2010 *http://www.publications.parliament.uk/pa/cm201011/cmgeneral/deleg4/101102/101102s01.htm*

12 *http://www.hmrc.gov.uk/tiin/tiin714.pdf*

88.2 EU law compliance

The dispute with the EU seems to have settled with the amending protocol of 20 March 2012. The press has reported that the EU now accept that the revised agreements are EU law compliant, though I have not seen an EU press release to that effect.

88.3 Definitions

88.3.1 *Standard definitions*

Article 2 STA contains standard commonsense definitions (not set out here) for:

"Contracting State"
"Switzerland"
"United Kingdom"
"competent authority"
"United Kingdom taxpayer"
"tax year"
"Swiss anticipatory tax" (the Swiss *impôt anticipé*)

88.3.2 *"Swiss paying agent"*

Article 2 (e) STA provides:

> "Swiss paying agent" means
> [i] banks under the Swiss Banking Act of 8 November 1934,
> [ii] securities dealers under the Swiss Stock Exchange Act of 24 March 1995 and
> [iii] natural and legal persons resident or established in Switzerland, partnerships and permanent establishments of foreign companies, which accept, hold, invest or transfer assets of third parties or merely make payments of income or gains for third parties or secure such payments in the normal course of their business.

This is very similar to the definition in article 6 of the Swiss/EU Savings Tax Agreement 2004. The article continues:

> Notwithstanding the foregoing, for the purposes of Part 3, a person is not considered to be a Swiss paying agent solely because that person pays out dividends and interest directly to its shareholders or creditors, provided that the total amount of these payments does not exceed CHF 1 million per year;

88.3.3 *"Relevant assets"*

Article 2(1)(f) STA provides:

> "relevant assets" means all forms of bankable assets booked or deposited with a Swiss paying agent including, but not limited to, the following:
> [a] cash accounts and precious metals accounts;
> [b] bankable assets held by a Swiss paying agent acting as a fiduciary agent;
> [c] all forms of stocks, shares and securities;
> [d] options, debts and forward contracts;
> [e] other structured products traded by the banks such as certificates and convertibles.

It is hard to see what [b] is for, but it does not matter.

Article 2(1)(f) STA continues:

> The following shall not be regarded as relevant assets for the purposes of this Agreement:
> [a] contents of safe deposit boxes;
> [b] real property;
> [c] chattels;
> [d] insurance contracts which are regulated by the Swiss Financial Market Supervisory Authority, with the exception of assets held by an insurance company in an account separate from the insurance company's main accounts combined with a minimal risk protection and where the pay-out or redemption is not restricted to death, disability or illness (hereinafter referred to as **"insurance wrappers"**);

Relevant assets may not be liquid assets.

88.3.4 *"Account/deposit" and "account/deposit holder"*

Article 2 STA provides commonsense definitions:

> g) "account or deposit" means an account or deposit holding relevant assets but the terms "account" and "deposit" when used independently shall only have this meaning if the context so requires;
> I) "account holder" or "deposit holder" means a person who is the contractual partner of a Swiss paying agent regarding relevant assets;

88.3.5 *Joint account*

Article 2 STA continues:

> If a relevant person holds an interest in a collective or joint account or deposit, the entire assets are to be attributed to the relevant person, unless the Swiss paying agent can determine all the persons holding an interest in such an account or deposit. In this case, the Swiss paying agent shall allocate assets according to the number of contractual partners, unless the Swiss paying agent has been informed of, and has received appropriate documentation regarding, a different allocation. If a relevant person holds an interest in a partnership, the rules for collective or joint accounts and deposits in this subparagraph apply accordingly;

88.3.6 *"Appointed dates"*

Article 2(1)(m) STA provides:

> m) the following terms mean:
> "appointed date 1" the 31 December 2002;
> "appointed date 2" the 31 December 2010;
> "appointed date 3" the last day of the month following a period of four months after the date of entry into force of this Agreement;
> "appointed date 4" the last day of the month following a period of five months after the date of entry into force of this Agreement;

As the STA came into force on 1 Jan 2013:
appointed date 3 is 31 May 2013
appointed date 4 is 30 June 2013.

88.3.7 *Undefined terms*

Article 2(1)(3) STA provides:

> As regards the application of this Agreement at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that Contracting State, any meaning under the applicable tax laws of that Contracting State prevailing over a meaning given to the term under other laws of that Contracting State.

This is standard form, based on Article 3(2) OECD model convention.

88.4 "Relevant person"

This is a key term as the STA only applies to relevant persons.

There are four categories of relevant person, where the individual is:

(1) direct beneficial owner

(2) beneficial owner through a domiciliary company
(3) beneficial owner through an insurance wrapper
(4) beneficial owner through a nominee

88.4.1 *Direct beneficial owner*

The first category is straightforward. Article 2(1)(h) STA provides:

> "relevant person" means any individual resident in the United Kingdom, who:
> [i] as a contractual partner of a Swiss paying agent, is the account holder or deposit holder and beneficial owner of assets;...

That is, in short, an individual with a Swiss bank account.

88.4.2 *Beneficial owner through "domiciliary company"*

The second category is:

> "relevant person" means any individual resident in the United Kingdom, who ...
> [ii] is, in accordance with the conclusions of a Swiss paying agent drawn in line with the prevailing Swiss due diligence obligations and taking into consideration all the circumstances known to it, the beneficial owner of assets held by:
> [a] a domiciliary company (i.e. legal entities, companies, institutions, foundations, trusts, fiduciary companies and other establishments not exercising a trading or manufacturing activity or another form of commercial operations);

The drafting is drawn from the Swiss banks' code of conduct with regard to the exercise of due diligence[13] (**"the Swiss Due Diligence Code"**) article 4.

"Domiciliary company" is a technical term not found in UK domestic tax law.

It may not be a company in the ordinary English sense, and the word "domiciliary" does not seem apt. The expression is perhaps an over-literal translation of *une société de domicile*. In this book I adopt the STA terminology but with quotation marks to avoid confusion by this unusual usage.

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13 *http://www.swissbanking.org/en/20080410-vsb-cwe.pdf.*

88.4.3 *Beneficial owner*

The key term is beneficial owner. This expression is used in several distinct senses.[14] Here the meaning is the one which applies for "the prevailing Swiss due diligence obligations". For this, see the Swiss Due Diligence Code and its commentary.[15] The question is one of Swiss law.

Article 2 STA specifies two cases where the individual is not the beneficial owner of assets held by the "domiciliary company".

The first case is where the "domiciliary company" is the beneficial owner (so by implication the individual is not). Article 2 STA provides:

> A domiciliary company in the aforementioned sense is considered to be the beneficial owner in exceptional cases if proof is provided
>
> [a] that it is itself subject to effective taxation under the general rules for direct taxation applicable under the law of its place of establishment or its place of effective management, or
>
> [b] that it is treated as non-transparent with reference to its income under United Kingdom law.

The STA FAQ provides:

> **1.4 Examples would be useful of where 'domiciliary companies' are/ are not 'subject to effective taxation'/companies treated as 'non transparent' under UK law etc**
>
> The intention is that this provision will follow the developing EUSD provisions on effective taxation.

This does not answer the question. While the EU Savings Directive does use the expression "effective taxation" it does so only in a very general context[16] and does not shed any light on its meaning.

It is suggested that the "domiciliary company" is transparent if it is within s.624 ITTOIA, or s.720 ITA. The words "in exceptional cases" seem inapt, as neither case [a] nor [b] are exceptional.

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14 See 25.12.1 (Meaning(s) of "beneficial ownership").

15 Accessible *http://www.step.org/substance-over-form*. See Lofts, "Substance over form A" STEP Journal (October 2011) accessible *http://www.stepjournal.org*.

16 Article 1.1 provides: "The ultimate aim of the Directive is to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident for tax purposes in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State."

88.4.4 *Discretionary trusts*

The second case where the individual is not beneficial owner of a "domiciliary company" is important. Article 2 STA continues:

> An individual resident in the United Kingdom is not considered to be a relevant person with regard to assets of associations of persons, asset structures, trusts or foundations, if it is not possible to ascertain the beneficial ownership of such assets, e.g. due to the discretionary nature of the arrangement.

This reflects article 43 of the Swiss Due Diligence Code:

> **43 Assets without any specific beneficial owner**
> In the case of associations of individuals or asset-holding entities and foundations where no specific individuals or entities are the beneficial owners (e.g. discretionary trusts), the contracting partner must be required to provide a written declaration that this is the case, rather than identifying the beneficial owner. ...
> Form T may be used for this declaration. ...

The commentary provides:

> Certain trusts and foundations under common law legal systems have beneficiaries but not beneficial owners. They can be treated as trusts and foundations with no specific beneficial owner. ...
> If an underlying company[17] declares that a trust is the beneficial owner, the underlying company must be identified as the contracting partner...

Protectors or beneficiaries of discretionary trusts are not regarded as beneficial owners and so are not relevant persons.

The STA is therefore aimed at evasion where individuals hold their own funds in Swiss accounts and does not apply to evasion where the individuals put their funds into trusts (or similar structures). This may have been deliberate as the tax issues raised by such trusts are much more complicated. How would clearance extend to beneficiaries and trustees? It seems unfortunate that the treaty does not offer evaders in that class the same opportunity to regularise their affairs, but there is still the Liechtenstein facility.

The position is different for revocable trusts. Article 44 Swiss Due

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17 [Footnote original] These are companies whose shares are held in a trust/foundation and which open an account relationship for the trust or foundation at a bank.

Diligence Code provides:

> For revocable vehicles (such as revocable trusts), those authorised to issue such revocation must be listed as the beneficial owners.

In practice I think revocable trusts are rarely used.

It is not clear whether HMRC realise this. The STA FAQ provides:

> **1.5 Are discretionary trusts covered?**
> Discretionary trusts are not excluded from the terms of the Agreement. Any beneficiary of a discretionary trust who receives a payment or other benefit from a trust account could be a relevant person for the purpose of the Agreement.

This is wrong.

88.4.5 *Beneficial owner through insurance wrapper*

The third category of relevant person is:

> "relevant person" means any individual resident in the United Kingdom, who ...
>
> [ii] is, in accordance with the conclusions of a Swiss paying agent drawn in line with the prevailing Swiss due diligence obligations and taking into consideration all the circumstances known to it, the beneficial owner of assets held by:...
>
> [b] an insurance company in an insurance wrapper;...
>
> The beneficial owner of an insurance wrapper is not considered a relevant person, where the insurance company confirms to the Swiss paying agent that it will deliver the appropriate certification to the competent authority of the United Kingdom.

"Insurance wrapper" is defined in article 2 STA: see 88.3.3 ("Relevant assets").

88.4.6 *Beneficial owner through nominee*

The fourth category of relevant person is:

> "relevant person" means any individual resident in the United Kingdom, who ...
>
> [ii] is, in accordance with the conclusions of a Swiss paying agent drawn in line with the prevailing Swiss due diligence obligations and taking into consideration all the circumstances known to it, the beneficial owner of assets held by:...
>
> [c] another individual by means of an account or a deposit with

a Swiss paying agent.

This would apply where the account is in the name of a nominee.

Article 2 STA provides:

> Where a Swiss paying agent has information suggesting that the individual
>
> [i] who receives a payment of income or gains in accordance with Article 19 paragraphs 1 and 2 [ie subject to SRT withholding] or
>
> [ii] for whom such a payment is secured
>
> is not the relevant person, that agent shall take reasonable steps to establish the identity of the relevant person. If the Swiss paying agent is unable to identify the relevant person, that agent shall treat the individual in question as the relevant person.

88.4.7 *Exclusion for certain agents*

Article 2 STA continues:

> For the purposes of Part 3, an individual is not considered a relevant person, if he or she:
>
> – acts as a Swiss paying agent; or
>
> – acts on behalf of a legal entity, an investment fund or a comparable investment scheme; or
>
> – acts on behalf of a relevant person who discloses to the Swiss paying agent his or her identity and State or jurisdiction of residence.

88.4.8 *Meaning of "residence"*

A person must be resident in the UK in order to qualify as a relevant person. The word "resident" has a variety of meanings.[18] It is necessary to ascertain the meaning of residence in this context and to determine whether individuals are UK resident within that meaning.

Article 3 STA provides:

> **Art. 3 Identity and residence of relevant persons**
>
> 1. [a] In order to establish the identity and residence of relevant persons the Swiss paying agent shall keep a record of the name, first name, birth date, address and residence details in accordance with the prevailing Swiss due diligence obligations in place when establishing business relationships.
>
> [b] Within this framework, individuals who have their principle [*sic*]

18 See 6.1 (Treaty-Residence - Introduction).

> private address in the United Kingdom based on the due diligence records of the Swiss paying agent are deemed resident in the United Kingdom for the purposes of this Agreement.
>
> 2. For contractual relations entered into, or transactions carried out in the absence of contractual relations, on or after the date of entry into force of this Agreement [1 January 2013], for individuals presenting a passport issued by the United Kingdom who declare themselves to be resident in a State or jurisdiction other than Switzerland or the United Kingdom, residence shall be established by means of a tax residence certificate issued by the competent authority of the State or jurisdiction in which the individual claims to be resident. Failing the presentation of such a certificate, the United Kingdom shall be considered the state of residence.

What is the position for pre-STA arrangements? The original STA provided:

> *For contractual relations entered into, or transactions carried out in the absence of contractual relations, before the date of entry into force of this Agreement, an identical procedure applies as of 1 January 2004 under the Agreement on the Taxation of Savings.*

This has been deleted by the amending protocol of March 2012.

These are rough and ready rules under which a person who is UK resident for UK tax law purposes may be categorised as non-resident, and vice versa; but in most cases they will give the right answer, and they deal with the problems inherent in the current absence of a definition of residence in UK tax law.

88.4.9 *Date of establishing residence*

Article 3 STA provides:

> 3. For the purposes of Part 2, residence shall be determined as at appointed date 2 [31 December 2010].

Thus the following persons do not qualify for the STA one-off payment facility:

(1) An individual who is non-UK resident on 31/12/2010 even if they have tax liabilities from earlier years.
(2) Personal representatives of an individual who died before 31 December 2010 even though even if the estate has tax liabilities from earlier years.

I wonder if that was deliberate. The rule does simplify matters.

88.5 "Non-UK domiciled"

88.5.1 *Non-UK domiciled individual*

Article 2(1)(j) offers separate definitions for the purposes of parts 2 and 3 STA:

> j) "non-UK domiciled individual" means:
> (i) for the purposes of Part 2 only, a person who
> [A] was not domiciled anywhere within the United Kingdom on appointed date 2 [31 December 2010] and
> [B] claimed the remittance basis of taxation for the tax year ending on 5 April 2011 or for the tax year ending on 5 April 2012 ...

That is, for part 2, a non-UK domiciled individual must be a remittance basis taxpayer in 2010/11 or 2011/12. An individual who did not claim the remittance basis in 2010/11 must do so in 2011/12. If a tax return has been made without a claim, an amended return to include the claim is possible until 31 January 2013: s.9A TMA 1970.

Article 2(1)(j) STA continues:

> j) "non-UK domiciled individual" means:
> (ii) for the purposes of Part 3 only, a person who
> [A] is not domiciled anywhere within the United Kingdom and
> [B] claims the remittance basis of taxation in the United Kingdom for the relevant tax year

That is, for part 3 a non-UK domiciled individual must be a remittance basis taxpayer in the relevant tax year (from 2012/13).

The provision is looking at actual domicile, ie an individual deemed UK domiciled for IHT purposes may qualify as a non-UK domiciled individual for the purposes of the STA.

88.5.2 *Domicile certificate*

Article 4 STA provides:

> **Art. 4 Certification process for identifying non-UK domiciled individuals for the purposes of this Agreement**
> 1. A Swiss paying agent may only accept a relevant person as a non-UK domiciled individual when provided with a certificate produced by a lawyer, an accountant or a tax adviser who is a member of a relevant professional body confirming that the relevant person is not domiciled within the UK and has claimed the remittance basis of taxation for the

tax years defined in Article 2 paragraph 1 letter j).
2. The following shall be verified by the lawyer, the accountant or the tax adviser before certifying that a relevant person is a non-UK domiciled individual for the purposes of this Agreement:
a) The UK tax return for the relevant tax year contains a claim or statement to be not domiciled anywhere within the UK; and
b) if appropriate, that tax return also contains a claim for the remittance basis under Part 14 Chapter A1 Income Tax Act 2007 and the tax chargeable under section 809H Income Tax Act 2007 has been paid; and
c) to the best of their knowledge, the domicile status of the relevant person is not formally disputed by the competent authority of the UK.

I refer to this as **"a domicile certificate"**.

88.5.3 *Date for delivery of domicile certificate*

Article 4 STA provides:

3. For the purposes of Part 2, the certificate shall be provided to the Swiss paying agent by appointed date 3 [31 May 2013].
4. For the purposes of Part 3, the relevant person shall first provide by 31 March the Swiss paying agent with a declaration of intent to claim the remittance basis of taxation for the following tax year. This declaration shall then be supported by a certificate to be provided to the Swiss paying agent by 31 March following the end of the relevant tax year.
5. The relevant person shall indicate in the declaration of intent how the Swiss paying agent shall proceed where sufficient funds are not available, whether:
a) the relevant person intends to meet any shortfall within 8 weeks from 31 March following the end of the relevant tax year; or
b) the relevant person authorises the Swiss paying agent to disclose information in line with Article 22 paragraph 3.
Where the relevant person fails to opt for one of the options above, letter b) shall apply as if the relevant person has provided written authorisation to the Swiss paying agent to disclose.

88.6 Anti-abuse

Article 34 STA provides:

1. The Contracting States recognise that the relevant persons remain free to book their assets in any State or jurisdiction of their choice.
2. Swiss paying agents shall not knowingly manage or encourage the use

> of artificial arrangements whose sole or main purpose is the avoidance of taxation of the relevant persons under the provisions of this Agreement in respect of relevant assets.

There are two requirements for article 34(2) STA:
(1) The arrangements are artificial; and
(2) the sole or main purpose is the avoidance of taxation.
What constitutes "artificial" arrangements is impossible to tell. The word is generally used to indicate tax avoidance in the strict sense, as opposed to mitigation,[19] and perhaps that is the meaning here. But since the avoidance/mitigation distinction is itself difficult, that does not take us far. The Swiss authorities will be the arbiters.

It appears from article 34(1) STA that merely booking (ie holding) assets in Switzerland or elsewhere is not artificial avoidance.

Article 34(3) STA provides a sanction for Swiss paying agents who encourage artificial avoidance arrangements but the burden rests ultimately on the individual:

> 3. [a] Notwithstanding that the relevant person is the party liable to the withholding tax in accordance with Article 19 paragraph 4, where a Swiss paying agent acts contrary to paragraph 2, the Swiss paying agent shall be liable to a payment which amounts to the withholding tax avoided. The payment shall be made to the competent authority of Switzerland, which shall transfer it to the competent authority of the UK.
>
> [b] The Swiss paying agent may exercise a right of redress against any such relevant person who participated in such arrangements.

Would the right of indemnity in [b] would be litigated in Swiss or UK courts? In the future, the contracts with the Swiss paying agent will no doubt deal with this.

88.7 Exemption from remittance charge

Where payments are made under the terms of the STA, those payments are not treated as remittances for UK tax purposes.

Para 26A Sch 36 FA 2012 provides:

> (1) Income or chargeable gains of a person are to be treated as not remitted to the United Kingdom if conditions A to D are met.

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19 See 32.17.2 (Artificial transactions and devices).

(2) Condition A is that (but for sub-paragraph (1)) the income or gains would be regarded as remitted to the United Kingdom by virtue of the bringing of money to the United Kingdom.
(3) Condition B is that the money is brought to the United Kingdom pursuant to a transfer made to HMRC in accordance with the Agreement.
(4) Condition C (which applies only if the money brought to the United Kingdom is a sum levied under Article 19(2)(b)) is that the sum was levied within the period of 45 days beginning with the day on which the amount derived from the income or gain in question was remitted as mentioned in Article 19(2)(b).
(5) Condition D is that the transfer is made in relation to a tax year in which section 809B, 809D or 809E of ITA 2007 (application of remittance basis) applies to the person.
(6) Sub-paragraph (1) does not apply in relation to money brought to the United Kingdom if or to the extent that—

(a) paragraph 18(2), or section 138(4)(a) or 140(5)(a) of TIOPA 2010, is applied in relation to it (set-off against other tax liabilities), or
(b) it is repaid or refunded by HMRC.

Para 26B sch 36 FA 2012 deals with the mixed fund rules:

26B (1) This paragraph applies if—

(a) but for paragraph 26A(1), income or chargeable gains would have been regarded as remitted to the United Kingdom by virtue of the bringing of money to the United Kingdom, and
(b) section 809Q of ITA 2007 (transfers from mixed funds) would have applied in determining the amount that would have been so remitted.

(2) The bringing of the money to the United Kingdom counts as an offshore transfer for the purposes of section 809R(4) of ITA 2007 (composition of mixed fund).

CHAPTER EIGHTY NINE

STA CLEARANCE FACILITY

89.1 Options for UK domiciliary

The STA offered two options to a UK domiciliary within its scope:
(1) one-off payment or
(2) one-off disclosure (which the STA calls "voluntary disclosure").

Article 5 STA provides:

> 1. Subject to paragraph 3 a relevant person who is not a non-UK domiciled individual and who held relevant assets with a Swiss paying agent at appointed dates 2 [31 December 2010] and 3 [31 May 2013] shall have the option
> [1] either to instruct the Swiss paying agent to make a one-off payment in respect of relevant assets in accordance with Article 9 paragraph 2[1] or
> [2] to authorise the Swiss paying agent to make a disclosure in accordance with Article 10.[2]

Thus the STA one-off payment facility only applied if (in short) the individual had a Swiss account at 31 December 2010, and an account (the same or different) in 2013. One could not opt in to the STA clearance facility by opening an account now, but one could opt out by closing it.

What if the individual did nothing? The default option is the one-off payment:

> 3. Where a relevant person fails to exercise by appointed date 3 [31 May 2013] one of the options described in paragraphs 1 and 2, then the Swiss paying agent shall levy the one-off payment in accordance with Article 9 paragraph 2.

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1 See 89.4 (One-off payment: UK domiciliaries).
2 See 89.9 (Disclosure option).

The deadlines have now passed, but the consequences of the new rules will be worked out over the next few years so the topic is still discussed in this edition.

89.2 Options for non-UK domiciliary

The non-UK domiciliary had 4 options:
(1) Full one-off payment - capital method
(2) Full STA one-off voluntary disclosure
(3) Limited one-off payment ("self-assessment method")
(4) Opt-out
If the individual did nothing, the default option is the full one-off payment - capital method.

89.2.1 *One-off payment: capital method*

Article 5 STA provides:

> 2. Subject to paragraph 3 a relevant person who is a non-UK domiciled individual and who held relevant assets with a Swiss paying agent at appointed dates 2 [31 December 2010] and 3 [31 May 2013] shall have the following options in relation to relevant assets:
>
> a) to instruct the Swiss paying agent to make a one-off payment in accordance with Article 9 paragraph 2 (hereinafter referred to as the **"capital method"**);

This is the same as the one-off payment option for the UK domiciliary. The advantage is that it offers the full clearance.

89.2.2 *Full STA one-off voluntary disclosure*

Article 5 STA provides:

> 2. Subject to paragraph 3 a relevant person who is a non-UK domiciled individual and who held relevant assets with a Swiss paying agent at appointed dates 2 [31 December 2010] and 3 [31 May 2013] shall have the following options in relation to relevant assets...
>
> b) to authorise the Swiss paying agent to make a disclosure in accordance with Article 10;[3]

This is the same as for a UK domiciliary.

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3 See 89.9 (STA one-off voluntary disclosure).

89.2.3 *One-off payment: self-assessment method*

The next two options are for a non-UK domiciliary only. Article 5 STA provides:

> 2. Subject to paragraph 3 a relevant person who is a non-UK domiciled individual and who held relevant assets with a Swiss paying agent at appointed dates 2 [31 December 2010] and 3 [31 May 2013] shall have the following options in relation to relevant assets...
>
> c) to disclose
>
> [i] all non-UK income and gains which have been remitted to the United Kingdom and
>
> [ii] all amounts which arose from taxable sources within the United Kingdom
>
> between appointed date 1 [31 December 2002] and the date of initialling of this Agreement [24 August 2011] and on which the full amount of UK tax has not been paid (hereinafter referred to as **"omitted taxable base"**) to the Swiss paying agent by
>
> [a] making a self-assessment of the omitted taxable base in the form prescribed and
>
> [b] to instruct the Swiss paying agent to make a one-off payment in accordance with Article 9 paragraph 3
>
> (hereinafter referred to as the **"self-assessment method"**);

Article 9(3) STA provides:

> 3. Where a non-UK domiciled individual has opted for the self-assessment method, the one-off payment shall be 34% of the omitted taxable base disclosed to the Swiss paying agent.

The advantage is that it offers a clearance to the extent of the self-assessed amount at the (relatively attractive) 34% rate.[4] The sanction for failing to self-assess correctly is that clearance is withdrawn: see 89.7.8 (Abuse of self-assessment method).

89.2.4 *Opt-out*

Article 5 STA provides:

> 2. Subject to paragraph 3 a relevant person who is a non-UK domiciled individual and who held relevant assets with a Swiss paying agent at appointed dates 2 [31 December 2010] and 3[31 May 2013] shall have

4 See 89.7.10 (Non-UK domiciled individuals on self-assessment basis).

the following options in relation to relevant assets: ...

d) to confirm to the Swiss paying agent that none of the options a) to c) in this paragraph is chosen (hereinafter referred to as the **"opt out method**").

In practice I expect properly informed non-UK domiciled individuals usually chose the opt-out.

89.3 Selecting the option

89.3.1 *Notice of option*

Article 6 STA provides:

> **Art. 6 Notification of the relevant person by Swiss paying agents**
> 1. Swiss paying agents shall within two months of the date of entry into force of this Agreement [ie by 28 Feb 2013] give notice to the holders of accounts and deposits in respect of which a relevant person has been identified about the content of this Agreement and the resulting rights and duties of relevant persons.
> 2. For relevant persons establishing a business relationship with a Swiss paying agent between the date of entry into force of this Agreement [1 January 2013] and appointed date 3 [31 May 2013], such notice shall be given at the time the contract is finalised and include a reference to the specific rights and duties provided for in Article 8 (change of bank account).

89.3.2 *Exercising the option*

Article 7 STA provides:

> **Art. 7 Rights and duties of relevant persons**
> 1. The relevant person must inform the Swiss paying agent in writing and by appointed date 3 [31 May 2013] which option described in Article 5 paragraphs 1 and 2 he or she chooses with respect to each account or deposit in existence at appointed date 3. This notification is irrevocable. Where a notification was made before the date of entry into force of this Agreement [1 January 2013], it shall become irrevocable if it has not been revoked as at that date.
> 2. The relevant person shall make sufficient funds available to the Swiss paying agent for the settlement of the one-off payment described in Article 9.
> 3. If the account holder or deposit holder is not the relevant person, the Swiss paying agent is entitled to act in accordance with the instructions and declarations of the account holder or deposit holder.

The STA FAQ provides:

> **2.2 Would it be possible for an individual with two accounts at the same bank to opt to treat each differently?**
> There is no bar in the Agreement to a person telling a paying agent to disclose one account and pay the one-off levy on another. However the accounts would need to separate accounts rather than one being the sub account of the other. Where an account is a sub-account both would be treated in the same way by the paying agent.

The view that sub-accounts constitute one single account and not two separate accounts seems odd, but perhaps it depends on what is meant by "sub-account".

89.3.3 *Late exercise of option*

Article 14 STA provides:

> **Art. 14 Failure to identify a relevant person**
> 1. In any case where
> [a] a Swiss paying agent fails to identify a relevant person and inform that person of his or her rights and duties in accordance with Article 7 and
> [b] that relevant person is subsequently identified by the Swiss Paying agent as a relevant person
> then, if the competent authorities of the Contracting States so agree, the relevant person may nonetheless exercise the option set out in Article 5 paragraphs 1 and 2 and the rights and duties set out in Article 7 shall apply until a date to be agreed by the competent authorities of the Contracting States.
> 2. Where a one-off payment is being made in accordance with Article 9,[5] a further amount shall be added to the one-off payment representing interest at the statutory rate applicable in the UK to unpaid tax debts between appointed date 3 [31 May 2013] and the date of payment. The competent authority of the UK shall inform the competent authority of Switzerland of the statutory rate applicable as at appointed date 3 [31 May 2013] and of any changes to the rate thereafter.

That would be a rare case.

89.4 One-off payment: UK domiciliaries

The following applies to UK domiciliaries and non-UK domiciliaries who

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5 See 89.3.3 (Late exercise of option).

elect for the "capital method" (or having failed to elect, find it applies to them by default).

Article 9 STA provides:

> **Art. 9 One-off payment and clearance of tax liabilities**
> 1. Subject to Articles 8[6] and 13,[7] a Swiss paying agent shall on appointed date 3 [31 May 2013] levy a one-off payment on the relevant assets of relevant persons.
> 2. Subject to paragraph 3, the one-off payment shall be calculated in accordance with Schedule I. The applicable rate is 34%.

89.4.1 *Certificate of payment*

Article 9 STA provides:

> 4. At the time the one-off payment is levied, the Swiss paying agent shall issue a certificate in the form prescribed to the relevant person. The certificate shall be considered approved by the relevant person, if he or she does not object within 30 days of issue.

89.4.2 *Transfer of money to HMRC*

Article 9 STA deals with administration:

> 5. The Swiss paying agent shall at the time of approval of the certificates issued in accordance with paragraph 4 transfer the one-off payments previously levied to the competent authority of Switzerland. Such transfers shall take place monthly starting one month after appointed date 3 [31 May 2013] with the last payment 12 months after appointed date 3.
> Subject to Article 35,[8] the competent authority of Switzerland shall transfer the payments to the competent authority of the UK in monthly instalments starting two months after appointed date 3 with the last instalment 13 months after appointed date 3.
> One-off payments which are levied at a later date in exceptional circumstances, e.g. due to legal proceedings, shall be transferred without delay by the Swiss paying agent to the competent authority of Switzerland, which shall transfer them without delay to the competent

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6 See 89.8.5 (Change of bank account).

7 See 89.7 (Cases where clearance not allowed).

8 Art. 35 provides: **"Expense allowance**
The competent authority of Switzerland shall deduct an expense allowance of 0.1% from amounts transferred to the competent authority of the United Kingdom in accordance with this Agreement."

authority of the UK.

6. The one-off payments in accordance with paragraphs 2 and 3 shall be calculated, levied and transferred to the competent authority of Switzerland by the Swiss paying agent in sterling. Where sterling is not the reference currency of the account or deposit, the Swiss paying agent shall convert the amount into sterling by using the fixed exchange rate published by the SIX Telekurs AG at the corresponding date. The competent authority of Switzerland shall transfer the payments to the competent authority of the UK in sterling.

The point is that HMRC are not told any details of individuals: thus Swiss principles of secrecy are maintained.

89.5 Computation of one-off payment

89.5.1 *The policy*

The STA FAQ provides:

> **2.9 What is the policy underlying the way the calculation of the formula is set?**
> The aim of the formula is to take into account the speed of growth in the account balances, so that the faster the assets accumulate, the higher the rate that is charged. The effective tax rate is positively dependant on the growth in capital and the level of the final capital in the account (which captures deemed interest). The formula also takes account of the length of time the account has been open.

The Swiss Bankers Association Q&A states that the effective tax rate for bank clients is likely to be between 20% and 25% of total assets.[9]

89.5.2 *Defined terms*

The formula uses the following terms:

T [**T**ax] = One-off payment
tr [**T**ax **R**ate] = 34%
tr(min) [Minimum **T**ax **R**ate] = 19%

n = **N**umber of years of the bank relationship before 31 December 2010
$0 \leq n \leq 8$ [ie, regardless of the number, N cannot exceed 8]

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9 *http://www.swissbanking.org/en/20111102-5000-masterdoku-einigung_uk_final-cfr.pdf*

C_b [**C**apital **b**ase?] = Capital stock at the end of the year the account was opened. For accounts opened before 1 January 2003, the capital stock at 31 December 2002.

Capital stock means the bank balance or the market value of the relevant assets.

C_i Capital stock at the end of year *i*
i Year *i*, $1 \leq i \leq 10$, whereby year 1 starts on 1 January 2003
That is, *i* may be between 1 and 10 for the years 2003-2012.
For example:
C_8 Capital stock at the end of year 8 (31 December 2010)
C_{10} Capital stock at the end of year 10 (31 December 2012)

Outflows: Inflows years 9 and 10 that compensate for outflows years 1 to 8

The STA FAQ provides:

> **2.8 What is definition of outflow for the purposes of Schedule 1? What is definition of inflow?**
> 'Outflows' are sums which were taken out of the account between 31 December 2002 and 31 December 2010. 'Inflows' are amounts which go into the same account between 1 January 2011 and 31 December 2012 which the relevant person can evidence to the Swiss paying agent equate to the outflows.

r Notional **R**ate of return = 3%.

89.5.3 C_r

The first step is to ascertain C_r.
This presumably stands for **R**elevant **C**apital but that label does not tell us much.
There are 3 possibilities. The first two are easy:

$C_r = C_8$ if $C_{10} < C_8$
That is, if C_{10} is smaller than C_8, then C_r equals C_8

$C_r = C_{10}$ if $C_8 \leq C_{10} \leq 1.2 \times C_8$
That is, if C_{10} is equal or greater than C_8 and equal or smaller than $1.2 \times C_8$, then C_r equals C_{10}

89.5.4 *Formula for C_r if C_{10} is greater than 1.2 × C_8*

The last possibility applies where C_{10} is greater than 1.2 × C_8

In this case C_r is the higher of 1.2 × C_8 and a formula:

$$\sum_{i=9}^{i=10} \text{value increases} + \sum_{i=1}^{i=8} \text{outflows}$$

I take this to mean the sum of the following nine items:

Value increase year 9
Value increase year 10
Outflow year 1
Outflow year 2
Outflow year 3
Outflow year 4
Outflow year 5
Outflow year 6
Outflow year 7
Outflow year 8

Article 9(12)(c) STA summarises the rule:

> 12. ... if C_{10} is greater than 1.2 × C_8, then C_r equals the higher of
> – 1.2 × C_8; or
> – C_8, plus the sum of the following:
> (i) inflows of capital between appointed date 2 [31 December 2010] and the date of entry into force of this Agreement [1 January 2013] which offset outflows between appointed dates 1 and 2 [31 December 2002 and 31 December 2010]; and
> (ii) increases between appointed date 2 [31 December 2010] and the date of entry into force of this Agreement [1 January 2013] in the value of relevant assets as at appointed date 2 (increases in value are income and gains as defined in Article 19 paragraph 1 and unrealised capital gains),
> if the relevant person provides the Swiss paying agent with all necessary documentation to enable it to apply the calculation in subparagraphs (i) and (ii) above by appointed date 3 [31 May 2013].

89.5.5 *Amount of one-off payment*

Once one has ascertained C_r one can move on to ascertain the amount of the STA one-off payment.

This is the higher of two amounts.

The first amount is straightforward – once one has ascertained C_r It is tr(min) × C_r that is, 19% of C_r

The second is the full tax rate (34%) applied to the sum of three elements.

The first element is 2/3 of:
C_r – (n/8 × C_b)
If the first element is negative (C_r less than C_b) then this element is taken as zero.

The second element is 1/3 of: n/10 × C_r
ie n/30 × C_r

The third element is 1/3 of: 1/10 × (C_9' and C_{10}')

This is computed as follows:

$C_9' = C_r + C_r \times r = 1.03 \times C_r$

$C_{10}' = C_r + C_r \times 2r = 1.06 \times C_r$

The STA explains C_9' as "Nominal capital at the end of year 9 (31 December 2011), resp. year 10 (31 December 2012)" .

89.5.6 *HMRC examples*

The STA FAQ gives two examples.
Example 1 is a case where C_{10} is greater than C_8, but less than 1.2 × C_8

> Swiss franc account opened in 1993 (so n = 8), cash amounts have been deposited in the account over the years and interest is credited each year.
>
> Balance 31 December 2002 (C_b) = CHF1m
> Balance 31 December 2010 (C_8) = CHF2m
> Balance 31 December 2012 (C_{10}) = CHF2.1m
>
> First calculate C_r. In this case C_{10} is greater than C_8, but less than 1.2 × C_8, so C_r = C_{10} = CHF2.1m
>
> Second calculate C_9' and C_{10}'.
> $C_9' = C_r \times 103\%$ = CHF2,163,000 and
> $C_{10}' = C_r \times 106\%$ = CHF2,226,000.
> So ½ × (C_9' + C_{10}') = CHF2,194,500
>
> T = 34% × CHF [2/3 × (2,100,000 – 1,000,000) + 1/3 × ((8/10 × 2,100,000) + 2/10 × 2,194,500)]
>
> = 34% × CHF [733,333 + 706300] = CHF489,475

Finally, check that this sum is greater than the minimum T of 19% × C_r (CHF399,000)

It is, so the one-off payment is CHF489,475 that is approximately 23.3% of the December 2012 balance.

Assuming the one-off payment is made in full, as the C_{10} amount is not more than 20 per cent greater than the amount in the account at C_8, the funds in the account at 31 December 12 are 'cleared' (see Article 9(7) STA) - subject to the exclusions in Article 9(13) STA.

The second example is one where C_{10} is less than C_8

Sterling account opened in 2007 (so n = 3), deposits in 2008 to 2011 and a large withdrawal in 2012.

Balance at 31 December 2007 (C_b) = £200,000
Balance at 31 December 2010 (C_8) = £1,000,000
Balance at 31 December 2012 (C_{10}) = £500,000

First calculate C_r. In this case C_{10} is less than C_8, so $C_r = C_8$ = £1,000,000

Second calculate C_9' and C_{10}'.
$C_9' = C_r \times 103\% = 1{,}030{,}000$
$C_{10}' = C_r \times 106\% = £1{,}060{,}000$
So ½ × (C_9' + C_{10}') = £1,045,000

T = 34% × £[2/3 × (1,000,000 – 3/8 × 200,000) + 1/3 × (3/10 × 1,000,000 + 2/10 × 1,045,000)]

= 34% × £[616667 + 169667] = £267,353

Finally, check that this sum is greater than the minimum T of 19% × C_r (£190,000)

It is, so the one-off payment is £267,353 that is approximately 26.7 per cent of the December 2010 balance. Assuming the one-off payment is made, the funds in the account at 31 December 2010 (£1,000,000) are 'cleared' (see Article 9(7)) subject to the exclusions in Article 9(13).

The STA FAQ does not give an example of the third category of case, where C_{10} is greater than 1.2 × C_8. Perhaps the author of the FAQ found the formula too difficult.

Further examples are found in INTM820511.

89.6 Clearance of UK tax liability

Article 9 STA provides:

> 7. [a] Subject to paragraph 12, following approval of the certificate issued under paragraph 4 the relevant person shall cease to have any liability to the UK taxes listed in paragraph 10 for the taxable periods or charges to tax referred to in paragraph 11, in relation to the relevant assets concerning which the one-off payment has been made.
>
> [b] This clearance shall also include without limitation interest, penalties and surcharges that may be chargeable in relation to those tax liabilities.
>
> [c] The relevant person shall also cease to have any liability to the UK taxes listed in paragraph 10 in relation to liabilities which arise from the estate of a deceased person in respect of relevant assets concerning which the one-off payment has been made.
>
> 8. The clearance of the tax liability described in paragraph 7 shall also apply to individuals who are jointly or severally liable....

I adopt the terminology of the STA and refer to this as **"clearance"**.

I do not understand what [c] is referring to, but if it is otiose it does no harm. Perhaps it was relevant to the (now abandoned) German STA.

89.6.1 *Taxes to which clearance applies*

Article 9(10) STA provides:

> 10. The United Kingdom taxes for which the clearance described in paragraph 7 shall apply are those listed in paragraph 63(1)(a), (b), (d) and (f) of Schedule 36 Finance Act 2008, but excluding liabilities to any or all of these taxes that have been transferred to a relevant person

The relevant provisions of para 63(1) Sch 36 FA 2008 are:

(a) income tax
(b) capital gains tax
(d) VAT
(f) inheritance tax

I do not understand what the exclusion refer to. (I also do not understand the reason for the convoluted drafting by reference, but that does not matter.)

National Insurance Contributions are not in the list, which could in principle be important. Clearance does not extend to third parties, such as a close company's liability on making a loan to participators, or an employer's NIC liabilities. Whether an employer's PAYE liabilities qualify for clearance would require further research.

Article 9(15) STA provides:

> Nothing in this Article has any bearing on the calculation of the basis for the collection of own resources accruing from value added tax according to Council Regulation 1553/89/EC

89.6.2 *Period for which clearance applies*

Article 9(11) STA provides:

> Paragraph 7 shall apply to liabilities to the UK taxes listed in paragraph 10 concerning:
>
> a) taxable periods ending before the date of entry into force of this Agreement [1 January 2013]; and
> b) in the case of taxable periods commencing before the date of entry into force of this Agreement but ending on or after the date of entry into force of this Agreement, income arising and gains realised before the date of entry into force of this Agreement; and
> c) where there is no taxable period, charges to tax arising before the date of entry into force of this Agreement.

In short, clearance applies up to the date of the STA.

HMRC say:

> **The Swiss Agreement and Inheritance Tax accounts**
>
> HMRC Trusts & Estates is aware of some instances where the beneficiaries or executors of an estate have paid the 'one-off charge' under the 2011 Tax Agreement between the UK and Switzerland. The payment satisfies historic tax liabilities in respect of assets held in Switzerland. If you have made such a payment, you will have received a clearance certificate from the relevant Swiss bank confirming you cease to have any further liability for, amongst other taxes, Inheritance Tax in relation to the assets detailed on the certificate for charges arising before 1 January 2013.
>
> However, the Swiss asset still forms part of the deceased's estate and may affect the Inheritance Tax that is payable on any other assets in the free estate and any aggregable fund, for example, settled property. It is clear from the cases we have seen, and from some comments on internet forums, that the consequences of making the 'one-off' payment are not fully recognised.
>
> If the Swiss asset was not declared in the IHT400 or IHT205, and either the nil rate band was already exceeded or the additional Swiss asset (for which a clearance certificate is now held) means that the nil rate band is now exceeded, then you must tell HMRC Trusts & Estates about the

> Swiss assets. Whilst the IHT attributable to the Swiss assets is covered by the 'one-off' charge, the tax payable in respect of the Free Estate or other aggregable property remains payable. Please also provide a copy of the clearance certificate from the Swiss bank.[10]

89.6.3 *Extent of clearance*

Article 9(12) STA provides:

> 12. The amount in the account or deposit cleared in accordance with paragraph 7 as of the date of the entry into force of this Agreement [1 January 2013] is equal to C_r as defined in Schedule I. ...

The article continues with an anti-avoidance rule:

> However, to the extent that
> [1] inflows of capital come directly or indirectly from the UK and
> [2] left the UK between the date of signature [6 October 2011] and the date of entry into force of this Agreement,
> the part of the one-off payment paid in respect of those inflows of capital shall be treated by the competent authority of the UK as a payment on account of UK taxes or other liabilities (including without limitation interest, penalties and surcharges) of that person in respect of those inflows of capital.

Thus adding to the Swiss account from the UK after 6/10/11 would not give a tax advantage. However it is accepted that additions to the account from outside the UK would do so.

89.7 Cases where clearance not allowed

There are about a dozen cases where clearance is not allowed.

89.7.1 *Current investigation*

Article 9(13) STA provides:

> 13. Paragraph 7 shall not apply:
> a) where, as at appointed date 3 [31 May 2013], the tax affairs of a relevant person with relevant assets are under investigation, unless prior to this investigation being commenced, a Swiss paying agent has been instructed by the relevant person to make a one-off payment in relation to those relevant assets in accordance with this Article.

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10 HMRC, Trusts & Estates Newsletter, April 2014.

Article 2(1)(n) STA defines "investigation:"

> n) "investigation" means:
>
> (i) any criminal investigation conducted by the competent authority of the UK relating
>
> [A] to those functions for which HMRC are responsible as set out in the Commissioners for Revenue and Customs Act 2005 and
>
> [B] to any money laundering offence within Part 7 of the Proceeds of Crime Act 2002 which is associated with those functions;
>
> or
>
> (ii) any civil enquiry of any kind that is supported by statutory information powers and is carried out for the purpose of ascertaining whether the UK tax liabilities of the relevant person are correct and up to date; or
>
> (iii) any coordinated, project-based enquiries by the competent authority of the UK into multiple identified taxpayers stemming from specific third party information;

An individual may not know that he or she is under investigation. HMRC say:

> HMRC will shortly begin writing to UK residents and organisations holding Swiss bank accounts with the HSBC in Geneva who may not have reported all their income and gains to HMRC.
>
> The department is acting on information received last year under a tax treaty. This revealed that more than 6,000 individuals, companies, trusts and other bodies held accounts and investments with HSBC Geneva.[11]

These enquiries would seem to fall within paragraph (iii) so no-one holding an HSBC account in Geneva would qualify for clearance.[12]

The STA FAQ provides:

> **1.8 In the definition of investigation, what does 'supported' by statutory information powers mean?**

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11 Press release NAT 81/11 (13 October 2011).

12 For a review of these enquiries as at 12 September 2011, see Evidence to House of Commons Treasury Committee *http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc1371-iii/uc137101.htm* It was said that all those concerned will receive letters from HMRC within 6 to 9 months of that date..

It means that the enquiry/investigation needs to be one where HMRC could, if required, invoke its statutory powers, for example Schedule 36 FA 2008 to obtain information.

1.9 What was policy behind this definition of investigation at Article 2(1)(m)(iii)?

The ways in which HMRC undertakes enquiries into tax positions is changing. An example of the type of investigation covered by this definition is the approach announced in respect of clients of HSBC Switzerland.

89.7.2 *Concluded investigation without full disclosure by taxpayer*

Article 9(13) STA continues:

13. Paragraph 7 shall not apply...
    b) where the relevant person was the subject of an investigation in the UK which has been concluded before appointed date 3 [31 May 2013]; and:
        (i) in the case of a criminal investigation this led to a conviction for offences which were punishable in the UK by two years or more imprisonment; or
        (ii) in the case of a civil investigation concluded after appointed date 1 [31 December 2002]:
            – HMRC determined that the prevailing guidance issued by the competent authority of the UK at the time warranted the completion of a Certificate of Full Disclosure or a Statement of Assets and Liabilities, or a civil penalty was chargeable under the Customs and Excise Management Act 1979; or
            – the investigation was carried out for the purpose of ascertaining the correct UK tax liability of the relevant person in relation to any assets or interest of the relevant person in Switzerland,

        and the relevant person did not declare an interest in relevant assets in Switzerland held before or during the investigation.

Where the relevant person fully disclosed any relevant assets held at the time of the investigation this letter [ie this paragraph (b)] shall not apply to payments of withholding tax under Part 3;

89.7.3 *Use of other disclosure facilities*

Article 9(13) STA continues:

13. Paragraph 7 shall not apply...
    c) where, at any time before appointed date 3 [31 May 2013], the

relevant person or their authorised representative has engaged with, participated in or been contacted personally by the UK competent authority in respect of any publicised UK disclosure facility, unless prior to this engagement, participation or contact, a Swiss paying agent has been instructed by the relevant person to make a one-off payment in relation to those relevant assets in accordance with this Article;

Article 2(1)(o) STA defines "disclosure facilities":

o) "UK disclosure facility" means any facility or campaign offered by the competent authority of the UK under which any individual liable to tax in the UK is or was able to regularise his or her UK tax position;

89.7.4 *Proceeds of non-tax crime*

Article 9(13) STA continues:

13. Paragraph 7 shall not apply...
d) where the relevant assets represent or are derived from (whether directly or indirectly) the proceeds of crime other than crime connected to non compliance with the tax legislation of the UK;

Clearance seems of academic interest since the proceeds of crime are in any event subject to confiscation.

89.7.5 *Systemic tax fraud*

Article 9(13) STA continues:

13. Paragraph 7 shall not apply...
e) where the relevant assets represent or are derived from (whether directly or indirectly) the proceeds of criminal attacks and systemic fraud against the tax and benefits regimes of the UK, including but not limited to cases where the UK authorities make payments to persons to which they are not entitled.

Examples are:
VAT Missing Trader Intra-Community Fraud
VAT Bogus registration repayment fraud
Organised Tax Credit fraud

89.7.6 *Credit where clearance does not apply*

Article 9(13) STA concludes:

In any of the above circumstances any one-off payment shall be treated

> by the competent authority of the UK as a payment on account of UK taxes or other liabilities (including without limitation interest, penalties and surcharges) of that person in respect of the relevant assets.

Article 9(14) STA provides:

> An individual will not be entitled to credit the one-off payment against any individual assessment in respect of the taxable periods or charges to tax referred to in paragraph 11.

Perhaps this means that the credit is set against all periods pro rata, not against any particular period. That may be important for computing interest on unpaid tax.

89.7.7 *Non-UK domiciled individuals opt-out*

Article 11 STA provides:

> **Art. 11 Opt-out for non-UK domiciled individuals**
> 1. Where relevant persons who are non-UK domiciled individuals have chosen the opt out method, Article 9 paragraphs 7 and 9 [clearance] shall not apply.
> 2. Swiss paying agents shall issue a certificate in the form prescribed to the relevant person.

89.7.8 *Abuse of self-assessment method*

Article 12 STA provides:

> **Art. 12 Wrongful behaviour in relation to non-UK domiciled status**
> 1. Clearance as described in Article 9 paragraphs 7 and 9 shall not be provided where a relevant person has:
> a) falsely declared that he or she is a non-UK domiciled individual; or
> b) elected for the self-assessment method to be applied when there are outstanding tax liabilities in respect of relevant assets which were not declared in the self-assessment.
> 2. Where paragraph 1 applies, the one-off payment shall be treated by the competent authority of the UK as a payment on account of UK taxes or other liabilities (including without limitation interest, penalties and surcharges) of that person.

89.7.9 *Failure to pay correct amount*

Failure to pay the correct one-off payment normally loses the benefit of clearance: see 89.8.2 (Failure to assess correct amount).

89.7.10 *Non-UK domiciled individuals on self-assessment basis*

Article 9 STA provides:

> 9. In the case of relevant persons who are non-UK domiciled individuals:
>
> a) if the capital method is applied, then the provisions of paragraph 7 [clearance] apply and future payments from the amount representing those funds as at the date following the date that the capital method is applied shall not generate a further tax liability in the UK;
>
> b) if the self-assessment method is applied, then the provisions of paragraph 7 [clearance] apply only to the income, gains and amounts disclosed in the self-assessment to the Swiss paying agent.

89.8 Procedure for making the one-off payment

89.8.1 *Insufficient funds*

Normally the one-off payment would be deducted from the account. Difficulties arise if the assets of the account are illiquid, or if funds have been withdrawn leaving insufficient to pay. Article 13 STA provides:

> **Art. 13 Insufficient funds**
>
> 1. [a] Where the relevant person informs in writing the Swiss paying agent that he or she opts for the one-off payment as described in Article 9, or the one-off payment is levied by default under Article 5 paragraph 3, but insufficient funds have been made available by the relevant person to the Swiss paying agent by appointed date 3 [31 May 2013], the Swiss paying agent shall grant the relevant person in writing an extension of up to eight weeks from appointed date 3 in order to secure the one-off payment.
>
> [b] Where Article 8 paragraph 2 applies, [transfer of accounts] but insufficient funds have been made available, the Swiss paying agent shall grant an extension of up to eight weeks from the date it levied the one-off payment.
>
> [c] The notice given by the Swiss paying agent shall include a reference to the possible consequences for the relevant person provided for in paragraph 3.
>
> 2. Where an extension is granted in accordance with paragraph 1, the Swiss paying agent shall levy the one-off payment on the day the extension ends.
>
> 3. Where the relevant person holds relevant assets with a Swiss paying

agent at appointed date 3 and the one-off payment cannot be levied owing to insufficient funds, the Swiss paying agent shall disclose the identity of the relevant person in accordance with Article 10 as if the relevant person had provided written authorisation to the Swiss paying agent to disclose.

89.8.2 *Failure to assess correct amount*

Article 15 STA provides:

> **Art. 15 Partially or wrongly levied one-off payment**
> 1. Where the Swiss paying agent does not levy the one-off payment in full owing to errors in calculation or execution, the Swiss paying agent may levy the missing amount from the relevant person. A further amount representing interest shall be added in accordance with Article 14 paragraph 2. The Swiss paying agent shall remain bound towards the competent authority of Switzerland to make the one-off payment in its entirety. The same shall apply to the interest charged. Subject to Article 34, the competent authority of Switzerland shall transfer without delay the received one-off payment and interest to the competent authority of the UK.
> 2. Clearance under Article 9 paragraphs 7 and 9 shall not be removed in cases falling under paragraph 1, if the relevant person has taken reasonable care in checking the certificate issued by the Swiss paying agent in accordance with Article 9 paragraph 4 and the missing amount was paid upon identification of the error in calculation or execution.
> 3. Where the one-off payment in accordance with Article 9 has been wrongly levied by the Swiss paying agent, the competent authority of the UK shall, on receipt of appropriate evidence, refund the one-off payment including interest less the expense allowance.

Article 34(3) STA also considers double payments:

> ... There are no circumstances in which the UK should retain amounts paid twice in respect of relevant assets. Where amounts have been paid twice, the competent authority of the UK shall refund the overpayment to the competent authority of Switzerland.
> 4. Paragraph 3 shall apply only in individual cases when clear, direct evidence is presented.

89.8.3 *Verification of agent's computations*

Article 16 STA provides:

> **Art. 16 Effect of the certificates**
> Where, for reasons other than the implementation of this Agreement, the

competent authority of the UK becomes aware of relevant assets, the competent authority of the UK may ask the relevant person to provide evidence that these assets were subject to the one-off payment in accordance with Article 9 or disclosed in accordance with Article 10. A valid certificate issued by the Swiss paying agent in accordance with Article 9 paragraph 4 or Article 10 paragraph 3 shall be considered sufficient evidence. Where the validity of a certificate is doubtful, the competent authority of the UK may ask the competent authority of Switzerland to verify its validity.

89.8.4 *Upfront Payment*

Article 17 STA provides:

Art. 17 Upfront payment by Swiss paying agents
1. Swiss paying agents shall within 20 days of the date of entry into force of this Agreement form an implementation vehicle which shall manage on their behalf all rights and obligations arising under this Article and act as a pooling and clearing institution.
2. Swiss paying agents shall make an upfront payment of CHF 500 million to the competent authority of Switzerland within 25 days of the date of entry into force of this Agreement. The competent authority of Switzerland shall transfer the amount of the upfront payment to the competent authority of the UK within one month of the date of entry into force of this Agreement.
3. Once the upfront payment made to the competent authority of the UK in accordance with paragraph 2 and the payments transferred to the competent authority of the UK in accordance with Article 9 paragraph 5 [one-off payments] reach the amount of CHF 1300 million, the competent authority of Switzerland shall offset the further payments under Article 9 paragraph 5 against the upfront payment according to paragraph 2. After complete offsetting of the upfront payment, further payments under Article 9 paragraph 5 shall be transferred to the competent authority of the UK. The above payments shall be converted on the date of offsetting by using the fixed exchange rate published by the SIX Telekurs AG.
4. The competent authority of Switzerland shall at the end of each month transfer to the implementation vehicle the payments by Swiss paying agents under Article 9 paragraph 5 offset with the upfront payment in accordance with paragraph 3.

The Swiss Bankers Association Q&A states, as one might expect, that the banks agreed among themselves how to share the upfront payment. The allocation was based on the size of the business with affected clients at 31

December 2010. As a quid quo pro of the STA, Swiss banks can operate in the British market under easier conditions, so it may perhaps be money well spent even if it were not directly recovered from account holders.[13]

89.8.5 *Change of bank account*

Article 8 STA provides:

> **Art. 8 Establishment of new business relationships**
> 1. Relevant persons establishing a business relationship with a Swiss paying agent between appointed date 2 [31 December 2010] and appointed date 3 [31 May 2013] shall provide the Swiss paying agent by appointed date 4 [30 June 2013] with a written confirmation stating whether:
>
> a) these relevant assets were booked with another Swiss paying agent as of appointed date 2; and
> b) the business relationship with that Swiss paying agent was ongoing as of appointed date 3.
>
> 2. Where the relevant assets referred to in the written confirmation provided in accordance with paragraph 1 were booked with a Swiss paying agent on appointed date 2 and the relevant person terminated the business relationship with that Swiss paying agent before appointed date 3, the new Swiss paying agent shall apply the measures in this Part. Each previous Swiss paying agent shall cooperate with the new Swiss paying agent when so requested. By appointed date 4 [30 June 2013] the relevant person shall:
>
> a) notify the new Swiss paying agent in accordance with Article 7 paragraph 1; and
> b) instruct in writing the new Swiss paying agent to request from each previous Swiss paying agent all necessary information for the application of the option chosen in accordance with Article 7 paragraph 1; and
> c) instruct in writing each previous Swiss paying agent to transfer on request to the new Swiss paying agent all necessary information for the application of the option chosen in accordance with Article 7 paragraph 1.
>
> 3. Where the relevant assets referred to in the written confirmation provided in accordance with paragraph 1 were booked with a Swiss paying agent on appointed date 2 and there is a continuing business relationship with that Swiss paying agent at appointed date 3, the new

13 *http://www.swissbanking.org/en/20111102-5000-masterdoku-einigung_uk_final-cfr.pdf*

Swiss paying agent shall not apply any further measures provided for in this Part on the relevant assets of the relevant person booked with it.
4. Where the relevant assets referred to in the written confirmation provided in accordance with paragraph 1 were not booked with a Swiss paying agent on appointed date 2, the new Swiss paying agent shall not apply any further measures provided for in this Part on the relevant assets of the relevant person booked with it.
5. If the relevant person does not comply with the duties provided for in paragraphs 1 to 4, the new Swiss paying agent shall disclose the available information in accordance with Article 10 as if the relevant person had provided written authorisation to the Swiss paying agent to disclose.

89.9 STA one-off voluntary disclosure

There are (at least) five types of disclosure relevant to our topic, and it is helpful to have terminology to distinguish them. I coin the following terminology:
"STA one-off voluntary disclosure" is disclosure under article 10, discussed in this paragraph.
"STA annual voluntary disclosure" is the disclosure to avoid the annual STA withholding tax.[14]
"**Self-disclosure"** means other forms of self-disclosure to HMRC (such as the Liechtenstein disclosure facility).
"STA government disclosure" is disclosure of information by the Swiss government under the STA.[15]
"DTA disclosure" is disclosure under the UK/Swiss DTA.[16]
Article 10 STA provides:

Art. 10 Voluntary disclosure
1. Where written authorisation by the relevant person has been given to disclose in accordance with Article 7 paragraph 1 the Swiss paying agent shall transfer the following information to the competent authority of Switzerland on a monthly basis starting one month after appointed date 3 [31 May 2013] with the last transfer six months after appointed date 3:
a) the identity (name, first name and date of birth) and address of the relevant person;

14 See 90.8 (Annual voluntary disclosure).
15 See 91.1 (Disclosure of information by Swiss authorities).
16 See 91.1.4 (DTA disclosure).

b) the UK tax reference number, if known;
c) the name and address of the Swiss paying agent;
d) the customer number of the account or deposit holder (customer, account or deposit number, IBAN-code);
e) for the time of the account's or deposit's existence between appointed date 1 [31 December 2002] and the date of entry into force of this Agreement [1 January 2013], the yearly account balance and statement of assets as at 31 December of each relevant year.

2. The competent authority of Switzerland shall communicate the information referred to in paragraph 1 to the competent authority of the UK on a monthly basis starting two months after appointed date 3 with the last communication of such information occurring seven months after appointed date 3. Later disclosures, e.g. due to legal proceedings, shall be communicated without delay by the Swiss paying agent to the competent authority of Switzerland, which shall communicate them without delay to the competent authority of the UK.

3. Swiss Paying agents shall issue a certificate in the form prescribed to the relevant person.

4. The competent authority of the UK may ask the competent authority of Switzerland for clarification or further information in cases where identification of the relevant person is not possible from the information provided.

89.10 Planning points for STA one-off payment facility

89.10.1 *UK resident and domiciled individual*

For a non-compliant UK domiciled individual who is within the STA, the lawful choices were:

(1) STA one-off payment
(2) self-disclosure

Self-disclosure would obviously be better than opting for STA one-off voluntary disclosure and waiting for an HMRC enquiry. The Liechtenstein Disclosure Facility is unaffected by the STA; this was a deliberate decision.[17] The cost of disclosure accompanied by use of the Liechtenstein disclosure facility may be lower than the STA one-off payment, as the basis of assessment is entirely different, the actual tax liabilities, rather than the STA formula. But the STA one-off payment offered the following advantages:

17 HM Treasury press release 98/11 *http://www.hm-treasury.gov.uk/press_98_11.htm*.

(1) A simple computation, no negotiation with HMRC, few professional expenses.
(2) Outside the naming and shaming provisions (s.94 FA 2009).

Note that closing the Swiss account before 31 May 2013 lost the possibility of clearance. Payments into the account could have increased the benefit of clearance.

Advance notice to the paying agent will bring forward the date from which clearance applies.

For a compliant person within the STA, the lawful choices were:
(1) opt for STA voluntary disclosure;
(2) close the account before 31 May 2013.

The person will need to be prepared for some enquiries if they opt for STA voluntary disclosure, but provided the relevant records are all in good order, the professional costs may not be too great.

89.10.2 *Non-UK domiciled UK resident individual*

In order to qualify as a non-UK domiciled individual, and so qualify for the opt-out of STA one off payment/disclosure, an individual must claim the remittance basis in 2010/11 or 2011/12 and obtain the necessary domicile certificate.

89.10.3 *Non-resident*

A non-resident with a UK passport must obtain a non-residence certificate.

89.11 The UK legislation

Sch 36 FA 2012 provides:

> *Application of this Part*
> 3(1) This Part applies if—
> (a) a one-off payment is levied in accordance with Part 2 of the Agreement,
> (b) a certificate is issued under Article 9(4) to a person ("P") in respect of that payment, and
> (c) the certificate is approved by P or considered approved by virtue of that Article.
> (2) The certificate is referred to in this Part as "the Part 2 certificate".
> *Qualifying amounts*
> 4(1) The Part 2 certificate applies to taxable amounts in respect of which the conditions in sub-paragraph (2) are met.
> (2) The conditions are—

(a) P is liable to tax on the amount,
(b) the amount is untaxed,
(c) the taxable event took place before the start date, and
(d) the necessary link with the certificate can be demonstrated.

(3) The necessary link is—
(a) in a case falling within Article 9(3) (non-UK domiciled individuals opting for self-assessment method), that the amount is included in the omitted taxable base by reference to which the one-off payment was calculated, and
(b) in any other case, that the amount forms part of or is represented by the assets comprised in the relevant capital by reference to which the one-off payment was calculated (referred to in the Agreement as C_r).

(4) For the purposes of sub-paragraph (3)(b), amounts are assumed to be attributed to assets in the way that produces the most beneficial outcome for P.

(5) Paragraph 11 makes further provision about the interpretation of subparagraph (2).

(6) Amounts to which the Part 2 certificate applies in accordance with this paragraph are referred to in this Part as "qualifying amounts".

Eligibility for clearance

5 (1) The effect of the Part 2 certificate depends on whether P is eligible for clearance.

(2) P is "eligible for clearance" if—
(a) none of the circumstances listed in Article 9(13)(a) to (e) apply (tax investigations etc), and
(b) Article 12(1) does not apply (wrongful behaviour in relation to non-UK domiciled status).

(3) Otherwise, P is "not eligible for clearance".

Effect if P eligible for clearance

6(1) This paragraph sets out the effect of the Part 2 certificate if P is eligible for clearance.

(2) P ceases to be liable to tax on qualifying amounts.

(3) Sub-paragraph (2) does not apply to a qualifying amount if—
(a) the amount was held in the United Kingdom,
(b) at some point during the period beginning with 6 October 2011 and ending immediately before the start date, it ceased to be held in the United Kingdom, and
(c) after that point (but before the start date) it began to be held in Switzerland.

(4) Instead, such part of the one-off payment as is attributable (on a just and reasonable basis) to the qualifying amount is to be treated as if it

were a credit allowable against the tax due from P taking account of that amount.

(5) The meaning of tax due "taking account of" an amount is explained in Part 5 of this Schedule.

(6) The form in which a qualifying amount was held in the United Kingdom is irrelevant (so references in sub-paragraph (3) to the amount include an asset representing the amount).

(7) The total qualifying amounts to which sub-paragraphs (2) and (4) can apply as a result of the Part 2 certificate is limited to X.

(8) If the total exceeds X, the particular qualifying amounts to which those subparagraphs apply are assumed to be those that would produce the most beneficial outcome for P.

(9) X is—

(a) in a case falling within Article 9(3), the value of the omitted taxable base by reference to which the one-off payment was calculated, and

(b) in any other case, the value shown in the Part 2 certificate as the value of the relevant capital (Cr).

Ceasing to be liable to tax

7(1) The result of "ceasing to be liable" to tax on a qualifying amount depends on the tax (or taxes) in respect of which the amount is untaxed.

(2) For income tax or capital gains tax, the result is that the amount is no longer liable to be brought into account in assessing the income tax or capital gains tax due from P for the tax year in which the amount would otherwise be liable to be brought into account.

(3) For inheritance tax, the result is that any inheritance tax due from P in respect of the chargeable transfer and attributable to the property whose value is included in the amount is no longer due from P.

(4) For VAT, the result is that P is no longer required to account for output tax on the amount in determining the VAT payable by P for the prescribed accounting period in which P would otherwise be required to account for output tax on the amount.

(5) But—

(a) ceasing to be liable to tax on a qualifying amount does not affect P's liability to tax on any other amount, and

(b) P's liability to tax on any other amount remains what it would have been, had the qualifying amount been brought into account in calculating that liability.

(6) Accordingly, if the qualifying amount were ever to be brought into account and it were found that the tax assessed on any other amount should have been higher as a result, P would remain liable for the extra tax due on that other amount and for any associated ancillary charge.

(7) For the purposes of sub-paragraphs (5) and (6), the qualifying amount is assumed to form the top slice of the total sum on which P is liable to tax.

Effect if P not eligible for clearance

8(1) This paragraph sets out the effect of the Part 2 certificate if P is not eligible for clearance.

(2) The one-off payment is to be treated as if it were a credit allowable against the tax due from P taking account of qualifying amounts.

(3) The one-off payment is to be applied for the purposes of sub-paragraph (2)—

(a) in the order specified in sub-paragraph (4), and

(b) subject to that, in the way that produces the most beneficial outcome for P.

(4) The order is—

(a) first, for VAT,

(b) then, for income tax,

(c) then, for capital gains tax, and

(d) finally, for inheritance tax.

Interest, penalties etc

9(1) Where, by virtue of this Part, P ceases to be liable to tax on a qualifying amount, P also ceases to be liable to any ancillary charge directly connected with that amount.

(2) Where, by virtue of this Part, all or part of a one-off payment is treated as if it were a credit allowable against the tax due from P taking account of a qualifying amount, the credit may also be used to offset any ancillary charge directly connected with that amount.

(3) Sub-paragraph (4) applies in the case of a qualifying amount that is part only of—

(a) an amount of income on which income tax is charged,

(b) a chargeable gain,

(c) the value of property forming part of the value transferred by a chargeable transfer, or

(d) the value of a supply on which VAT is charged.

(4) The amount of any ancillary charge directly connected with that qualifying amount is determined by apportioning the ancillary charge directly connected with the income, gain or value on a just and reasonable basis.

Repayments

10 Nothing in this Part entitles any person to a repayment or refund of tax, save for any repayment or refund to which P may be entitled by virtue of paragraph 6(4) or 8(2) if the credit allowable under that paragraph exceeds the total amount of tax against which the credit is

allowable.

Paragraph 4: supplementary provision

11(1) This paragraph explains how paragraph 4(2) is to be read for each description of taxable amount.

(2) For income and chargeable gains—

(a) the reference to P being "liable to tax" includes a case where P would be so liable if the income or gain were to be remitted to the United Kingdom,

(b) "the taxable event" takes place when the income arises or the gain accrues (whether or not, in a remittance basis case, it is remitted to the United Kingdom), and

(c) the income or gain is "untaxed" if it has not been brought into account in an assessment to income tax or, as the case may be, capital gains tax for the tax year in which it is required to be brought into account.

(3) For the value of property forming part of the value transferred by a chargeable transfer—

(a) "the taxable event" takes place when the chargeable transfer is made (or, in the case of a potentially exempt transfer, when death occurs), and

(b) the value of the property is "untaxed" if it has not been brought into account in determining the value transferred by the chargeable transfer.

(4) For the value of supplies on which VAT is charged—

(a) "the taxable event" takes place when P makes the supply, and

(b) the value of the supply is "untaxed" if output tax on the supply has not been accounted for in determining the VAT payable by P for the prescribed accounting period in which P is required to account for output tax on the supply.

(5) Paragraph 4(2)(a) is not satisfied in a case where P is liable to tax only because the liability has been transferred to P as a result of action taken by HMRC (for example, as a result of a notice given under section 77A of VATA 1994 or a direction given under regulation 81 of the Income Tax (PAYE) Regulations 2003 (SI 2003/2682)).

Refund of one-off payment

12 If a one-off payment is refunded by HMRC in accordance with Article 15(3), this Part ceases to apply with respect to that payment.

Part 4 of the schedule deals with IHT:

20 This Part affects inheritance tax.

Application of this Part

21(1) This Part applies if—

(a) an amount is withheld under Article 32(2) in respect of relevant assets of a deceased person ("P"), and
(b) a certificate is issued under Article 32(6) in respect of the withholding of that amount.

(2) The certificate is referred to in this Part as "the Article 32 certificate".

(3) The relevant assets in relation to which the Article 32 certificate is issued are referred to as "the cleared assets".

(4) Any reference in this Part to "the chargeable transfer" is to the transfer made (under section 4 of IHTA 1984) on P's death.

Effect of Article 32 certificate

22(1) The cleared assets are to be treated as if they were excluded property in determining the value of P's estate immediately before P's death.

(2) As a result, any ancillary charge directly connected with those assets is also extinguished.

(3) But—

(a) treating the cleared assets as if they were excluded property does not affect any liability to inheritance tax on the rest of P's estate, and
(b) that liability remains what it would have been, had the cleared assets not been treated as excluded property.

(4) Accordingly, if the cleared assets were ever to be included in an account or further account under section 216 or 217 of IHTA 1984 in respect of the chargeable transfer and it were found that the inheritance tax charged on the value of the property in P's estate other than the cleared assets should have been higher, the extra tax charged on the value of that other property remains due, together with any associated ancillary charge.

(5) For the purposes of sub-paragraphs (3) and (4), the value of the cleared assets is assumed to form the highest part of the value transferred by the chargeable transfer.

Election in respect of Article 32 certificates

23(1) This paragraph applies if the cleared assets for each of the Article 32 certificates issued in respect of P's death are included in full in an account or further account delivered in respect of P's death under section 216 or 217 of IHTA 1984 within the time permitted for delivering such an account or further account.

(2) The person who delivers the account or further account may elect to disapply paragraph 22.

(3) An election under this paragraph must be made in writing at the same time as the account or further account in which all the cleared

assets are included, and signed by each person delivering the account or further account.

(4) An election may only be made under this paragraph if it is accompanied by each of the Article 32 certificates.

(5) If an election is made under this paragraph—

(a) paragraph 22 does not apply to the cleared assets for any of the Article 32 certificates issued in respect of P's death, and

(b) the amounts withheld under Article 32(2) are instead to be treated as if they were credits allowable against the inheritance tax due on the value transferred by the chargeable transfer (calculated with the value of all those cleared assets brought into account).

Repayments

24 Nothing in this Part entitles any person to a repayment or refund of tax, save for any repayment to which a person may be entitled as a result of paragraph 23 if the credit allowable under that paragraph exceeds the inheritance tax due from the person on the value transferred by the chargeable transfer.

CHAPTER NINETY

STA WITHHOLDING TAX

90.1 STA withholding tax

Taxpayers have two options:

(1) STA withholding tax. If this option is taken, it is implied that the income/gains need not be disclosed on a UK return.

(2) STA annual disclosure, in which case UK tax will assessed under UK tax rules.

Article 19 STA provides:

> 1. Subject to the provisions of Article 21[1] a final withholding tax (hereinafter referred to as **"withholding tax"**) shall be levied by a Swiss paying agent in respect of relevant persons on the following income and gains of such persons arising on relevant assets at the rates specified:
>
> a) interest income as defined in Article 25, unless a retention is levied, or disclosure is made, in accordance with the Agreement on the Taxation of Savings: 48%;
>
> b) dividend income as defined in Article 26: 40%;
>
> c) other income as defined in Article 27: 48%;
>
> d) capital gains as defined in Article 28: 27%.

I adopt the STA term **"withholding tax"** (or to distinguish it from other withholding taxes, "STA withholding tax"). The word "final" does not seem apt but perhaps the point is that no expenses can be deducted.[2]

The specified rates are set very slightly below top UK rates. The House of Commons Treasury Committee criticised this:

> 53. We are concerned that the levies on Swiss bank accounts will result in those who have sought to avoid tax by concealing their assets

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1 See 90.2 (Interaction with other taxes).

2 The tax may be repaid: see 90.3 (Credit for withholding tax).

> offshore receiving more favourable tax treatment than those who were compliant in the first place. The rates of tax to be withheld from income and capital are lower than the top rates of tax in the UK. This seems to reward those who have deliberately avoided tax over those who have not. Mr Hartnett explained that the reason for the withholding rates being slightly lower than the rates that would apply in the UK was that:
>
> > The 48% is a calculation based on the top rate of 50% when money would often not come in, or generally not come in, until 31 January following the end of the tax year. This money will come in earlier, so we calculated a withholding based on that anticipation of money.[3]
>
> 54. This logic is not followed in domestic withholding taxes on UK income, where tax rates do not vary depending on whether income tax is withheld at source (such as through PAYE or withholding tax on savings income) or paid at the end of the tax year following the submission of a tax return. We do not see why those with offshore bank accounts, who may not currently be fulfilling their tax obligations, should be treated any differently.[4]

David Hartnett's position is, with respect, quite right. The analogy with other withholding taxes is inexact, because those are compulsory, whereas the STA is a regime into which the taxpayer may or may not adopt.

STA withholding does not apply to assets in discretionary trusts.[5]

90.1.1 *Commencement of STA withholding tax*

Article 44(2) STA provides:

> Part 3 shall apply to income arising and gains realised on or after the date of entry into force of this Agreement [1 January 2013]. Article 33 shall apply only where a relevant person dies on or after the date of entry into force of this Agreement.

90.1.2 *Remittance basis taxpayer*

Article 19 STA provides:

> 2. A non-UK domiciled individual shall only be liable to the withholding

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3 Evidence to House of Commons Treasury Committee (12 September 2011) *http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc1371-iii/uc137101.htm*

4 "Closing the Tax Gap: HMRC's record at ensuring tax compliance" (March 2012)

5 See 88.4.4 (Discretionary trusts).

tax in respect of the income and gains described in paragraph 1 where:
a) such income and gains have a UK source; or
b) amounts are derived from such income and gains that do not have a UK source and are remitted to the UK.

There is no guidance on source, but it would be sensible to adopt UK tax law principles - so far as one knows what they are. The STA FAQ provide:

> **3.1 What is the expectation on the banks to determine whether income/gains have a UK source? Simplistically, obvious items such as UK dividends, UK bonds etc can be captured; however it may be more difficult to analyse structured products and derivatives.**
> In the context of there being no clearance if the withholding tax is not paid, the expectation is that the banks will do the best they can.

Article 19(2) STA continues:

> For the purposes of this Agreement only, "remitted" means
> [i] those amounts directly transferred to a payee in the UK, unless the relevant person declares to the Swiss paying agent that such amount is not remitted in a taxable form, or
> [ii] amounts which the relevant person declares to the Swiss paying agent to be a remittance.
> Where transfers or payments other than under letter b) are made which are remittances or deemed remittances under UK law, paragraph 5 shall not apply.

In practice it will be rare for income/gains to be "remitted" in this limited sense, unless a non-domiciliary specifically wanted to do that.

The non-UK domiciled individual does not have an opt-out option for STA withholding tax but tax under para (b) is essentially on an opt-in basis, since it only applies if the individual directs foreign income to be directly received in the UK. An individual might do that to get the benefit of clearance but that would be unusual.

90.1.3 *Uncertified non-UK domiciliary*

Article 19(3) STA provides:

> 3. Where a relevant person has made a declaration of intent in accordance with Article 4 paragraph 4,[6] but his or her status as non-UK

6 See 88.5.3 (Date for delivery of domicile certificate).

> domiciled individual has not been certified by the date specified in that paragraph [31 March following the end of the relevant tax year], the Swiss paying agent shall not treat such a relevant person as a non-UK domiciled individual and shall accordingly levy the tax in accordance with paragraph 1 from the beginning of the relevant tax year...

In this situation, 19(3) nudges the tax rates up to UK top rates, presumably to reflect late payment of withholding tax:

> ...Contrary to paragraph 1, the applicable tax rates are:
> a) interest income as defined in Article 25, unless a retention is levied, or disclosure is made, in accordance with the Agreement on the Taxation of Savings: 50%;
> b) dividend income as defined in Article 26: 42.5%;
> c) other income as defined in Article 27: 50%;
> d) capital gains as defined in Article 28: 28%.

Article 19(3) STA concludes:

> Any withholding tax levied in accordance with paragraphs 1 and 2 shall be fully credited against the withholding tax levied in accordance with this paragraph, even in cases where the credit exceeds the amount of this withholding tax.

How can this happen?

90.1.4 *Failure to pay withholding tax*

Article 19(3) STA provides:

> Where the relevant person has opted to meet any shortfall within 8 weeks from 31 March following the end of the relevant tax year, but fails to do so, the Swiss paying agent shall disclose the identity of the relevant person in accordance with Article 22 as if the relevant person had provided written authorisation to the Swiss paying agent to disclose.

90.1.5 *Computation of liability*

Article 19(3) STA concludes:

> To ensure a proper implementation of this deferred withholding tax, the Swiss paying agent shall compute on an ongoing basis the withholding tax due under paragraph 1.

90.1.6 *Nominees*

Article 19(4) STA provides:

4. The relevant person is the party liable to the withholding tax.

Article 19(4) STA continues:

> Income and capital gains from assets held by a Swiss paying agent acting as a fiduciary agent shall be treated in the same way as the underlying asset would be if held by the relevant person.

90.1.7 *Clearance*

Article 19(5) STA provides:

> 5. [a] Subject to Article 23,[7] where withholding tax is levied in accordance with this Article the relevant person shall cease to have any liability to UK taxes including interest, penalties and surcharges that are chargeable in respect of the income or gains falling within paragraph 1 or 2.

I refer to this as **"clearance"**.

SA106 Notes 2013 provides:

> Do include details of your Swiss income. This applies even if you have paid withholding tax on these amounts ... under the UK/Swiss Tax Cooperation Agreement, which came into force on 1 January 2013.

That seems doubtful. One would have expected that reference to income in the tax return do not include income which is not liable to UK tax.

Article 19(5) STA continues:

> [b] Any other tax liabilities of the relevant person in the UK, including liabilities to tax in respect of income or gains, are not affected by this paragraph.

This may be aimed at the situation where:

(1) T fails to declare income ("the original income").
(2) T transfers the income to a Swiss account and income arises ("new income").

STA withholding applies to the new income but the clearance does not extend to the tax liability for the original income.

90.1.8 *Future amendment of tax rates*

Article 20 STA provides:

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7 See 90.3 (Credit for withholding tax).

> **Art. 20 Amendment of tax rates**
> 1. The competent authority of the United Kingdom shall without delay inform the competent authority of Switzerland in writing about publicly announced and adopted changes to United Kingdom law regarding the tax rates applicable to income, gains on relevant assets, and inheritances.
> 2. Where the United Kingdom highest rates of taxation on income, gains or inheritances are amended after the date of signature of this Agreement [6 October 2011], the rates of taxes levied under this Part shall simultaneously and correspondingly be amended by the number of percentage points that the statutory rates have been amended, unless the competent authority of Switzerland has informed the competent authority of the United Kingdom in writing, within 30 days of receipt of any information provided under paragraph 1, that it will not adjust the applicable tax rates under this Part. The competent authority of Switzerland shall publish without delay all adjustments to the rates of the taxes levied under this Part and ensure that Swiss paying agents are informed of these adjustments.

Thus the Swiss authorities have a discretion if the UK increases its rates, or if following a decrease, UK rates return to 2011/12 levels: they need not increase the withholding tax rate. Perhaps the point is theoretical.

Article 20(2) STA continues:

> The competent authority of Switzerland shall publish without delay all adjustments to the rates of the withholding tax levied under this Part and ensure that Swiss paying agents are informed of these adjustments.

90.2 Interaction with other taxes

90.2.1 *Swiss/EU Savings Tax Agreement 2004*

Article 1(3) STA provides:

> Notwithstanding any other provision, Part 3 shall not apply to income or gains in respect of which a retention is levied, or disclosure is made, in accordance with the Agreement dated 26 October 2004 between the Swiss Confederation and the European Community providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (hereinafter referred to as "Agreement on the Taxation of Savings").[8]

8 For completeness: art.1(4) anticipates amendments to the Swiss/EU Savings Tax Agreement: "Notwithstanding any other provision, with effect from the date of application of the relevant provisions of any amendment to the Agreement on the

This is carefully drafted not to tread on EU toes.

The amending protocol of March 2012 provides the following declaration:

> **Joint Declaration concerning a tax finality payment**
> According to Switzerland's policy not to attract undeclared funds and the desire of the United Kingdom to provide tax finality to United Kingdom taxpayers who have had retention levied in accordance with the Agreement on the Taxation of Savings, the United Kingdom and Switzerland have agreed the following:
> United Kingdom taxpayers who have paid both the retention under the Agreement on the Taxation of Savings and a 13% tax finality payment on interest income shall cease to have any liability for the relevant tax year to United Kingdom taxes chargeable on those interest payments, including interest, penalties and surcharges that are chargeable on those interest payments.
> By choosing to pay the retention on interest income in application of the Agreement on the Taxation of Savings, a United Kingdom taxpayer is also authorising the payment of 13% on such interest amount. Swiss paying agents shall issue a certificate to United Kingdom taxpayers demonstrating that the tax finality payment has been made. The revenue generated by this payment shall be transferred to the competent authority of the United Kingdom via the competent authority of Switzerland.
> In case of an amendment of the applicable tax rate on interest income according to the Agreement between the United Kingdom of Great Britain and Northern Ireland and the Swiss Confederation on cooperation in the area of taxation, the tax finality payment shall be adjusted accordingly.

90.2.2 *Swiss anticipatory tax*

Article 21 STA considers the interaction of STA withholding with other taxes:

(1) Swiss anticipatory tax (*impôt anticipé*)
(2) UK tax levied at source
(3) Foreign tax

Article 21(1) STA provides:

Taxation of Savings, including by way of a new agreement, the reference in para-graph 3 to the Agreement on the Taxation of Savings shall be to that Agreement as so amended"

> 1. The levy of the Swiss anticipatory tax is not affected by anything in this Agreement. To the extent provided for by the Double Taxation Convention, the Swiss paying agent shall in its own name and on behalf of the relevant person file with the Swiss authorities for total or partial reimbursement. The Swiss anticipatory tax which cannot be claimed back according to the Double Taxation Convention (residual tax) shall be credited against the withholding tax.

90.2.3 *UK tax at source*

Article 21(2) STA provides:

> 2. If tax is levied at source in accordance with the law of the UK on income falling within Article 19 paragraphs 1 and 2 [income subject to STA withholding tax], the Swiss paying agent shall credit this tax at source against the withholding tax. This credit may not, however, exceed the amount of the withholding tax.

It is difficult to see how the credit could exceed the amount of the withholding tax, unless the rates vary considerably in the future.

90.2.4 *Foreign taxes*

Article 21(3) STA provides:

> 3. If tax is levied in a third State or jurisdiction on income falling within Article 19 paragraphs 1 and 2 [income subject to STA withholding tax], the Swiss paying agent shall credit this tax against the withholding tax, to the extent that any arrangements between the UK and that third State or jurisdiction for the avoidance of double taxation exclude the reimbursement of the tax levied in that third State or jurisdiction. This credit may not, however, exceed the amount of the withholding tax.

90.3 Credit for withholding tax

Article 23 STA provides:

> **Art. 23 Treatment of withholding tax as payment on account**
> 1. The relevant person may request, on production to the competent authority of the UK of a certificate issued in accordance with Article 30, that the withholding tax is treated by the competent authority of the UK as a payment on account of UK taxes or other liabilities (including without limitation interest, penalties and surcharges) of that person in respect of the relevant tax year to which the certificate relates. In this circumstance, Article 19 paragraph 5 [clearance] shall not apply.
> 2. Where a payment received by a relevant person has been subject to

taxes and retentions other than as provided for in this Agreement and the UK grants a tax credit for such taxes and retentions in accordance with its national law or double taxation conventions, such other taxes and retentions shall be credited before the procedure in paragraph 1 is applied.
3. Paragraphs 1 and 2 shall not apply to the extent that the taxes or retentions described in paragraph 2 have been credited based on Article 21.

90.4 Basis of assessment of STA withholding tax

90.4.1 *Deductions*

Article 24 STA provides:

> **Art. 24 Basis of assessment**
> 1. The amount on which the withholding tax shall be levied is the amount before any deductions.

90.4.2 *Interest*

Article 24 STA provides:

> 2. The withholding tax on interest income shall be levied as follows:
> a) in the case of interest income within the meaning of Article 25 paragraph 1 letter a): on the gross amount of interest paid or credited;
> b) in the case of interest income within the meaning of Article 25 paragraph 1 letter b) or d): on the amount of interest or revenue referred to in those letters;
> c) in the case of interest income within the meaning of Article 25 paragraph 1 letter c): on the amount of interest referred to in that letter.

This seems a somewhat cumbersome way to express the point, but it does not matter.

90.4.3 *Dividends*

Article 24 STA provides:

> 3. The withholding tax on dividend income shall be levied as follows:
> a) in the case of a dividend within the meaning of Article 26 paragraph 1 letter a): on the gross amount of the dividend paid or credited or, if the dividend is never paid or credited, on the market value of the dividend in kind at the time of accrual;

b) in the case of a dividend within the meaning of Article 26 paragraph 1 letter b): on the amount of dividends referred to in that letter;
c) in the case of a dividend within the meaning of Article 26 paragraph 1 letter c): on the amount of income referred to in that letter.

90.4.4 *Other income*

Article 24 STA provides:

4. The withholding tax on other income shall be levied as follows:
a) in the case of other income within the meaning of Article 27 paragraph 1 letter a): on the gross amount of the other income paid or credited;
b) in the case of other income within the meaning of Article 27 paragraph 1 letter b): on the amount of other income referred to in that letter;
c) in the case of other income within the meaning of Article 27 paragraph 1 letter c): on the amount of other income referred to in that letter.

90.5 Capital gains

90.5.1 *Computation of gain*

Article 24 STA provides:

5. The withholding tax shall be levied on capital gains accruing on the disposal of relevant assets. Capital gains are computed by deducting the acquisition costs and incidental costs of acquisition and disposal from the disposal value, whereby:
a) Acquisition costs are the actual costs of purchase in every case, apart from in the exceptional case where accurate records are no longer available.
b) If accurate records of the acquisition costs are not available, the acquisition costs are the market value of the asset at 31 March 1982 or, if the asset was not in existence at that date, the market value of the asset on the date of creation.
c) If such market value is not known, the acquisition costs are deemed to be nil.

This is not the same as the computation of the gain for CGT principles, for instance it would include gains not chargeable to CGT (such as exempt gilts and qualifying corporate bonds; but the end result will generally be

the same. Sterling is the basis of computation.[9]

90.5.2 *Disposal*

Article 24 STA provides:

> d) The transfer by a relevant person of relevant assets to the account or deposit of a third person constitutes a disposal except in cases where the transfer takes place between spouses or civil partners. In such case the disposal value shall be deemed to be the market value of the assets.

The transfer to a relevant person's own account is not a disposal. The spouse exemption is wider than the CGT spouse exemption, but there is no charity exemption.

90.5.3 *Losses*

Article 24 STA provides:

> 6. Capital losses accruing on the disposal of relevant assets booked in Switzerland can be offset against future capital gains accruing on the disposal of relevant assets booked in Switzerland to the extent they arise on assets held by the same Swiss paying agent.
> 7. Capital losses accruing on the disposal of relevant assets cannot be carried back to set against earlier capital gains or transferred to an account held with another Swiss paying agent.

This may be more generous than the CGT rule for remittance basis taxpayers but may be less generous than the rule for arising basis taxpayers.

Losses from one account may be set against profits in another account, if the accounts are held with the same bank or other paying agent.

90.5.4 *No other reliefs*

> 8. No other allowances or reliefs are available to set against any capital gains or enhance any capital losses accruing on the disposal of relevant assets.

90.6 Definitions for withholding tax

The STA distinguishes between four types of receipt:
(1) interest

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9 See Article 29(2) STA set out at 90.7 (Administration of STA withholding tax).

(2) dividends
(3) other income
(4) gains

These terms are elaborately defined.

Whether income is classified as interest or as other income does not matter for the STA, as the withholding tax rate is the same, but it matters for Swiss/EU Savings Tax Agreement 2004.

Whether income is classified as dividends or interest/other income matters as the withholding tax rate is different.

90.6.1 *Interest*

Article 25 STA provides:

> **Art. 25 Definition of interest income**
>
> 1. For the purposes of this Part, "interest income" means:
>
> a) interest paid, or credited to an account, relating to debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular it includes income from government securities and income from bonds or debentures as well as premiums and prizes attached to such securities, bonds or debentures, but excluding interest from loans between private individuals not acting in the course of their business. Penalty charges for late payments shall not be regarded as interest income;
>
> b) interest accrued or capitalised at the sale, refund or redemption of debt claims referred to in a);
>
> c) income deriving from interest payments either directly or through an entity referred to in Article 4 paragraph 2 of Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments (hereinafter referred to as the "Directive") distributed or retained by:
>
> (i) undertakings for collective investment domiciled in an EU Member State;
>
> (ii) entities domiciled in an EU Member State which exercise the option under Article 4 paragraph 3 of the Directive and which inform the Swiss paying agent of this fact;
>
> (iii) undertakings for collective investment established outside the territory of the EU and Switzerland;
>
> (iv) Swiss investment funds;
>
> d) income realised upon the sale, refund or redemption of shares or units in the following undertakings and entities:
>
> (i) undertakings for collective investment domiciled in an EU Member State;
>
> (ii) entities domiciled in an EU Member State which exercise the option under Article 4 paragraph 3 of the Directive and which inform the Swiss paying agent of this fact;

(iii) undertakings for collective investment established outside the territory of the EU and Switzerland;
(iv) Swiss investment funds.

2. As regards paragraph 1 letters c) and d), where a Swiss paying agent has no information concerning the proportion of the income which derives from interest payments, the total amount of the income shall be considered to be an interest payment.

This is similar to the definition in art.7 of the Swiss/EU Savings Tax Agreement 2004 and art.6 of the EU savings directive.

90.6.2 *Dividends*

Article 26 STA provides:

Art. 26 Definition of dividend income

For the purposes of this Part, "dividend income" means:

a) dividends paid, or credited to an account being income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt claims, participating in profits as well as income from other corporate shares which is subjected to the same taxation treatment as income from shares by the laws of the State or jurisdiction of which the company making the distribution is a resident;

This wording is based on art.10 OECD model convention.

b) income from dividends either directly or through an entity referred to in Article 4 paragraph 2 of the Directive distributed or retained by:
   (i) undertakings for collective investment domiciled in an EU Member State;
   (ii) entities domiciled in an EU Member State which exercise the option under Article 4 paragraph 3 of the Directive and which inform the Swiss paying agent of this fact;
   (iii) undertakings for collective investment established outside the territory of the EU and Switzerland;
   (iv) Swiss investment funds;
c) income realised upon the sale, refund or redemption of shares or units in the following undertakings and entities:
   (i) undertakings for collective investment domiciled in an EU Member State;
   (ii) entities domiciled in an EU Member State which exercise the option under Article 4 paragraph 3 of the Directive and which inform the Swiss paying agent of this fact;
   (iii) undertakings for collective investment established outside the territory of the EU and Switzerland;
   (iv) Swiss investment funds.

90.6.3 *Other income*

Article 27 STA provides:

Art. 27 Definition of other income

For the purposes of this Part, "other income" means:

a) substitute payments for interest and dividends within the meaning of Articles 25 paragraph 1 letter a) and 26 paragraph 1 letter a) or sums treated for tax purposes as income arising from relevant assets under the taxation laws of the UK, as well as other fees and commissions including those received in connection with structured financial instruments, securities lending, repo business, swaps and comparable transactions;

b) other income either directly or through an entity referred to in Article 4 paragraph 2 of the Directive distributed or retained by:
   (i) undertakings for collective investment domiciled in an EU Member State;
   (ii) entities domiciled in an EU Member State which exercise the option under Article 4 paragraph 3 of the Directive and which inform the Swiss paying agent of this fact;
   (iii) undertakings for collective investment established outside the territory of the EU and Switzerland;
   (iv) Swiss investment funds;

c) income realised upon the sale, refund or redemption of shares or units in the following undertakings and entities:
   (i) undertakings for collective investment domiciled in an EU Member State;
   (ii) entities domiciled in an EU Member State which exercise the option under Article 4 paragraph 3 of the Directive and which inform the Swiss paying agent of this fact;
   (iii) undertakings for collective investment established outside the territory of the EU and Switzerland;
   (iv) Swiss investment funds.

90.6.4 *Capital gains*

Article 28 STA provides:

Art. 28 Definition of capital gains

For the purposes of this Part, "capital gains" means:

a) all gains realised on the disposal of relevant assets, except where the gain is interest income, dividend income or other income in accordance with Articles 25 to 27;

b) capital gains realised either directly or through an entity referred to in Article 4 paragraph 2 of the Directive distributed or retained by:
   (i) undertakings for collective investment domiciled in an EU Member State;

(ii) entities domiciled in an EU Member State which exercise the option under Article 4 paragraph 3 of the Directive and which inform the Swiss paying agent of this fact;
(iii) undertakings for collective investment established outside the territory of the EU and Switzerland;
(iv) Swiss investment funds;

c) income realised upon the sale, refund or redemption of shares or units in the following undertakings and entities:
(i) undertakings for collective investment domiciled in an EU Member State;
(ii) entities domiciled in an EU Member State which exercise the option under Article 4 paragraph 3 of the Directive and which inform the Swiss paying agent of this fact;
(iii) undertakings for collective investment established outside the territory of the EU and Switzerland;
(iv) Swiss investment funds.

90.7 Administration of STA withholding tax

Article 29 STA provides:

> **Art. 29 Administrative handling**
> 1. Swiss paying agents shall levy the withholding tax on an arising basis and transfer all taxes levied not later than two months after the end of the calendar year to the competent authority of Switzerland. With the transfer, the Swiss paying agents shall declare to the competent authority of Switzerland the allocation of the taxes levied under this Part to the different categories of income and capital gains.
> 2. The withholding tax shall be calculated, levied and transferred to the competent authority of Switzerland by the Swiss paying agent in sterling. Where sterling is not the reference currency of the account or deposit, the Swiss paying agent shall convert the amount into sterling by using the fixed exchange rate published by the SIX Telekurs AG at the corresponding date.
> 3. The competent authority of Switzerland shall transfer the withholding tax levied to the competent authority of the UK in sterling in one instalment within a period of three months following the end of the calendar year.

90.7.1 *Certificate of withholding tax*

Article 30 STA provides:

Art. 30 Certificates issued by Swiss paying agents
1. Swiss paying agents shall issue to the relevant person a certificate in the form prescribed at the end of each tax year and when the banking relationship is ended.
2. The competent authority of the UK shall accept certificates issued by Swiss paying agents as sufficient evidence of payments of withholding tax made under this Part.

90.7.2 *Change of paying agent*

Article 31 STA provides:

Art. 31 Transfer of relevant assets
Where a relevant person transfers relevant assets from one Swiss paying agent to the account or deposit of another, the first Swiss paying agent shall transfer the relevant data regarding these assets necessary for the second Swiss paying agent to comply with the terms of this Agreement.

90.8 Annual voluntary disclosure

Article 22 STA provides:

Art. 22 Voluntary disclosure
1. Where a relevant person who is not a non-UK domiciled individual expressly authorises the Swiss paying agent to disclose to the competent authority of the UK the income arisen and capital gains realised on an account or deposit, the Swiss paying agent shall disclose such income and capital gains instead of levying the withholding tax.
2. Where a relevant person who is a non-UK domiciled individual expressly authorises the Swiss paying agent to disclose to the competent authority of the UK the income and capital gains that have a UK source and remittances to the UK from an account or deposit, the Swiss paying agent shall disclose such income, capital gains and remittances instead of levying the withholding tax.
3. A disclosure shall include the following information:
a) the identity (name, first name and date of birth) and address of the relevant person;
b) the UK tax reference number, if known;
c) the name and address of the Swiss paying agent;
d) the customer number of the account or deposit holder (customer, account or deposit number, IBAN-code);
e) the tax year concerned;

For relevant persons except non-UK domiciled individuals:
f) the total amount of income as defined in Article 19 paragraph 1;
g) the total amount of capital gains and losses realised as calculated

in accordance with Articles 24 and 28;

For relevant persons who are non-UK domiciled individuals:

h) the total amount of income and capital gains as defined in Article 19 paragraph 2 letter a);

i) the total amount of remittances as defined in Article 19 paragraph 2 letter b).

This is the equivalent of article 10 (voluntary disclosure)[10] but the disclosure takes place annually.

Article 29(4) STA provides:

> 4. With respect to voluntary disclosures in accordance with Article 22 Swiss paying agents shall transfer the information according to Article 22 paragraph 3 not later than three months after the end of the tax year to the competent authority of Switzerland. The competent authority of Switzerland shall transfer this information to the competent authority of the UK. Such communications shall be automatic and take place once a year within a period of six months following the end of the tax year.

90.9 IHT withholding

The drafting refers to an "authorised person" defined in art.2(1)(q) STA:

> q) "authorised person" means all the personal representatives of a deceased relevant person or the beneficiary or beneficiaries to whom the relevant assets pass as a result of the death.

Article 32 STA provides:

> 1. Where a Swiss paying agent becomes aware of the death of a relevant person, it shall freeze the relevant assets of which the relevant person was the beneficial owner at the date of death. The Swiss paying agent shall cancel the freezing of the relevant assets after tax has been withheld in accordance with paragraph 2 or the authorised person has consented to disclosure in accordance with paragraph 3. Notwithstanding the foregoing, withdrawals shall be allowed up to a maximum of 60% of the relevant assets at the date of the relevant person's death.
>
> The Swiss paying agent shall cancel the freezing of relevant assets when provided by the authorised person in due time with a certificate produced by a lawyer, an accountant or a tax adviser who is a member of a relevant professional body con-firming that the deceased person

10 See 89.9 (Disclosure option).

was not domiciled within the United Kingdom and was not considered as deemed domiciled for inheritance tax purposes in United Kingdom tax law. In that case, no tax shall be withheld in accordance with para-graph 2 and there shall be no disclosure in accordance with paragraph 3.

2. An authorised person can, within a period of one year from the date of the relevant person's death, give the Swiss paying agent written authorisation to make a disclosure in accordance with paragraph 3. In the absence of such authorisation, once this period has expired or upon subsequently becoming aware of the relevant person's death, the Swiss paying agent shall withhold an amount of 40% of the relevant assets booked at the date of the relevant person's death. The Swiss paying agent shall without delay transfer the tax withheld to the competent authority of Switzerland. Article 29 paragraph 2 shall apply to the amount withheld under this paragraph.

3. Where written authorisation has been provided by the authorised person, the Swiss paying agent shall without delay transfer the following information to the competent authority of Switzerland:

a) the identity (name, first name, date of birth and, if known, the date of death) and address of the deceased person;
b) the name and address of the Swiss paying agent;
c) the customer number of the account or deposit holder (customer, ac-count or deposit number, IBAN-code);
d) if known, the name and address of the authorised person;
e) the account balance and statement of assets as at the date of death.

4. Where due to insufficient funds the Swiss paying agent is unable to withhold the full amount of the tax according to paragraph 2, it shall make a disclosure in accordance with paragraph 3 as if the authorised person had provided written authorisation to the Swiss paying agent to disclose, provided that the authorised per-son has not made available the necessary funds within a period specified by the Swiss paying agent, not exceeding eight weeks.

5. The competent authority of Switzerland shall without delay transfer the tax withheld according to paragraph 2 or the information according to paragraph 3 to the competent authority of the United Kingdom.

6. When withholding the tax in accordance with paragraph 2 or making the dis-closure in accordance with paragraph 3, the Swiss paying agent shall issue to the authorised person a certificate in the form prescribed.

7. The authorised person may request, on production to the competent authority of the United Kingdom of a certificate issued in accordance with paragraph 6, that the tax withheld in accordance with paragraph 2

is treated as a payment on account of United Kingdom inheritance tax (including without limitation interest and penalties) payable in respect of the relevant assets at the date of death of the relevant person. The competent authority of the United Kingdom shall refund any excess to the authorised person. In this circumstance, paragraph 8 shall not apply.
8. Where tax is withheld in accordance with paragraph 2, the authorised person shall cease to have any liability to United Kingdom inheritance tax in respect of the relevant assets at the date of death of the relevant person, including interest and penalties that are chargeable. Any other tax liabilities of the deceased person in the United Kingdom, including liabilities to tax in respect of income or gains, are not affected by this paragraph.

90.10 Planning points for STA withholding tax regime

90.10.1 *UK domiciliary*

The withholding tax regime is not likely to be attractive, except for those for whom secrecy is overwhelmingly important. So the practical choice for the UK domiciliary is:
(1) to opt for STA annual voluntary disclosure.
(2) to move the account from Switzerland.
As the disclosure relates to present rather than past income, STA voluntary disclosure should not necessarily lead to greatly increased HMRC enquiries, though one should be prepared for some, especially regarding the source of the funds in the account.

90.10.2 *Non-UK domiciliary*

For the non-UK domiciliary who elects for the remittance basis, the practical course is to certify non-domicile and arrange no UK source income or remittances received directly in the UK.

90.10.3 *Non-resident*

A non-resident with a UK passport must obtain an annual non-residence certificate.

90.11 The UK provisions

Schedule 36 FA 2012 provides:

Taxes affected
13 The taxes affected by this Part are—
(a) income tax, and

(b) capital gains tax.

Application of this Part

14 (1) This Part applies if—

(a) a sum is levied under Article 19 on an amount of income or a gain of a person, and

(b) a certificate is issued to the person under Article 30(1) in respect of the levying of that sum (or sums that include that sum).

(2) This Part also applies if—

(a) a retention is made under EUSA from an amount of income or a gain of a person,

(b) a tax finality payment, as contemplated by the Joint Declaration, is made on the same income or gain, and

(c) a certificate is issued to the person under the Joint Declaration in respect of the making of that payment (or payments that include that payment).

(3) In this Part—

(a) the person is referred to as "P",

(b) the certificate is referred to as "the relevant certificate",

(c) the amount of income, or the gain, is referred to as "the cleared amount",

(d) the account or deposit (within the meaning of the Agreement) to which the certificate relates (or to which certificates relate that include the certificate) is referred to as "the underlying account", and

(e) the sum levied under Article 19 on the cleared amount or, as the case may be, the tax finality payment made on it is referred to as "the transferred sum".

Effect of relevant certificate

15(1) The effect of the relevant certificate depends on whether P makes an election under paragraph 16 in respect of the underlying account for the applicable year.

(2) "The applicable year" is the tax year for which P is liable to income tax or, as the case may be, capital gains tax on the cleared amount.

(3) If P makes an election, the transferred sum is to be treated as if it were a credit allowable against the income tax or, as the case may be, capital gains tax due from P for the applicable year.

(4) If P does not make an election, P ceases to be liable to income tax or, as the case may be, capital gains tax on the cleared amount.

(5) Sub-paragraph (4) is to be read in accordance with paragraph 7.

(6) Where P ceases to be liable to tax on the cleared amount, P also ceases to be liable to any ancillary charge directly connected with that amount.

Election

16(1) P may make an election under this paragraph in respect of the underlying account for a tax year if all the affected amounts are included in full in a return (or amended return) made by P under Part 2 of TMA 1970 for that tax year.

(2) In relation to a tax year, an amount is an "affected amount" if—

(a) a certificate is issued to P under Article 30(1) or the Joint Declaration in respect of the levying of a sum, or the making of a tax finality payment, on that amount,

(b) the account or deposit to which the certificate relates is the underlying account, and

(c) the amount is required to be brought into account in assessing the income tax or capital gains tax due from P for that tax year.

(3) An election under this paragraph must be made in the return or amended return in which the affected amounts are included.

(4) An election may only be made under this paragraph if it is accompanied by all the relevant certificates relating to the underlying account.

(5) For the purposes of paragraph 15, P is treated as making an election under this paragraph in respect of the underlying account for a tax year if a claim is made under Part 3 of TIOPA 2010 (double taxation relief for special withholding tax) in relation to any of the affected amounts.

(6) Section 143 of TIOPA 2010 (taking account of special withholding tax in calculating income or gains) applies with any necessary modifications in relation to a tax finality payment as it applies in relation to special withholding tax.

Other credits to be allowed first

17 Other than a credit allowed under Part 3 of TIOPA 2010, any credit for foreign tax allowed under that Act against the income tax or, as the case may be, capital gains tax due from P for the applicable year is to be allowed before effect is given to paragraph 15(3).

Repayments

18(1) Sub-paragraph (2) applies if the amount of a credit allowable under paragraph 15(3) exceeds the amount of income tax or, as the case may be, capital gains tax due from P for the applicable year (before set-off).

(2) The excess is to be set against any amount of the other tax (income tax or capital gains tax) due from P for that year.

(3) Nothing in this Part entitles any person to a repayment or refund of tax, save for any repayment to which P may be entitled as a result of paragraph 15(3) if, in relation to a credit allowable under that paragraph, there is any remaining balance after applying—

(a) sub-paragraph (2), and
(b) section 138(4)(a) or 140(5)(a) of TIOPA 2010, if applicable to the cleared amount.

Relationship with special withholding tax rules

19 The Joint Declaration does not count for the purposes of section 136(6)(b) of TIOPA 2010 (definition of "special withholding tax") as a corresponding provision of international arrangements.

CHAPTER NINETY ONE

DISCLOSURE OF INFORMATION BY SWISS AUTHORITIES

91.1 Disclosure of information by Swiss authorities

91.1.1 *STA government disclosure*

Article 33 STA provides:

> **Art. 33 Accompanying measures to safeguard this Agreement's purpose**
> 1. Notwithstanding any other provisions under which the competent authority of the UK may request information from Switzerland, in order to safeguard this Agreement's purpose the competent authority of Switzerland shall on request provide information to the competent authority of the UK if the identity of a UK taxpayer and plausible grounds are provided by the competent authority of the UK. The request does not have to include the name of the Swiss paying agent.

I refer to this as "**STA government disclosure"**.

> 2. For the purpose of identifying the UK taxpayer, the competent authority of the UK shall provide name, address, and, if known, date of birth, professional activity and other information identifying the UK taxpayer.

Plausible grounds is defined:

> 3. Plausible grounds for the request exist where the competent authority of the UK has identified on a case-by-case basis a tax risk in relation to the UK taxpayer and sees plausible, non-arbitrary grounds for checking the tax position of a UK taxpayer. These grounds shall be based on an analysis of a range of information such as previous tax returns, level of income, third party information and knowledge of the persons who were involved in completing a tax return. So called "fishing expeditions" are excluded.
> 4. The competent authority of the UK shall inform the UK taxpayer in

advance about the intended request for information, unless the competent authority of the UK has reasonable grounds for believing that this might seriously prejudice the assessment or collection of tax.
5. The competent authority of the UK shall confirm in its request that the requirements for such a request are met and shall indicate for which time period within the ten years prior to the request the information is needed. Based on this request, the competent authority of Switzerland shall investigate the existence of accounts and deposits.
6. Institutions governed by the Swiss Banking Act of 8 November 1934 shall on request by the competent authority of Switzerland disclose to the competent authority of Switzerland the existence of accounts and deposits of UK taxpayers to the extent required by this Article.
7. Where the UK taxpayer subject to this request has an account or deposit in Switzerland in the time period referred to in the request, the competent authority of Switzerland shall provide the name of the institution concerned and the number of existing accounts and deposits during the time period referred to in the request to the competent authority of the UK.

91.1.2 *Protected account*

Article 33 STA provides two exceptions:

8. No information according to paragraph 7 shall be provided:
   a) where the UK taxpayer has no account or deposit;

That seems self-evident, but the next exception is more important:

   b) in respect of accounts or deposits of the UK taxpayer where:
      (i) there was after appointed date 2 [31 December 2010] no change in the beneficial ownership.
      A change of ownership due to an inheritance shall be regarded as a change of beneficial ownership for the purposes of this subparagraph; and
      (ii) the one-off payment was levied in accordance with Article 9 paragraph 2 on all the assets in the account or deposit as at the date of entry into force of this Agreement [1 January 2013]; and
      (iii) the income arising and capital gains realised after the date of entry into force of this Agreement were taxed in accordance with Article 19 paragraphs 1 and 2 [STA withholding] 2, or, if appropriate, the tax finality payment in accordance with the joint declaration concerning a tax finality payment was applied; and
      (iv) no new money was deposited into the account or deposit after

> appointed date 2 [31 December 2010]. For the purposes of this subparagraph, assets deposited between appointed date 2 and the date of entry into force of this Agreement which are part of the relevant assets as defined under Article 9 paragraph 12 do not qualify as new money.

This excludes STA government disclosure where an individual has made the one-off payment. I refer to this as **"a protected account"**. But DTA disclosure may apply.

91.1.3 *Administration*

Article 33 STA continues:

> 9. In any case the competent authority of the UK may request administrative or judicial assistance based on the pertinent legal provisions applicable in Switzerland.
> 10. The competent authority of Switzerland shall inform the UK taxpayer before the information is transmitted about the intended exchange of information. The UK taxpayer may appeal against the intended exchange of information to the extent provided by Swiss law.
> 11. The joint commission shall following the entry into force of this Agreement determine by mutual consent the maximum number of admissible requests per calendar year under this Article. The maximum number of requests must be proportionate to the perceived risk of non-compliance by investors and in the first three years that number shall be in the low to mid hundreds and shall not exceed 500 per year. No requests for information under this Article shall be made until the joint commission has reached agreement on the maximum number of requests.
> 12. The maximum number of requests per calendar year shall be subject to a yearly review at the beginning of the year and, if necessary, adjusted for that year based on the requests made three years before. The first review shall take place at the beginning of 2016. Where the competent authority of the UK has in the year under review requested information in less than 20% of the maximum number of admissible requests under this Article, the maximum number of requests per calendar year shall not be adjusted. Where the competent authority of the UK has in the year under review requested information in 20% or more of the maximum number of admissible requests under this Article, the following rules apply:
> a) Requests leading solely to the identification of accounts or

deposits as defined in paragraph 8 letter b)[1] shall not be taken into consideration when determining the number of successful requests and the total number of requests under letters b) and c).

b) If more than two thirds of the total number of requests as determined in accordance with letter a) lead to the direct or indirect identification of additional UK tax liability which amounts to at least £10,000, the maximum number of requests per calendar year shall increase by 15% for the year of the review.

c) If less than one third of the total number of requests as determined in accordance with letter a) lead to the direct or indirect identification of additional UK tax liability which amounts to at least £10,000, the maximum number of requests per calendar year shall decrease by 15% for the year of the review.

In case of indirect identification of additional UK tax liability, a link between the account or deposit identified under this Article and the additional tax liability found is required.

13. This Article shall apply to requests concerning taxable periods beginning on or after the date of entry into force of this Agreement.

Article 37 STA provides:

Art. 37 Use and disclosure of information received under this Agreement

1. Subject to paragraphs 2 and 3, any information that a Contracting State receives from the other Contracting State under this Agreement shall be treated as confidential and shall, without the consent of the relevant person, only be used for the purposes of the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals or the oversight of the above in relation to taxes and tax matters. The Contracting States shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. A Contracting State may use information received for other purposes, if this information can be used for such other purposes according to the law of both Contracting States and the competent authority of the supplying Contracting State gives its consent to such other use.

3. Paragraphs 1 and 2 shall not apply to information received by the competent authority of the United Kingdom as a result of voluntary disclosure made by a relevant person under Articles 10 and 22 or an authorised person under Article 33 paragraph 3.

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1 See 91.1.2 (Protected account).

HMRC state:

> This power is in addition to, and goes further than, the provisions for information exchange under the UK-Switzerland Double Taxation Agreement.

I do not see how it goes further. Dave Hartnett is reported as saying:

> I think it's important to realise that the UK and Switzerland made a change in the double taxation agreement at the beginning of this year, and that is, the article 25[2] of the standard double taxation agreement, which provides for exchange of information on request, applies for Switzerland, so that, if you were investing in Switzerland, and we had reason to be worried about that, we could ask the Swiss what they know about you, but in a specific context. What this extended provision will do is that, in future, if we needed to ask about you, the Swiss will search their banking system - the whole banking system - and provide us with everything they actually know about you, so we would get a lot more information. There's a novelty with this provision as well, and that is that the more successful HMRC is in identifying people who have additional tax liability to pay, the greater the number of people we will be able to search for. The 500 raises like a ratchet. And if we are hopeless at identifying people who have hidden the money the 500 will come down.[3]

It will be interesting to see the number of disclosure requests and their success rate - if that information is made public.

91.1.4 *DTA disclosure*

Article 25 of the Swiss/UK double taxation agreement (revised in 2010) provides:

> **Article 25 Exchange of information**
> 1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not

2 The original erroneously reads: 26.

3 [2011] STI 2651.

restricted by Articles 1 and 2.

2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.

3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person. In order to obtain such information, the tax authorities of the requested Contracting State shall have the power to enforce the disclosure of information covered by this

> paragraph, notwithstanding paragraph 3 or any contrary provisions in its domestic laws.

I refer to this as **"DTA disclosure"**.

In Parliament, the Exchequer Secretary to the Treasury said:

> The protocol also updates the exchange of information article to the latest OECD standard.
> An additional protocol reproduces material from the OECD model tax information exchange agreement and the commentary to the OECD model double taxation agreement. That material was inserted at Switzerland's request and is designed to provide reassurance that the UK will not engage in fishing expeditions to Swiss banks. It is in line with what Switzerland has agreed with other countries, and we are content that it does not undermine the OECD model provisions. In particular, it does not prevent Switzerland agreeing at some future date to provide more information automatically or spontaneously.[4]

91.2 Tracing withdrawn funds

Article 18 STA provides:

> **Art. 18 Destinations of withdrawn assets**
> The competent authority of Switzerland shall within 12 months of appointed date 3 [31 May 2013] report to the competent authority of the UK the 10 States or jurisdictions to which relevant persons who closed their account or deposit between the date of signature of this Agreement [6 October 2011] and appointed date 3 [31 May 2013] have transferred the largest volume of relevant assets. The report shall also include the number of relevant persons concerned for each State or jurisdiction. The Contracting States shall not make public the data collected and reported based on this Article.

The significance of closing the account before 31 May 2013 is that the relevant person escaped the STA regimes.

The significance of the figure this produces is questionable. Relevant persons who close accounts are not necessarily non-compliant. The figure will not record those who transfer assets but do not close their account (perhaps leaving a small amount which is dealt with by the STA one-off payment).

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4 *http://www.publications.parliament.uk/pa/cm201011/cmgeneral/deleg4/101102/101102s01.htm*

The UK could make a good guess to which jurisdictions those evading the STA transfer their assets, but this gives better founded data, which may facilitate further action. For now, HMRC content themselves with threats:

> This agreement will ensure that we know where money that flees Switzerland is heading. We won't be far behind.[5]

91.3 Stolen data

A declaration supplemental to the STA provides:

> The Government of the UK declares ... that it will not actively seek to acquire customer data stolen from Swiss banks.

The Swiss Bankers Q&A puts the point differently:

> The UK has committed not to use information from purchased data carriers containing stolen data in future for legal proceedings against Swiss banks or their employees.[6]

If HMRC do use stolen data, the individual concerned is not likely to be able to know, and if they did suspect that, there is not much the individual could do about it.

5 HMRC press release 6 October 2011.

6 *http://www.swissbanking.org/en/20111102-5000-masterdoku-einigung_uk_final-cfr.pdf*

CHAPTER NINETY TWO

CRIMINAL LAW AND PROFESSIONAL CONDUCT

92.1 Tax offences

This chapter considers criminal law and professional conduct issues raised by the STA.

The principal tax offence is the common law offence of fraud on the revenue.

A UK resident and domiciled individual with an undisclosed Swiss account is likely to commit this offence.

92.2 Waiver (?) of criminal prosecution

HMRC deal with this matter in a document described as a letter. This reflects an attempt to satisfy two incompatible policy considerations:

(1) To encourage defaulters to regularise their affairs. This requires an amnesty or at least the impression of an amnesty. Defaulters are less likely to disclose themselves if there is a risk, or perceived risk, of prosecution.

(2) To keep the possibility of prosecution, or at least the impression of a that possibility, for one or more of the following reasons:
   (a) for use when HMRC feel that justice may require prosecution
   (b) for appearances:
      (i) to placate those opposed to the policy of an amnesty
      (ii) to keep defaulters compliant, by making them dependent on the mercy of HMRC to avoid prosecution
      (iii) *pour encourager les autres.*

Parts of the HMRC letter suggest that there will be (more or less) no prosecution whereas other parts make it plain that they may be.

What is actually intended is left unclear - there is no reason for HMRC to make up their minds, and they may have parked the issue to deal with on an *ad hoc* basis when it arises.

92.3 Prosecution of relevant person (the individual)

The HMRC letter provides:

> In view of the signing of the Agreement between the UK and the Swiss Confederation on cooperation in the area of taxation, the competent authority of the UK [HMRC] wishes to set out its position in relation to the criminal investigation of relevant persons for past liabilities incurred before the date of this Agreement[1] in respect of relevant assets.
> Provided that a relevant person agrees either
> [1] to make a one-off payment in accordance with Article 9 of this Agreement or
> [2] to make a voluntary disclosure in relation to his/her relevant assets in accordance with Article 10 of this Agreement and fully cooperates with HMRC,
> that person is highly unlikely to be subject to a criminal investigation by HMRC for a tax-related offence for past liabilities in respect of relevant assets from the date he or she irrevocably opted for one of the options, unless
> [1] either his/her relevant assets represent the proceeds of crime (other than crime connected to a tax-related offence) or
> [2] represent the proceeds of crime connected to criminal tax-related offences punishable by two years or more imprisonment.

At first sight this appears to be a qualified waiver of prosecution, though "highly unlikely" is wording chosen to fall short of a guarantee.

However the relevant assets will in principle constitute the proceeds of crime (fraud on the Revenue, ie tax evasion), the maximum penalty for which always exceeds two years imprisonment.[2] Thus in terms the "waiver" will never apply. I wonder if that was noticed.

The relevant person cannot irrevocably opt for one of the options until the STA takes effect, which is not before 1 January 2013.[3]

The STA FAQ provides:

> **4.1 HMRC statement re criminal investigations - please confirm what period this is aimed at: the interim period and/or after agreement enters into force?**

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1 The date the agreement was signed, 6 October 2011? Or the date it came into force, 1 January 2013?

2 As a common law offence, the maximum penalty is life imprisonment.

3 See 89.3 (Selecting the option).

> The statement was given in the context of the position once the agreement comes into force.

That was not in fact stated in the statement but since the statement is so qualified, perhaps it does not matter.

92.4 Prosecution of advisors and paying agents

It is an offence to assist an individual to commit fraud on the revenue, or to agree with someone to do so.

The HMRC letter continues:

> [1] Professional advisers, Swiss paying agents and their employees will need to comply with their legal obligations in respect of money laundering.
>
> [2] Whilst it is never possible to provide an absolute assurance against a criminal investigation,[4] it is highly unlikely to be in the public interest of the UK that professional advisers, Swiss paying agents and their employees will be subject to a criminal investigation by HMRC.

At first sight this again appears to be a qualified waiver of prosecution, though "highly unlikely" is wording chosen to fall short of a guarantee.

What is the relationship between points [1] and [2]? Presumably it is implying that the "waiver" does not extend to money laundering offences. I discuss that topic further below.

> [3] Any assurances relate only to investigations undertaken by HMRC. HMRC does not have sole responsibility for the criminal investigation of tax-related offences and no assurances are given in respect of any activity by other UK law enforcement agencies.

This is a strange restriction on the waiver, given that the STA is an agreement between the *United Kingdom* and Switzerland, not an

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4 Why not? The authors of the Liechtenstein disclosure facility presumably did not agree, since they gave an unqualified assurance in schedule 7 para 9:

"A relevant person who makes a full, accurate and unprompted disclosure to HMRC under the disclosure facility, will not be subject to criminal investigation by HMRC for a tax-related offence, unless the source of the funds from which the relevant person has benefited or may benefit constitutes "criminal property" within the meaning specified in section 340 of the Proceeds of Crime Act 2002 (provided that the definition of criminal property for this purpose will not include property that has arisen solely as a result of illegal tax evasion)."

agreement made by HMRC.

> [4] Any assurances given in this letter regarding criminal investigation apply only in relation to a criminal investigation against a relevant person in respect of relevant assets in Switzerland. No such assurances can be given regarding a criminal investigation against any person in respect of assets situated outside Switzerland.

That is a commonsense restriction if "relevant assets in Switzerland" just means "relevant assets" since the STA only relates to such assets. It is considered that that is the right construction.

92.5 Money laundering: Introduction

In this section I consider four criminal offences relating to money laundering, which are found in part 7 Proceeds of Crime Act 2002 ("POCA"). A full discussion of this topic requires a book to itself. I focus on the issues relevant to professionals advising on the STA.

Conviction of any of these offences is punishable by up to 14 years imprisonment and an unlimited fine.

92.5.1 *"Money laundering"*

In the normal sense of the expression, money laundering is the process whereby the proceeds of crime are disguised so that they appear to come from a legitimate source.

Section 340 POCA defines the expression more widely. It includes all forms of handling or possessing criminal property, including possessing the proceeds of one's own crime, and facilitating the handling or possession of criminal property:

> (1) This section applies for the purposes of this Part....
> (11) Money laundering is an act which—
> (a) constitutes an offence under section
> [i] 327,[5]
> [ii] 328[6] or
> [iii] 329,[7]
> (b) constitutes an attempt, conspiracy or incitement to commit an offence specified in paragraph (a),

5 See 92.6 (Concealing/transferring criminal property).
6 See 92.7 (Assisting money laundering).
7 See 92.8 (Possession of criminal property).

(c) constitutes aiding, abetting, counselling or procuring the commission of an offence specified in paragraph (a), or
(d) would constitute an offence specified in paragraph (a), (b) or (c) if done in the UK.

92.5.2 *"Criminal property"*

Section 340 POCA provides:

(1) This section applies for the purposes of this Part.
(2) Criminal conduct is conduct which—
(a) constitutes an offence in any part of the UK, or
(b) would constitute an offence in any part of the UK if it occurred there.
(3) Property[8] is criminal property if—
(a) it constitutes a person's benefit from criminal conduct or it represents such a benefit (in whole or part and whether directly or indirectly), and
(b) the alleged offender knows or suspects that it constitutes or represents such a benefit.

The Consultative Committee of Accounting Bodies (CCAB) comment on "criminal property":

2.28 Money laundering occurs only when criminal property has accrued to someone from a criminal act. In addition, it must be borne in mind that for property to be criminal property not only must it constitute a person's benefit from criminal conduct, but the alleged offender (ie, the person alleged to be laundering criminal property) must know or suspect that the property constitutes such a benefit. This means, for instance,

8 Defined s.340 POCA:
(9) Property is all property wherever situated and includes—
(a) money;
(b) all forms of property, real or personal, heritable or moveable;
(c) things in action and other intangible or incorporeal property.
(10) The following rules apply in relation to property—
(a) property is obtained by a person if he obtains an interest in it;
(b) references to an interest, in relation to land in England and Wales or Northern Ireland, are to any legal estate or equitable interest or power;
(c) references to an interest, in relation to land in Scotland, are to any estate, interest, servitude or other heritable right in or over land, including a heritable security;
(d) references to an interest, in relation to property other than land, include references to a right (including a right to possession).

that if someone has made an innocent error, even if such an error resulted in benefit and constituted a strict liability criminal offence, then the proceeds are not criminal property for the purposes of POCA and no money laundering offence has arisen until and unless the offender becomes aware of the error (eg, s167(3), Customs and Excise Management Act 1979). MLROs need to consider carefully before reporting whether the information or other matter they intend to report meets these criteria. Examples of unlawful behaviour which may be observed, and may well result in advice to a client to correct an issue, but which are not reportable as money laundering are given below:

- offences where no proceeds or benefit results, such as the late filing of company accounts. However, businesses and individuals should be alert to the possibility that persistent failure to file accounts could represent part of a larger offence with proceeds, such as fraudulent trading or credit fraud involving the concealment of a poor financial position.
- misstatements in tax returns, for whatever cause, but which are corrected before the date when the tax becomes due.
- attempted frauds where the attempt has failed and so no benefit has accrued (although as this may still be a Fraud Act offence in England, Wales and Northern Ireland or the common law offence of fraud in Scotland, individuals and businesses may wish to consider reporting to their local police force or, once operational, the 'National Fraud Reporting Centre'). This includes '419' letters and other attempted advanced fee frauds where there is no knowledge of benefit accruing. In the case of such letters, individuals and businesses may wish to consider following the guidance on the Metropolitan Police Fraud Alert internet pages (http://www.met.police.uk/fraudalert). Where a client refuses to correct, or unreasonably delays in correcting, an innocent error that gave rise to proceeds and which was unlawful, businesses should consider what that indicates about the client's intent and whether the property has therefore now become criminal property.[9]

For completeness: Section 340 POCA continues with provisions which widen the scope of "criminal property":

9 Anti-money Laundering Guidance for the Accountancy Sector (August 2008) accessible to CIOT members on *http://www.tax.org.uk*.

(4) It is immaterial—
(a) who carried out the conduct;
(b) who benefited from it;
(c) whether the conduct occurred before or after the passing of this Act.

(5) A person benefits from conduct if he obtains property as a result of or in connection with the conduct.

(6) If a person obtains a pecuniary advantage as a result of or in connection with conduct, he is to be taken to obtain as a result of or in connection with the conduct a sum of money equal to the value of the pecuniary advantage.

(7) References to property or a pecuniary advantage obtained in connection with conduct include references to property or a pecuniary advantage obtained in both that connection and some other.

(8) If a person benefits from conduct his benefit is the property obtained as a result of or in connection with the conduct.

92.6 Concealing/transferring criminal property

Section 327(1) POCA provides:

A person commits an offence if he—
(a) conceals[10] criminal property;
(b) disguises criminal property;
(c) converts criminal property;
(d) transfers criminal property;
(e) removes criminal property from England and Wales or from Scotland or from Northern Ireland.

This would include transferring criminal property from a Swiss account to a trust or other entity.

A professional advisor is not likely to commit this offence but if the client has done so, or may do so, that has consequences for the advisor's responsibilities for assisting/disclosing.

92.7 Assisting money laundering

Section 328(1) POCA provides:

10 Defined in subsection (3): "Concealing or disguising criminal property includes concealing or disguising its nature, source, location, disposition, movement or ownership or any rights with respect to it."

> A person commits an offence if he enters into or becomes concerned in an arrangement which he knows or suspects facilitates (by whatever means) the acquisition, retention, use or control of criminal property by or on behalf of another person.

An example would be to suggest to an individual within the scope of the STA that they should transfer their funds to a trust or to a jurisdiction outside Switzerland in order to avoid the STA. (That would also constitute the offence of fraud on the revenue, or assisting or conspiring to commit that offence).

The scope of this was somewhat restricted in *Bowman v Fels* [2005] 1 WLR 3083 which held that the conduct of litigation did not amount to being concerned in an arrangement within s.328.

92.8 Possession of criminal property

Section 329(1) POCA provides:

> A person commits an offence if he—
> (a) acquires criminal property;
> (b) uses criminal property;
> (c) has possession of criminal property.

A professional advisor is not likely to commit this offence but if the client has done so, or may do so, that has consequences for the advisor's responsibilities for assisting/disclosing.

92.9 Defence of authorised disclosure

There is a defence to these offences if an "authorised disclosure" is made under section 338 POCA. If an authorised disclosure is made before a prohibited act under section 327-329, appropriate consent is required.

92.10 Duty to disclose money laundering

Section 330(1) POCA provides:

> A person commits an offence if the conditions in subsections (2) to (4) are satisfied.

I refer to these conditions as the disclosure conditions.

92.10.1 *Disclosure condition 1: Knowledge*

Section 330(2) POCA provides:

> The first condition is that he—

(a) knows or suspects, or
(b) has reasonable grounds for knowing or suspecting,

that another person is engaged in money laundering.

The CCAB offer guidance on "knows or suspects":

> 2.25 Having knowledge means actually knowing that something is the case.
> 2.26 Case law suggests that suspicion is a state of mind more definite than speculation, but falls short of knowledge based on evidence. It must be based on some evidence, even if that evidence is tentative – simple speculation that a client may be money laundering is not sufficient grounds to form a suspicion. Similarly, a general assumption that low levels of crime (eg, not declaring all cash takings) are endemic in particular industry sectors does not amount to reasonable grounds for suspicion of particular clients operating in that sector.
> 2.27 A frequently used description is that '…A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to a "slight opinion, but without sufficient evidence"' (*Queensland Bacon PTY v Rees* [1966] 115 CLR 266 at 303, per Kitto J). In another more recent case, *Da Silva* [2007] 1 WLR 303, 'It seems to us that the essential element in the word "suspect" and its affiliates, in this context, is that the defendant must think that there is a possibility, which is more than fanciful, that the relevant facts exist. A vague feeling of unease would not suffice.'[11]

The CCAB comment on "reasonable grounds":

> 2.29 Individuals in the regulated sector must make an internal report or a SAR, as applicable, if there are 'reasonable grounds' for knowledge or suspicion, as well as actual knowledge or suspicion. This 'reasonable grounds' test creates an objective test – persons in the regulated sector will not be able to rely on an assertion of ignorance or naivety where this would not be reasonable to expect of a person with their training and position. For example, a person might be considered to have reasonable grounds for knowledge of money laundering if he had actual knowledge of, or possessed information which would indicate to a reasonable person, that another person was committing or had committed a money laundering offence; or had deliberately ignored the

11 Anti-money Laundering Guidance for the Accountancy Sector (August 2008) accessible to CIOT members on *http://www.tax.org.uk*.

obvious inference from information (ie,. wilfully shutting one's eyes) known to him that another person was committing or had committed a money laundering offence. Please note that the interpretation of 'reasonable grounds' has not, as yet, been tested by the courts for the purposes of POCA.

2.30 'Reasonable grounds' should not be confused with the existence of higher than normal risk factors which may affect certain sectors or classes of persons. For example, cash-based businesses or complex overseas trust and company structures may be capable of being used to launder money, but this capability of itself is not considered to constitute 'reasonable grounds'.

2.31 Existence of higher than normal risk factors require increased attention to gathering and evaluation of 'know your client' information, and heightened awareness of the risk of money laundering in performing professional work, but do not of themselves require a report of suspicion to be made. For 'reasonable grounds' to come into existence, there needs to be sufficient information to advance beyond speculation that it is merely possible someone is laundering money, or a higher than normal incidence of some types of crime in particular sectors.

2.32 It is important that individuals do not turn a blind eye to information, but make reasonable enquiries such as a professional with their qualifications, experience and expertise might be expected to make in such a situation within the normal scope of their assignment or client relationship, and draw a reasonable conclusion such as may be expected of a person of their standing. Individuals should exercise a healthy level of professional scepticism, and if unsure of the action that should be taken, consult with their MLRO or otherwise in accordance with their businesses' procedures. If in doubt, individuals should err on the side of caution and make a report to their MLRO.[12]

92.10.2 *Disclosure condition 2: Professional advisor*

Section 330(2) POCA provides:

> The second condition is that the information or other matter—
>
> (a) on which his knowledge or suspicion is based, or
>
> (b) which gives reasonable grounds for such knowledge or suspicion,
>
> came to him in the course of a business in the regulated sector.

12 Anti-money Laundering Guidance for the Accountancy Sector (August 2008) accessible to CIOT members on *http://www.tax.org.uk*.

Under schedule 9 POCA, the regulated sector includes:

> the provision of advice about the tax affairs of other persons by a firm or sole practitioner who by way of business provides advice about the tax affairs of other persons;

Thus tax practitioners are in the regulated sector.

92.10.3 *Disclosure condition 3: Knowledge of identity*

Section 330(3A) POCA provides:

> The third condition is—
> (a) that he can identify the other person mentioned in subsection (2) or the whereabouts of any of the laundered property,[13] or
> (b) that he believes, or it is reasonable to expect him to believe, that the information or other matter mentioned in subsection (3) will or may assist in identifying that other person or the whereabouts of any of the laundered property.

Disclosure conditions 1 to 3 will be met by an advisor to a non-compliant UK resident and domiciled individual with a Swiss bank account.

92.10.4 *Disclosure condition 4: Disclosure to SOCA*

Disclosure is one option. Section 330(4) POCA provides:

> The fourth condition is that he does not make the required disclosure[14] to—
> (a) a nominated officer, or
> (b) a person authorised for the purposes of this Part by the Director General of SOCA,
> as soon as is practicable after the information or other matter mentioned in subsection (3) comes to him.

Thus in the absence of some other defence, s.330 effectively imposes a duty to disclose the client. There are defences of reasonable excuse and

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13 This has a commonsense definition in subsection (5A) "The laundered property is the property forming the subject-matter of the money laundering that he knows or suspects, or has reasonable grounds for knowing or suspecting, that other person to be engaged in."

14 Defined subsection (5) "The required disclosure is a disclosure of—
(a) the identity of the other person mentioned in subsection (2), if he knows it,
(b) the whereabouts of the laundered property, so far as he knows it, and
(c) the information or other matter mentioned in subsection (3)."

lack of knowledge which are not discussed here. The main defence is professional privilege.

92.11 Professional privilege

Section 330 POCA provides:

> (6) But he does not commit an offence under this section if...
> (b) he is a professional legal adviser or relevant professional adviser and—
> (i) if he knows either of the things mentioned in subsection (5)(a) and (b), he knows the thing because of information or other matter that came to him in privileged circumstances, or
> (ii) the information or other matter mentioned in subsection (3) came to him in privileged circumstances, or
> (c) subsection (7) or (7B) applies to him.
>
> (7B) This subsection applies to a person if—
> (a) he is employed by, or is in partnership with, a professional legal adviser or a relevant professional adviser to provide the adviser with assistance or support,
> (b) the information or other matter mentioned in subsection (3) comes to the person in connection with the provision of such assistance or support, and
> (c) the information or other matter came to the adviser in privileged circumstances.
>
> (10) Information or other matter comes to a professional legal adviser or . . . relevant professional adviser in privileged circumstances if it is communicated or given to him—
> (a) by (or by a representative of) a client of his in connection with the giving by the adviser of legal advice to the client,
> (b) by (or by a representative of) a person seeking legal advice from the adviser, or
> (c) by a person in connection with legal proceedings or contemplated legal proceedings.

This is similar to legal professional privilege. The Law Society comment:

> 5.3.2. It is important to note that common law privilege and the 330(6) exemption differ particularly in relation to the protection given to "advice".
> 5.4. When advice is given or received in circumstances where litigation is neither contemplated nor reasonably in prospect, common law LPP

will normally only apply to communications between a solicitor and his client for the purpose of obtaining or providing legal advice, or which form part of the chain of correspondence between solicitor and client for the purpose of obtaining legal advice. Therefore, save in limited circumstances, communications between solicitors and third parties will not fall within common law LPP. An exception where common law LPP might apply is where the third party is merely acting as a conduit or post box (see *Jones v Great Central Railway [1910]) AC 4*).

5.5. In contrast, the 330(6) exemption applies, to any information received by a professional legal adviser from a client or a representative of a client for the purpose of giving or obtaining legal advice. A "representative" is not defined in POCA but the Law Society takes a wide interpretation. For example, information communicated by a client's tax adviser to the professional legal adviser may fall within the 330(6) exemption when in the professional legal adviser's hands. The tax adviser is not however a professional legal adviser and therefore falls outside the 330(6) exemption and may of course commit an offence himself under s330 POCA if he fails to make a disclosure under the section.

5.5.1. Following the Court of Appeal's decision in *Three Rivers District Council v Bank of England (No 5)* [2003] QB 1556 (which is unaffected by the House of Lords decision referred to elsewhere) communications by a solicitor with employees of a corporate client may not be protected by common law LPP if the employee cannot be considered to be "the client" for these purposes. The Court of Appeal concluded that some employees may be clients, some may not. However, even if a junior employee might not be a client for the purposes of common law LPP they may fall within the meaning of "representative" for the purposes of the 330(6) exemption.

5.5.2. Under Common law, privileged information can be shared or disclosed within law firms, without losing the protection of LPP, e.g. with secretaries, other fee earners, the MLRO. This can also include those with a common interest, e.g. in certain circumstances co-defendants (see *Gotha City v Sotheby's* (no.1) [1998] 1 WLR 114)). However, except where litigation is in contemplation, arguably the 330(6) exemption only applies to information received by a professional legal adviser from a client or a representative of a client, or from a person seeking legal advice, in the circumstances outlined in section 330(10)(a) and (b). For example, during the course of a transaction a vendor may provide copies to the purchaser of legal advice received by the vendor, but require that it be kept confidential and stipulate that in disclosing it, privilege in the information is not waived. Since the 330(6)

exemption only applies to information provided by a client or his or her representative, to a professional legal adviser, whilst it will apply if the vendor or his lawyer gives it to the purchaser who then passes it to the purchaser's professional legal adviser, it will not apply if it is simply put in a data room and the purchaser's professional adviser inspects it.

What is legal advice in a transaction?

5.6. Whereas the range of those whose communications fall within the 330(6) exemption may be broader than within common law LPP, under both heads the communications must relate to legal advice. A definition of the scope of common law advice privilege has recently been approved by the House of Lords in *Three Rivers District Council and others v Bank of England* [2004] UKHL 48 at 111 as covering "all communications between a solicitor and his client relating to a transaction in which the solicitor has been instructed for the purpose of obtaining legal advice … notwithstanding that they do not contain advice on matters of law and construction, provided that they are directly related to the performance by the solicitor of his professional duty as legal adviser of his client".

5.7. By way of example, in a conveyancing transaction, common law advice privilege will be limited to all such communications with, and instructions from, the client and any advice given to the client, (including any working papers and drafts prepared by the solicitor)[15] for the purpose of giving that advice, provided they are directly related to the performance by the solicitor of his professional duty as legal adviser of his client. Thus before making a disclosure to NCIS under s.338, the solicitor must ensure that his knowledge or suspicion does not arise from information imparted within this definition.

5.8. Adapting the *Three Rivers* definition to the wording of s.330 (10), the exemption under the section will cover all communications between a professional legal adviser and his client or his client's representative relating to a transaction in which the professional legal adviser has been instructed for the purpose of obtaining legal advice, notwithstanding that they do not contain advice on matters of law and construction, provided that they are directly related to the performance by the professional legal adviser of his professional duty as legal adviser of his client.

5.9. In the conveyancing example given above, the 330(6) exemption will cover, in addition to the "common law" items, communications

15 [Footnote original] It will not of course cover documents sent to the other side in a transaction, or any documents of title, including conveyances, transfers, mortgages etc. for these are either not confidential and/or not communications.

with third parties, such as surveyors, tax advisers or accountants, provided to the professional legal adviser to enable him to advise his client and directly related to the performance by the professional legal adviser of his professional duty as legal adviser of his client.
5.10. Thus, a conveyancing solicitor does not commit an offence under s.330 if he fails to disclose, if his knowledge, suspicion, or reasonable grounds for knowledge or suspicion, arose from communications of such a nature with his client or a representative of his client:
Note: Solicitors' costs
Solicitors concerned about their receipt of costs, including payment on account, should have regard not only to paragraph 2.30 of the Guidance which describes the "adequate consideration" defence to the section 329 offence, but also this judgment which confirms that legal professional privilege excludes the reporting requirement under the other principal offences, namely sections 327 and 328.[16]

92.11.1 *Crime/fraud exception*

Section 330 POCA continues:

(11) But subsection (10) does not apply to information or other matter which is communicated or given with the intention of furthering a criminal purpose.

The CCAB guidance provides:

7.42 ... An example of this might be where tax advice was sought ostensibly to enable the affairs of a tax evader to be regularised but in reality was sought to aid continued evasion by improving the evader's understanding of the relevant issues.
7.43 The crime/fraud exception also applies where communication takes place between a client and his adviser in circumstances where the client is the innocent tool of a third party's criminal or fraudulent purpose. An example of this might be where a money launderer gives money to a family member, who is unaware of the source of that money, to purchase a property, for which purpose he communicates with his adviser.
7.44 The crime/fraud exception does not apply where the adviser is approached to advise on the consequences of a crime or fraud or similar conduct that has already taken place and where the client has no intention, in seeking advice, to further that crime or fraud. This means

16 Bowman v Fels guidance 13/09/2005.

> that a person who is concerned that he may be guilty of tax evasion can approach a tax adviser for legal advice in this regard without fear of the exception being invoked. This remains the case even if the potential client declines a client relationship having received the advice, and the adviser does not know whether the person will proceed to rectify his affairs. However, if the person behaves in a way that makes the adviser suspicious that he intends to use the advice to further his evasion, then a money laundering report could be required.
> 7.45 The crime/fraud exception is a difficult area and the Courts will not usually allow the exception to be invoked unless there is reasonably compelling circumstantial evidence available that demonstrates that the communications have in some way been intended to further the crime or the fraud. A mere speculation may not be sufficient as a basis to invoke it. It is strongly recommended that professional or legal advice is sought in all cases of doubt.[17]

Bar Council guidance provides:

> 15. NB Section 330 (11) makes it clear that LPP does not extend to information which is communicated with the intention of furthering a criminal purpose. Under the criminal law, one intends something if one can foresee its natural consequences . It is not clear whose intention is relevant for the purposes of this section. At common law, the client's fraudulent intention is sufficient to throw aside the cloak of LPP even if the legal adviser is unaware of it: see *Cox v Railton* 14 QBD 153. However, in *Bowman v Fels* [2005] 1 WLR 3083 the Court of Appeal expressed some sympathy for the view that unless a barrister is actually aware of his client's intention to further a criminal purpose, the information would be protected from disclosure and no offence would be committed: see paragraphs 93 and 94. Given the serious penal consequence of the statute for barristers if they do not make a relevant disclosure, the Bar Council believes the views tentatively expressed by the Court of Appeal in those passages are correct.[18]

The Law Society say:

> 5.11. Neither common law LPP nor the 330(6) exemption apply to

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17 Anti-money Laundering Guidance for the Accountancy Sector (August 2008) accessible to CIOT members on *http://www.tax.org.uk.*

18 POCA guidance (January 2008) *http://www.barcouncil.org.uk/for-the-bar/practice-updates-and-guidance/guidance-on-the-professional-conduct-of-barristers/proceeds-of-crime-act-2002/*

communications made with the intention of furthering a criminal purpose. For this exception to apply in either context, the solicitors should have prima facie evidence of such an intention, which as indicated at 4.14, need not be that of the client.
5.12. ... The Law Society believes that a solicitor should not make a report unless there is prima facie evidence that he is being used in the furtherance of a crime.
Note:
The question of protecting client confidentiality is a key consideration for professional legal advisers considering reporting under either the principal money laundering offence provisions (to which common law LPP applies) or under the section 330 failure to report offence (to which the 330(6) exemption applies). In either case solicitors should refer to section 6 regarding tipping off.[19]

92.11.2 *Relevant professional adviser*

This term is defined in s.330 (14) POCA:

> A relevant professional adviser is an accountant, auditor or tax adviser who is a member of a professional body which is established for accountants, auditors or tax advisers (as the case may be) and which makes provision for—
>
> (a) testing the competence of those seeking admission to membership of such a body as a condition for such admission; and
>
> (b) imposing and maintaining professional and ethical standards for its members, as well as imposing sanctions for non-compliance with those standards.

92.12 Overseas conduct exemption

For completeness: All the money laundering offences have a territorial limitation. This is set out each time in the same words.[20] Section 327 POCA provides:

> (2A) Nor does a person commit an offence under subsection (1) if—
>
> (a) he knows, or believes on reasonable grounds, that the relevant criminal conduct[21] occurred in a particular country or territory

19 Bowman v Fels guidance 13/09/2005.

20 See s.328(3), 330(7A) POCA.

21 Defined in subsection (2B): "In subsection (2A) "the relevant criminal conduct" is the criminal conduct by reference to which the property concerned is criminal property."

outside the UK, and

(b) the relevant criminal conduct—

(i) was not, at the time it occurred, unlawful under the criminal law then applying in that country or territory, and

(ii) is not of a description prescribed by an order made by the Secretary of State.

Para 2 Proceeds of Crime Act 2002 (Money Laundering: Exceptions to Overseas Conduct Defence) Order 2006, SI 2006/1070 provides:

(1) Relevant criminal conduct of a description falling within paragraph (2) is prescribed for the purposes of sections 327(2A)(b)(ii), 328(3)(b)(ii) and 329(2A)(b)(ii) of the Proceeds of Crime Act 2002 (exceptions to defence where overseas conduct is legal under local law).

(2) Such relevant criminal conduct is conduct which would constitute an offence punishable by imprisonment for a maximum term in excess of 12 months in any part of the UK if it occurred there other than—

(a) an offence under the Gaming Act 1968;

(b) an offence under the Lotteries and Amusements Act 1976, or

(c) an offence under section 23 or 25 of the Financial Services and Markets Act 2000.

So the overseas conduct exemption does not amount to much. In particular, it does not exclude tax offences (the penalty for which exceeds 12 months).

92.13 Professional conduct

The CIOT and ATT issued guidance **("the CIOT guidance")** on 1 December 2011. This provides:

1 [1]Members can only accept a new client who has past tax irregularities on the basis that they will make full disclosure to the member and propose to regularise their tax affairs completely. (Section 4.2 Professional Rules and Practice Guidelines). Members should therefore enquire into the source of the funds in any Swiss account and the existence of other under declarations unrelated to any Swiss account. This is both an ethical and reputational matter for the member and in the best interests of the client, who otherwise remains exposed to HMRC enquiry, higher penalties and, in the worst case, criminal prosecution.

[2] Note that a member would have to refuse to act for a new or existing client who was determined to wait until 2013 before disclosure since in addition to the points mentioned, if HMRC issued Code 9 to the client in the meantime, it would leave the member open to accusations of

> negligence as Liechtenstein Disclosure Facility access would be denied.

I am not sure about point [2]. Negligence is not the issue, as that can be dealt with by appropriate advice. The CIOT guidance continues:

> 2 Where a member is asked to advise an existing client on an undeclared account, the member should consider whether the relationship of trust between the member and the client has broken down and whether the member should continue to act.

The advisor has the opportunity to sack the client if they wish. The guidance continues:[22]

> 4 The member must undertake the usual money laundering identification checks before accepting the client. The profile of these engagements suggests that these individuals are at higher risk than usual of being involved in money laundering, so extra checks may be needed (Regs 7 and 14 The Money Laundering Regulations 2007 and Section 4 CCAB AML guidance with Tax Sector appendix). Both the need for particular care over money laundering identification and the need to ensure that the prospective client genuinely intends to regularise his/her tax affairs suggest that an initial face to face meeting would usually be appropriate.
> 5 It is possible that criminals may use regularisation of their tax affairs as a method to bring illegally acquired funds back into the regular economy, especially in the case of the Liechtenstein Disclosure Facility. The member would need to be satisfied as to the suitability of the client and the account given as to the source of the funds. If the member became concerned that the client may be using regularisation of their tax affairs as a method to bring illegally acquired funds back into the regular economy during the course of the engagement, the member should consider the need to obtain consent from the Serious Organised Crime Agency (SOCA) to proceed with the engagement (Sections 335-336 Proceeds of Crime Act 2002 and Section 8 CCAB AML guidance with Tax Sector appendix).
> 6 A member should only advise within the scope of his own professional competence (Section 5.2 Professional Rules and Practice Guidelines), so should only accept engagements to advise on undeclared income or gains where he/she has sufficient relevant knowledge and experience.
> 7 The member's advice would normally set out the alternatives available to the client. The options of making a traditional disclosure to HMRC

22 There is no para 3.

> or of using the Liechtenstein Disclosure Facility are clearly valid options that correct the past non-disclosure. We will need to be quite clear whether the option of paying the Swiss Withholding Tax (WHT) anonymously is a legal option which corrects the past non-disclosure in each case. There are a number of uncertainties about this which will need to be assessed as further details of the WHT route are published - see points 8, 9 and 10 below.
> 8 We understand that the WHT route will not regularise funds which have passed through the Swiss bank account but been withdrawn before the reference date. We will need to confirm this as details of the WHT arrangements are published.

That seems perfectly clear.

> The WHT route also does not, of course, regularise any matter unrelated to the Swiss bank accounts. Hence in some cases there are matters which would not be regularised by the WHT route and the WHT route would still leave the client with undeclared income or gains. In such cases the member must advise the client to make a disclosure to HMRC and regularise all their tax affairs and cannot recommend the WHT route.
> 9 A member cannot currently advise a client to take no action until the WHT option comes in. The WHT arrangements will not apply until 2013. Hence advising a client to wait for the WHT option implies advising them to submit another fraudulent tax return (the return due by 31 January 2012). It would also leave the client exposed to an HMRC investigation and potential action (up to criminal prosecution in the worst case) for a considerable period of time. This issue has been raised with HMRC.

It seems extraordinary to announce an amnesty in the future without current effect, even for an extraordinary agreement like the STA.

> 10 We will need to confirm what effect the WHT option has on the taxpayer's obligation to make a correct and complete return in future years. It is understood that paying the WHT on future income and gains does satisfy all future tax obligations relating to the Swiss account, but this needs to be confirmed with HMRC.
> 11 Members must comply with the anti-money laundering reporting requirements during the engagement. The privilege exemption would apply in many situations but not in all circumstances, so members should be alert to their reporting obligations throughout the engagement, particularly given the high risk profile of these engagements (Section 330 Proceeds of Crime Act 2002 and Statutory Instrument 2006 No

308; Sections 6 and 7.26 -7.46 of CCAB AML guidance with Tax Sector appendix and Section 12 of the appendix). Examples of instances where reports to SOCA would be necessary would include situations where the member knows or suspects (or has reasonable grounds to know or suspect) that the funds were generated from wider criminal activities or that the client's tax frauds are more extensive than the client has disclosed to the member in order to obtain professional advice.

APPENDIX ONE

TERMINOLOGY

App. 1.1 Introduction

This appendix considers some ubiquitous statutory terms:
- United Kingdom
- Spouse and Civil Partner
- "Living together as husband and wife"
- Child

App. 1.2 "United Kingdom" and related expressions

App. 1.2.1 *"United Kingdom"*

Interpretation Act 1978 Sch 1 provides that "United Kingdom" means Great Britain and Northern Ireland.

The Isle of Man and the Channel Islands do not form part of the UK.

App. 1.2.2 *"Great Britain"*

"Great Britain" means England, Wales and Scotland: s.1 Union with Scotland Act 1706 provides:

> That the two Kingdoms of England and Scotland shall upon the First day of May which shall be in the year 1707 and forever after be united into one Kingdom by the name of Great Britain …

App. 1.2.3 *"England"*

The definition of "England" is not usually an issue for tax. However, for completeness, para 5(a) Sch 2 Interpretation Act 1978 provides:

> in any Act passed before 1st April 1974, a reference to England includes Berwick upon Tweed and Monmouthshire and, in the case of an Act passed before the Welsh Language Act 1967, Wales.

App. 1.2.4 *Territorial sea*

"Territorial sea" extends 12 nautical miles from shore, further defined in the United Nations Convention on the Law of the Sea.

Section 1013 ITA provides:

> The territorial sea of the UK is treated for the purposes of the Income Tax Acts as part of the UK.

Section 276 TCGA and s.830 ICTA make the same point for CGT and corporation tax. Section 172 SSCBA makes the same point for NIC.

There is no equivalent provision in the IHT legislation so the territorial sea is not part of the UK for IHT purposes (though this will not often be important).[1]

App. 1.3 "Spouse" and related expressions

The word "spouse" is used frequently in tax legislation so its meaning is important. The IHT Manual provides:

> **11032. Definition of spouse and civil partner** [July 2011]
> The IHT legislation does not define 'spouse' or 'civil partner' so the definitions come from general law. Consequently, the exemption applies to transfers between people who are lawfully married to each other at the time of the transfer and to transfers between people who are registered as civil partners of each other at the time of the transfer.
> Spouses include
> - people who are legally married but separated
> - parties to a valid polygamous marriage.[2] The marriage confers the Section 18 IHTA 1984 exemption on all transfers to all the spouses of the transferor or deceased who qualify under Section 18 IHTA 1984. Where the Section 18(2) IHTA 1984 limit applies because of foreign domicile of those spouses (IHTM11033), the total exemption (including any similar lifetime exemptions) may not exceed the

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1 This is perhaps a consequence of art 127(1) United Nations Convention on the Law of the Sea: "Traffic in transit shall not be subject to any customs duties, taxes or other charges except charges levied for specific services rendered in connection with such traffic."

2 [Author's note] See CG Manual:
22070 Definitions [March 2006]
A polygamous marriage may be recognised as valid in UK law if it was valid in the country in which the ceremony occurred and, broadly, it was contracted by persons domiciled in that country.

Section 18(2) IHTA 1984 limit of £55,000.[3]

The following are not spouses

- people who are living together but not lawfully married, however long the relationship may have lasted (in England, Wales and Northern Ireland)
- In Scotland the one form of irregular marriage that has been recognised by Scots law is that by cohabitation with habit and repute. This arises where a man and woman cohabit together as husband and wife and behave towards each other as such for a considerable length of time, so it is generally believed by the society and neighbourhood in which they live, and among their friends and relatives that they are married. They are then presumed to be married, although it is impossible to state precisely the place and a time when they exchanged the consent which is essential for marriage. Marriage by cohabitation with habit and repute was abolished by The Family Law (Scotland) Act 2006. It will remain an issue for the Courts for some time to come, however, since claims can still be admitted if based on a period of cohabitation that occurred before the commencement of the Act. If it is claimed that this common law style of marriage entitles the parties to the exemption under Section 18(1) IHTA 1984 in either a death or lifetime situation you should refer the file to Technical.
- parties to a bigamous marriage
- people who were formerly lawfully married but divorced before the date of death/transfer

The argument that discrimination between married and unmarried couples is in breach of Art. 14 ECHR (Prohibition of discrimination) has failed, though only narrowly.[4]

App. 1.3.1 "*Spouse" outside formal legal documents*

UK legislation at present distinguishes between a civil partner and a spouse in its terminology and, strictly, the word "spouse" does not (in the absence of special context) include a civil partner. However for (almost) all practical purposes the two are in the same position and in loose language they are elided.[5] It is tiresome to constantly refer to spouse/civil

3 The text has not yet been updated for the FA 2013 changes.

4 *Holland v IRC* [2003] STC (SCD) 43; *Burden v UK* [2007] STC 252.

5 Under foreign law, a civil partner may not be regarded as married, even though a same sex marriage may be recognised: see 70.12.2 (Meaning of "spouse" in US/UK IHT DTT).

partner. So in the discussion in this book "spouse" is generally used to mean either a spouse or a civil partner. The Law Commission does the same[6] and I expect this is standard usage outside the formal context of statutes and legal documentation such as trust deeds and wills.

App. 1.3.2 *Same-sex marriages*

The Marriage (Same Sex Couples) Act 2013 (**"M(SSC)A"**) provides separate rules for:
(1) existing legislation[7] and
(2) new legislation[8]
I refer to **"pre- and post- M(SSC)A legislation"** which is clearer.
For pre-M(SSC) A legislation, para 1 Sch 3 M(SSC)A provides:

> (1) In existing England and Wales legislation—
> (a) a reference to marriage is to be read as including a reference to marriage of a same sex couple;
> (b) a reference to a married couple is to be read as including a reference to a married same sex couple; and
> (c) a reference to a person who is married is to be read as including a reference to a person who is married to a person of the same sex.
>
> (2) Where sub-paragraph (1) requires a reference to be read in a particular way, any related reference (such as a reference to a marriage that has ended, or a reference to a person whose marriage has ended) is

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6 Law Commission, *Intestacy & Family Provision Claims on Death* (December 2011), para 1.38: "The legal treatment of husbands, wives and civil partners is identical in the law of intestacy and family provision claims, and for brevity we use the term "spouse" in this Report to refer to all three..."

7 Section 11(7) M(SSC)A provides a definition: "In Schedules 3 and 4 "existing England and Wales legislation" means—
(a) in the case of England and Wales legislation that is primary legislation, legislation passed before the end of the Session in which this Act is passed (excluding this Act), or
(b) in the case of England and Wales legislation that is subordinate legislation, legislation made on or before the day on which this Act is passed (excluding legislation made under this Act)".

8 Section 11(7) M(SSC)A provides a definition: "In Schedules 3 and 4 ...
"new England and Wales legislation" means—
(a) in the case of England and Wales legislation that is primary legislation, legislation passed after the end of the Session in which this Act is passed, or
(b) in the case of England and Wales legislation that is subordinate legislation, legislation made after the day on which this Act is passed."

to be read accordingly.
(3) For the purposes of sub-paragraphs (1) and (2) it does not matter how a reference is expressed.

For post-M(SSC)A legislation, para 5(1) sch 3 M(SSC)A provides:

(1) This paragraph applies to provision made by—
(a) this Act and any subordinate legislation made under it, or
(b) new England and Wales legislation,
including any such provision which amends existing England and Wales legislation.

Three sets of definitions follow. The first concerns the ubiquitous terms husband/wife/widow/widower:

(2) The following expressions have the meanings given—
(a) "husband" includes a man who is married to another man;
(b) "wife" includes a woman who is married to another woman;
(c) "widower" includes a man whose marriage to another man ended with the other man's death;
(d) "widow" includes a woman whose marriage to another woman ended with the other woman's death;
and related expressions are to be construed accordingly.

The other definitions concern expressions found only after the M(SSC)A:

(3) A reference to marriage of same sex couples is a reference to—
(a) marriage between two men, and
(b) marriage between two women.
(4) A reference to a marriage of a same sex couple is a reference to—
(a) a marriage between two men, or
(b) a marriage between two women.

I do not know why a distinction is drawn between pre- and post-M(SSC)A legislation. The Act's explanatory notes discuss the provisions without answering this question.[9] For instance, the definition of "relevant

9 103.Part 1 sets out details of how particular terms used in existing legislation in England and Wales are to be read once marriage of same couples becomes possible. The particular terms mentioned in paragraph 1 are references to a marriage, a married couple or married person in existing legislation in England and Wales; these are to be read as also referring to a marriage of a same sex couple, married same sex couples or to a person married to someone of the same sex.
104.Under paragraph 1(2), such references are also to be read across to, for example, cases where a marriage has ended. A reference to a person as a widow would be read

as including a reference to a woman whose marriage to another woman ended with the other woman's death, for example.

105.Paragraph 1(3) ensures that existing England and Wales legislation will be interpreted in accordance with paragraphs 1(1) and (2) no matter what language it uses in making reference to any of the relevant concepts.

106.Paragraph 2 particularly deals with references to couples living together as if married; these are to be read as also referring to a person who is living with someone of the same sex as if they are married.

107.Paragraph 3 deals with legislation where there is existing provision which deals differently with a man and a woman living together as if married, and a same sex couple living together as if civil partners. The effect of this paragraph is to preserve the current effect for same sex couples despite the introduction of marriage of same sex couples. In other words, the current distinction is maintained by which an unmarried opposite sex couple are treated as if married, while an unmarried same sex couple not in a civil partnership are treated as if in a civil partnership.

108.Paragraph 4 ensures that the terms specified in Part 1 of Schedule 3 are not the only terms whose meaning will change once marriage of same sex couples becomes possible.

Examples

• Section 105(1) of the Children Act 1989, as amended, defines the meaning of "child of the family" for the purposes of that Act:

"'child of the family', in relation to parties to a marriage, or to two people who are civil partners of each other, means –

(a) a child of both of them, and

(b) any other child ... who has been treated by both of them as a child of their family;".

The effect of paragraph 1(1)(a) of Schedule 3 means that the reference to "parties to a marriage" is to be interpreted now as including a reference to a marriage of a same sex couple.

• Section 144(4) of the Adoption and Children Act 2002 defines the meaning of "a couple" for the purposes of that Act:

"In this Act, a couple means –

(a) a married couple, or

(aa) two people who are civil partners of each other, or

(b) two people (whether of different sexes or the same sex) living as partners in an enduring family relationship.".

Paragraph 1(1)(b) allows for the reference here to a married couple now to include a married same sex couple.

• Section 2(1) of the Offices, Shops and Railway Premises Act 1963 as amended states that: "This Act shall not apply to any premises to which it would, apart from this subsection, apply, if none of the persons employed to work in the premises is other than the husband, wife, civil partner .....of the person by whom they are so employed." The terms "husband" and "wife" here refer to a person who is married for the purposes of paragraph 1(1)(c) of Schedule 3. This means that "husband" here will be read as including a man or a woman in a marriage of a same sex couple, as well as

person" in the ITA remittance basis includes "the individual's husband or wife."[10] In new legislation that wording would include parties to a same-sex marriage. By normal rules of construction, that should not apply to pre-M(SSC)A legislation! That would be a very strange result indeed. It is suggested that the Courts should apply a commonsense approach, that (where the context requires, as it normally will) references in pre-M(SSC)A legislation to husbands and wives should include same sex spouses, even though that essentially requires one to ignore the words of schedule 3. This is consistent with s.11 M(SSC)A:

> (1) In the law of England and Wales, marriage has the same effect in relation to same sex couples as it has in relation to opposite sex couples.
> (2) The law of England and Wales (including all England and Wales legislation whenever passed or made) has effect in accordance with subsection (1).

In Northern Ireland, a same-sex marriage has the status of a civil partnership,[11] which for tax (as generally) has the same consequences as marriage. In Scotland the position is governed by the Marriage and Civil Partnership (Scotland) Act 2014.

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a man married to a woman. In a similar way, "wife" will be read as including a woman married to another woman or a man married to a man. The result is that this section is to be read as including both male and female spouses in marriages of same sex couples.

Part 2 – New England and Wales legislation

109. Part 2 governs how new legislation made after the passing of this Act is to be interpreted. It sets out the meanings of specific words relating to marriage (such as "husband" and "wife"). It reflects the main principle of the Act, which is to put marriage of same sex couples on an equal footing with marriage of opposite sex couples. This will ensure that gender-specific terms such as "husband" keep their gender-specific effect.

110. It should be noted that in Part 7 of Schedule 4, paragraph 27 provides a power for the Secretary of State to modify or disapply the provisions of Schedule 3 in specified circumstances.

Example

• The term "husband" will in future legislation include a man who is married to another man (but not a woman married to another woman); and "wife" will include a woman who is married to another woman (but not a man married to another man) unless specific alternative provision is made.

10 See 11.4 (Relevant person: close family).

11 Schedule 2 M(SSC)A 2013.

App. 1.3.3 *Cross references*

For the definition of "spouse" in special contexts, see:
27.3.4 (Meaning of "spouse/civil partner" in settlor-interested trust provision)
70.12.2 (Meaning of "spouse" in US/UK IHT DTT)

App. 1.4 Meaning of "civil partner"

Schedule 1 Interpretation Act 1978 provides:

> "Civil partnership" means a civil partnership which exists under or by virtue of the Civil Partnership Act 2004 (and any reference to a civil partner is to be read accordingly).

This takes us to s.1(1) Civil Partnership Act 2004 which provides:

> A civil partnership is a relationship between two people of the same sex ("civil partners")—
>
> (a) which is formed when they register as civil partners of each other—
>
> (i) in England or Wales (under Part 2),
>
> (ii) in Scotland (under Part 3),
>
> (iii) in Northern Ireland (under Part 4), or
>
> (iv) outside the United Kingdom under an Order in Council made under Chapter 1 of Part 5 (registration at British consulates etc. or by armed forces personnel), or
>
> (b) which they are treated under Chapter 2 of Part 5 as having formed (at the time determined under that Chapter) by virtue of having registered an overseas relationship. ...

Thus there are two types of civil partnership:
(1) those made under UK law, and
(2) overseas relationships.

App. 1.4.1 *Overseas relationships treated as civil partnerships*

Section 212(1) CPA 2004 provides:

> For the purposes of this Act an overseas relationship is a relationship which—
>
> (a) is either
>
> [i] a specified relationship or
>
> [ii] a relationship which meets the general conditions, and
>
> (b) is registered (whether before or after the passing of this Act) with a responsible authority in a country or territory outside the

United Kingdom ...

Thus there are two types of overseas relationships:
(1) specified ones, and
(2) those not specified which meet the general conditions.

Section 213 and schedule 20 CPA 2004 defines "specified relationships":

Country or territory	**Description**
Andorra	uni estable de parella
Argentina	marriage
Argentina: Autonomous City of Buenos Aires	unión civil
Australia: Australian	
Capital Territory	civil partnership
New South Wales	a relationship registered under the Relationships Register Act 2010
Queensland	civil partnership
Tasmania	significant relationship
Victoria	registered domestic relationship
Austria	eingetragene Partnerschaft
Belgium	cohabitation légale, wettelijke samenwoning or gesetzliches zusammenwohnen; marriage
Brazil	marriage; união estável
Canada	marriage
Manitoba	the relationship referred to as common-law relationship or as union de fait
Nova Scotia	domestic partnership
Quebec	union civile or as civil union
Colombia	unión de hecho
Czech Republic	registrované partnertsví
Denmark	marriage; registreret partnerskab
Ecuador	unión civil
Finland	rekisteröity parisuhde or as registrerad partnerskap
France	pacte civile de solidarité
Germany	Lebenspartnerschaft
Greenland	the relationship referred to as nalunaarsukkamik inooqatigiinneq or as registreret partnerskab
Hungary	bejegyzett élettársi kapcsolat
Iceland	marriage; staðfesta samvist
Ireland	civil partnership
Isle of Man	civil partnership
Jersey	civil partnership
Liechtenstein	eingetragene Partnerschaft
Luxembourg	partenariat enregistré or eingetragene partnerschaft
Mexico:	
Coahuila	pacto civil de solidaridad

Mexico City Federal District	marriage; sociedad de convivencia
Netherlands	geregistreerde partnerschap; marriage
New Zealand	civil union
Norway	marriage; registrert partnerskap
Portugal	marriage
Slovenia	zakon o registraciji istospolne partnerske skupnosti
South Africa	civil partnership; marriage
Spain	marriage
Sweden	marriage; registrerat partnerskap
Switzerland	the relationship referred to as eingetragene Partnerschaft as partnenariat enregistré or as unione domestica registrata
USA:	
California	domestic partnership; marriage
Colorado	the relationship between designated beneficiaries
Connecticut	civil union; marriage
Delaware	civil union
Columbia	marriage
Hawaii	civil union; reciprocal beneficiary relationship
Illinois	civil union
Iowa	marriage
Maine	domestic partnership
Massachusetts	marriage
Nevada	domestic partnership
New Hampshire	marriage
New Jersey	civil union; domestic partnership
New York	marriage
Oregon	domestic partnership
Rhode Island	civil union
Vermont	civil union; marriage
Washington	state registered domestic partnership
Wisconsin	domestic partnership
Uruguay	unión concubinaria

Section 214 CPA 2004 explains the "general conditions":

> The general conditions are that, under the relevant law—
>
> (a) the relationship may not be entered into if either of the parties is already a party to a relationship of that kind or lawfully married,
>
> (b) the relationship is of indeterminate duration, and
>
> (c) the effect of entering into it is that the parties are—
>
> (i) treated as a couple either generally or for specified purposes, or
>
> (ii) treated as married.

App. 1.4.2 *Pre-2000 civil partnerships under foreign law: Transitional rules*

Section 215 CPA 2004 provides:

> **215 Overseas relationships treated as civil partnerships: the general rule**
> (1) Two people are to be treated as having formed a civil partnership as a result of having registered an overseas relationship if, under the relevant law, they—
> (a) had capacity to enter into the relationship, and
> (b) met all requirements necessary to ensure the formal validity of the relationship.
> (2) Subject to subsection (3), the time when they are to be treated as having formed the civil partnership is the time when the overseas relationship is registered (under the relevant law) as having been entered into.
> (3) If the overseas relationship is registered (under the relevant law) as having been entered into before this section comes into force, the time when they are to be treated as having formed a civil partnership is the time when this section comes into force.

Persons with existing overseas relationships became civil partners in England law without doing anything more.

App. 1.4.3 *The future*

Civil partnerships are now subject to a review whose terms of reference include an assessment of the need for civil partnerships now that same-sex marriage is available.[12] Abolition of civil partnerships would be a worthwhile simplification; but it remains to be seen whether that is achievable now, or must wait a generation.

App. 1.5 "Living together as husband and wife"

The Claimant Compliance Manual provides:

> **15040 Couples who are Unmarried and Not Civil Partners** [April 2010]
> ... The legislation does not say what conditions must exist before we will conclude that a couple are LTAHAW [living together as husband and wife]. We have therefore adopted the approach used by the DWP. Using the same approach for same-sex couples means they are not treated any more or less favourably. Since 1977 the Department for Work and Pensions (DWP - formerly the Benefits

12 *https://www.gov.uk/government/publications/civil-partnerships-review-terms-of-reference-and-timetable*

Agency) has followed a standard approach to the question of whether a man and woman are living together based on a list of criteria to be considered both individually and as a whole. Working Families' Tax Credit (WFTC) adopted the same criteria and this has continued for WTC and CTC. This approach ensures unmarried couples are not treated any more or less favourably than married couples.

Living together as husband and wife (LTAHAW) has its normal meaning in every day language, but the Courts and administrative practice have developed a number of criteria to help apply that meaning to every day situations. They are:-

- living in the same household - CCM15070-CCM15075
- stability of relationship - CCM15080
- financial support - CCM15090
- dependent children - CCM15100
- public acknowledgement - CCM15110

Remember that these are only indicators to help you form a sustainable view of whether a couple are living together for the purposes of the tax credit claim. They are not intended as a crude checklist and you should not apply a blanket "four out of five ticked" type test. The weight and worth of each indicator will vary from relationship to relationship and you should arrive at your conclusions on the balance of evidence, based on the facts (see CCM15060). However, you need to be aware of the changing nature of relationships - see CCM15045.

15045 Modern-Day Relationships [April 2010]

Since the LTAHAW criteria was devised in the 1970's, the United Kingdom has undergone major social and economic changes. These have had an impact on the nature of personal relationships.

In the 1970's a typical couple might not have lived together before marriage and, after marrying, they might have pooled the whole of their income with the man as the main breadwinner and the woman possibly working part-time and responsible for childcare and running the household.

By 2004, 70% of first domestic partnerships involved unmarried couples and it is now common for each party in a couple to work full-time, keep their own incomes and bank accounts and perhaps only pay money into a joint account for items of joint responsibility. Often because of demands on time both parties share childcare and domestic tasks.

It may therefore be more difficult to identify the criteria shown at CCM15040 but you should still explore all of these items.

15060 Balance of Evidence [February 2013]

It is not possible to lay down hard and fast rules about the weight and worth of the various criteria in establishing that a couple are living together. You will need to decide every case on its merits and on the balance of evidence. Sometimes the conclusion will be obvious, and at other times it will be a very fine judgement. Although you must consider each of the five criteria listed at CCM15040 you might not be able to gather evidence for each of them. For example the customer might say they have no idea what others think of their relationship.

If you are having difficulties in making up your mind about what the evidence

means, you may find it helpful to list the evidence on both sides of the argument. This should help you identify where the balance of evidence lies – though you should not base your decision on a crude numerical assessment, as some elements of the evidence may be far more critical than others.

If you still cannot decide, you may want to discuss the issues with your manager, or with another colleague in your team. If the issues are particularly difficult, you may, after consulting your manager, want to refer to your Claimant Compliance Group Manager.

Where there is no reply to your opening letter – see CCM15370.

15070 Living in the Same Household [February 2013]

The customer may admit they live in the same household as the suspected partner but that does not automatically mean they are Living Together as Husband and Wife (LTAHAW) or Living Together as Civil Partners (LTACP).

There may be any number of reasons why a man and woman share accommodation. They include:

- a couple with disabilities or ill health may care for and support each other
- one of them may require care/support to live a normal life
- the customer may provide accommodation for a friend, or relative or tenant
- the customer may have been provided with accommodation by a friend, relative or landlord in that person's own home.
- a formerly married or unmarried couple may still live in the same house until they reach a financial agreement. During periods when property prices or rents are high, the property market is sluggish, or negative equity is common, former couples may be compelled by economic necessity to share the same premises for some time after the relationship has ended- see CCM15395

The relevant factors to consider when determining whether a couple are living in the same household may be:-

- how/why the couple came together
- is rent received or paid? If so the income will (unless it is exempt under the rent a room scheme) be treated as income in the hands of the recipient.
- what kind of accommodation they share
- if there is no formal rent agreement how are costs shared? How would exceptional expenditure be met? For example, if major unexpected repairs had to be carried out or home improvements made.
- any absences from the household - why and how often - see CCM15073
- any other reasons for them living in the same household.

Even if you establish a couple are living in the same house this does not necessarily mean they are LTAHAW or LTACP. Before you can amend the award you must therefore consider the other criteria detailed at CCM15080-CCM15110.

15073 Absences From The Home [February 2013]

Absences from the home, whether occasional or regular, do not necessarily mean that a couple is not LTAHAW or LTACP. For instance, the absence could be due to:-

- work (eg. oil rig worker or long distance lorry driver)
- hospital in-patient
- holiday

- visit to relatives
- higher education
- custody of less than 52 weeks
- armed forces

This list is not exhaustive, but gives some suggestions to the types of absence. The common feature of all of these reasons for absence is their temporary nature. There is no specific period of time after which an absence ceases to be temporary and you will need to draw conclusions based on the particular facts of each case. Factors to be considered include:

- the length of the absence
- how much longer it is expected to last
- to what extent the couple have maintained contact
- their future intentions

One situation you might encounter is where the partner works away for a few days at a time and either lives with friends or in hotels/bed and breakfast accommodation. They only return to the customer's home for a couple of days at a time, the suggestion is this is purely to see the children and they stay at the customer's home as they have nowhere else to stay in the area. As well as exploring the other criteria described in CCM15080-CCM15110 you will need to establish

- the reason why they have this arrangement
- how long has the arrangement lasted
- how much longer is it likely to last?
- what would happen if the partner lost their job?

15075 Undisclosed Partner has No Other Address [February 2013]

A customer may accept that the suspected partner uses their address for mailing purposes. This could be for:

- tax and benefit purposes
- financial purposes (bank account, credit card, loan)
- for motor vehicle purposes (insurance, vehicle registration)

The customer might suggest this is because the suspected partner has no fixed abode and simply drifts around a series of friends or because their mail is not secure at their own home.

You are entitled to ask for evidence of the suspected partner's other accommodation address and often an appeal tribunal will ask for this sort of information. However, you cannot demand that they provide such information nor can you say that if they do not provide evidence of an alternative address you will treat them as LTAHAW or LTACP and terminate their award.

The absence of such evidence is not conclusive proof that the customer is living with the suspected partner. Where the customer cannot provide such evidence you must still look at all of the other criteria and decide their various strengths and weaknesses. In addition, you should consider whether it is reasonable for the suspected partner to be using the customer's address.

15080.Stability of Relationship [April 2010]

The length of time a couple have been together does not necessarily indicate how stable the relationship is. At one end of the scale you may come across couples who have known each other only a few weeks or days, but who have moved in

together with the firm intention of staying together.[13] At the other end of the scale may be couples who have divorced after say 25 years of marriage and who are still both occupying the formal marital home until they can afford to live apart. Some couples may also have a history of repeated temporary splits and reconciliations.

Relevant factors may be: –

- on what basis they split household chores and responsibilities, such as cooking, cleaning and paying bills
- whether they are both involved in caring for any children who live in the household
- whether they tend to spend their leisure time together or separately
- whether they normally take joint holidays
- whether they plan any future activities or responsibilities jointly or separately
- whether they intend to get engaged or married
- whether the relationship has a volatile history ie. the couple is known to have had several splits and reconciliations.

An established pattern of domestic or financial activity will usually indicate an established relationship.

15090 Financial Support [February 2013]

How a couple organise their finances will vary from couple to couple. Relevant factors may be:

- the existence of joint accounts or investments. If the customer claims that the joint account is being maintained because one of them is credit blacklisted, does the pattern of transactions suggest that the other person is withdrawing his/her wages for their own use? Or are there indications that the wages are available to meet general household expenditure?
- the extent to which money and other financial resources are pooled.
- who pays the household expenses?
- whether the suspected partner makes regular payments to the customer, and if so, what they are for.
- whether the suspected partner would provide financial support if the customer's income ceased.
- whether the customer would support the suspected partner if their income ceased.
- whether a set amount of maintenance to be paid by the absent parent following a decision by the CSA or a binding agreement between the parties.

At any meeting you should attempt to establish the customer's incomings and outgoings so that you can see whether they could exist on their own income. If you have already seen bank statements and household bills you should be ready to challenge suspect items. For example deposits into the bank account, direct

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13 The RDR Manual makes the same point:

33030. Relevant person - definition [July 2010]

... There is a no minimum period for cohabitation; it is a question of fact as to whether two individuals are living together as spouses or civil partners.

debits, patterns of withdrawal or any expenses for which you would have expected to see bills but none have been produced.

15100 Dependent Children [February 2013]

Joint responsibility for a child or children (who may belong to either or both of the couple) may be an indication that the couple is LTAHAW or LTACP, but it is not conclusive proof. Relevant factors may be:

- parentage of the child or children.
- whether, and how, the couple exercises joint responsibility, for example:
  - who visits the school or delivers/collects to and from the school
  - who would the school contact in an emergency
  - who arranges and takes the children to and from medical and dental appointments
  - who exercises control of or offers guidance to the children
  - who the Child Benefit Office has as the alternative payee
  - who provides financial support/pocket money/pays for treats
  - who buys the clothes and or toys.

An intention to adopt by the non-birth partner could be a particularly telling indication of the couple's long term view of the family unit. You should not, because of its sensitivity, seek out the information; but if it is spontaneously offered you should give it proper weight in arriving at your conclusions. Be wary of drawing conclusions about the current relationship based on say the fact that the children continue to be known by the surname of the ex-husband or ex-partner as this is common practice and is not evidence of a continuing relationship between the parents. Nor does the presence of photographs of the child's father or mother indicate the customer is living with that person.

15110 Public Acknowledgement [February 2013]

An important consideration is how the outside world (including family, friends, neighbours, social workers, employers, schools, childcare providers, etc.), perceive the couple. Relevant factors may be:

- Whether both members use the same surname
- Whether schools/child care providers/employers/others regard them as a couple
- Whether they engage in social activities together
- Whether they are joint members of clubs/leisure centres/societies
- Whether they plan and organise their lives jointly.

CCM5500 lists the third parties you can legally approach for information during the course of your examination. You cannot obtain information from family members, friends, neighbours, social workers or schools, unless they also fall into one of the categories listed at CCM5500.

For example – A family member may also be an employer, or a neighbour may also provide registered child care. But it is perfectly acceptable for you to ask the customer what their family/neighbours etc. would say if they were asked whether they regarded him/her as being a member of a couple.

15120 Sexual Relationship [February 2013]

DWP used to consider the couple's sexual relationship as one of the criteria for determining LTAHAW but this is no longer the case. The couple's sexual relationship is of little help in deciding whether they are living together as

husband and wife or living together as civil partners. There may be no sexual relations in a marriage or civil partnership and sexual relationships of a casual nature, where neither partner has any lasting commitment to the other, are a common feature of contemporary life.

You must not ask any questions about a couple's sexual relationship. If the customer introduces the subject, you should take note of any information volunteered but should bear in mind (and explain to the customer) that it is unlikely to have any relevance to the question of whether they are living together as husband and wife.

Appeal tribunals sometimes ask customers about their sexual relationships, however, it remains our policy that you must not ask such questions. If a tribunal asks you why you have not established the position you should say that our internal policy, in common with that in DWP, is not to ask about this side of the relationship.

In one particular appeal case the Social Security Commissioner said that where there has never been a sexual relationship between the parties, strong alternative grounds are needed to reach the conclusion that the relationship is akin to husband and wife. However, absence of a sexual relationship at anytime where there has been one in the past is not itself indicative that the couple are not LTAHAW.

Where the customer's sole objection to your conclusion is that they have no sexual relationship with the suspected partner or they appeal against a decision on these grounds you should seek further advice via your TALLO from Technical Advice Line.

15150 Reasons for Failure To Report A Partner [February 2013]

Customers may offer a range of reasons or excuses for their failure to report the existence of a partner. These may include:

- S/he does not stay here all of the time - see CCM15073.
- S/he lives at another address but uses my address as a post box - see CCM15075.
- I thought s/he could stay 3 nights a week without it affecting my entitlement.
- S/he does not give me any money, or payments are not regular - see CCM15090.
- S/he is not the mother/father of my child (ren).
- S/he is a lodger - see CCM15070.
- S/he is just a friend.
- It is hard being a single parent.
- The Government does not pay people like me enough.
- The rules on income are not fair.
- We do not have a sexual relationship - see CCM15120.

The 3 nights rule is a popular misconception. No such legal loophole exists. If a suspected partner spends 3 nights with the customers on a regular basis, s/he may be a member of an established couple. Also, the children's parentage is not, in isolation, reliable evidence.

You will need to explain to the customers the criteria which we use to determine whether they are living together as husband and wife or living together as civil partners - see CCM15040. You will then need to establish the facts by

considering all the evidence from all legally available sources, including the customer.

15160 Respecting Customer's Privacy [February 2013]

In all your contacts with customers you must always be aware of Human Rights issues, and of the need to respect the customer's privacy. It is particularly important that you adopt this approach in any discussions which may touch on their private life.

You should avoid any impression that you are examining the customer's home or household for signs of any such relationship. You must not ask about the customer's sleeping arrangements in an attempt to find out whether s/he shares a bedroom with another adult.

Customers may however volunteer information of this kind when, for example, confirming the number of children who live there; describing how friends or relatives sometimes stay to help out with childcare or explaining that their ex-partners stays in the spare room whenever they come to visit the children. If the customer simply says their partner stays overnight when they come to visit or care for the children you must not ask where they sleep.

You should not normally ask customers about the number of bedrooms in their house but if the customer has suggested that an adult who lives in the house is a paying lodger, it is reasonable to expect the lodger would have his/her room rather than sleeping on a sofa or floor.

In the circumstances it will be appropriate to ask how many bedrooms there are and what room(s) the lodger occupies, and to test the answer in the light of other information/evidence. The number of bedrooms and the ages/sexes of the other occupants of the house will be relevant. For example the customer may live in a 3 bedroom house with 2 children, a boy of 12 and a girl of 16, and it will be reasonable to ask what arrangements have been made so that the lodger can occupy his/her own room.

It is important that any questions you need to ask should be directed at establishing the room the lodger occupies and their relationship with the customer and not at establishing who the customer sleeps with.

15170 (This text has been withheld because of exemptions in the Freedom of Information Act 2000) [February 2013]

15180 (This text has been withheld because of exemptions in the Freedom of Information Act 2000) [February 2013]

15190 Customer Has Been Involved in Different Relationships [February 2013]

Where the customer has been involved in relationships with different partners at different times during the year, you should treat the ending of one and beginning of another as a CoC on each occasion. However, where the customer has split up and reconciled with the same partner, you should normally ignore the splits and treat the customer and partner as a couple throughout the period.

If the customer objects to this approach you should consider whether in spite of the temporary break in the relationship, the customer and partner would still be considered a couple in accordance with other relevant criteria eg. nature of any financial support. If you cannot establish that the couple were effectively living together throughout the period, you should apply the CoC provisions to each

break in the relationship.

15195 Date on which Customers Became A Couple [February 2013]

The question of whether the customer was in reality a member of a couple is not just relevant to the date at which the claim commenced. Becoming or ceasing to be a member of a couple is a notifiable change of circumstances so it is also relevant at all other times during the year.

You will sometimes have evidence that places the suspected partner at the customer's address at one or more dates during the year for example a series of letters signed by the partner to his/her employer or tax office. However, you may not be able to point to anything which strongly indicates their presence at the beginning of the year or claim period.

When challenged about the existence of a partner, customers may be reluctant to admit to their failure to declare the partner on the claim, claiming instead that s/he only moved in some time later.

You will need to use your judgement in these cases. As a general rule if you are confident the evidence you have is reasonable proof that the customer was a member of a couple from the date the claim commenced, you should put that date forward to the customer. If you feel there is some doubt around that date, or you would have difficulty in substantiating it, but you are convinced that the customer was a member of a couple at some point during the year, you should propose to the customer an appropriate date from which they should be treated as a member of a couple. You should be prepared to negotiate the date with the customer bearing in mind the important factor of getting the claim on the right basis for the future. However, you must remember that your decision may have to be defended before an appeal tribunal so you must have evidence to support the proposal.

15200 Information held by HMRC [February 2013]

A case identified for enquiry on the grounds of a suspected undisclosed partner will usually have been selected because information held by us indicates another adult living at the customer's address. The CCRO will have checked HMRC and other databases and other available information sources, before passing the case to you. You will therefore already have most of the evidence you will want to discuss with the customer before you open the case.

The information is likely to include some or all of the following sources.

Type	**Identifies**
Voter's List	Suspected partner listed?
HMC address database	What address does the HMRC hold for suspected partner?
Telephone Directory	What address/phone number is listed for suspected partner?
Yellow Pages/Other	Ditto for self employed suspected partner.
SA	Ditto for self employed suspected partner.
TRP Data Mart	Any joint bank accounts etc, listed?
COP/CODA	Any additional allowances?
Child Benefit	Partner shown on original claim/as alternative payee?
Previous Claims	Was partner shown on earlier WFTC/DPTC/WTC/CTC claims?
Equifax/Experian	Is suspected partner shown at customer's address?

DWP	Intelligence suggesting a live-in partner?
CSA	Maintenance paid? Reference to partner in interview notes.
Housing or Council Tax Benefit	Details of occupants. CT reduction for single adult being Received?
Letters on File	Any indication (particularly recent) of suspected partner living at customer's address?

15210. Information from Customer [February 2013]

Despite the information that will have been given to you by the CCRO there will also be information you can only obtain from the customer or with the customer's agreement, for example:

- Bank statements - are they joint? If not, do they contain evidence of joint incomings/outgoings/spending?
- Utilities and other bills - who are these sent to?
- Council tax bills - a single occupier is entitled to a reduction, which will be identified on the statement.
- Mortgage claims/statement - whose name appears on any documentation?
- Rent book - whose name appears in the book as landlord and tenant?
- Hire purchase agreements - whose name is on the documents?
- Services and rentals eg. TV, satellite, telephone agreements - whose name are they in?
- Marriage certificate - does it show a recent marriage to the suspected partner?

(This text has been withheld because of exemptions in the Freedom of Information Act 2000)

15220 Short Term Relationships [February 2013]

In some cases the customer might admit they had a partner during the period under review but says they are no longer a couple. You will need to review the facts to establish whether they are in fact still a couple.

Where the customer admits to a short term relationship which you accept has now ended you will need to decide whether the relationship amounted to them living together as husband and wife (LTAHAW) or living together as civil partners (LTACP). You will need to explore the criteria at CCM15040.

There are no hard and fast rules as to the length of time a couple are together before we consider it to be LTAHAW or LTACP. If they are LTAHAW or LTACP then we will treat them as a couple for tax credit purposes even if they are only together a short time. However, in reality a short term relationship (less than 3 months) is unlikely to meet the criteria at CCM15040. They may satisfy one of the criteria but not the others. In such cases you will have to use your judgement and you should consult your manager if necessary. Remember your decision may have to be defended before an appeal tribunal so you must have evidence to support the proposal.[14]

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14 Earlier versions of this guidance are (1) The Independent Taxation Manual (paragraphs now withdrawn) and (2) the ACG–WFTC/DPTC Applicant Compliance Guide para 9010 (not set out here as it adds nothing to the Claimant Compliance Manual). The text is in the 9th ed of this work.

The Law Commission consultation paper "Intestacy and Family Provision" (October 2009) has some useful comments:

> 2.70 The requirement that the applicant should have been living "as" the spouse or civil partner of the deceased has been the subject of analysis by the courts. In *Re Watson*, it was said that the test is:
>
> > whether, in the opinion of a reasonable person with normal perceptions, it could be said that the two people in question were living together as husband and wife; but, when considering that question, one should not ignore the multifarious nature of marital relationships.[15]
>
> 2.71 Accordingly, it was not determinative in that case that Mr Watson and Miss Griffiths had not continued a sexual relationship during the period when they were living together, nor that they had informally agreed to share outgoings, nor that Miss Griffiths had rejected Mr Watson's marriage proposal. On the whole of the evidence the judge reached the conclusion that Miss Griffiths had been living "as the wife" of Mr Watson.
>
> 2.72 The couple must have been living in the same household, which means that it does not matter if the parties each have a separate home, provided that they have formed one joint household. It has been said that this seems:
>
> > To have elements of permanence, to involve a consideration of the frequency and intimacy of contact, to contain an element of mutual support, to require some consideration of the degree of voluntary restraint upon personal freedom which each party undertakes, and to involve an element of community of resources.[16]

The Law Commission also consider the salacious possibility that an individual may have more than one cohabitee:

> 4.108 ... where the deceased was a party to more than one cohabiting relationship at the date of death, it may be more difficult to determine whether the deceased "was sufficiently involved in either household for

15 [Footnote original] [1999] 1 FLR 878, 883, by Lord Neuberger of Abbotsbury.

16 [Footnote original] *Churchill v Roach* [2002] EWHC 3230, [2004] 3 FCR 744, 761. See also *Kotke v Saffarini* [2005] EWCA Civ 221, [2005] 2 FLR 517, a case on similar wording in section 1(3)(b) of the Fatal Accidents Act 1976, where the Court of Appeal held at [59] that it was correct to distinguish between "wanting and intending to live in the same household, planning to do so, and actually doing so".

one or both to amount to cohabitation at all".[17] However, cases may arise in which it can be shown that both partners are cohabitants within the definition adopted, for example where there are religious marriages which do not qualify as legal marriages.

App. 1.5.1 *Prohibited Relationships*

The Claimant Compliance Manual provides:

> **15025 Prohibited Relationships** [February 2013]
> The law prohibits certain relationships by relatives. For example a woman cannot marry or form a civil partnership with her grandfather or her uncle and a man cannot marry or form a civil partnership with his daughter or sister. A full list of prohibited relationships is contained at CCM15030.
> Where you establish that a customer is living as a couple with a relative who appears on the list of prohibited relationships we do not consider this to be an LTAHAW or LTACP situation. The reason for this is that the couple cannot marry or become civil partners in law so we cannot say they are living together as husband and wife as they could never be husband and wife or living together as civil partners as they could never be civil partners. The customer will therefore be treated as a single customer.
> **15030 List of Prohibited Relationships - Marriage** [February 2013]
> Throughout the United Kingdom and Guernsey, Jersey and the Isle of Man, the law prohibits certain blood relatives, step relatives and relatives-in-law from getting married.
> A man cannot marry his:
> • mother
> • adopted mother/ former adoptive mother
> • daughter
> • adoptive daughter/ former adoptive daughter
> • grandmother
> • granddaughter
> • sister
> • aunt
> • niece
> A woman cannot marry her:
> • father
> • adopted father/ former adoptive father
> • son
> • adoptive son/ former adoptive son
> • grandfather
> • grandson
> • brother

17 [Footnote original] Cohabitation: the Financial Consequences of Relationship Breakdown (2007) Law Com No 307, para 3.68.

- uncle
- nephew

Additionally, people cannot marry if:

- either of them is aged less than 16, or
- in a 'step' relationship, the younger person had, before reaching age 18:
- lived in the same household as the older person, and/or
  - – been treated as a child of the older person's family, or
- in an 'in-law' relationship:
  - – either person involved is aged less than 21, and/or
  - – any person originally involved in creating the 'in-law' relationship' is still alive, for example we do not consider LTAHAW if a man lives in the same household as his daughter-in-law and the man's son or wife is still alive.

If you are unsure whether the customer is in a prohibited relationship you should seek further advice from the Benefits and Credits Technical Team in Preston.

15032. List of Prohibited Relationships - Civil Partners [April 2010]

The law in the United Kingdom prohibits certain blood relatives, step relatives and relatives by civil partnership from forming a civil partnership. The legislation in Scotland is slightly different from the legislation that applies in England, Wales and Northern Ireland.

In England, Wales and Northern Ireland someone cannot form a civil partnership with their:

- parent
- adopted parent/ former adoptive parent
- child
- adoptive child/ former adoptive child
- grandparent
- grandchild
- brother, sister, half-brother or half-sister
- parent's brother, sister, half-brother or half-sister
- niece or nephew

Additionally, someone cannot form a civil partnership with the:

- Child of former civil partner
- Child of former spouse
- Former civil partner of grandparent
- Former civil partner of parent
- Former spouse of grandparent
- Former spouse of parent
- Grandchild of former civil partner
- Grandchild of former spouse

If:

- either of them is aged less than 21, or
- the younger person had, before reaching age 18:
- lived in the same household as the older person, and/or
- been treated as a child of the older person's family, or

Additionally, someone cannot form a civil partnership with the:

- Child of former civil partner
- Child of former spouse

- Former civil partner of parent
- Former spouse of parent

If:

- either person involved is aged less than 21, and/or
- any person originally involved in creating the relationship is still alive, for example we do not consider LTACP if a woman lives in the same household as her daughter-in-law and the woman's son or husband is still alive.

In Scotland someone cannot form a civil partnership with their:

- parent
- adopted parent/ former adoptive parent
- child
- adoptive child/ former adoptive child
- grandparent
- grandchild
- brother, sister, half-brother or half-sister
- parent's brother, sister, half-brother or half-sister
- niece or nephew

Additionally, someone cannot form a civil partnership with the:

- Child of former civil partner
- Child of former spouse
- Former civil partner of grandparent
- Former civil partner of parent
- Former spouse of grandparent
- Former spouse of parent
- Grandchild of former civil partner
- Grandchild of former spouse

App. 1.5.2 *Same-sex cohabitees*

The M(SSC)A again provides separate rules for existing and for new legislation. Para 2 Sch 3 M(SSC)A provides:

> (1) In existing England and Wales legislation—
>
> (a) a reference to persons who are not married but are living together as a married couple is to be read as including a reference to a same sex couple who are not married but are living together as a married couple;
>
> (b) a reference to a person who is living with another person as if they were married is to be read as including a reference to a person who is living with another person of the same sex as if they were married.
>
> (2) Where sub-paragraph (1) requires a reference to be read in a particular way, any related reference (such as a reference to persons formerly living together as a married couple) is to be read accordingly.
>
> (3) For the purposes of sub-paragraphs (1) and (2) it does not matter how a reference is expressed.

3 (1) This paragraph applies to existing England and Wales legislation which deals differently with—

(a) a man and a woman living together as if married, and

(b) two men, or two women, living together as if civil partners.

(2) If two men, or two women, are living together as if married, that legislation applies to them in the way that it would apply to them if they were living together as civil partners.

For new legislation, para 5 M(SSC)A provides:

(1) This paragraph applies to provision made by—

(a) this Act and any subordinate legislation made under it, or

(b) new England and Wales legislation, including any such provision which amends existing England and Wales legislation.

..

(5) A reference to a same sex couple who are not married but are living together as a married couple is a reference to—

(a) two men who are not married but are living together as a married couple, or

(b) two women who are not married but are living together as a married couple.

Fortunately, for tax purposes, and most other purposes, it will not be necessary to distinguish between living together as civil partners or as a married couple.

App. 1.6 Meaning of "child"

In the absence of a specific definition, the position is correctly explained in RDR3:

> **C15** A child can be either an individual's own natural child or a child they have adopted. It does not include step-children, unless the individual has adopted them.

Sometimes step-children are expressly included.

APPENDIX TWO

CONSTRUCTION OF DEEMING PROVISIONS

App. 2.1 Construction of deeming provisions

The general topic of the interpretation (or construction) of statutes requires a book to itself, and many such books have been written. However most of the principles of interpretation can only be expressed at a high level of generality which makes their application doubtful and their usefulness to the practitioner questionable. In short, as Voltaire observed, language is difficult to put into words.

This appendix concerns the specific topic of the construction of deeming provisions. These are common in tax statutes, and the same issues arise at various points in this book. It is therefore convenient to consider them as a separate topic.

The general rule of construction which applies to deeming provisions is this:

> If you are bidden to treat an imaginary state of affairs as real, you must surely, unless prohibited from doing so, also imagine as real the consequences and incidents which, if the putative state of affairs had in fact existed, must inevitably have flowed from or accompanied it.[1]
>
> ... [B]ecause one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs...[2]

However context can show that the general rule should not be applied. It is merely a general canon of construction from which "only limited assistance can be derived in choosing between alternative interpretations

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1 *East End Dwellings v Finsbury Borough Council* [1952] AC 109 at p.132.

2 *Marshall v Kerr* 67 TC 56 at p.79A.

of the Act".[3] Experience shows that Parliament has often failed to foresee all the consequences of its deeming, and nowadays the courts apply deeming provisions in a purposive and context-sensitive manner.[4] This is reaffirmed in *Bricom v IRC*[5] where the Court of Appeal referred to the dictum:

> The hypothetical must not be allowed to oust the real further than obedience to the statute compels.

The Court of Appeal said:

> ... I do not read this as intending to lay down a special rule which requires a statutory hypothesis to be narrowly and literally construed. The scope of a deeming provision is a question of construction and is not subject to any special rule. As on any other question of statutory construction, the Court must attempt to ascertain the intention of Parliament from the words used in the light of the legislative purpose. A statutory hypothesis, no doubt, must not be carried further than the legislative purpose requires, but the extent to which it must be carried depends upon ascertaining what that purpose is.

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3 *Russell v IRC* [1988] STC 195 at p.205.

4 In *Murphy v Ingram* [1973] Ch 363 at p.446 Megarry J said:

> A research student in search of a suitable topic for a thesis might do worse than to choose as his subject "the Dangers of Deeming".

But the modern approach reduces these dangers and *Murphy* itself would be decided differently today. For an example, see *De Rothschild v Lawrenson* 67 TC 300 at p.316.

5 *Bricom v IRC* 70 TC 272.

APPENDIX THREE

WHAT DO WE MEAN BY "REAL"?

App. 3.1 Introduction

The word "real" (and similar expressions such as "genuine") are often casually used, by lawyers and others, but they require careful thought. The most profound treatment I know is JL Austin, *Sense and Sensibilia*[1] Chapter 7. I set that out here in full with kind permission of OUP. If it was required reading before anyone wrote the word "real", a great deal of confusion might be avoided.

BUT NOW, PROVOKED LARGELY BY THE FREQUENT AND unexamined occurrences of 'real', 'really', 'real shape', &c, in the arguments we have just been considering, I want to take a closer look at this little word 'real'. I propose, if you like, to discuss the Nature of Reality a genuinely important topic, though in general I don't much like making this claim.

There are two things, first of all, which it is immensely important to understand here.

1. 'Real' is an absolutely *normal* word, with nothing new-fangled or technical or highly specialized about it. It is, that is to say, already firmly established in, and very frequently used in, the ordinary language we all use every day. Thus *in this sense* it is a word which has a fixed meaning, and so can't, any more than can any other word which is firmly established, be fooled around with *ad lib*. Philosophers often seem to think that they can just 'assign' any meaning whatever to any word; and so no doubt, in an absolutely trivial sense, they can (like Humpty-Dumpty).

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1 The text of the entire book is accessible on:
http://selfpace.uconn.edu/class/percep/AustinChs1-6.pdf;
http://selfpace.uconn.edu/class/percep/AustinChs7-11.pdf

There are some expressions, of course, 'material thing' for example, which only philosophers use, and in such cases they can, within reason, please themselves; but most words are *in fact* used in a particular way already, and this fact can't be just disregarded. (For example, some meanings that have been assigned to 'know' and 'certain' have made it seem outrageous that we should use these terms as we actually do; but what this shows is that the meanings assigned by some philosophers are *wrong*.) Certainly, when we have discovered how a word is in fact used, that may not be the end of the matter; there is certainly no reason why, in general, things should be left exactly as we find them; we may wish to tidy the situation up a bit, revise the map here and there, draw the boundaries and distinctions rather differently. But still, it is advisable always to bear in mind *(a)* that the distinctions embodied in our vast and, for the most part, relatively ancient stock of ordinary words are neither few nor always very obvious, and almost never just arbitrary; *(b)* that in any case, before indulging in any tampering on our own account, we need to find out what it is that we have to deal with; and *(c)* that tampering with words in what we take to be one little corner of the field is always liable to have unforeseen repercussions in the adjoining territory. Tampering, in fact, is not so easy as is often supposed, is not justified or needed so often as is often supposed, and is often thought to be necessary just because what we've got already has been misrepresented. And we must always be particularly wary of the philosophical habit of dismissing some (if not all) the ordinary uses of a word as 'unimportant', a habit which makes distortion practically unavoidable. For instance, if we are going to talk about 'real', we must not dismiss as beneath contempt such humble but familiar expressions as 'not real cream'; this may save us from saying, for example, or seeming to say that what is not real cream must be a fleeting product of our cerebral processes.

2. The other immensely important point to grasp is that 'real' is *not* a normal word at all, but highly exceptional; exceptional in this respect that, unlike 'yellow' or 'horse' or 'walk', it does not have one single, specifiable, always-the-same *meaning*. (Even Aristotle saw through this idea.) *Nor* does it have a large number of different meanings - it is not *ambiguous*, even 'systematically'. Now words of this sort have been responsible for a great deal of perplexity. Consider the expressions 'cricket ball', 'cricket bat', 'cricket pavilion',' cricket weather'. If someone did not know about cricket and were obsessed with the use of such 'normal' words as 'yellow', he might gaze at the ball, the bat, the

building, the weather, trying to detect the 'common quality' which (he assumes) is attributed to these things by the prefix 'cricket'. But no such quality meets his eye; and so perhaps he concludes that 'cricket' must designate a *non-natural* quality, a quality to be detected not in any ordinary way but by *intuition*. If this story strikes you as too absurd, remember what philosophers have said about the word 'good'; and reflect that many philosophers failing to detect any ordinary quality common to real ducks, real cream, and real progress, have decided that Reality must be an *a priori* concept apprehended by reason alone.

Let us begin, then, with a preliminary, no doubt rather haphazard, survey of some of the complexities in the use of 'real'. Consider, for instance, a case which at first sight one might think was pretty straightforward - the case of a 'real colour'. What is meant by the 'real' colour of a thing? Well, one may say with some confidence, that's easy enough: the *real* colour of the thing is the colour that it looks to a normal observer in conditions of normal or standard illumination; and to find out what a thing's real colour is, we just need to be normal and to observe it in those conditions.

But suppose *(a)* that I remark to you of a third party, 'That isn't the real colour of her hair'. Do I mean by this that, if you were to observe her in conditions of standard illumination, you would find that her hair did not look that colour? Plainly not - the conditions of illumination may be standard already. I mean of course, that her hair has been *dyed*, and normal illumination just doesn't come into it at all. Or suppose that you are looking at a ball of wool in a shop, and I say, 'That's not its real colour.' Here I *may* mean that it won't look that colour in ordinary daylight; but I *may* mean that wool isn't that colour before it's dyed. As so often, you can't tell what I mean just from the words that I use; it makes a difference, for instance, whether the thing under discussion is or is not of a type which is *customarily* dyed.

Suppose *(b)* that there is a species of fish which looks vividly multi-coloured, slightly glowing perhaps, at a depth of a thousand feet. I ask you what its real colour is. So you catch a specimen and lay it out on deck, making sure the condition of the light is just about normal, and you find that it looks a muddy sort of greyish white. Well, is *that* its real colour? It's clear enough at any rate that we don't have to say so. In fact, is there any right answer in such a case?

Compare: 'What is the real taste of saccharine?' We dissolve a tablet in

a cup of tea and we find that it makes the tea taste sweet; we then take a tablet neat, and we find that it tastes bitter. Is it *really* bitter, or *really* sweet?

(c) What is the real colour of the sky? Of the sun? Of the moon? Of a chameleon? We say that the sun in the evening sometimes looks red - well, what colour is it *really*? (What are the 'conditions of standard illumination' for the sun?)

(d) Consider a *pointilliste* painting of a meadow, say; if the general effect is of green, the painting may be composed of predominantly blue and yellow dots . What is the real colour of the painting?

(e) What is the real colour of an after-image? The trouble with this one is that we have no idea what an alternative to its 'real colour' might be. Its apparent colour, the colour that it looks, the colour that it appears to be? - but these phrases have no application here. (You might ask me, 'What colour is it really?' if you suspected that I had lied in telling you its colour. But 'What colour is it really?' is not quite the same as 'What is its real colour?').

Or consider 'real shape' for a moment. This notion cropped up, you may remember, seeming quite unproblematic, when we were considering the coin which was said to 'look elliptical' from some points of view; it had a real shape, we insisted, which remained unchanged. But coins in fact are rather special cases. For one thing their outlines are well defined and very highly stable, and for another they have a *known* and *nameable* shape. But there are plenty of things of which this is not true. What is the real shape of a cloud? And if it be objected, as I dare say it could be, that a cloud is not a 'material thing' and so not the kind of thing which has to have a real shape, consider this case: what is the real shape of a cat? Does its real shape change whenever it moves? If not, in what posture *is* its real shape on display? Furthermore, is its real shape such as to be fairly smooth-outlined, or must it be finely enough serrated to take account of each hair. It is pretty obvious that there is *no* answer to these questions - no rules according to which, no procedure by which, answers are to be determined. Of course, there are plenty of shapes which the cat definitely is not - cylindrical, for instance. But only a desperate man would toy with the idea of ascertaining the cat's real shape 'by elimination'.

Contrast this with cases in which we *do* know how to proceed: 'Are those real diamonds?', 'Is that a real duck?' Items of jewellery that more or less closely resemble diamonds may not be real diamonds because they are paste or glass; that may not be a real duck because it is a decoy, or a

toy duck, or a species of goose closely resembling a duck, or because I am having a hallucination. These are all of course quite difference cases. And notice in particular *(a)* that, in most of them 'observation by a normal observer in standard conditions' is completely irrelevant; *(b)* that something which is not a real duck is not a *non-existent* duck, or indeed a non-existent anything; and *(c)* that something existent, e.g. a toy, may perfectly well not be real, e.g. not a real duck.[2]

Perhaps by now we have said enough to establish that there is more in the use of 'real' than meets the cursory eye; it has many and diverse uses in many diverse contexts. We must next, then, try to tidy things up a little; and I shall now mention under four headings what might be called the salient features of the use of 'real' - though not *all* these features are equally conspicuous in all its uses.

1. First, 'real' is a word that we may call *substantive-hungry*. Consider:
   'These diamonds are real';
   'These are real diamonds'.

This pair of sentences looks like, in an obvious grammatical respect, this other pair:

'These diamonds are pink';
'These are pink diamonds'.

But whereas we can *just* say of something 'This is pink', we can't *just* say of something 'This is real'. And it is not very difficult to see why. We can perfectly well say of something that it is pink without knowing, without any reference to, what it *is*. But not so with 'real'. For one and the same object may be both a real *x* and not a real *y*; an object looking rather like a duck may be a real decoy duck (not just a toy) but not a real duck. When it isn't a real duck but a hallucination, it may still be a real hallucination - as opposed, for instance, to a passing quirk of a vivid imagination. That is, we must have an answer to the question ' A real *what*?', if the question 'Real or not?' is to have a definite sense, to get any

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2 'Exist', of course, is itself extremely tricky. The word is a verb, but it does not describe something that things do all the time, like breathing, only quieter - ticking over, as it were, in a metaphysical sort of way. It is only too easy to start wondering what, then, existing *is*. The Greeks were worse off than we are in this region of discourse - for our different expressions 'to be', 'to exist' and 'real' they made do with the single word ..... We have not their excuse for getting confused on this admittedly confusing topic.

foothold. And perhaps we should also mention here another point - that the question 'Real or not?' does not always come up, can't be raised. We *do* raise this question only when, to speak rather roughly, suspicion assails us - in some way or other things may not be what they seem; and we *can* raise this question only if there *is* a way, or ways, in which things may be not what they seem. What alternative is there to being a 'real' after-image?

'Real' is not, of course, the only word we have that is substantive-hungry. Other examples, perhaps better known ones, are 'the same' and 'one'. The same *team* may not be the same *collection of players*; a body of troops may be one *company* and also three *platoons*. Then what about 'good'? We have here a variety of gaps crying out for substantives - 'A good *what*?', Good *at* what? - a good book, perhaps, but not a good novel; good at pruning roses, but not good at mending cars.[3]

2. Next, 'real' is what we may call a *trouser-word*. It is usually thought, and I dare say usually rightly thought, that what one might call the affirmative use of a term is basic - that, to understand '*x*', we need to know what it is to be *x*, or to be an *x*, and that knowing this apprises us of what it is *not* to be *x*, not to be an *x*. But with 'real' (as we briefly noted earlier) it is the *negative* use that wears the trousers. That is, a definite sense attaches to the assertion that something is real, a real such-and-such, only in the light of a specific way in which it might be, or might have been, *not* real. 'A real duck' differs from the simple ' a duck' only in that it is used to exclude various ways of being not a real duck - but a dummy, a toy, a picture, a decoy, &c.; and moreover I don't know *just* how to take the assertion that it's a real duck unless I know *just* what, on that particular occasion, the speaker has it in mind to exclude. This, of course, is why the attempt to find a characteristic common to all things that are or could be called 'real' is doomed to failure; the function of 'real' is not to contribute positively to the characterisation of anything, but to exclude possible ways of being *not* real - and these ways are both numerous for particular kinds of things, and liable to be quite different for things of different kinds. It is identify of general function combined with immense diversity in specific applications which gives to the word 'real' the, at first sight,

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3 In Greek the case of *σοφος* [wise] is of some importance; Aristotle seems to get into difficulties by trying to use *σοφια* [wisdom] 'absolutely', so to speak, without specification of the field in which *σοφια* is exercised and shown. Compare on *δεινοτης* [cunning] too.

baffling feature of having neither one single 'meaning', nor yet ambiguity, a number of different meanings.

3. Thirdly, 'real' is (like 'good') a *dimension-word*. I mean by this that it is the most general and comprehensive term in a whole group of terms of the same kind, terms that fulfil the same function. Other members of this group, on the affirmative side, are, for example, 'proper', 'genuine', 'live', 'true', 'authentic', 'natural'; and on the negative side, 'artificial', 'fake', 'false', 'bogus', 'makeshift', 'dummy', 'synthetic', 'toy' - and sch nouns as 'dream', 'illusion', 'mirage', 'hallucination' belong here as well.[4] It is worth noticing here that, naturally enough, the *less* general terms on the affirmative side have the merit, in many cases, of suggesting more or less definitely what it is that is being excluded; they tend to pair off, that is, with particular terms on the negative side and thus, so to speak, to narrow the range of possibilities. If I say that I wish the university had a proper theatre, this suggest that it has at present a *makeshift* theatre; pictures are genuine as opposed to *fake*, silk is natural as opposed to *artificial*, ammunition is live as opposed to *dummy*, and so on. In practice, of course, we often get a clue to what it is that is in question from the substantive in the case, since we frequently have a well-founded antecedent idea in what respects the kind of thing mentioned could (and could not) be 'not real'. For instance, if you ask me 'Is this real silk?' I shall tend to supply 'as opposed to artificial', since I already know that silk is the kind of thing which can be very closely simulated by an artificial product. The notion of its being *toy* silk, for instance, will not occur to me.[5]

A large number of questions arises here - which I shall not go into - concerning both the composition of these families of 'reality' words and 'unreality' words, and also the distinctions to be drawn between their individual members. Why, for instance, is being a *proper* carving knife one way of being a real carving knife, whereas being *pure* cream seems

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4 Of course, not all the uses of all these words are of the kind we are here considering - though it would be wise not to assume, either, that any of their uses are *completely* different, *completely* unconnected.

5 Why not? Because silk can't be a '*toy*'. Yes, but why not? Is it that a toy is, strictly speaking, something quite small, and specially made or designed to be manipulated in play? The water in toy beer-bottles is not toy beer, but *pretend* beer. Could a toy watch actually have clockwork inside and show the time correctly? Or would that be just a *miniature* watch?

not to be one way of being *real* cream? Nor to put it differently: how does the distinction between real cream and synthetic cream differ fro the distinction between pure cream and adulterated cream? Is it just that adulterated cream still is, after all, *cream*? And why are false teeth called 'false' rather than, say, 'artificial'? Why are artificial limbs so-called, in *preference* to 'false'? Is it that false teeth, beside doing much the same job as real teeth, look, and are meant to look, *deceptively* like real teeth? Whereas an artificial limb, perhaps, is meant to do the same job, but is neither intended, nor likely, to be *passed off* as a real limb.

Another philosophically notorious dimension-word which has already been mentioned in another connection as closely comparable with 'real', is 'good'. 'Good' is the most general of a very large and diverse list of more specific words, which share with it the general function of expressing commendation, but differ among themselves in their aptness to, and implications in, particular contexts. It is a curious point, of which Idealist philosophers used to make much at one time, that 'real' itself, in certain uses, may belong to this family. 'Now this is a *real* carving knife!' May be one way of saying that this is a good carving knife.[6] And it is sometimes said of a bad poem, for instance, that it isn't really a poem at all; a certain standard must be reached, as it were, even to *qualify*.

4. Lastly, 'real' also belongs to a large and important family of words that we may call *adjuster-words* - words, that is, by the use of which other words are adjusted to meet the innumerable and unforeseeable demands of the world upon language. The position, considerably over-simplified no doubt, is that at a given time our language contains words that enable us (more or less) to say what we want to say in most situations that (we think) ware liable to turn up. But vocabularies are finite; and the variety of possible situations that may confront us is neither finite nor precisely foreseeable. So situations are practically bound to crop up sometimes with which our vocabulary is not already fitted to cope in any tidy, straightforward style. We have the word 'pig', for instance, and a pretty clear idea which animals, among those that we fairly commonly encounter, are and are not to be so called. But one day we come across a new kind of animal, which looks and behaves very much as pigs do, but not *quite* as pigs do; it is somehow different. Well, we might just keep

6 Colloquially at least, the converse is also found: 'I gave him a good hiding' - 'a real hiding' - 'a proper hiding'.

silent, not knowing what to say; we don't want to say positively that it *is* a pig, or that it is *not*. Or we might, if for instance we expected to want to refer to these new creatures pretty often, invent a quite new word for them. But what we could do, and probably would do first of all, is to say, 'It's *like* a pig'. ('Like' is *the* great adjuster-word, or, alternatively put, the main flexibility-device to whose aid, in spite of the limited scope of our vocabulary, we can always avoid being left completely speechless.) And then, having said of this animal that it's *like* a pig, we may proceed with the remark, 'But it isn't a *real* pig'. If we think of words as being shot like arrows at the world, the function of these adjuster-words is to free us from the disability of being able to shoot only straight ahead; by their use on occasion, such words as 'pig' can be, so to speak, brought into connexion with targets lying slightly off the simple, straightforward line on which they are ordinarily aimed. and in this way we gain, besides flexibility, precision; for if I can say, 'Not a real pig, but like a pig', I don't have to tamper with the meaning of 'pig' itself.

But, one might ask, do we *have* to have 'like' to serve this purpose? We have, after all, other flexibility-devices. For instance, I might say that animals of this new species are 'piggish'; I might perhaps call them 'quasi pigs', or describe them (in the style of vendors of peculiar wines) as 'pig-type' creatures. But these devices, excellent no doubt in their way, can't be regarded as substitutes for 'like', for this reason: they equip us simply with new expressions on the same level as, functioning in the same way as, the word 'pig' itself; and thus, though they may perhaps help us out of our immediate difficulty, they themselves may land us in exactly the same *kind* of difficulty at any time. We have this kind of wine, not real port, but a tolerably close approximation of port, and we call it 'port type'. But them someone produces a new kind of wine, not port exactly, but also not quite the same as what we now call 'port type'. So what are we to say? It is port-type type? It would be tedious to have to say so, and besides there would clearly be no future in it. But as it is we can say that it is *like* port-type wine (and for that matter rather like port, too); and in saying this we don't saddle ourselves with a *new word*, whose application may itself prove problematic if the vintners spring yet another surprise on us. The word 'like' equips us *generally* to handle the unforeseen, in a way in which new words invented *ad hoc* don't, and can't.

(Why then do we need 'real' as an adjuster-word as well as 'like'? Why exactly do we want to say, sometimes 'It is like a pig', sometimes 'It is not a real pig? To answer these questions properly would be to go a long way

towards making really clear the use, the 'meaning', of 'real'.)[7]

It should be quite clar, then, that there are no criteria to be laid down *in general* for distinguishing the real from the not real. How this is to be done must depend on *what* it is with respect to which the problem arises in particular cases. Furthermore, even for particular kinds of things, there may be many different ways in which the distinction may be made (there is not just *one* way of being 'not a real pig')—this depends on the number and variety of the surprises and dilemmas nature and our fellow men may spring on us, and on the purposes and dilemmas we have been faced with hitherto. And of course, if there is *never* any dilemma or surprise, the question simply doesn't come up; if we had simply never had occasion to distinguish anything as being in any way like a pig but not a *real* pig, the words 'real pig' themselves would have no application—as perhaps the words 'real after-image' have no application.

Again, the criteria we employ at a given time can't be taken as *final*, not liable to change. Suppose that one day a creature of the kind we now call a cat takes to talking. Well, we say to being with, I suppose, 'This cat can talk.' But then other cats, not all, take to talking as well; we now have to say that some cats talk, we distinguish between talking and non-talking cats. But again we may, if talking becomes prevalent and the distinction between talking and not talking seems to us to be really important, come to insist that a *real* cat to be a creature that can talk. And this will give us a new case of being 'not a real cat', i.e. being a creature just like a cat except for not talking.

Of course—this may seem perhaps hardly worth saying, but in philosophy it seems it does need to be said—we make a distinction between 'a real *x*' and 'not a real *x*' only if there is a way of telling the difference between what is a real x and what is not. A distinction which we are not in fact able to draw is—to put it politely—not worth making.

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7 Incidentally, nothing is gained at all by saying that 'real' is a *normative* word and leaving it at that, for 'normative' itself is much too general and vague. Just how, in what way, is 'real' normative? Not, presumably, in just the same way as 'good; is. And it's differences that matter.

APPENDIX FOUR

MEMBERS OF PARLIAMENT

App. 4.1 Residence & domicile of MPs and members of House of Lords

Section 41 Constitutional Reform and Governance Act 2010 provides special rules for MPs and members of the House of Lords ("MLs"):

(1) Subsection (2) applies if a person is for any part of a tax year[1]—
  (a) a member of the House of Commons, or
  (b) a member of the House of Lords.[2]

(2) The person is to be treated for the purposes of the taxes listed in subsection (3) as resident and domiciled in the UK for the whole of that tax year.

(3) The taxes are—
  (a) income tax,
  (b) capital gains tax, and
  (c) inheritance tax.

In practice this means MPs and MLs are deemed UK resident and domiciled for almost all tax purposes, though minor taxes such as NICs slip through the net. EN CRGA provides:

---

1 IHT does not use the concept of tax years, so s.41(9) CRGA 2010 provides:
"In this section, in relation to inheritance tax—
  (a) 'tax year' means a year beginning on 6 April and ending on the following 5 April, and
  (b) 'the tax year 2010-11' means the tax year beginning on 6 April 2010."

2 Section 41(5)(10) CRGA 2010 defines ML:
"For the purposes of this section and section 42 a person is a member of the House of Lords if the person is entitled to receive writs of summons to attend that House....
(10) In determining for the purposes of this section and section 42 whether a person is entitled to receive writs of summons to attend the House of Lords, ignore—
  (a) section 2 of the Forfeiture Act 1870;
  (b) sections 426A and 427 of the Insolvency Act 1986."

> 269.The section provides that MPs and peers are deemed ROD [resident ordinarily resident and domiciled] for the whole of each tax year in which they are a member of either House (including those tax years in which they are a member for only part of the year). This means that they will be deemed ROD from the start of the tax year in which they become a member of that House and to the end of the tax year in which they cease to be a member.

DT relief may apply where a treaty has a suitable tie-breaker.

Section 41(4) CRGA 2010 defines when a person becomes or ceases to be a MP or a ML:

> For the purposes of this section a person—
>
> (a) becomes a member of the House of Commons when (having been elected to that House) the person makes and subscribes the oath required by the Parliamentary Oaths Act 1866 (or the corresponding affirmation), and
>
> (b) ceases to be a member of that House when—
>
> (i) the Parliament to which the person was elected is dissolved, or
>
> (ii) the person's seat is otherwise vacated.

Since a person will know the exact date when they become an MP or ML, they have an opportunity for pre-appointment planning and there may even be some scope for further planning when deemed UK domiciled (eg in relation to the IHT spouse exemption if the spouse if UK domiciled).[3] Note that when a person ceases to be a ML or MP, they will continue to be deemed IHT domiciled for another three or four years.

Sinn Fein MPs do not take their seats at Westminster so happily escape deemed UK residence and domicile.

Section 41(6) CRGA 2010 excludes judges[4] and bishops (the section is after all only a *political* exercise). This level of micro-detail cannot sensibly be covered even in this book which seeks to be comprehensive: it would be surprising if there are more than one or two individuals concerned (if indeed there are any at all).

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3 See Slevin "Not Quite the Same", Taxation, (19 May 2011).

4 This makes sense, as a ML who holds a disqualifying judicial office is disqualified from sitting or voting in the House of Lords: s.137(7) Constitutional Reform Act 2005.

App. 4.2 Members of the European Parliament

The rules do not apply to MEPs. EN CRGA 2010 para 275 discusses the position of a MEP who is also a member of the House of Lords but as far as I am aware no-one falls in this category.

App. 4.3 Commentary

Stephen Timms (then Financial Secretary to the Treasury) said:

> This is how the vast majority of the UK population is taxed, so it seems right to me ... that MPs and Members of the House of Lords should be taxed on that basis and should not have access to the remittance basis. It is helpful that there is now clear, albeit rather belated, cross-party support for action, following the Conservative's change of position to supporting the principle that MPs and Members of the House of Lords should be required to pay tax in full on their overseas income, gains and assets.[5]

A great deal more could be said about the policy issues relating to these provisions. They were not debated in Parliament: the clauses were a late amendment to the CRGA, which was enacted in a breathless ping pong procedure just before the dissolution of Parliament. But the context of the rules is wholly political - the scrabble for public approval and to knock the opposition - so it would be unrealistic to expect cool and considered reflection. The debate is long-standing.[6]

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5 Hansard, 5 Jan 2010, Column 52WH.

6 There was a comparable debate in relation to Lord Vestey who (though resident and domiciled when ennobled in 1922) had shortly before been a tax exile: see *"Vestey: Royal Commission evidence and ensuing debate"* accessible *http://www.kessler.co.uk/tfd-archive*.

APPENDIX FIVE

VISITING FORCES

App. 5.1 The treaty background

The taxation of visiting forces is based on two treaties:
(1) NATO Status of Forces Agreement 1951 ("NATO SOFA").[1]
(2) Partnership for Peace Status of Forces Agreement 1995 ("PfP SOFA").[2]
A third treaty, EU Status of Forces Agreement 2003, despite its date, has not yet come into force.[3] Its taxation provisions are similar to the existing treaties.

The PfP SOFA incorporates the 1951 treaty by reference.

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1 The full title is: Agreement Between the Parties to the North Atlantic Treaty Regarding the Status of Their Forces 19 June 1951.
Accessible *http://www.nato.int/cps/en/natolive/official_texts_17265.htm*.

2 The full title is: Agreement among the States Parties to the North Atlantic Treaty and the other States participating in the Partnership for Peace regarding the Status of their Forces, 19 June 1995.
Accessible *http://www.nato.int/cps/en/natolive/official_texts_24742.htm*.

3 The full title is: Agreement between the member states of the European Union concerning the status of military and civilian staff seconded to the institutions of the European Union, of the headquarters and forces which may be made available to the European Union in the context of the preparation and execution of the tasks referred to in article 17(2) of the treaty on European Union including exercises, and of the military and civilian staff of the member states put at the disposal of the European Union to act in this context.
http://www.official-documents.gov.uk/document/cm75/7572/7572.pdf.
Secondary legislation which will implement EU SOFA has likewise not yet come into force: The Visiting Forces and International Military Headquarters (EU SOFA) (Tax Designation) Order 2012.

App. 5.2 Residence for IT and CGT

App. 5.2.1 *Treaty background*

Article X NATO SOFA provides:

> 1. [a] Where the legal incidence of any form of taxation in the receiving State depends upon residence or domicile, periods during which a member of a force or civilian component is in the territory of that State by reason solely of his being a member of such force or civilian component shall not be considered as periods of residence therein, or as creating a change of residence or domicile, for the purposes of such taxation...

A period of presence would not normally create a change of domicile (except for IHT deemed domicile) but the drafter also had in mind civil law conceptions of domicile which is more like habitual residence.

App. 5.2.2 *"Visiting Forces"*

Section 833 ITA provides:

> (1) This section applies to an individual who—
> (a) is a member of a visiting force of a designated country or of a civilian component of such a force,
> (b) is in the UK, but only because of being a member of the force or the civilian component, and
> (c) is not a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen.
> (2) For the purposes of subsection (1)—
> (a) members of the armed forces of a designated country who are attached to a designated international military headquarters[4] are treated as a visiting force of that country, and
> (b) whether an individual is a member of a civilian component of such a force is to be determined accordingly.
> (2A) This section also applies to an individual within subsection (3) or (3A).
> (3) An individual is within this subsection if the individual—

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4 Defined in subsection (7):
" In this section—
'allied headquarters' means an international military headquarters established under the North Atlantic Treaty, and
'designated' means designated for the purpose in question by or under an Order in Council made for giving effect to an international agreement."

(a) is of a category for the time being agreed between Her Majesty's Government in the UK and the other members of the North Atlantic Council,
(b) is employed by a designated allied headquarters,
(c) is in the UK, but only because of being employed by the designated allied headquarters, and
(d) is not a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen

(3A) An individual is within this subsection if the individual—
(a) belongs to the EU civilian staff,
(b) is in the UK, but only because of serving as part of that staff, and
(c) is not a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen.....

(6) Subsections (1) to (3) are to be interpreted as if—
(a) they were in Part 1 of the Visiting Forces Act 1952, and
(b) references in that Act to a country to which a provision of that Act applies were references to a designated country.

I refer to a person within (1) as visiting forces.

Forty-nine countries have been designated:

(1) Designated NATO countries

Albania, Belgium, Bulgaria, Canada, Croatia, Czech Republic, Denmark, Estonia, France, Germany, Greece, Hungary, Iceland, Italy, Latvia, Lithuania, Luxembourg, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Turkey, United States of America.[5]

(2) Designated PfP countries

Armenia, Austria, Azerbaijan, Belarus, Bosnia and Herzegovina, Finland, Georgia, Ireland, Kazakhstan, Kyrgyz Republic, Malta, Moldova, Montenegro, Russia, Serbia, Sweden, Switzerland, Tajikistan, the former Yugoslav Republic of Macedonia, Turkmenistan, Ukraine, Uzbekistan.[6]

The following HQs have been designated:

5 The Visiting Forces and International Military Headquarters (NATO and PfP) (Tax Designation) Order 2012 No. 3071, Schedule 2.

6 The Visiting Forces and International Military Headquarters (NATO and PfP) (Tax Designation) Order 2012 No. 3071, Schedule 3.

(1) Headquarters of the Supreme Allied Commander Transformation (HQ SACT)
(2) Supreme Headquarters Allied Powers Europe (SHAPE)
(3) Maritime component Command Headquarters Northwood (CC-MAR HQ Northwood)
(4) Commander Submarines Allied Naval Forces North (COMSUBNORTH)
(5) NATO Airborne Early Warning and Control Force (NAEW&CF)
(6) NATO Joint Electronic Welfare Core Staff (NATO JEWCS)
(7) Headquarters United Kingdom–Netherlands Amphibious Force (UKNLAF)
(8) Headquarters United Kingdom–Netherlands landing Force (UKNLLF)
(9) The European Air Group (EAG)
(10) The Intelligence Fusion Centre (IFC)
(11) Headquarters Allied Rapid Reaction Corps (HQ ARRC)[7]

HMRC TDSI Guidance Notes (October 2012) provide:

> **4.50 Civilian component of visiting armed forces**
> ... A person is a member of a civilian component of a visiting force if his or her passport contains
> • an uncancelled entry made by or on behalf of the sending country stating that the bearer is a member of a civilian component of a visiting force of that country, and
> • an uncancelled recognition stamp of the UK Home Office.
> Employees of foreign contractors hired in the UK are not members of the civilian component of a visiting force. Their residence status is determined according to the normal rules ....[8]

App. 5.2.3 *Residence and domicile relief*

Section 833(4) provides the relief:

> If this section applies to an individual throughout a period, the period is not treated for income tax purposes as—
> (a) a period of residence in the UK, or
> (b) creating a change of the individual's residence or domicile.

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7 The Visiting Forces and International Military Headquarters (NATO and PfP) (Tax Designation) Order 2012 No. 3071, Schedule 4.

8 HMRC, TDSI Guidance Notes for Financial Institutions (October 2012), see *http://www.hmrc.gov.uk/taxon/guidance-notes.pdf.*

Section 11(1) TCGA extends the relief to CGT:

> If section 833 of ITA 2007 (visiting forces and staff of designated allied headquarters) applies to an individual throughout a period, the period is not treated for capital gains tax purposes as—
>
> (a) a period of residence in the UK, or
>
> (b) creating a change of the individual's residence or domicile.

App. 5.2.4 *Personal allowances*

Section 833(5) ITA provides:

> Subsection (4) does not affect the operation of section 56 or 460 of this Act (residence etc of claimants) in relation to an individual for any tax year.

EN ITA explains:

> 2498. Subsection (5) ensures that an individual to whom this section applies has the benefit of the personal reliefs to which the individual would be entitled if resident in the UK. Such reliefs will, accordingly, be available in calculating the individual's liability to UK income tax on such income as, for example, UK bank interest, dividends from UK resident companies and UK-based earnings which are not exempt under section 303 of ITEPA.

App. 5.3 Employment income

App. 5.3.1 *Treaty background*

Article X.1 NATO SOFA provides:

> ... Members of a force or civilian component shall be exempt from taxation in the receiving State on the salary and emoluments paid to them as such members by the sending State or on any tangible movable property the presence of which in the receiving State is due solely to their temporary presence there.

App. 5.3.2 *The relief*

Section 303 ITEPA provides:

> (1) No liability to income tax arises in respect of earnings if—
>
> (a) they are paid by the government of a designated country to a member of a visiting force of that country or of a civilian component of such a force, and

(b) that person is not a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen.

(2) [*This is a definition provision identical to s.833(2) set out above*]

(3) No liability to income tax arises in respect of earnings if they are paid by a designated international military headquarters to an employee of a category for the time being agreed between Her Majesty's government in the UK and the other members of the North Atlantic Council.

(4) But where the employee is a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen, subsection (3) only applies if it is necessary for it to do so to give effect to an agreement between parties to the North Atlantic Treaty.

(4A) No liability to income tax arises in respect of earnings if—

(a) they are paid by the government of a designated country to a person belonging to the EU civilian staff, and

(b) that person is not a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen.

(5) & (6) [*These are definition provisions identical to s.833(6)(7) set out above]*.

App. 5.4 IHT reliefs

App. 5.4.1 *Excluded property*

Section 155(1) IHTA provides:

> Section 6(4) above applies to—
>
> (a) the emoluments paid by the Government of any designated country to a member of a visiting force of that country, not being a British citizen, a British Dependent Territories citizen, a British National (Overseas) or a British Overseas citizen, and
>
> (b) any tangible movable property the presence of which in the UK is due solely to the presence in the UK of such a person while serving as a member of the force.

This takes us to s.6(4) which provides:

> Property to which this subsection applies by virtue of section 155(1) or (5A) below is excluded property.

In short, emoluments and tangible movable property of visiting forces qualify as excluded property for IHT purposes.

App. 5.4.2 *IHT deemed domicile*

Section 155(2) IHTA provides:

> A period during which any such member of a visiting force as is referred to in subsection (1) above is in the UK by reason solely of his being such a member shall not be treated for the purposes of this Act as a period of residence in the UK or as creating a change of his residence or domicile.

Thus (in short) visiting forces do not become IHT deemed domiciled even if they reside 17 or more years in the UK (but in practice I expect that hardly ever happens). It is considered that the relief does not apply to members of visiting forces who are British citizens (etc) even though on a literal reading one might say that such persons are "referred to" in s.155(1).

App. 5.4.3 *"Visiting Force" and other definitions*

Section 155 IHTA provides

> (3) References in subsections (1) and (2) above to a visiting force shall apply to a civilian component of a visiting force as they apply to the force itself, and those subsections shall be construed as one with Part I of the Visiting Forces Act 1952 but so that for the purposes of this section references to a designated country shall be substituted in that Act for references to a country to which a provision of that Act applies.
> (4) For the purpose of conferring on persons attached to any designated allied international military headquarters the like benefits as are conferred by subsections (1) and (2) above on members of a visiting force or civilian component, any members of the armed forces of a designated country shall, while attached to any such headquarters, be deemed to constitute a visiting force of that country, and there shall be a corresponding extension of the class of persons who may be treated as members of a civilian component of such a visiting force.
> (5A) Section 6(4) also applies to—
>
> (a) the emoluments paid by the Government of any designated country to a person belonging to the EU civilian staff, not being a British citizen, a British overseas territories citizen, a British National (Overseas) or a British Overseas citizen, and
> (b) any tangible movable property the presence of which in the UK is due solely to the presence in the UK of such a person serving as part of that staff.
>
> (5B) A period during which any such person belonging to the EU civilian staff as is referred to in subsection (5A) is in the UK by reason

solely of that person belonging to that staff is not to be treated for the purposes of this Act as a period of residence in the UK or as creating a change of that person's residence or domicile.

Section 155 IHTA provides:

(6) For the purposes of this section—
"allied headquarters" means any international military headquarters established under the North Atlantic Council;
"designated" means designated for the purpose in question by or under any Order in Council made for giving effect to any international agreement.
""the EU civilian staff" means—

(a) civilian personnel seconded by a member State to an EU institution for the purposes of activities (including exercises) relating to the preparation for, and execution of, tasks mentioned in Article 43(1) of the Treaty on European Union (tasks relating to a common security and defence policy), as amended from time to time, and
(b) civilian personnel (other than locally hired personnel)—
  (i) made available to the EU by a member State to work with designated international military headquarters or a force of a designated country, or
  (ii) otherwise made available to the EU by a member State for the purposes of activities of the kind referred to in paragraph (a).

(7) Any Order in Council made under section 73 of the Finance Act 1960 which is in force immediately before the passing of this Act shall have effect for the purposes of this section as if had also been made under this section, and may be varied or revoked accordingly.

The exemption is not available to spouses of visiting forces.

App. 5.5 SDLT

Section 74A FA 1960 provides an exemption for land acquired as barracks or for training; this is too specialist a topic to be discussed here

APPENDIX SIX

STUDENTS

App. 6.1 Introduction

In general a student is taxed in the same way as any other individual.

For school fees paid by trusts, see 30.4.13 (Payment of school/university fees).

App. 6.2 DT relief

Article 20 OECD Model Convention provides:

> Payments which a student or business apprentice who is or was immediately[1] before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

The OECD commentary provides:

> 3. The Article covers only payments received for the purpose of the recipient's maintenance, education or training. It does not, therefore, apply to a payment, or any part thereof, that is remuneration for services rendered by the recipient and which is covered by Article 15 (or by Article 7 in the case of independent services). Where the recipient's training involves work experience, however, there is a need to distinguish between a payment for services and a payment for the recipient's maintenance, education or training. The fact that the amount paid is similar to that paid to persons who provide similar services and

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1 The OECD commentary provides: "2. The word "immediately" was inserted in the 1977 Model Convention in order to make clear that the Article does not cover a person who has once been a resident of a Contracting State but has subsequently moved his residence to a third State before visiting the other Contracting State."

are not students or business apprentices would generally indicate that the payment is a remuneration for services. Also, payments for maintenance, education or training should not exceed the level of expenses that are likely to be incurred to ensure the recipient's maintenance, education or training.

4 For the purpose of the Article, payments that are made by or on behalf of a resident of a Contracting State or that are borne by a permanent establishment which a person has in that State are not considered to arise from sources outside that State.

DTR manual provides:

1930 Visiting students and apprentices [February 2006]

Most double taxation agreements provide that students and business apprentices who visit the UK solely for the purpose of their education or training and who, immediately before coming here, were residents of the other country shall be exempt from UK tax on payments which they receive from outside the UK for their maintenance, education or training. Some agreements also provide that certain remuneration which a student or business apprentice receives from employment in this country shall be exempt from UK tax. Various limitations are imposed in particular agreements, often relating to monetary limits, the student's need to supplement grant income, or the type of employment. In every case when an agreement provides an exemption of this type, details of any limitations are given in Part IV of this volume.

Claims for exemption under a students' Article are dealt with in the District which, but for the agreement, would have dealt with any tax on such payments or remuneration. In examining claims, refer to the relevant double taxation agreement to ensure that the conditions for exemption are fulfilled. The following notes give some guidance on matters to be taken into account in considering whether exemption is due

(a) The exemption does not extend to income or capital gains derived by a student or business apprentice from his own investments or from trust income to which he is absolutely entitled.

(b) Whether payments or remuneration are for the student's etc. maintenance, education or training, or for supplementing his resources, or are reasonably necessary, is a question of fact and the onus is on the claimant to provide the evidence. The figures quoted in Statement of Practice SP4/86 (see SE1314) can be used as a guide. Where the payments or remuneration seem to be unreasonably high, refer the case to Personal Tax Division (Schedule E), Sapphire House, Solihull.

(c) If the payments or remuneration exceed the amount needed for the

student's etc. maintenance, education or training, the whole amount is taxable and not merely the excess.

(d) Where the Article provides that remuneration is to be exempted up to a certain monetary limit and the student or business apprentice is resident in the UK under UK domestic law, that amount is additional to the personal allowances available under UK law. For example, if the monetary limit in the agreement is 1,000 and the claimant is entitled to a personal allowance in the relevant year of 3,445, earnings of 4,445 or less will be exempt.

APPENDIX SEVEN

ENTERTAINERS AND SPORTSPEOPLE

App. 7.1 Entertainers and Sportspeople: Introduction

This appendix considers the taxation of non-resident entertainers and sportspeople **("E&S rules")**.

The legislation is scattered: trading income rules are in ITTOIA, withholding tax is in ITA, and the bulk of the rules are in Income Tax (Entertainers and Sportsmen) Regulations 1987 ("ITESR"). The policy of the tax law rewrite was not to rewrite or update statutory instruments, so the ITESR retains the out of date references to the original legislation in schedule 11 FA 1986.[1] The policy is understandable, but the consequence is that the rewrite has left the law in this area more difficult to follow rather than easier. When quoting ITESR, I add the current statutory references in brackets.

HMRC have issued guidance which I call **"HMRC E&S guidance"**.[2]

App. 7.2 Definitions

It is helpful first to deal with some definitions. Because the legislation is scattered, most definitions have to be repeated or cross referenced; but we muddle through.

App. 7.2.1 *"Entertainer" and "performer"*

Reg 2(1) ITESR defines "entertainer":

> In these Regulations unless the context otherwise requires ...
> "entertainer" means any description of individuals (and whether

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1 The FA 1986 can be found at *http://www.legislation.gov.uk/ukpga/1986/41/pdfs/ukpga_19860041_en.pdf.*

2 HMRC, "A Guide to paying Foreign Entertainers" *http://www.hmrc.gov.uk/leaflets/feu50_0300.htm*

> performing alone or with others) who give performances in their character as entertainers or sportsmen in any kind of entertainment or sport;
> and "entertainment or sport" in this definition includes any activity of a physical kind, performed by such an individual, which is or may be made available to the public or any section of the public and whether for payment or not.

ITTOIA and ITA use the expression:

> an entertainer, sportsman or sportswoman[3] of a prescribed description ("a performer")

This incorporates the same definition.

HMRC E&S guidance provides:

> **Which entertainers and sportsmen are involved?**
> The following list is not exhaustive. athletes, golfers, cricketers, footballers, tennis players, boxers, snooker players, darts players, motor racing drivers, jockeys, ice skaters, contestants in chess tournaments, singers, musicians, conductors, models, dancers, actors, TV and radio personalities, variety entertainers. The person may appear alone or with others in a team, choir, band, group, orchestra, opera company, ballet company, troupe or circus.

App. 7.2.2 *"Relevant activity" and "prescribed description"*

Section 13(8) ITTOIA provides the definition of "relevant activity":

> In this section and section 14—
> "relevant activity" means an activity of a prescribed description[4]

We turn to reg 6(1) ITESR to find the "prescribed description" of a relevant activity:

> Subject to this regulation, any activity performed in the UK by an entertainer (whether alone or involving others) of any of the descriptions in paragraph (2) is an activity of a prescribed description ("relevant activity") for the purposes of paragraph 1 of [Schedule 11 FA 1986], that Schedule and these Regulations.

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3 Note the change from the "sportsmen" of the 1987 regulations: gender neutral drafting was one of the policies of the tax law rewrite.

4 Section 966(7)(a) ITA repeats the definition for ITA.

That is, the definition in reg. 6 applies for all E&S purposes. So we read on to reg 6(2) ITESR:

> A relevant activity to which paragraph (1) refers is an activity
> [a] performed in the UK by an entertainer
> [b] in his character as entertainer
> on or in connection with a commercial occasion or event ...

The regulation goes on to expand this:

> and includes—
> (a) any appearance of the entertainer by way of or in connection with the promotion of any such occasion or event;
> (b) any participation by the entertainer in or for sound recording, films,[5] videos, radio, television or other similar transmissions (whether live or recorded).

Regulation 6(3) ITESR provides a commonsense definition of "commercial occasion or event":

> A commercial occasion or event to which paragraph (2) refers includes any description of occasion or event—
> (a) for which an entertainer (or other person) might receive or become entitled, for or by virtue of the entertainer's performance of the activity, to receive anything by way of cash or any other form of property; or
> (b) which is designed to promote commercial sales or activity by advertising, the endorsement of goods or services, sponsorship, or other promotional means of any kind.

App. 7.2.3 *"Payment" and "transfer"*

Section 13 ITTOIA provides:

> (9) In this section and section 14—
> (a) references to a payment include references to a payment by way of loan of money, and
> (b) references to a transfer do not include references to a transfer of money but, subject to that, include references to—
> (i) a temporary transfer (as by way of loan), and

5 Defined reg. 6(4) ITESR: "film" includes any record (with or without sound), however made, of a sequence or series of one or more visual images, which is a record capable of being used as a means of showing part or all of that sequence or series as a moving or still picture..."

(ii) a transfer of a right (whether or not a right to receive money).

(10) This section does not apply to payments or transfers of a kind prescribed in regulations under section 966(6) of ITA 2007.

App. 7.3 Deemed UK trade

Section 13(1) ITTOIA provides:

> This section applies if an entertainer, sportsman or sportswoman of a prescribed description (a "performer")—
>
> (a) is non-UK resident in a tax year, and
>
> (b) performs a relevant activity in the UK in the tax year.

ITTOIA EN provides:

> 92. A visiting performer may not be in the UK long enough to become resident for tax purposes. And any relevant activities may not be part of a trade, profession or vocation carried on in the UK. So, without this section, there would be no liability to tax on the activities in the UK.

If the conditions of s.13(1) are met, there are three deemings:

(1) A deemed trade, which is:

(a) Deemed to be a UK trade

(b) Deemed to be a separate trade

(2) Payment to prescribed third parties deemed made to performer.

Firstly the deemed UK trade. Section 13(2) ITTOIA provides:

> If a payment or transfer connected[6] with the relevant activity is made, the performer is treated for income tax purposes as performing the relevant activity in the course of a trade, profession or vocation carried on in the UK.

I refer to this as **"the notional UK trade"**. ITESR refers to it as "Schedule 11 trade". I use the word "trade" to include a profession or vocation.

The income of the notional UK trade is taxed as UK source trading income. The remittance basis does not apply.

The notional UK trade is deemed to be a separate trade. Section 13(7) ITTOIA provides:

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6 See App 7.4 ("Connected with" a relevant activity) [[#"Connected with" a relevant activity | "Connected with" a relevant activity]].

> If—
>
> (a) income tax is chargeable on profits arising from payments or transfers (made to any person), and
>
> (b) the payments or transfers are connected with the relevant activity,
>
> the tax is charged as if the payments or transfers were received in the course of a separate trade, profession or vocation (distinct from any other trade, profession or vocation carried on by the performer).

I am not quite sure why this is needed; perhaps to emphasise that expenses of the non-UK activity cannot be deducted in computing the profits of the notional UK trade.

App. 7.4 "Connected with" a relevant activity

The expression "connected with" the relevant activity matters because payments/transfers connected with the relevant activity are taxed as part of the deemed trade, and subject to withholding tax.

Section 13(8) ITTOIA provides:

> In this section and section 14 a payment or transfer is connected with a relevant activity if it has a connection of the prescribed kind with that activity.[7]

We turn to reg 3(1) ITESR to find the " prescribed kind" of connection:

> This regulation applies for the purposes of and subject to the provisions of paragraph 2 of [Schedule 11 FA 1986], the other provisions of that Schedule and these Regulations.

That is, the definition applies for all E&S purposes. So we read on to reg 3(2) ITESR:

> Subject to paragraph (3) a payment or a transfer made or, in respect of or which in any way derives either directly or indirectly from, the performance of a relevant activity, has a connection of a prescribed kind with the relevant activity.

Reg 3(3) ITESR provides three exceptions where a payment/transfer is not connected with the relevant activity. The significance is to disapply all the E&S rules.

The first exception is where a deduction of tax regime already applies:

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7 Section 966(7)(b) ITA repeats the definition for ITA.

(3) The following are descriptions of payments to which paragraph (2) shall not apply—

(a) a payment out of which a sum representing tax is or falls to be deducted under the Taxes Act apart from [Schedule 11 FA 1986] or these Regulations;

Other deduction regimes have priority over the E&S rules. This would apply to royalties.

The second exception concerns payments to UK residents (which should constitute a taxable receipt of the UK resident):

(3) The following are descriptions of payments to which paragraph (2) shall not apply...

(b) (i) a payment (to which paragraph (ii) applies) made to a person who is resident in the UK, not being a person who is connected[8] with or an associate[9] of the entertainer concerned;

(ii) a payment to which paragraph (i) refers is a payment—

(a) which falls to be made for the provision of services ancillary to the performance of a relevant activity, and

(b) which is of an amount or value which does not exceed what would be reasonable for that provision between persons dealing with each other at arms' length;

The third exception concerns royalties for sound recordings:

(3) The following are descriptions of payments to which paragraph (2) shall not apply...

(c) any payment made to an entertainer in respect of the proceeds of sale of records[10] deriving from a sound recording made by the entertainer, being payments calculated by reference to those proceeds or payments on accounts of those proceeds.

The reason for this is, perhaps, that (1) records (unlike concerts and sports

---

8 Regulation 2(2) incorporates the standard definition: "S.533 of the Taxes Act [1970] (meaning of connected persons) applies for the purposes of these Regulations."

9 Regulation 13 ITESR incorporates the close company definition: "associate" has the meaning given to it by section 303(3) of the Taxes Act [1970]; see 85.5 (Associates)[[Control, Connected, Close and Related Expressions#Associates | Associates]].

10 Defined reg. 6(4) ITESR: "record" in this definition includes video.

events) could be made anywhere; or (2) royalties are covered by an entirely different tax regime.

App. 7.5 No notional trade when activity otherwise taxable

Section 13(4) ITTOIA provides two exceptions where there is no notional UK trade:

> (4) Subsection (2) [deemed notional UK trade] does not apply—
> (a) so far as the performer would otherwise be performing the relevant activity in the course of a trade, profession or vocation carried on in the UK, or

In this case the charge is on the actual trade, not a notional UK trade.

The second exception is:

> (4) Subsection (2) [notional UK trade] does not apply...
> (b) if the relevant activity is performed in the course of an employment or office.

In this case the charge is on the employment, not a notional UK trade.

These two exceptions disapply the deemed notional trade under s.13(2), but not the third party rules under s.13(5) to which I now turn.

App. 7.6 Payment to third parties

Section 13(3) ITTOIA provides:

> It does not matter whether the payment or transfer is made to the performer or anyone else.

Section 13(5) ITTOIA provides:

> If a payment or transfer connected with the relevant activity is made to—
> (a) a person other than the performer, and
> (b) that person is of a prescribed description,
> the payment or transfer is treated for income tax purposes as made instead to the performer in the course of a trade, profession or vocation carried on in the UK.

An argument that a territorial principle prevented the application of the charge where the payment was made between non-resident companies was rightly rejected in *Agassi v Robinson* 77 TC 678.

I refer to the person of a prescribed discription as **"a prescribed third party"**.

App. 7.6.1 *Prescribed third parties*

Regulation 7(1) ITESR provides:

> Any description of person in paragraph (2) is a person (not being the entertainer) to whom paragraph 7(1) of [Schedule 11 FA 1986 = s.13(5) ITTOIA] refers.

So we read on to reg 7(2) ITESR. There are four categories of prescribed third party.

The first category is controlled persons:

> (2) The descriptions of persons to whom paragraph (1) refers are-
> (a) any person who is under the control[11] of the entertainer;

The second category is certain non-residents:

> (2) The descriptions of persons to whom paragraph (1) refers are ...
> (b) any person who is—
> (i) not resident in the UK, and
> (ii) not liable to tax by reason of residence, domicile, place of management or otherwise, in a territory outside the UK where the rate of tax charged on the profits or income of such a person is a rate exceeding 25%;[12]

The third category is certain settlements:

> (2) The descriptions of persons to whom paragraph (1) refers are ...
> (c) (i) subject to paragraph (ii), any person in receipt (whether directly or indirectly) of
> [A] a connected payment[13] or
> [B] value transferred[14] by a connected transfer
> which is, is treated as, or falls to be included in the computation of, income arising under a settlement in

---

11 Reg 2 ITESR incorporates the ultra-wide definition: "control" shall be construed in accordance with s.302(2) to (6) of the Taxes Act [1970]; see 85.3 (Control in ultra-wide sense)[[Control, Connected, Close and Related Expressions#Control in ultra-wide sense | Control in ultra-wide sense]].

12 The figure of 25% ought to be reduced in line with the reduction of CT rates since 1987 (when the CT rate was 35%).

13 Defined reg 2 IETSR: a payment or transfer to which reg 3 ITESR applies is described as "connected".

14 Defined reg 2 ITESR: "value transferred" in relation to a transfer means the gross amount to which regulation 17(1) refers.

relation to which the entertainer is a settlor;[15]

The fourth category concerns arrangements under which the performer may benefit:

(2) The descriptions of persons to whom paragraph (1) refers are ...
(d) (i) any person
[A] to whom paragraph (2) of this regulation does not otherwise apply[16]
[B] who receives any connected payment or connected transfer (whether directly or indirectly) at or in respect of a time when there is in force between that person and the entertainer concerned a contract or arrangement to which paragraph (ii) applies;
(ii) a contract or arrangement to which paragraph (i) refers is a contract or arrangement by or under which it is reasonable to suppose that the entertainer (or other person who is connected with or is an associate of the entertainer) is, will or may become, entitled to receive amounts, whether by way of cash or other value, not substantially less than the appropriate amount of profits or gains arising from the connected payment or connected transfer to which [para 8(1) sch 11 FA 1986 = s.13(2) ITTOIA] applies.

App. 7.7 Computation of profits of notional trade

Regulation 8 ITESR provides some self-explanatory rules for the computation of the profits of the deemed UK trade:

(1) Subject to the provisions of these Regulations, the profits or gains (to which paragraph 7(2) of [Schedule 11 FA 1986] refers) shall be computed in accordance with the provisions of the Taxes Act relating to the charging of profits or gains under Case I or II (as the case may be) of Schedule D, so that a just and reasonable amount of such a payment or value transferred by such a transfer is charged to tax as such profits or gains; and

---

15 Para (c)(ii) incorporates the settlement-arrangement definitions of these terms:
"for the purposes of paragraph (i):—
"income arising under a settlement" and "settlor" have the meanings given to them by section 454 of the Taxes Act [1970], and
"settlement" has the meaning given to it by section 444(2) of the Taxes Act [1970]".

16 Para [A] seems otiose, but it does not matter.

(2) Notwithstanding any provision of the Taxes Act, in computing the said profits or gains such deductions of expenses incurred by any person (not being the entertainer) in relation to the payment or transfer concerned shall be made as are just and reasonable.

Regulation 16 ITESR provides for apportionment:

(1) The provisions of paragraph (2) are by way of supplementation of the provisions of section 127 of the Taxes Act.
(2) Where, in the case of any payment, value transferred or profits or gains to which Schedule 11 or these Regulations apply, it is necessary, in order to arrive at the appropriate amount of such payment, value or profits or gains for any tax year or other period, to make any apportionment, division or aggregation of any amounts or values, any such apportionment, division or aggregation, shall be made as is just and reasonable.

Apportionment issues have often proved controversial.

App. 7.8 Trading Losses

Regulation 15 ITESR provides:

(1) In this regulation–
  (a) "world-wide trade" means a trade of an entertainer which is a trade apart from Schedule 11 and these Regulations, and a "Schedule 11 trade" means a trade which is a separate trade of an entertainer only by virtue of Schedule 11 and these Regulations;
  (b) "trade" includes profession or vocation.
(2) For the purposes of section 171 of the Taxes Act (carry forward of losses) the world-wide trade and the Schedule 11 trade shall be treated as the same trade.
(3) For the purposes of section 174 of the Taxes Act (carry back of terminal losses) a loss sustained for any relevant period under a Schedule 11 trade (to which otherwise that section would apply) shall not be a terminal loss except where the world-wide trade is permanently discontinued in that period, in which case such a loss in either trade shall be available under that section to be deducted or set off against profits or gains of those trades.
(4) For the purposes of section 30 of the Finance Act 1978 (losses in early years of trade) the world-wide trade and the Schedule 11 trade shall be treated as the same trade, but that section shall ap-ply to any such loss of an entertainer only in the tax year in which the world-wide

trade was first carried on and in the next 3 succeeding tax years.

App. 7.9 Withholding tax

Section 966 ITA provides:

(1) This section applies if—
  (a) an entertainer, sportsman or sportswoman of a prescribed description ("a performer") who is non-UK resident for a tax year performs a relevant activity in the UK in the tax year, and
  (b) a payment or transfer connected with the relevant activity is made.

(2) It does not matter—
  (a) whether the payment or transfer is made to the performer or anyone else, or
  (b) when the payment or transfer is made...

(6) This section does not apply to payments or transfers of such a kind as may be prescribed.

App. 7.9.1 *Deduction on making payment*

Section 966(3) ITA provides:

> If a payment within subsection (1)(b) is made the person who makes the payment must, on making it, deduct from it a sum representing income tax and account to HMRC for the sum.

App. 7.9.2 *Deduction on making transfer*

Section 966(4) ITA provides:

> If a transfer within subsection (1)(b) is made the person who makes the transfer must account to HMRC for a sum representing income tax.

App. 7.9.3 *Amount of tax deducted*

Regulation 4 ITESR provides:

(1) Each of the sums mentioned in paragraph 2(2) and (3) of Schedule 11 [FA 1986 = s.966 ITA] ("tax payment") shall be calculated in accordance with the rules prescribed by this regulation.

(2) Except where
  [a] it is otherwise provided by these Regulations or
  [b] there is an arrangement to which this regulation refers,
  the tax payment shall be a proportion
    [i] of the connected payment or
    [ii] of the value transferred by a connected transfer

equal to the basic rate of income tax for the tax year in which the payment or transfer is made.

Regulation 17(1) ITESR provides grossing up:

(a) The actual worth of what is transferred by a transfer to which paragraph 2(3) of Schedule 11 [FA 1986 = s.966(4) ITA] applies ("the net value") shall be treated as a net amount corresponding to a gross amount from which income tax at the basic rate has been deducted; and
(b) the said gross amount shall be treated as the value of what is transferred for the purposes of paragraph 2(4) of Schedule 11.

Regulation 17(2) ITESR defines net value:

(a) The net value to which paragraph (1) refers shall be the cost of what is transferred, and
(b) the cost of what is transferred to which sub-paragraph (a) refers is the cost in or in connection with its provision (including its provision to the person who makes the transfer) or transfer, less so much of that cost which has been borne by the entertainer.

App. 7.9.4 *Personal allowance*

Regulation 4(3) ITESR (in short) exempts payments and transfers within the personal allowance:

(3) (a) Subject to sub-paragraph (b), where the connected payments and the value transferred by connected transfers for a tax year made to an entertainer, or to a person who is connected with him or who is an associate of his, do not together exceed the relevant amount[17] the tax payment shall be a nil amount;
(b) connected payments and the value transferred by connected transfers made by any person who is connected with any other person by whom connected payments or connected transfers are made to the entertainer, or by any associate of such other person, shall together be treated as constituting a single connected payment in determining whether they exceed the relevant amount.

17 Reg 2 ITESR defines this: "the relevant amount" means the amount of the personal allowance in section 35(1) ITA 2007 which applies for the tax year in which the payment or transfer is made.

App. 7.10 Agreements with HMRC

Regulation 4(4)-(6) ITESR allows HMRC to make different arrangements:

> (4) An arrangement to which paragraph (2) refers is an arrangement in writing between
>
> [a] the Board and
>
> [b] the person by whom the connected payment or connected transfer is made, the entertainer, or the recipient of the connected payment or connected transfer,
>
> made following a decision by the Board on an application to which regulation 5 refers, under which the tax payment is an amount which, as a proportion of the connected payment or value transferred by the connected transfer, is an amount less than the said basic rate ("reduced tax payment").
>
> (5) The reduced tax payment may be arrived at by reference to a percentage of the connected payment or of the value transferred by a connected transfer or as a lump sum calculated without reference to any such percentage.
>
> (6) In making an arrangement of the kind to which paragraph (2) refers the Board–
>
> (a) shall, subject to sub-paragraph (b) and paragraph (7) below, at all times aim at securing that the tax payment shall be, as nearly as may be, the amount of the liability to tax of the entertainer or other person arising in relation to the connected payment or connected transfer under the Tax Acts, Schedule 11 and these Regulations, and
>
> (b) may take into account the fact that the liability to the Board for tax has, in a manner satisfactory to them, been secured or otherwise provided for, whether by a guarantee (of whatever person) or other means.

HMRC E&S guidance provides:

> **Application to HMRC to limit the amount of tax withheld**
>
> An application may be made in writing by the entertainer or anyone else authorised to do so on their behalf. Where the application is agreed, it allows the payer to deduct an amount other than the basic rate of tax which corresponds as near as to the entertainer's final UK liability on that payment.
>
> An application to HMRC to limit the amount of tax withheld may be made in writing or on form FEU 8. Any letter which advises the Unit that detailed figures are to follow is considered to constitute an advance

notification of an application **but does not constitute the application itself.**

Applications to the Foreign Entertainers Unit must be made no less than 30 days before the date the payment is due.

If the application is not agreed tax must be accounted for at the basic rate on all related payments.

How to make a reduced tax payment application (RTPA)

The information required to enable an agreement to be made includes:

- dates of arrival in and departure from the UK
- whether the entertainer is likely to return to the UK again before the 5 April
- a projection of actual or estimated total income due from all sources
- a schedule confirming; the date of each performance/event, the name and address of the venue and the name and address of the promoter
- a schedule of the projected actual or estimated expenses which will be incurred
- a copy of each relevant engagement contract or agreement (these do not need to be signed copies).

The application should give sufficient information to show how figures have been arrived at (including the basis for any estimates) and how expenditure appropriate to several countries has been apportioned.

In some cases you may be authorised to deduct a reduced rate of tax, a fixed sum or no tax from the gross payment. This could apply, for example, where an entertainer has to meet substantial expenditure out of a gross fee thus reducing the expected UK tax liability.

In reaching an agreement the Foreign Entertainers Unit will make allowances for admissible expenses. What can be allowed depends on the general rules covering expenditure allowable in arriving at taxable business profits under Section 34 Income Tax (Trading and Other Income) Act 2005 and the facts of each case. Normally allowances will be made for:

- general subsistence expenses
- commission, manager's and agent's fees
- UK travel
- international air fares to and from the UK where the entertainer comes to the UK to perform and returns directly to his or her home country

Other expenses may be allowable. What is allowable in each case will need to be agreed with the Foreign Entertainers Unit including the proportion of any costs appropriate to several countries.

Further information can be obtained about Reduced Tax Payment Applications including further advice regarding the preparation of an

entertainer RTPA.
If the point you wish to check is not covered in this guidance or at the above link then contact the Foreign Entertainers Unit.
How do you know that a reduced tax payment has been authorised?
The Foreign Entertainers Unit will authorise you to deduct a reduced amount of tax by sending you a form FEU 4. Even where you have been a party to the agreed arrangement with HMRC you must wait until you get the form FEU 4.
If you have not received an authorisation form FEU 4 by the time the payment is due you must deduct tax at the basic rate on all related payments.

App. 7.11 Chains of payments

Regulation 4(7) ITESR provides:

> Where–
>
> (a) a person makes a connected payment or connected transfer in relation to a relevant activity, and
>
> (b) in respect of the same relevant activity that person has received a connected payment or connected transfer in respect of which the amount of the tax payment has been paid under these Regulations,
>
> the person concerned shall not be required to deduct out of the connected payment or pay in respect of the connected transfer (to which sub-paragraph (a) refers) any sum to which paragraph 2 of Schedule 11 applies unless, and to the extent that, the tax payment which then falls to be made exceeds the amount of the tax payment to which sub-paragraph (b) refers.

The default rule is that deduction is made at the start of the chain.
HMRC E&S guidance provides:

> **How do you deal with payment chains?**
> Some activities may give rise to a chain of payments. Every payer in the chain must deduct tax as required by law unless the payment is exempt.
> *Example*
> A concert is arranged at a venue. The venue owners control the box office and pay over the ticket proceeds to the promoter less their costs and Withholding Tax. The promoter is then required to deduct Withholding Tax from the fee payable to the entertainer. The promoter should deal with this as follows:
> He must deduct Withholding Tax (where it is due) from the payment made to the entertainer and pay over the net amount.

He must issue a tax deduction certificate form FEU 2, to the entertainer confirming the pay and tax details.
He declares the payment made and the tax deducted on the form FEU 1 (boxes 5 & 6) and shows the tax already withheld from the payment made to him in box 8.
Example
A Promoter engages a non-resident entertainer to appear at a UK venue. The Entertainer is the only non-resident entertainer the promoter engages in the quarter. The sequence of payments is as follows:
The Venue pays £100,000 less £20,000 tax to the Promoter
The Promoter pays £60,000 less £12,000 tax to the Entertainer
The Promoter is liable to account to HMRC for £12,000 but as the payment he has received has had £20,000 Withholding Tax deducted from it he can treat the £12,000 as paid.
Entries on the Promoter's return form FEU 1
The amount and income tax columns of the Promoter's return for the relevant period should be completed as follows:

Payment	Amount	Tax
	60,000	12,000
Less tax already paid by Venue		12,000
Tax payable now		Nil

Evidence of the tax already paid must be provided with the FEU1 return by including part 3 of the FEU2 tax deduction certificate which is supplied by the Venue.

However it is possible to agree a different rule. Regulation 5 ITESR provides:

(1) Where a connected payment or connected transfer falls to be made subject to a tax payment to which regulation 4(2) refers the person by whom the connected payment or connected transfer is made, the entertainer, or recipient of the connected payment or connected transfer, may make an application in writing to the Board, not later than 30 days before the connected payment or connected transfer falls to be made, that it shall be subject instead to a reduced tax payment (within the meaning of regulation 4).
(2) Unless and until there is in force an arrangement under which such a reduced tax payment falls to be made regulation 4(2) shall at all times continue to apply to the connected payment or connected transfer.

HMRC E&S guidance provides:

Middleman Applications

Payers can ask for an arrangement which moves the withholding point further down the chain so that payments between specified payers can be made without deduction of tax. This can only be done with the Foreign Entertainers Unit's approval.

If the concert promoter makes a 'Middleman' application, the Unit may agree to the promoter being the witholding point, therefore the venue will not have to withold tax. The promoter will then have to deduct tax at basic rate on his or her payment or a reduced amount if an entertainer's application for a reduced tax payment has been made and agreed.

The Unit will ask for certain information in support of any 'Middleman' application you make, for example, a copy of any contract, dates of appearances, and probably a copy of the budget. If you are submitting a 'Middleman' application for the first time the Unit will be happy to advise you on the procedure and level of information required....[18]

App. 7.12 Position of payor

Reg 12 ITESR provides:

(1) Where under these Regulations there is accounted for and paid to the Board an amount of tax which is–

(a) in respect of a connected payment or connected transfer, or

(b) paid under an assessment made under paragraph 11,

that amount shall, subject to this regulation, be treated as a payment of tax on account of the tax liability (of whatever person) in respect of the connected payment or connected transfer concerned.

(2) Where, in respect of a connected payment or connected transfer, there is a liability to tax under the Tax Acts as well as under Schedule 11 or these Regulations, the Board shall allocate any payment made to them to which paragraph (1) refers as is just and reasonable in discharge of some or all of those liabilities of the entertainer or other person concerned to whom these Regulations apply.

(3) Where–

(a) by virtue of paragraph 8 of Schedule 11 and these Regulations a connected payment or the value transferred by a connected transfer falls to be included in the amount of profits or gains to which paragraph 8(1)(a) refers, and

(b) the amount of the connected payment or the value transferred

18 See *http://www.hmrc.gov.uk/feu/appromers.htm*

(or an amount in respect of that value) is charged to tax under Schedule E

the amount charged under Schedule E (to which sub-paragraph (b) refers) shall be treated as expenditure which falls to be deducted in computing the profits or gains to which sub-paragraph (a) refers.

(4) Where a payment is a connected payment–

(a) which is, is treated as, or falls to be included in a computation of, income of the entertainer chargeable to tax by virtue of the provisions of Part XVI of the Taxes Act, or

(b) which is a receipt of a company which provides the services of the entertainer to perform the relevant activity, being a receipt which falls to be included in the computation of its profits which are chargeable to tax under Schedule D,

the charge under Schedule 11 shall have effect and the charges to which sub-paragraphs (a) and (b) refer shall be disregarded.

(5) A person making a connected payment or connected transfer in respect of which a tax payment has been made by virtue of these Regulations shall furnish the recipient with a certificate showing the gross amount of the payment or the value transferred, the amount of the tax payment, and the amount actually paid.

HMRC E&S guidance provides:

How are payments dealt with in your Self Assessment or Corporation Tax accounts?

If the income you receive is attributed to the entertainer under the rules set out in Regulation 7 ITESR then the tax withheld from the payment you receive will be treated as a payment on account of the entertainer's UK liability.

You will not be charged to UK tax on that income and there will be no repayment of the Withholding Tax to you.

But if:

- you are UK resident and
- the income you receive is not attributed to the entertainer under the above rules then the payment you receive will be a receipt of your own business

The amount of the assessable income will be the payment received plus the amount of the Withholding Tax which has been deducted. You will be able to claim the gross payment you make as a deduction in your UK Income Tax or Corporation Tax accounts.

'Gross payment' means the payment to the entertainer or intermediary plus the tax accounted for to HMRC.

If you make the payment in a series of payments as described at How to

work out the tax, you may be entitled to set off tax withheld from payments you receive against your UK tax liabilities or claim a repayment of tax.

Example

A UK Venue pays box office income of £100,000 to a UK Promoter in respect of the performance of a non-UK resident entertainer. The Entertainer is paid a fee of £60,000 by the Promoter

Withholding Tax

A venue pays £80,000 to the promoter. This is £100,000 less £20,000 which is 20% tax. The £20,000 tax is paid to HMRC.

The promoter pays £48,000 to the entertainer. This is £60,000 less £12,000 which is 20% tax. The £12,000 tax is paid to HMRC.

Treatment in the accounts

The Venue is allowed the expense of £100,000 (that is the gross payment shown in his accounts).

The Promoter has a receipt of £100,000 as income and is allowed £60,000 as an expense in its accounts.

Tax set offs

The Promoter can claim to set the excess Withholding Tax of £8,000 against its Income Tax/Corporation Tax liability for that accounting period. i.e. £20,000 less the payment of £12,000.

If the Promoter had a tax liability of less than £8,000 it can claim a repayment of the amount by which £8,000 exceeds its Income Tax/Corporation Tax liability for that accounting period.

HMRC E&S guidance provides:

Is Withholding Tax due on payments made to Groups, Theatre Companies, Productions, etc, which include both UK resident and non-resident entertainers?

For example, a music group or a theatre company which includes both UK resident and non-resident performers.

Yes, Withholding Tax is due

Unless advised otherwise by the Foreign Entertainers Unit the payer must account for Withholding Tax on the total payment, including expenses, made to or in respect of the group or theatre company.

If the payee/group/theatre company want the payer to calculate and deduct tax only on the non UK resident performers, the payee/group/theatre company must apply to the Foreign Entertainers Unit for agreement to do this.

How to work out the Withholding Tax

Where you are paying or transferring money it is very straightforward to work out the tax.

Assuming the basic rate percentage for the year of payment is 20 per cent then you should deduct this percentage from each payment made.

Example

Gross Payment	£10,000
Tax (10,000 × 20%)	£2,000
Net amount paid to entertainer	£8,000

The same applies to a loan of money. You should deduct tax from the amount of the loan.

All payments of Withholding Tax made to HMRC must be made in sterling. If you make a payment directly or indirectly to an entertainer in a foreign currency you should calculate the Withholding Tax due using the rate of exchange at the time when the payment is made or at the rate used at the time the foreign currency was purchased. The rate of exchange used should be shown on your return form FEU 1.

If the transfer of an asset is involved (for example, a motor car for a 'hole in one' during a golf competition) you must account for the tax as if the asset's cost to you or in connection with providing it was the net amount of the payment.

Withholding Tax is also due on expenses provided for an entertainer. For example, hotel accommodation, airfares, UK transport etc.

In the absence of an agreement with the Foreign Entertainers Unit, Withholding Tax must be accounted for and paid by the payer, from its own funds, on payments made in respect of expenses provided for an entertainer.

The Withholding Tax due must be calculated as follows:

The cost of the expenses, to the payer, must be grossed up, at the basic rate of tax, to give the true cost of the benefit to the artiste.

Withholding Tax due must be calculated at the basic rate on the grossed up value of the expenses.

The withholding tax calculated must be paid by the payer from its own funds: it must not be deducted from the overall payment made to the artiste.

Example

The airline ticket costs you £1,000. You need to work out the gross amount of the payment and pay tax on that amount. To work out the gross amount you do the following sum.

Net amount of payment £1000 × 20 (basic rate of tax) divided by 80 (100% – 20% basic rate of tax) = £250

Add the tax amount £250 to the net payment £1000 to get the gross payment £1250

Add the result to the net payment to get the gross payment.

£250 + £1,000 = £1,250

Tax (£1,250 × 20%) = £250

VAT Implications

VAT is not chargeable on Withholding Tax and you should therefore exclude the VAT when calculating Withholding Tax due.

When calculating the amount of tax due on a payment to be made either to, or in respect of an entertainer you must not include VAT (if any) charged to you.

If you are a venue paying the gross ticket sales to a promoter or entertainer, the VAT element of each individual ticket price must be taken out.

App. 7.13 Administration

Reg 9 ITESR deals with returns:

(1) A person who makes a connected payment or connected transfer shall, in accordance with this regulation, make a return to the Board of the connected payment or connected transfer which he makes and of any tax payment (including a nil amount) for which he is accountable to the Board.

(2) A return shall be made in the tax year for each successive period ending on 30th June, 30th September, 31st December and 5th April.

(3) The return for each period shall be made within 14 days after the end of the period.

(4) [This deals with notices requiring information, but is now effectively superceded by more general HMRC information powers]

(5) The [TMA 1970] shall apply to a return to which this regulation relates as it applies to a return under the Taxes Acts.

Reg 10 ITESR deals with the due date for tax payments:

(1) A tax payment (including any reduced tax payment), whether any deduction out of a connected payment or provision in respect of a connected transfer has been made or not, shall be due at the time by which the return under regulation 9(1) is to be made ("the due date") and payment shall be made before, or at the time when, that return is made.

(2) A payment at any time so due shall be payable by the person who makes the connected payment or connected transfer concerned, without the making of any assessment in respect of it.

(3) Subject to the provisions of regulation 11, tax which has become due and payable under this regulation (whether or not it has been paid when the assessment is made) may be assessed on the per-son from

whom it is due if that tax, or any part of it, is not paid on or before the due date.

Reg 11 ITESR deals with assessments, Reg 13 ITESR deals with tax overpayments of tax and reg. 14 incorporates the TMA rules. These need not be set out here.

App. 7.14 DT Agreements

Article 17 OECD Model Convention provides:

> 1. Notwithstanding the provisions of Articles 7 [Business profits] and 15 [Employment income], income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.
> 2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised.

The OECD Model Commentary provides:

> 1. Paragraph 1 provides that artistes and sportsmen who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are of a business or employment nature. This provision is an exception to the rules in Article 7 and to that in paragraph 2 of Article 15, respectively.
> 2. This provision makes it possible to avoid the practical difficulties which often arise in taxing artistes and sportsmen performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to business activities. To achieve this it would be sufficient to amend the text of the Article so that an exception is made only to the provisions of Article 7. In such a case, artistes and sportsmen performing in the course of an employment would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article.

About a dozen UK treaties contain a cultural exemption.

App. 7.14.1 *"Artiste" and "Sportsmen"*

The International Manual provides:

> **INTM153190 Description of double taxation agreements: Artistes/entertainers/athletes** [March 2011]
> This Article is generally entitled artistes and athletes, but the terms entertainers and sportsmen can also be used. We do not consider there is any difference between the terms artistes and entertainers and sportsmen and athletes.

The OECD Commentary provides:

> 3. Paragraph 1 refers to artistes and sportsmen. It is not possible to give a precise definition of "artiste", but paragraph 1 includes examples of persons who would be regarded as such. These examples should not be considered as exhaustive. On the one hand, the term "artiste" clearly includes the stage performer, film actor, actor (including for instance a former sportsman) in a television commercial. The Article may also apply to income received from activities which involve a political, social, religious or charitable nature, if an entertainment character is present. On the other hand, it does not extend to a visiting conference speaker or to administrative or support staff (e.g. cameramen for a film, producers, film directors, choreographers, technical staff, road crew for a pop group etc.). In between there is a grey area where it is necessary to review the overall balance of the activities of the person concerned.
> 4. An individual may both direct a show and act in it, or may direct and produce a television programme or film and take a role in it. In such cases it is necessary to look at what the individual actually does in the State where the performance takes place. If his activities in that State are predominantly of a performing nature, the Article will apply to all the resulting income he derives in that State. If, however, the performing element is a negligible part of what he does in that State, the whole of the income will fall outside the Article. In other cases an apportionment should be necessary.
> 5. Whilst no precise definition is given of the term "sportsmen" it is not restricted to participants in traditional athletic events (e.g. runners, jumpers, swimmers). It also covers, for example, golfers, jockeys, footballers, cricketers and tennis players, as well as racing drivers.

The Commentary discusses the concept of sports or entertainment:

> 6. The Article also applies to income from other activities which are usually regarded as of an entertainment character, such as those deriving

from billiards and snooker, chess and bridge tournaments.

7. Income received by impresarios, etc. for arranging the appearance of an artiste or sportsman is outside the scope of the Article, but any income they receive on behalf of the artiste or sportsman is of course covered by it.

App. 7.14.2 *Income derived as an entertainer*

The OECD Commentary provides:

8. Paragraph 1 applies to income derived directly and indirectly by an individual artiste or sportsman. In some cases the income will not be paid directly to the individual or his impresario or agent. For instance, a member of an orchestra may be paid a salary rather than receive payment for each separate performance: a Contracting State where a performance takes place is entitled, under paragraph 1, to tax the proportion of the musician's salary which corresponds to such a performance. Similarly, where an artiste or sportsman is employed by e.g. a one person company, the State where the performance takes place may tax an appropriate proportion of any remuneration paid to the individual. In addition, where its domestic laws "look through" such entities and treat the income as accruing directly to the individual, paragraph 1 enables that State to tax income derived from appearances in its territory and accruing in the entity for the individual's benefit, even if the income is not actually paid as remuneration to the individual.

9. Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was no direct link between the income and a public exhibition by the performer in the country concerned. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (see paragraph 18 of the Commentary on Article 12), but in general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State. Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article 7 or Article 15, as appropriate. Payments received in the event of the cancellation of a performance are also outside the scope of Article 17, and fall under Articles 7 or 15, as the case may be.

App. 7.14.3 *Computation*

The OECD commentary provides:

10. The Article says nothing about how the income in question is to be computed. It is for a Contracting State's domestic law to determine the extent of any deductions for expenses. Domestic laws differ in this area, and some provide for taxation at source, at a low rate based on the gross amount paid to artistes and sportsmen. Such rules may also apply to income paid to groups or incorporated teams, troupes, etc. Some States, however, may consider that the taxation of the gross amount may be inappropriate in some circumstances even if the applicable rate is low. These States may want to give the option to the taxpayer to be taxed on a net basis. This could be done through the inclusion of a paragraph drafted along the following lines ...

App. 7.14.4 *Receipts by third parties*

The OECD commentary provides:

11. Paragraph 1 of the Article deals with income derived by individual artistes and sportsmen from their personal activities. Paragraph 2 deals with situations where income from their activities accrues to other persons. If the income of an entertainer or sportsman accrues to another person, and the State of source does not have the statutory right to look through the person receiving the income to tax it as income of the performer, paragraph 2 provides that the portion of the income which cannot be taxed in the hands of the performer may be taxed in the hands of the person receiving the remuneration. If the person receiving the income carries on business activities, tax may be applied by the source country even if the income is not attributable to a permanent establishment there. But it will not always be so. There are three main situations of this kind:

a) The first is the management company which receives income for the appearance of e.g. a group of sportsmen (which is not itself constituted as a legal entity).
b) The second is the team, troupe, orchestra, etc. which is constituted as a legal entity. Income for performances may be paid to the entity. Individual members of the team, orchestra, etc. will be liable to tax under paragraph 1, in the State in which a performance is given, on any remuneration (or income accruing for their benefit) as a counterpart to the performance; however, if the members are paid a fixed periodic remuneration and it would be difficult to allocate a portion of that income to particular performances, member countries may decide, unilaterally or bilaterally, not to tax it. The profit element accruing from a performance to the legal entity would be liable to tax under

paragraph 2.

c) The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, e.g. a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries "look through" such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory. Other countries cannot do this. Where a performance takes place in such a country, paragraph 2 permits it to impose a tax on the profits diverted from the income of the artiste or sportsman to the enterprise. It may be, however, that the domestic laws of some States do not enable them to apply such a provision. Such States are free to agree to other solutions or to leave paragraph 2 out of their bilateral conventions.

11.1 The application of paragraph 2 is not restricted to situations where both the entertainer or sportsman and the other person to whom the income accrues, e.g. a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer or sportsman is not a resident of that other State. Conversely, where the income of an entertainer resident in one of the Contracting States accrues to a person, e.g. a star-company, who is a resident of a third State with which the State of source does not have a tax convention, nothing will prevent the Contracting State from taxing that person in accordance with its domestic laws.

App. 7.14.5 *Double tax credit relief*

The INTM provides:

INTM168063 Foreign tax paid on trade income: limitation on credit: Artistes/athletes/sportsmen [January 2011]
As indicated in INTM153190, the country in which an entertainer or

sportsman performs has primary taxing rights over the income he derives from his performances in that country. Many foreign countries impose a withholding tax on the payments made for such performances at a fixed percentage of the gross payments. These are final taxes and normally claims cannot be made to the foreign country to have the expenses incurred in earning the payments deducted from the gross amounts. Where a resident entertainer or sportsman is charged to UK Income Tax on profits or gains arising from any profession or vocation, he is entitled to credit for these foreign taxes against the UK tax on the UK measure of that income, that is, the income less the expenses incurred in earning it. The credit will be the lesser of the foreign tax and the tax at his marginal rate (see INTM165040 onwards).

Where, however, a resident entertainer or sportsman is employed by a service company, the income from his performances is income of that company and he is paid a salary out of that income. Credit for the foreign tax paid on the payments for his performances is due against the Corporation Tax payable by the company on its profits. The income of the entertainer or sportsman is remuneration from the service company and not the original fees paid to the company and he is not therefore entitled to credit for such foreign tax against the UK tax on his salary. Nonetheless, it is possible that that a different treatment may be available where the foreign tax is imposed in a personal capacity on the entertainer etc notwithstanding that the performance payments are made to the service company. This treatment is intended to put the entertainer etc in a similar position when receiving remuneration from a service company in respect of overseas income that can be matched to a particular source, to the one he would have been in had he received the income direct. For instance, if a clear and direct link can be made between the fees for the performance in the overseas country and the income arising to the performer in the form of remuneration from the service company then it may be that the remuneration derived by the entertainer can be identified with the income taxed by the foreign tax authority. Where there such a link can be made, and the interval between the two events is short, it may be possible to allow the tax credit against income tax charged on the entertainer etc. Any credit given to the entertainer etc must be restricted in accordance with TIOPA10/S36 and S37, by reference to expenses (see INTM168010 onwards.)

Please therefore refer to Personal Tax International (PTI) Advisory. (part of Charity, Assets & Residence) where (i) a claim to credit for foreign tax is made by the entertainer or sportsman and (ii) the foreign tax has been imposed on the income received by the service company

but (iii) the overseas tax authority has disregarded the existence of the service company and taxed the income as if it belonged to the entertainer or sportsman. This treatment will not be available where a deduction for the foreign tax has been allowed to the company under S112 TIOPA10.

APPENDIX EIGHT

HOW TO IMPROVE RESIDENCE AND DOMICILE TAXATION

"To tax and to please, no more than to love and to be wise, is not given to men."[1] The following programme of tax reform is therefore split into two parts. Part 1 is a list of short technical improvements with no significant tax cost, no significant winners or losers, and not politically contentious. It represents some cheap and easy improvements to charity tax to which no-one should object or find difficult, the "low lying fruit" of charity tax reform.

Part 2 touches on tax avoidance on which HMRC are very sensitive.

Part 1: Low lying fruit

Proposal	Reference
Those born in the UK and deemed domiciled here on IHT principles (17 years residence) should be treated as UK domiciled for all tax purposes, not just IHT.	See 1.4 (Suitability of domicile as a fiscal test)
Repeal s.721(3) ITEPA.	See 3.3 (The concept of domicile)
Naturalised citizens should be deemed UK domiciled for tax purposes.	See 3.11.5 (Commentary)
English/Northern Ireland law definition of domicile should adopt the amendments made in Scotland. (This involves a general law reform, not just tax law.)	See 3.15 (Child's domicile in Scotland)

1 Edmund Burke, First Speech on the Conciliation with America (1774).

IT/CGT definition of trustee residence should apply for IHT.	See 5.18.1 (Trustee residence for IHT: Commentary)
Repeal s.82 and s.65(3) TCGA (collection of exit charge from trustees).	See 8.5.2 (Commentary)
TNR rules: exemption if foreign tax paid and annual exemptions.	See 9.26 (TNR rules: commentary)
Define RFI to mean all foreign source income; repeal s.830(1)(b), (2), (3) ITTOIA.	See 10.3.2 (Let's simplify the definition of RFI); 56.4 (Withdrawal of unremittable income relief)
"Relevant persons" for remittance purposes should just be the taxpayer, spouse, CP, cohabitee and minor children.; investment relief can be abolished as unnecessary.	See 11.8.1 (Commentary) 11.11 (Commentary: let's simplify remittance and relevant person rules); 12.24 (Remittance investment relief: commentary)
Foreign services relief: delete condition B and repeal s.809W(5) ITA.	See 12.26.4 (Services relief condition B: commentary); 12.26.6 (Exceptions: s.730 & s.87 benefits)
A person remitting from a mixed fund can determine what constituent of the fund the remittance consists of.	See: 13.16 (ITA mixed fund rules: commentary)
Delete requirement that "foreign employers" must be resident outside the UK.	See 22.13 (Foreign employer)
Align taxation of trades, professions and vocations so the same rules apply to all.	See 15.2 (Charge on trading income)
Source of interest should be as specified in OECD model.	No-one knows what the current test is. See 18.10.1 (Commentary)
Define "ordinary place of abode" in line with residence.	See 18.15.6 (Commentary)

The DTA self-certificate system for royalties should apply to interest.	See 18.17.11 (Commentary)
Repeal relief for exempt foreign currency securities.	See 19.8 (Exempt foreign currency securities)
Align treatment of Baker & Garland trusts, ie extend s.464 ITA to all trusts.	See 26.3.5 (Commentary)
Collect tax on income of settlor-interested trust from the settlor.	See 27.8 (Taxation of trustees of settlor-interested trust)
S.731 remittance basis should apply only if benefit is remitted (like the s.87 remittance basis).	See 30.36.9 (Commentary)
The statutory definition of "commercial" in s.738 ITA should be repealed.	See 32.6.4 (Commentary)
Restore motive defence old condition B.	See 30.13.8 (Section 733 computation: commentary)
Abolish Accrued Income remittance basis (make gains subject to CGT).	See 37.9.7 (Commentary)
Transactions in financial assets should in principle be deemed non-trading. The IME, AIF and OFTR exemptions can be repealed.	See 42.11 (Commentary)
Repeal s.56(3)(a)-(f) - an odd list of entitlements to personal allowances.	See 47.6.3 (Commentary)
Repeal relief for pre-1991 protected trusts: there are probably none left in existence.	See 50.7.4 (Commentary: let's abolish relief for pre-1991 protected trusts)
Align definition of "spouse" for CGT and IT settlor-interested trust rules, ie apply s.625(4) ITTOIA for CGT.	See 50.4.2 (Civil partner and same-sex spouse of settlor).
Repeal s.87 interest surcharge.	See 51.13.1 (Commentary)

Schedule 4B & 4C TCGA should only apply where there is a purpose specifically to avoid s.87 or s.86.	See 52.29 (Commentary)
Repeal carry back of losses on death.	See 54.5 (Carry-back of losses on death)
Personal CGT losses should be deductible against s.87 gains.	See 54.7.1 (Commentary)
The taxation of foreign currency should be the same as foreign currency bank accounts.	See 55.11.2 (Commentary)
Yearly exchange rate averaging; Currency conversion date for income remittance is date of receipt, not date of remittance.	See 55.13 (Commentary: solution to remaining foreign currency problems)
Repeal s.80 IHTA. The cure is worse than the disease.	See 62.14.11 (Commentary)
UK bank accounts to qualify as excluded property as non-UK accounts.	See 62.20.4 (Commentary)
Repeal s.731(6) ITEPA (illegitimacy taken into account).	See 74.4.2 ("Family")
Abolish the s.105 charge and extend s.106 to cover all the acquisition cost.	See 74.20.6 (Commentary)
Shadow directors should be taken out of the benefit in kind charge.	See 74.26 (Living accommodation charge: commentary)
Replace POA rules with focussed anti-avoidance rules.	See 76.39.3 (Assessment)
A single definition of "settlor" which applies for all taxes.	See 80.3.9 (Commentary); 80.9.3 (Commentary: extending IT/CGT appointment rules to IHT)

Repeal s.473 ITA (& CGT equivalent); dead letter law.	See 80.33.6 (Commentary)
Repeal para 21B Sch 24 FA 2007 which has never been used.	See 82.1 (Concept(s) of situs)
Treat all assets other than UK land and securities as non-UK situate for the purposes of IHT & CGT.	See 82.36 (Reform of IHT/CGT situs rules)
Failing that, a second best: All securities situate for CGT in the place of incorporation of the company. s.275(1)(c) should be replaced by a rule that a debt is situate where the debtor is resident (applying the UK tax definition of residence). Repeal s.s.275(1)(k) TCGA (situs of judgement debt).	See 83.8.4 (Commentary); 83.13.5 (Commentary). 83.11 (Debt rules: commentary)
Provision that usufruct is not an IHT-settlement.	See 84.16.5 (Commentary)
Define PE by reference to OECD model definition.	See 86.12 (Commentary: let's have one definition of PE)
Replace branch/agency with PE.	See 86.16 (Commentary: let's abolish branch/agency)

Part 2: Reforms involving tax avoidance provisions

Proposal	**Reference**
Repeal POA rules; replace with IHT charge on death in case of *Eversden*, *Ingram* and Home Loan schemes; repeal s.102(5A)-(5C) FA 1986.	See 76.39 (Commentary); 63.10.2 (Restriction on GWR spouse exemption).
Repeal corporate property regime; or allow election for transparency	See 75.45.6 (Some ways forward)

APPENDIX NINE

REFORM OF OFFSHORE ANTI-AVOIDANCE RULES

App. 9.1 Reform of anti-avoidance rules: Introduction

This chapter reviews proposals for simplification of the IT and CGT anti-avoidance rules which apply to non-resident trusts and companies.

The rules discussed in this chapter may be classified in two ways:

"IT rules": s.720, s.731 ITA; s.624 ITTOIA; as opposed to:

"CGT rules": s.13, 86 and 87 TCGA.

Alternatively the rules may be classified as:

"Settlor rules": s.624, 720, and 86, which apply to settlors/transferors, as opposed to:

"Benefit rules": s.731 and s.87, which apply on receipt of benefits.

"The CIOT reform paper" is the CIOT paper entitled "Reform of two anti-avoidance provisions".[1]

App. 9.2 Outline of reforms discussed

The reforms discussed in this chapter are as follows:

(1) To reduce the overlap of IT rules so only one IT rule applies at any one time. At present the IT rules overlap and s.624, s.720 and s.731 rules can all operate at the same time. (The CGT rules overlap rather less.)

(2) To align IT and CGT benefit rules

(3) To align IT and CGT settlor rules

Points (2) and (3) are possible if and so far as the IT/CGT rules are both aiming to achieve the same result, namely (in short) to tax income/gains arising to non resident entities and

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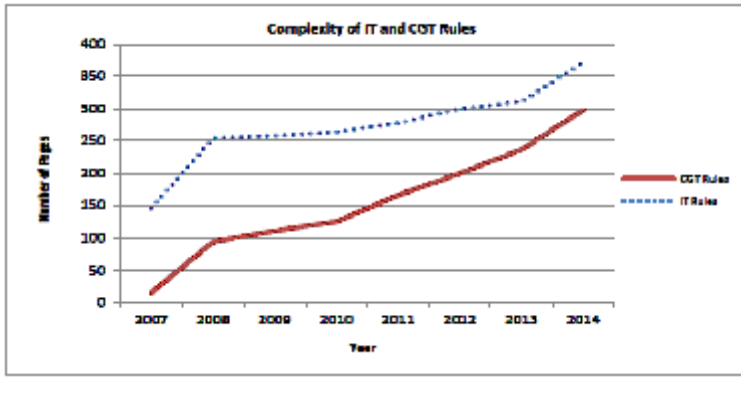
1 (October 2012) accessible *http://www.tax.org.uk/Resources/CIOT/Documents/2012/10/121002_s13_trans_assets_CIOT.pdf*

(a) tax the individual responsible for funding the entity on the entity's income/gains (on an arising basis or remittance basis)
(b) tax other individuals who receive benefits from the entity on the benefits (on a receipts basis or a remittance basis)

The inheritance taxation of trusts is the topic most in need of reform but that issue is not discussed here as it is too far from the themes of this book.[2]

App. 9.3 The need for reform

The burden of operating the many sets of rules has increased in recent years as all the rules have become wider and more complicated. The growth in complexity can be (approximately)[3] measured by the number of pages discussing the topics in succeeding editions of this book. The figures are striking:



The burden of separate codes was, I think, acceptable (if sub-optimal) when they emerged[4] but is now extravagant. No reader who studies this

2 See Kessler, "The Quest for Fair Inheritance Taxation of Trusts" (2012) *http://www.kessler.co.uk/wp-content/uploads/2012/10/JK4393-Lecture-Trust-tax-reform-5.pdf*

3 The page count is a rough proxy for the ever growing complexity of the law, but not an altogether bad one. Some of the page growth is due to better coverage of the law, and does not reflect increasing complexity. However I think it would be correct to say that 90% of the growth is due to ever-increasing complexities. A major change leads to growth over several succeeding years as the implications and HMRC guidance gradually emerge.

4 A historical note: The emergence of distinct IT and CGT benefit rules at the same time in the FA 1981 is puzzling. (The CIOT reform paper uses stronger language: "bizarre ... inexplicable"). The explanation is no doubt that those responsible for

book will doubt the need for reform.

App. 9.4 How to assess proposed reforms

Assessment of proposed reforms raises two sets of issues.

The first is that propounded by the Government in the FA 2008 reforms: do the reforms produce a system which is fairer, simpler, and/or easier to operate;[5] if not in absolute terms, then measured from the starting point of the present system.

The second set of issues is whether there are winners and losers. If there are none, or few, the reforms may be described as **"technical"** and should not be politically controversial.

If a reform produces a balance of winners and losers, the Treasury may not be affected but losers generally object more loudly than winners so the political issues remain. Winners and losers need to be identified and the results defendable.

If the reform produces losers, harder transitional issues may arise.

As the numbers become significant the reforms will become more political.[6]

The emphasis in this chapter is on more technical reforms, but no worthwhile reform can be achieved without some winners or losers. Effective tax simplification cannot be achieved by technical reforms alone.

App. 9.5 Critique of present rules

Alignment of the IT/CGT benefit rules raises the question whether to take the CGT rules or the IT rules as the starting point for an aligned system. Is one better than the other, and if so, which?

App. 9.5.1 *Criticism of s.87 regime*

The Jersey court commented on the s.87 regime, in a variation of trusts case, and was not flattering:

> In essence, as we understand it, as a result of the changes introduced in

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drafting the one did not liaise with those responsible for the other. There was no public consultation for either.

5 See 1.7 (2008 reforms: assessment)[[Foreign Domicile Tax Reform#2008 reforms: assessment | 2008 reforms: assessment]].

6 In practice politics depends on salience as well as significance; the lively debate on the proposal in Budget 2012 to impost a "Pasty tax" is an illustration.

> the 1998 Finance Act of the United Kingdom, [extending the s.87 regime to settlements with foreign domiciled settlors] UK resident beneficiaries are liable to be assessed for capital gains tax on the uplift in capital value in the underlying settlement assets between the date of the Settlement and the date of any appointment to them. ... such liability might be very significant and indeed account for a major proportion of the Trust assets ever appointed to them. It appears that this particular tax regime disregards the fact that the beneficiaries were not the owners of the assets during which time the gains were made, had no control over what gains were made or how the assets were invested or whether income or capital was appointed or retained. It is not as if the underlying settlement assets were UK beneficially owned assets either or naturally fell within the UK tax net during the period of the Settlements. The tax, as the Court understands it, is calculated by reference to the time during which the beneficiaries were only discretionary objects of the Trust, artificially treating them as if they had a control which neither legally or actually they had. ... this is the clearest possible case where the artificial and unduly harsh nature of the basis of taxation would indeed prompt the exercise of discretion [to vary the trusts].[7]

The essence of the criticism is that the s.87 charge in its post-1998 form is excessively wide; even more so in its post-2008 form. There is no doubt that it operates a very rough justice. The Court approved a variation - adding the settlor as a beneficiary - whose purpose was to facilitate arrangements to avoid the charge.

App. 9.5.2 *Criticism of ToA regime*

The tribunal has described the ToA legislation as "some of the most complex in the Taxes Acts".[8] That is really saying something.

The CIOT reform paper concludes:

> Essentially the current rules [the transfer of assets code] are not fit for purpose.

App. 9.6 Proposal to align benefit rules

It is easier to criticise than to construct. Nevertheless, I think all readers who study the topic will agree with the CIOT, the Jersey Court and the first-tier tribunal, that neither the IT rules nor the CGT rules can be

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7 Re *DDD Settlement* [2011] JRC 243 at [25] accessible *http://www.jerseylaw.je*.

8 *Williams v HMRC* TC/2011/02663, 23 January 2012 (unreported).

defended as reasonably satisfactory as they stand. That being the case, there may not be much to chose between them. It matters less which set of rules one starts with, if one goes on to tinker with them; the way forward is to combine features of both.

The CIOT's proposal to align the benefit rules would adopt the CGT benefit rules to IT, (but adding a motive defence). The CIOT reform paper provides:

> Income arising to [non-settlor-interested] trusts could, as indicated above, be covered by adapting TCGA 1992 section 87-97 to income, albeit preserving a motive defence.
> Income arising to companies could be covered by adapting TCGA 1992 section 13. This is particularly so now, given that it is now proposed to give s13 a proper motive defence and a sensible de minimis limit.
> As indicated above, the adaptation of TCGA 1992 sections 87-97 to income would have to have a motive defence built into it. The reason is that many trusts, at the time of creation, have no UK connection. It would be wrong to tax a beneficiary who comes to the UK by reference to income arising before he immigrated. A motive defence would be a blunt way of doing this.

App. 9.7 Overlap of ToA and settlor-interested trust rules

The CIOT reform paper provides:

> The key point is that the ToA code is only required if the income arises to a non resident entity which is for income tax purposes opaque. If the entity is not opaque, anti avoidance legislation is not needed at all, as then the income is taxed on general principles as that of the underlying owner or owners....

In particular, a settlor-interested trust within s.624 is transparent.

It is already the case that s.720 does not apply where s.624 does apply.[9] The CIOT proposal is that s.624 should exclude the ToA rules altogether, ie the non-transferor rules (s.731) do not apply so that:

(1) income of a trust within s.624 is not relevant income.
(2) benefits conferred by a trust within s.624 do not count for the purposes of s.731.

Thus only one anti-avoidance rule applies at a time.

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9 See 27.10 (Sections 624 and 720: comparison)[[Settlor-interested Trusts#Sections 624 and 720: comparison | Sections 624 and 720: comparison]].

For this purpose is a trust is within s.624 when the settlor is UK resident (whether or not a remittance basis taxpayer).

When the settlor is non-resident, the better course would be to amend s.624 so it does not apply, leaving s.731 to apply.

App. 9.8 Overlap of CGT settlor rules and CGT benefit rules

The overlap of s.86 and s87 can be avoided by providing that a trust is not within the scope of s.87 if it is within the scope of s.86.

App. 9.9 Alignment of IT and CGT settlor rules

Residence of individuals is a sensible connecting factor for UK taxation: everyone will accept that an individual who is UK resident should be subject to UK tax on an arising or remittance basis. Residence of *trustees* is a matter which is chosen by the appointment of trustees, and makes very little sense as a connecting factor in the taxation of trusts.[10]

This is recognised in four contexts where trustee residence is (more or less) irrelevant for UK tax purposes:

(1) IT settlor rules: s.624
(2) CGT settlor rules: s.86
(3) Chargeable event gains
(3) Inheritance taxation of trusts

In these cases the connecting factor for UK taxation is the residence or domicile of the settlor: trustee residence is less important or irrelevant.

App. 9.9.1 *IT & CGT settlor rules compared*

The differences between the IT and CGT settlor rules (s.624 and s.86) are striking. The most important are:

(1) Definition of "settlor-interested": CGT definition much wider
(2) Foreign domiciled settlor: within s.624 but not within s.86
(3) Non-resident settlor: partly within s.624 (UK source income) but not within s.86.
(4) Definition of "settlement": Non-classic settlements within s.624 but not within s.86; non-bounteous settlements within s.86 but not s.624.

These distinctions only due to contingent historical development; none are attributable to careful policy deliberation. There is no good policy reason

10 It might be said that UK resident trustees enjoy the benefit of the UK legal system; but it would be more accurate to say that the UK economy enjoys the benefit of work opportunities for UK resident trusts.

why the rules should be different for the two taxes. A simpler and more rational system would apply the same rules.

App. 9.9.2 *Definitions of "settlor-interested"*

The rich variety of rules for the UK taxation of trusts offers four possible starting points:

(1) A trust is within the scope of UK tax if
   (a) the settlor/spouse is UK resident and
   (b) the settlor (or close family) is a beneficiary.
   This is (in short) the IT model under the IT settlor rules.
(2) Ditto but relax (a) so it sufficies if the settlor's wider family is a beneficiary. This is (in short) the CGT model under the CGT settlor rules.
(3) Ditto but delete (a): the beneficiaries do not matter. This is the chargeable event model for life policies
(4) Ditto but relax (b): a trust is within the scope of UK tax if the settlor is UK domiciled at the time the settlement is made. It does not matter who the beneficiaries are. This is (in short) the IHT model.

App. 9.9.3 *The difficulties of aligning settlor rules*

Once one opens up the debate as to which is better, intractable problems appear. Changes in this area would be substantive and not merely technical, and in particular:

(1) Reform will produce losers.
(2) The other proposals made in this chapter are technical reforms on which, I think, there ought to be fairly widespread agreement among those who understand the tax system. But here there will be no general agreement, so there will be less support for any reform. If one sets out all the options, not one of them would command a majority support.

There are fundamental decisions to make, and no logical principles on which to make them; contemplation just leaves one feeling giddy. The basis question is the purpose of settlor rules. In origin the purpose of the rule was to tax the settlor on benefits expected to accrue to the settlor. Hence the IT settlor rule is restricted to settlor-interested trusts. But if more widely extended, as in CGT, the purpose is rather to tax the trust. If that is the purpose, then the logic leads to the conclusion that the rule should not be restricted to *settlor-interested* trusts, as is the case for chargeable event gains and IHT.

App. 9.9.4 *A proposal*

Tax reform, as politics, is the art of the possible. Perhaps the most realistic course is to leave the current settlor rules unaligned. Certainly that would be better if a more ambitious reform programme threatened the less controversial and badly needed technical reforms set out above. The CIOT reform paper wisely did not enter this arena.

If one were sufficiently radical, bold, or foolhardy, to enter into this arena, however, the author's solution would be as follows.

(1) Adopt the CGT definition of a settlor-interested trust.

(2) Extend the CGT rules to settlor-interested trusts.

A remittance basis settlor would qualify for the remittance basis.

Conversely, trusts should be exempt from CGT and IT on foreign income in relation to property provided (or wholly provided) by foreign domiciled non-resident settlors. At that point one falls back on the s.731/s.87 regime.

This is (I think) the basis of trust taxation in Canada, New Zealand and, I suspect, most other common law jurisdictions. HMRC made a proposal of this kind in 1972, though nothing came of it.[11]

DT relief would apply where the trustees are treaty-resident in a foreign state.

Of course, domicile and residence of the settlor are not perfect connecting factors. Such a thing does not exist. International families can sometimes break the link by:

(1) transfers to individuals who are not connected to the UK, and

(2) the individual settles or resettles the property.

However this is easier to say than to do.[12]

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11 Inland Revenue, Tax Reform Committee First Report on Avoidance (1972) *http://www.kessler.co.uk/tfd-archive.*

12 See 80.36 (Planning to create trust with foreign domiciled settlor)[[Who is the Settlor?#Planning to create trust with foreign domiciled settlor | Planning to create trust with foreign domiciled settlor]].

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